

Executive Summary

Overview

Melbourne Water is a water resource manager, providing waterways and drainage services to the greater Melbourne community and wholesale water, sewerage and recycled water services to retail water businesses. In doing so, we are committed to managing our business efficiently to achieve our vision of 'working together to ensure a sustainable water future'.

In providing waterways and drainage services, Melbourne Water works with Government, regulators and the community to deliver programs to improve and protect the health of rivers and creeks and enhance their environmental, economic and social values. Melbourne Water also plans and delivers drainage infrastructure to service urban growth and provide a safe level of flood protection for communities within the Port Phillip and Westernport region.

This Waterways Water Plan summarises the outcomes, actions and expenditures that Melbourne Water proposes to undertake and the prices it proposes to charge over the 2008 regulatory period (2008/09 to 2012/13).¹ Performance over the 2005 regulatory period (2005/06 to 2007/08) is also discussed, as are the factors impacting on performance over the 2005 and 2008 regulatory periods.

Over the past two years, Melbourne Water has made considerable effort to define its role as a regional provider of waterways and drainage services and to set clear goals and targets for its programs. This has included:

- Extensive engagement with local governments and the community in Melbourne Water's extended operating area to establish service levels and charging arrangements²
- Revised terms of reference and membership of the Waterways Advisory Committee to strengthen its role in and the participation of regulators in preparing Melbourne Water's Waterways Operating Charter
- Preparing a new Waterways Operating Charter as required by Government via Melbourne Water's Statement of Obligations. The revised Charter provides targets and programs to ensure an appropriate level of flood protection, improve the health, amenity and understanding of our rivers and creeks, manage environmental flows and development, and engage stakeholders and the community
- Preparing major strategies that underpin and support Operating Charter targets and programs and associated expenditures including the:
 - Flood Management and Drainage Strategy which responds to a 2005 performance audit by the Auditory General and Melbourne Water's obligations as floodplain management authority under the Water Act 1989
 - Waterways Water Quality Strategy which provides actions to monitor and improve stormwater quality and its impact on our rivers and creeks given Melbourne Water's obligations as 'caretaker of river health' and a 'Protection Agency' under the Environmental Protection Act 1970
 - Regional River Health Strategy and Addendum which also supports Melbourne Water's role as caretaker of river health and the long term aim of improving Melbourne's rivers and creeks with increasing numbers of native fish, platypus and plant life
 - Development Planning Strategy and program which supports Melbourne Water's obligations as statutory referral authority under the Planning and Environment Act 1987 and floodplain management authority under the Water Act 1989

¹ All expenditures and prices have been expressed in real 2006/07 dollars.

² Following the Government's 2004 White Paper, Our Water Our Future, Melbourne Water's waterways and drainage operating area was extended by Order-in-Council in November 2005, to include parts of the Westernport, Werribee and Maribyrnong catchments, for which there was previously no designated regional authority responsible for managing waterways and drainage

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- Community and Stakeholder Engagement Framework which is consistent with the Government's expectations set out in Melbourne Water's Statement of Obligations.

The proposals included in this Waterways Water Plan reflect the outcomes of this work and Melbourne Water's commitment to:

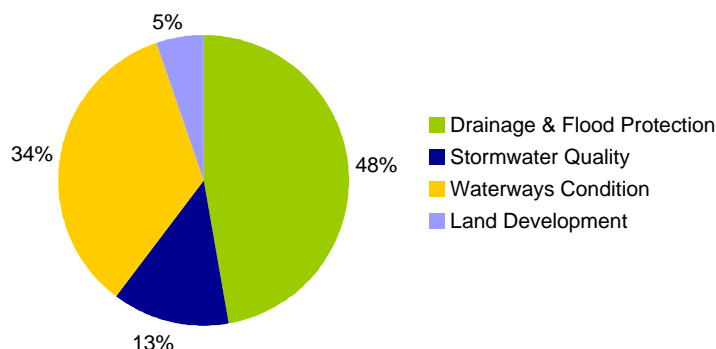
- Consolidate newly introduced services to customers in Melbourne Water's extended waterways operating area
- Improve awareness of flood risks and adopt a more targeted drainage and flood protection capital works program focusing on intolerable flooding risks
- Build on the improvements to river health and stormwater quality achieved over the current regulatory period, to achieve ten year targets set out in the Regional River Health Strategy, the Waterways Operating Charter and Waterways Water Quality Strategy
- Continue to plan appropriately for urban growth and provide efficient and responsive services to the development industry
- Continue to undertake monitoring and research to better understand the effectiveness of management actions in relation to river health, environmental and recreational water quality and flood management and enable an adaptive approach to program delivery
- Continue to engage local government, the private sector and the community to gain a shared understanding of waterway and flooding issues and priorities to develop more inclusive, cost effective outcomes including greater use of at source rather than end of pipe solutions.

The Waterways Water Plan has also been prepared in a changing environment, characterised by climate uncertainty and drought, changes in obligations and industry wide increases in costs. Rainfall has been at historically low levels resulting in less water being available for environmental needs, river diverters and supply to metropolitan Melbourne. Melbourne has also experienced a number of major storms in recent years which have resulted in localised flooding and property damage. Melbourne Water's service obligations have increased since the Essential Services Commission (the Commission) last set prices in 2005. There have also been industry wide increases in some key input costs such as contract and labour rates. These factors have impacted on Melbourne Water's financial and non financial performance over the current regulatory period, and increased the challenges associated with moving to a longer regulatory period, highlighting the need for a regulatory framework that provides for appropriate risk allocation and adaptive service delivery.

Delivering new obligations and services to an expanded service area in an increasing input cost environment will necessitate an increase in capital and operating expenditure despite ongoing initiatives to improve the efficiency and effectiveness of service delivery. The contribution of each major program area to the proposed waterways and drainage required revenue (excluding corporate costs) is provided by Figure 1 below.

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Figure 1: Proposed waterways and drainage required revenue by program 2008/09 – 2012/13³



Drainage and flood protection services make the largest contribution to the proposed required revenue.

Increasing expenditures will in turn lead to an increase in prices. Melbourne Water's waterway and drainage prices are forecast to increase on average for customers in its existing service area by inflation plus 1% per year over the 2008 regulatory period. Melbourne Water also proposes to commence charging for waterway and drainage services provided to customers in its extended operating area.

In addition to improving the services Melbourne Water provides, the Waterways Water Plan also includes proposals to improve the basis of the prices we use to fund waterways and drainage activities. The proposed prices have been developed in consultation with Government and key stakeholders to ensure that prices:

- Better reflect the extent to which customers impact on, or benefit, from the services provided
- Take into account the interests of customers (including appropriate transitional arrangements)
- Are understandable to customers
- Are consistent with providing a sustainable regulated revenue stream for regulated activities
- Minimise administration costs.

A key determinant of future prices and returns to Government is the weighted average cost of capital (WACC). Melbourne Water and the metropolitan retail water businesses have received independent advice that the WACC should be 6.4% rather than the 5.1%, as currently adopted by the Commission. However, adopting a higher WACC could increase prices by a further 1.7% per year. Melbourne Water has used the lower WACC recommended by the Commission in this Waterways Water Plan.

In preparing this Waterways Water Plan, Melbourne Water has endeavoured to clarify future stakeholder requirements and priorities, recommend appropriate changes to the regulatory framework, continue to refine its forecasting methodologies and adopt the best available information to put forward realistic expenditure estimates.

The proposals included in this Water Plan have been tested with the community via a Consultation Draft released on 10 October 2007. Additional information has been included in this Water Plan to respond to issues raised by submissions where appropriate. Where comments related to government or regulatory policy, Melbourne Water has raised this issue with the relevant party.

³ Excludes corporate costs.

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Background and industry context

Melbourne Water

Melbourne Water is a statutory corporation, fully owned by the Victorian Government.

Melbourne Water is a water resource manager, providing waterways and drainage services to the greater Melbourne community and wholesale water, sewerage and recycled water services to retail water businesses.

As Victoria's largest urban water business, Melbourne Water provides over 60% of the State's potable water, and 11% of total water supplied in Victoria for urban and rural purposes. Melbourne Water also currently treats around 300 GL⁴ of sewage collected by the three metropolitan retail water businesses, of which over 20% is currently recycled.

The Government's White Paper, *Our Water Our Future*, designated Melbourne Water as the caretaker of river health and authority responsible for waterway, regional drainage and floodplain management across the entire Port Phillip and Westernport region (an area of more than 12,000 km² with 3.6 million residents). Successful provision of this role involves:

- **Community and stakeholder engagement and involvement** to build trust and strengthen working relationships with key stakeholders and the community
- **Managing waterways** to ensure Melbourne's rivers and creeks are healthy, with increased numbers of native fish, platypus and plant life
- **Managing environmental flows** to ensure sufficient environmental flows to support river health and protect beneficial uses of the waterways
- **Managing water quality** in collaboration with others to achieve objectives for water quality in accordance with State environmental protection policies and targets set out in the Regional River Health Strategy and Waterways Water Quality Strategy
- **Flood and drainage management** to minimise all currently known intolerable flooding risks to public health and safety, property and infrastructure and increase community understanding and preparedness for floods
- **Managing urban growth** to ensure urban development achieves appropriate standards of flood protection, protects waterway health and is sensitive to other environmental and social values, delivers an efficient service and provides accurate, timely and reliable information to the development industry and community
- **Monitoring, investigations and research** to build a comprehensive knowledge base to improve decision making and evaluate progress against performance targets.

A detailed description of Melbourne Water's waterways and drainage services, its goals and targets is provided in the Waterways Operating Charter for 2008/09 to 2012/13.⁵

⁴ A gigalitre (GL) is equivalent to a billion litres.

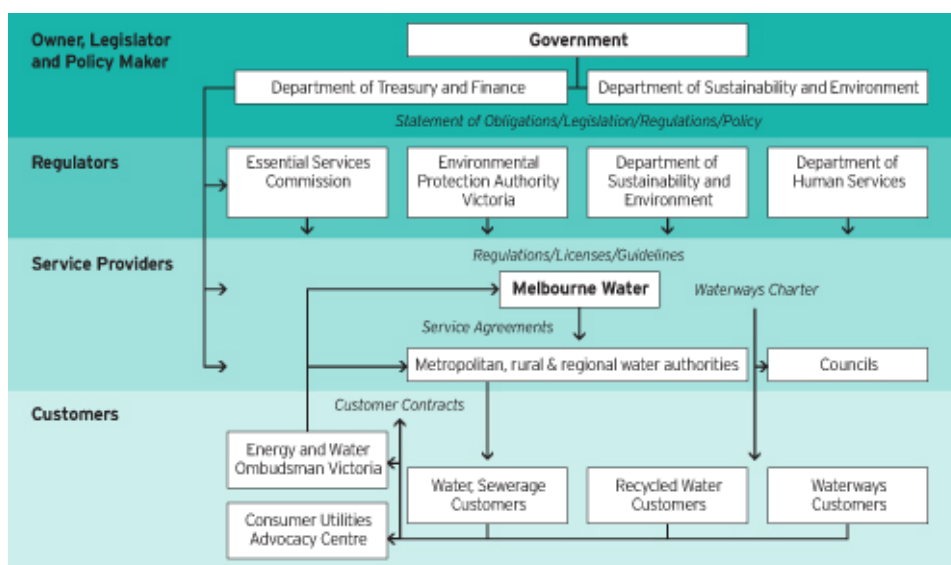
⁵ A copy of the Waterways Operating Charter is available on Melbourne Water's website www.melbournewater.com.au

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Regulatory framework

The structure of the Melbourne metropolitan water industry is illustrated below in Figure 2.

Figure 2: Industry structure and regulatory framework



The water industry in Melbourne clearly separates the roles of ownership, regulation and service provision.

The State Government sets the policy and legal framework, specifies water business obligations and monitors water business performance. The Minister for Water, supported by the Department of Sustainability and Environment, sets out specific requirements for each business through Statements of Obligations. The Minister for Water is also responsible for allocating water resources. In the metropolitan sector, the Treasurer, in consultation with the Minister for Water, monitors financial performance and represents the State Government's shareholder interests, including returns to Government and borrowing requirements.

The Commission regulates prices and customer service standards for prescribed water, sewerage, waterways and drainage and recycled water services across Victoria consistent with its legislative requirements⁶ and the Water Industry Regulatory Order. EPA Victoria sets and enforces environmental standards consistent with key principles set out in the Environment Protection Act 1970.

Waterways and drainage service standards are set out in Melbourne Water's Waterways Operating Charter which is developed in consultation with its Waterways Advisory Committee representing key stakeholder and customer interests and the Department of Sustainability and Environment. Local governments manage the local drainage network (catchments generally less than 60 hectares) and work with Melbourne Water to provide flood protection and manage stormwater quality.

Melbourne Water also provides wholesale water, sewerage and recycled water services to the retail water businesses who provide reticulation services and manage the interface with water and sewerage customers.

⁶ Legislative provisions relevant to the Commission's regulation of the water industry include those of the Essential Services Commission Act 2001 and the Water Industry Act 1994 as amended by the Water Legislation (Essential Services Commission and Other Amendments) Act 2003.

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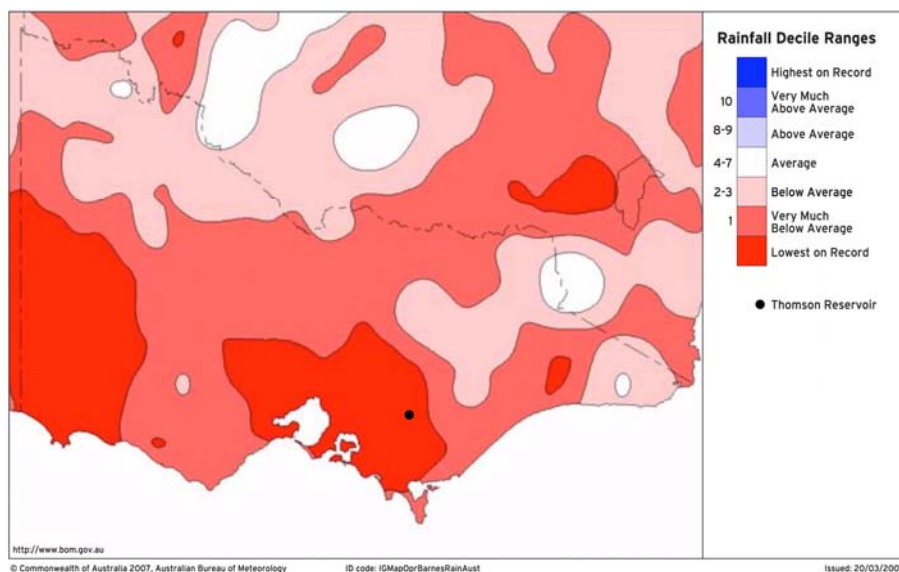
Operating environment

This Waterways Water Plan has been prepared in a changing environment.

Climate uncertainty

The last decade has seen some of the lowest rainfall on record across Melbourne's water supply catchments and its rivers and creeks (see Figure 3). For example, Yarra River stream flows for the 2006 calendar year were the second lowest on record and for the period 1997/98 to 2006/07 were about 63% less than the long term average (1892/93 to 2006/07).

Figure 3: Rainfall deciles for Victoria – 1997 to 2006



Melbourne's water supply catchments and its rivers and creeks have experienced very low rainfall for an extended period.

In addition to the effects of the drought, Melbourne has also experienced a number of major storms in recent times. Events in 2003, 2004, and 2006 led to localised flooding, disruption and property damage.

Figure 4: Localised flooding in 2005



Dandenong Creek, Dandenong, 2005

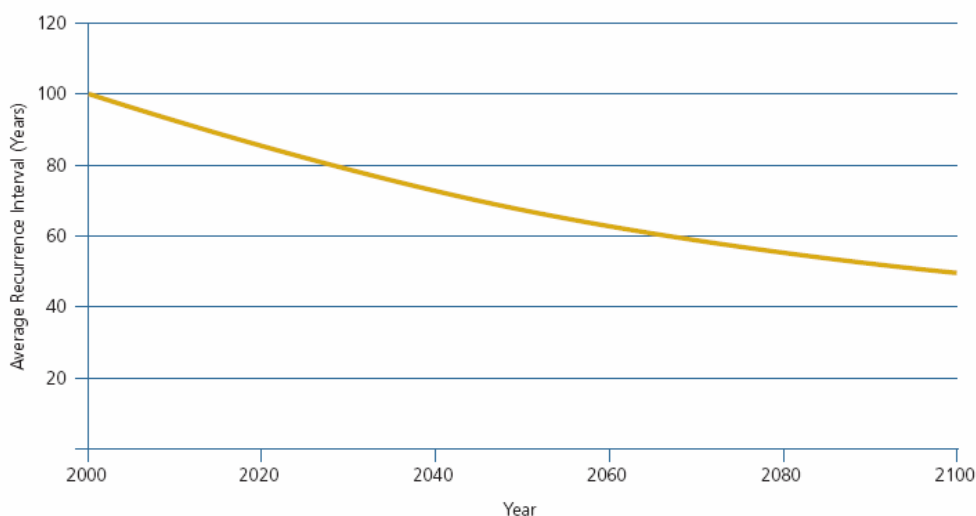
Kororoit Creek, Deer Park, 2005

While in the midst of drought Melbourne has also experienced major storms causing localised flooding.

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The Melbourne Climate Change Study was completed by CSIRO in March 2005. The study anticipates that while the amount of overall rainfall received each year is predicted to decrease, the rainfall may occur in more intense storm events rather than our normal winter and spring rains. This change in rainfall patterns is more likely to result in an increase in overland flows than riverine flooding because the short, sharp nature of these intense storms results in sudden large volumes of water. As illustrated in Figure 5, it is likely that storms that occur on average every 100 years in 2000 are likely to occur once every 50 years by 2100 which could also result in more frequent flooding above existing floor levels.

Figure 5: Change in average storm recurrence intervals



Research suggests that storms that occur on average every 100 years in 2000 are likely to occur once every 50 years by 2100.

Implications for Melbourne Water

Melbourne Water has previously been able to rely on historical records as a basis for planning for the future. Recent experience and an increasing body of scientific information⁷ suggest that Melbourne may have experienced a step change in the frequency, magnitude, location and duration of our weather events. While there will continue to be uncertainty as to the exact size of this change, it is clear that there is a need for:

- Ongoing research on climate change/variability and its implications for water businesses
- Effective planning and investment that optimises the use of available water supplies, strikes an effective balance between community and environmental needs and includes appropriate provision for contingency measures
- Adaptive program delivery
- A regulatory framework that not only creates incentives for improved performance while ensuring a reasonable allocation of risks in an uncertain operating environment.

⁷ For example, The Intergovernmental Panel on Climate Change's Fourth Assessment Report 2007 concludes that the evidence supporting warming of earth's climate system is unequivocal. The Melbourne Climate Change Study was completed by the Commonwealth Scientific and Industrial Research Organisation (CSIRO) in March 2005 and identified the potential for higher average and summer temperatures, reduced rainfall and more extreme weather events.

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Climatic conditions pose challenges in delivering waterways and drainage services. For example, Melbourne Water works in partnership with Government agencies, industries, landowners and the community to manage environmental flows for river health and to support a wide range of beneficial uses. The challenge for Melbourne Water is how to manage environmental flows given competing demands for water, particularly when a reduction in stream flows is anticipated with climate change.

The degree of impact on river health will depend upon the magnitude and variability of the change in stream flows. The current extreme drought has seen a temporary reduction in environmental flows. More frequent or intense droughts will require environmental flows to be carefully monitored and managed in consultation with Government and the community to avoid environmental decline of rivers and creeks. The current drought has also resulted in river diverters' access to water being restricted or suspended to avoid environmental impacts necessitating effective customer engagement and enforcement.

More frequent, intense storms in different locations have the potential to place increased demands on Melbourne Water's and local government's stormwater assets. Further, as experienced in the 2005 regulatory period, there may be significant expenditures associated with responding to the effects of flooding where there is inadequate provision for overland flows. Increasing urbanisation is also likely to increase run-off and infrastructure upgrades may be necessary to preserve required service levels.

The effects of climate change on the intensity and duration of storms are not well understood. The challenge, therefore, is to develop greater understanding of the likely timing and impacts of climate change to enable the development of appropriate adaptation strategies.

New waterways and drainage obligations

Melbourne Water's operating environment has also changed as a result of ongoing industry reform and policy development that was not known at the time of the Commission's 2005 Price Determination. For example, additional waterways and drainage expenditures have arisen from:

- Undertaking initiatives in the Government's Yarra River Action Plan to reduce the environmental impact of stormwater on waterways in urban areas
- Managing waterway environmental flows in line with newly established bulk entitlements and environmental entitlements.

Industry wide cost increases

Unanticipated industry wide increases in some key input costs have, and will, impact on expenditure levels and financial performance. For example, infrastructure providers in Australia, including water, electricity, gas and transport businesses, have, and will continue to, experience significant construction cost pressures. Industry wide increases are also being experienced in labour and contract rates.

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Progress over 2005 regulatory period

The urban water industry is a little over two thirds of the way through the 2005 regulatory period and Melbourne Water has achieved a high level of compliance with the targets included in the Commission's 2005 Price Determination. It has become clear, however, that continued achievement of high levels of compliance will see Melbourne Water's total capital and operating expenditures over the 2005 regulatory period vary from the benchmark expenditures adopted by the Commission in its 2005 Price Determination.

Service outcomes

To date, Melbourne Water has achieved most of its 2005/06 and 2006/07 performance targets in relation to waterways and drainage services and is making good progress towards its end of period targets as illustrated in Tables 1 and 2.

Table 1: Three year performance indicators

Key Performance Indicator	Progress towards three year target (%)		Three year target (no.)
	2005/06	2006/07	2007/08
Waterways condition			
Regional River Health Strategy			
– rivers with negotiated environmental flow regimes	40%	67%	6
– rivers with improvements made to environmental flow regimes	57%	75%	8
– area of streamside land under management agreements	20%	55%	500 Ha ⁸
– length of streamside land revegetated	46%	76%	260 km
– barriers where fish passage is improved	30%	40%	10
– length of river subject to streamside weed control	37%	> 100%	300 km
– plans developed for rivers and creeks of high social value	100%	> 100%	2
– rivers where heritage values are protected or improved	67%	> 100%	15
– plans developed for rivers and creeks of high environmental value	100%	> 100%	2
– investigations to fill data gaps in high value or high risk rivers or creeks	100%	> 100%	6
– sites subject to bed and bank stabilisation	35%	> 100%	20

⁸ The target for area of streamside land under management agreements was originally incorrectly specified as five hectares. The target was revised following discussions with the Commission.

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Table 2: Annual performance indicators

Key Performance Indicator	2005/06		2006/07		2007/08
	2005 Water Plan target	Actual	2005 Water Plan target	Actual	2005 Water Plan target
Drainage and flood protection					
– flood prone floors that are protected ⁹	32	52	36	52	81
– development applications processed within timeframe	100%	100%	100%	100%	100%
– planning controls: percentage of new properties meeting new flood protection	100%	100%	100%	100%	100%
– planning controls: number of flood prone properties in redevelopment areas reduced (approximate number)	250	250	250	267	250
Stormwater quality					
– cumulative reduction in nitrogen loads to Port Phillip Bay from wetlands	37 tonne	52 tonne	56 tonne	54.5 tonne	59 tonne
Diversion services					
– number of licences greater than 5ML/year metered or assessed for metering at 30 June	640	642	732	704	732

As detailed in Table 1, Melbourne Water has made good progress towards achieving the 2007/08 targets in relation to the Regional River Health Strategy¹⁰ and has achieved all drainage and flood protection targets specified in the Commission's 2005 Price Determination for 2005/06 and 2006/07. To improve response times for processing development applications, the current information technology processing system was upgraded in 2006 with a further upgrade planned before the end of the 2005 regulatory period to streamline the approval process.

The target for reduction in nitrogen loads to Port Phillip Bay from wetlands was met in 2005/06, with an annual reduction of 21.3 tonnes in nitrogen to give a cumulative reduction of 52 tonnes (Table 2).¹¹ Nitrogen loads arising from the impact of urban stormwater run-off to Port Phillip Bay have been reduced using water quality improvement infrastructure (e.g. wetlands). The result for 2006/07, however, is slightly short of the target due to delays experienced in completing the revegetation phase of some projects due to poor planting conditions arising from the drought. The program to achieve nitrogen reduction targets has been reviewed and further wetlands and projects are planned for the remainder of the 2005 regulatory period.

The 2005/06 target for the number of licences greater than 5 ML¹² per year metered, or assessed for metering, was met. However, the target for 2006/07 was not met due to delays in the supply of additional meters by the supplier and diversion of resources to urgent drought related projects.

⁹ The yearly targets for 2005/06 – 2007/08 were revised following discussions with the Commission.

¹⁰ These targets do not cover Melbourne Water's extended operating areas which were included subsequent to the Commission's 2005 Price Determination.

¹¹ This is a cumulative target that was carried over into the 2005 regulatory period.

¹² A megalitre (ML) is equivalent to a million litres.

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Demand outcomes

Melbourne Water's waterways and drainage customer numbers (excluding Melbourne Water's extended waterways area¹³) are expected to grow to 1.5 million by the end of the 2005 regulatory period consistent with the forecast used by the Commission in its 2005 Price Determination. Table 3 illustrates a minor difference between 2005 Water Plan forecasts and actual customer numbers over the 2005/06 to 2006/07 period.

Table 3: Actual and forecast waterway and drainage customer numbers

	2005/06		2006/07		2007/08
	2005 Water Plan forecast	Actual	2005 Water Plan forecast	Actual	2005 Water Plan forecast
Number of customers¹⁴	1,452,018	1,458,708	1,475,503	1,485,825	1,498,887

In relation to the cash contributions received by Melbourne Water from the development industry for the construction of drainage infrastructure to service urban growth, forecast contributions for the 2005 regulatory period are expected to be \$13.8 million higher than forecasts used by the Commission in its 2005 Price Determination (excluding Melbourne Water's extended waterways area). This is a result of higher than anticipated levels of industrial land development activity occurring due to favourable economic conditions and, as discussed below, is more than off set by increased capital expenditure to meet the needs of the development industry.

Table 4 outlines developer cash contribution comparisons between 2005 Water Plan forecasts and actual numbers over the 2005/06 to 2006/07 period.

Table 4: Actual and forecast developer cash contributions¹⁵

	2005/06		2006/07		2007/08	
	2005 Water Plan forecast (\$M)	Actual (\$M)	2005 Water Plan forecast (\$M)	Actual (\$M)	2005 Water Plan forecast (\$M)	Forecast (\$M)
Developer cash contributions	30.2	31.4	31.1	36.2	30.9	38.3

¹³ Properties within Melbourne Water's extended waterways and drainage boundary areas were not included in the Commission's 2005 Price Determination.

¹⁴ The mid-point has been applied to actual year end property numbers to ensure consistency with the methodology used to calculate 2005 Water Plan forecasts.

¹⁵ 2007/08 figure is based on 2007/08 – 2009/10 Corporate Plan forecasts.

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Capital expenditure outcomes

Melbourne Water has, in the main, delivered the service standards and outcomes detailed in the Commission's 2005 Price Determination. However, delivering these outcomes and accommodating new obligations is expected to see Melbourne Water spend \$34.7 million more than the allowance provided by the Commission for the 2005 regulatory period (including corporate allocations). Higher than planned expenditure has impacted on financial performance and been managed through increased borrows, reprioritisation of some capital projects, efficiency initiatives and higher than planned developer cash contributions.

Figure 8 illustrates, at an aggregate level, these higher than planned capital expenditures over the 2005 regulatory period, which are driven by:

- New regulatory obligations not included in the 2005 Water Plan in relation to implementing initiatives in the Yarra River Action Plan to reduce the environmental impact of stormwater on waterways in urban areas (\$0.9 million)
- Additional expenditure related to the extension of Melbourne Water's waterway boundary (\$11.9 million) which was not included in the Commission's 2005 Price Determination given the timing of the Government's decision to extend Melbourne Water's operating area and the uncertainty regarding future expenditure requirements. As directed by the Commission in its 2005 Price Determination, Melbourne Water has ring fenced the additional extended area expenditures for recovery through prices in the 2008 regulatory period
- Higher than expected expenditure (\$31.6 million) on developer-funded drainage growth works due to:
 - Higher than anticipated levels of industrial land development activity requiring capital works to be brought forward
 - Increased land acquisition costs for retarding basins and wetlands
 - Increased costs of meeting environmental standards and heritage requirements.

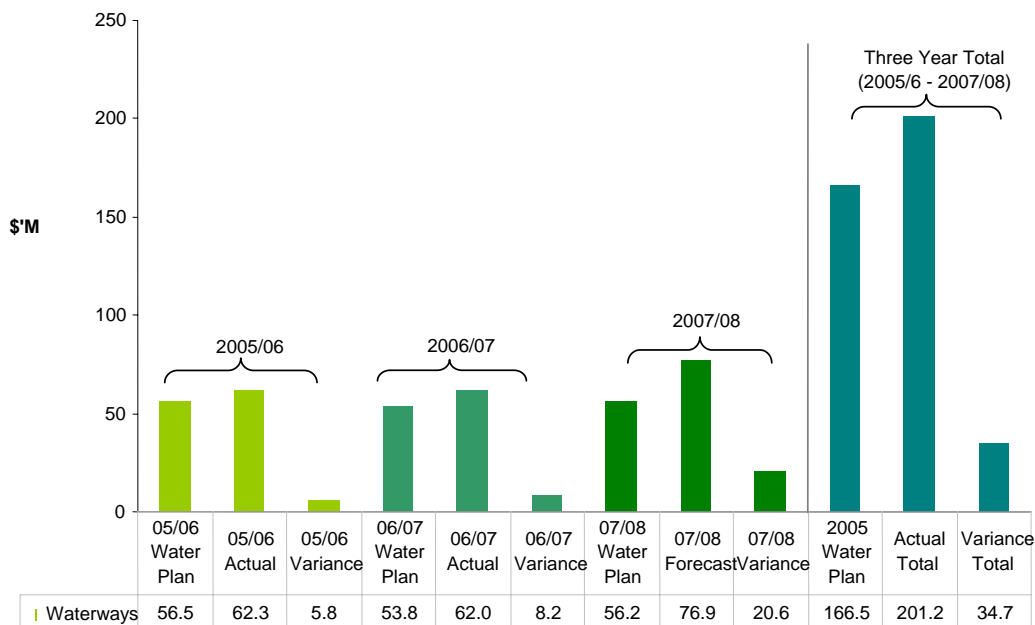
Melbourne Water has in place processes to ensure that the additional capital expenditures incurred over the 2005 regulatory period are prudent and efficient. This includes its competitive tendering processes, capital planning and delivery framework and its asset management system.

The drivers of increased capital expenditures are offset by reductions in Regional River Health Strategy expenditures and nitrogen water quality treatment works over the 2005 regulatory period (\$11.8 million) due to project delays. Delays in project delivery have been attributed to building the necessary capacity to plan and deliver an extensive waterway improvement works program, comprised of a large number of small value projects which are dependant on weather conditions and require building relationships with landowners to access waterways. A subsequent review of project planning processes has been undertaken and improvements implemented to increase the capital planning and delivery capabilities for waterways related works.

There are no material variances in corporate related capital expenditures.

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Figure 8: Waterways and drainage capital expenditure – 2005/06 to 2007/08¹⁶



Higher than expected expenditure on developer funded drainage growth works and additional expenditure in Melbourne Water’s extended areas contribute to the increase in capital expenditure over the 2005 regulatory period.

Operating expenditure outcomes

Melbourne Water’s operating expenditures are expected to exceed the expenditures allowed by the Commission in its 2005 Price Determination (including corporate allocations) by \$41.4 million. Figure 9 illustrates, at an aggregate level, the higher than planned operating expenditures over the 2005 regulatory period which are driven by:

- New legislative and regulatory obligations not included in the 2005 Water Plan, in particular:
 - Implementing initiatives in the Yarra River Action Plan to reduce the environmental impact of stormwater on waterways in urban areas (\$10.9 million)
 - Managing environmental flows in line with newly established Environmental Entitlements, as the Manager of Environmental Reserves (\$0.5 million)
- Additional expenditure related to the extension of Melbourne Water’s waterway boundary (\$19 million)¹⁷
- Increase in business as usual expenditure as a result of:
 - Higher than planned expenditure for labour. This is driven by pay increases above the 3.5% allowed in the Commission’s 2005 Price Determination consistent with Melbourne Water’s Enterprise Agreement and by additional labour as the business positions itself to meet its obligations over the 2008 regulatory period (\$3.6 million)

¹⁶ 2007/08 figures are based on 2007/08 – 2009/10 Corporate Plan forecasts.

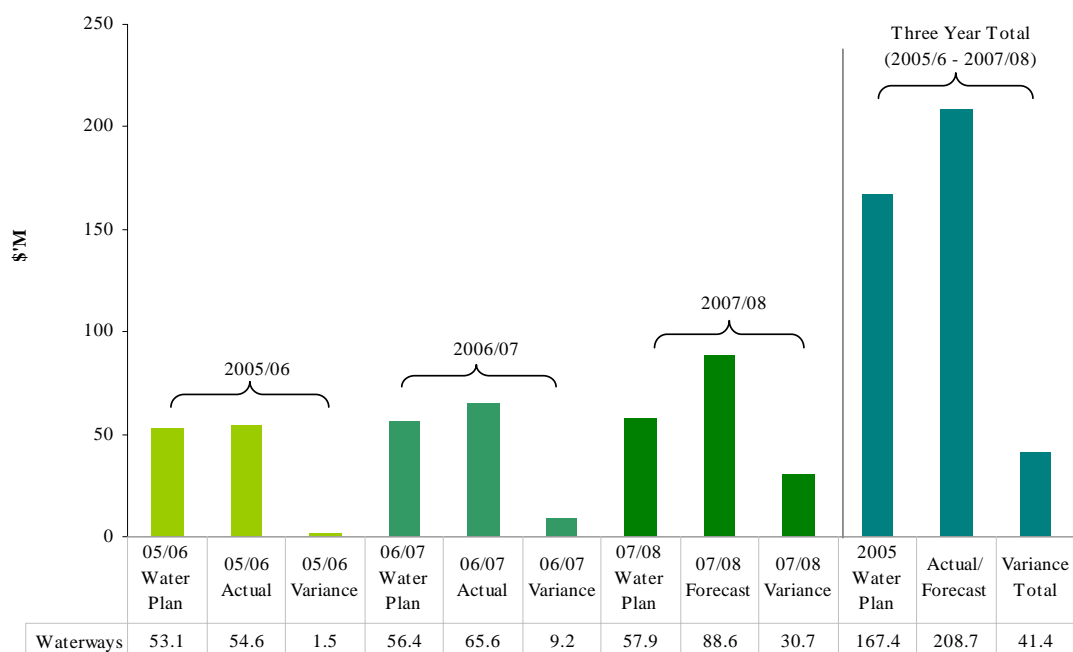
¹⁷ Extended area expenditures were not included in the Commission’s 2005 Price Determination given the timing of the Government’s decision to extend Melbourne Water’s operating area and the uncertainty regarding future expenditure requirements. As directed by the Commission in its June 2005 Final Decision, Melbourne Water has ring fenced the additional extended area expenditures which are eligible to be recovered through prices in the 2008 regulatory period. Expenditure includes estimate costs associated with introducing charges from 2008/09.

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- Higher civil maintenance costs (\$5.6 million). This includes additional clean up costs associated with the 2005/06 floods and more maintenance for the increasing number of wetlands and retarding basins (e.g. desilting)
- One off corporate costs associated with implementing drainage rate reform in Melbourne Water's existing waterways and drainage boundary area (estimated \$2.8 million).¹⁸

Increased operating expenditures have impacted on financial performance and have been partially offset by costs savings through efficiency initiatives and project reprioritisation.

Figure 9: Waterways and drainage operating expenditure – 2005/06 to 2007/08¹⁹



Introducing services to Melbourne Water's extended boundary areas together with new obligations and increased business as usual expenditures have contributed higher operating expenditure than provided for in the Commission's 2005 Price Determination.

¹⁸ Preliminary estimate will be revised following further consultation with retail water businesses.

¹⁹ 2007/08 figures are based on 2007/08 – 2009/10 Corporate Plan forecasts.

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Proposals for the 2008 regulatory period

Regulatory framework

The current framework for economic regulation is in its fourth year, and while much has been achieved, further refinement is possible.

Melbourne Water supports moving to a longer regulatory period as a means of reducing the costs associated with economic regulation and strengthening incentives for improved performance. However, in doing so it will be important that the framework for economic regulation provides sufficient mechanisms to enable water businesses to deal with the uncertainties and risks that may arise over the 2008 regulatory period.

Melbourne Water has seen a significant number of new obligations added to its service responsibilities over the first two years of the current regulatory period due to Government directions. This, combined with the effects of the worst drought on record, has had a material impact on Melbourne Water's financial performance.

In order to adequately manage uncertainty and ensure optimal risk allocation, the regulatory framework for waterways and drainage services needs to incorporate a cumulative, end-of-period, pass through mechanism for additional and new legislative or regulatory obligations that are unforeseen and which arise once the 2008 Water Plan period has commenced. This would be symmetrical in application²⁰ and have a materiality threshold of 1% of waterways and drainage revenues (currently at 2.5% of revenues).

In principle, Melbourne Water also supports provision within the regulatory framework for a within-period pass through process (as identified in the Commission's March 2007 Guidance Paper) for certain, specified major projects that are either still being considered by regulatory agencies or the Government or which are in the very early stages of planning. In practice, there are no waterways and drainage projects planned for the next regulatory period that are sufficiently large or uncertain to warrant application of this mechanism.²¹

Provided these mechanisms are in place to manage uncertainty, Melbourne Water considers that over the 2008 regulatory period price caps should be applied to its waterways and drainage prices.

Proposed service outcomes

In delivering its waterways and regional drainage services, Melbourne Water must comply with the Waterways Operating Charter, as required under its Statement of Obligations.

The Waterways Operating Charter is developed in consultation with a Waterways Advisory Committee made up of Government, regulatory and community representatives and summarises obligations emanating from various pieces of legislation and Government policy and sets out long term aims, specific ten year goals and performance targets for waterways and regional drainage services. The outcomes to be delivered over the 2008 regulatory period are summarised below for each service.

²⁰ That is, apply to increases and decreases in costs arising from additional and new legislative or regulatory obligations.

²¹ This is in contrast to water and sewerage services where application of this mechanism would be appropriate for projects such as seawater desalination, the Sugarloaf Interconnector Pipeline or the Eastern Treatment Plant outfall extension or advanced effluent treatment.

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Managing river health

River and creek management works will be delivered to meet Regional River Health Strategy implementation targets that contribute towards the ten year goal of having 50% of rivers and creeks in good or excellent condition by 2015. This includes works to protect and improve the condition of river and creek beds and banks, aquatic habitat and streamside vegetation, programs to manage and improve environmental flows in major rivers and creeks, along with undertaking detailed planning to assist in the effective implementation of waterway programs. The five year implementation targets for river health are outlined in Table 5 below.

In addition, licences for stream diversions and farm dams will be managed to ensure environmental flows are protected and to meet service requirements set out in Melbourne Water's Customer Charter for Diversion Services.

Table 5: River health five year implementation targets

	Five Year Target 2008/09 to 2012/13
Number of rivers with negotiated environmental flow regimes ¹	12 ^
Number of rivers with improvements made to environmental flow regimes ¹	17 ^
Area of streamside land under management agreements	10 km ²
Length of streamside land revegetated ~ +	1026 km#
Number of fish barriers removed	31
Length of riparian land subject to weed management +	2042 km#
Number of plans developed for rivers and creeks of high social value	15 ^
Rivers where heritage values are protected or improved	34
Number of plans developed for rivers and creeks of high environmental value	11 ^
Number of investigations to fill data gaps in rivers or creeks	55
Number of sites subject to bed and bank stabilisation	55
Number of Index River Condition reaches with instream habitat reinstated	12

¹ Target relates to rivers within Melbourne Water's area of responsibility.

~ Kilometres of rivers and creeks for streamside revegetation may overlap with kilometres of weed management.

+ Length calculated for both sides of the stream.

^ Denotes action which covers multiple Management Units counted as one target in the overall targets.

Target has been adjusted to reflect 80% of the total kilometres of stream length.

Managing water quality

Works and programs will be delivered to manage runoff from urban and rural areas to meet Waterways Water Quality Strategy implementation targets. These targets contribute towards the ten year goal to protect and improve water quality in waterways and bays in accordance with long term State environmental protection policies. This will be achieved by working collaboratively with others²² to significantly counteract the effects of growth in greater Melbourne and achieve a net reduction in pollutant loads.

²² This includes Government agencies, local government, industry, rural landholders and the community.

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This includes working in partnership with stakeholders and the community to develop regulatory frameworks that ensures urban development meets best practice stormwater quality objectives and institutionalises water sensitive urban design. Also included are initiatives to increase community awareness of water quality improvement actions, programs to build the capacity of industry, and local government, to deliver sustainable urban water management and works to reduce pollutant loads from stormwater and rural runoff.

The five year implementation targets for water quality are outlined in Table 6 below.

Table 6: Stormwater quality five year implementation targets

Target Area	Five Year Target 2008/09 to 2012/13
Planning for improved water quality	
Develop a draft Better Bays and Waterways Plan	2008
Percentage of programs implemented from the Better Bays and Waterways Plan assigned to Melbourne Water	100%
New or revised State Government requirements for all industrial, commercial, residential development to meet best practice water quality objectives	2013
Equipping agencies, communities and industry to manage water quality	
Develop and commence implementation of a land management program to manage run-off in rural areas	2009
Decrease in number of rivers and creeks where stock access poses a high risk to water quality	Demonstrated decrease
Number of training modules delivered under the Clearwater program per year with assistance from Melbourne Water	10
Percentage of local governments with improved performance in delivering sustainable urban water management (as measured by the Council Needs Analysis)	70%
Number of guidelines and/or tools prepared to assist in the application of best practice stormwater management	6
Number of rain gardens built in the community with support from Melbourne Water	10,000*
Targeted water quality works	
Percentage of local governments that have committed to water sensitive urban design implementation targets for pollutant loads, flow and effective imperviousness	50%
Percentage of actions implemented from council Stormwater Management Plans assigned to Melbourne Water	30%
Reduction of nitrogen loads in urban stormwater by 2010	100 tonnes
Annual reduction in nitrogen loads through the establishment of wetlands for the period 2010 to 2013	2 tonnes
Number of pollution load hotspots addressed	8
Monitoring, investigations and research	
Number of new monitoring programs to fill knowledge gaps for toxicants and pesticides	2
Percentage of health risk assessments completed for major rivers and creeks with a high level of recreational activity	100%
Completion date for delivering the faecal investigations program	2013

* Denotes a target that covers multiple programs.

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In response to EPA Victoria comments on Melbourne Water's Consultation Draft, further information has been included in Chapter 5 to clarify Melbourne Water's responsibilities in relation to reducing catchment loads and the outcomes it proposes to deliver to meet State environment protection policy requirements.

Regional drainage and floodplain management

Flood protection works will be delivered over the 2008 regulatory period to reduce currently known intolerable flood risks by 10%, which contributes towards the ten year goal of reducing intolerable flood risks by 30% by 2018. This includes further consultation with stakeholders and research into defining flood tolerability and programs designed to increase community and local government understanding and preparedness for flood risks.

Managing urban growth

Works and programs will be delivered to meet the ten year goal of ensuring that urban development achieves appropriate standards of flood protection and environmental performance. At the same time these works will provide for regional drainage and water quality improvement infrastructure to service growth areas in a sustainable manner, whilst delivering an efficient level of service.

Monitoring, investigations and research

Monitoring, investigations and research programs will be implemented for river health, environmental and recreational water quality and flood management to determine:

- Changes in condition over time
- Address gaps in understanding and to explore new technologies
- Provide information for management decisions so that activities, plans and policies are based on sound knowledge and best practice
- Track progress towards achieving targets.

Community and stakeholder engagement

Communication and engagement programs will be implemented to inform the community, Government and stakeholders and raise awareness of issues related to the health of the region's rivers, water quality and flooding, and to provide opportunities for their involvement in improving waterway health.

Forecast demands

The expected increase in rateable waterways and drainage properties is around 126,300 over the 2008 regulatory period, representing an average annual growth rate of 1.6%. This varies across retail water business areas due to different rates of development activity. The corresponding increase in rateable properties in the extended areas is forecast to be about 37,400 over the 2008 regulatory period, representing an average annual growth rate of 4.1%. The higher annual growth rate is due to a larger number of growth corridors in the extended areas compared to the existing retail water business areas.

Forecasts of property growth are consistent with the Government's Victoria in the Future 2004 projections.

In relation to developer cash contributions, Melbourne Water forecasts to receive a total of \$228.8 million²³ in contributions from the development industry to provide drainage related works for urban expansion. This represents an average annual growth rate of 6% over the 2008 regulatory period from 2007/08 levels.

²³ Includes \$19.9 million in the extended boundary areas.

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Forecasts of land development activity have been informed by detailed planning, expected development rates sourced from the land development industry and Government's Victoria in the Future 2004 projections.

Planning processes underpinning proposed expenditures

Melbourne Water's proposed outcomes and expenditure for the 2008 regulatory period have been developed through Melbourne Water's Planning Framework (see Figure 10) which:

- Ensures alignment with Government policy priorities, customer needs, regulator requirements and prudent risk management
- Ensures alignment between long term planning and day to day operational considerations
- Factors in broader economic, social and environmental considerations
- Achieves continuous improvement through regular benchmarking and review of planning processes and outcomes.

Figure 10: Melbourne Water's planning framework



Melbourne Water's planning framework ensures alignment of planning processes and promotes continuous improvement.

Melbourne Water's vision, sustainability principles, values and goals are outlined in Sustainable Water – A Strategic Framework.²⁴ This framework ensures Melbourne Water's long-term objectives are aligned to Government, regulatory and customer priorities as set out in key documents such as the Waterways Operating Charter, Our Water Our Future, the Central Region Sustainable Water Strategy, Our Environment Our Future and Melbourne 2030. It also provides the context for Melbourne Water's planning process, ensuring that social, environmental and economic aspects are all considered.

²⁴ A copy of the Strategic Framework is available on Melbourne Water's website www.melbournewater.com.au

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Regular review and continuous improvement are an integral part of Melbourne Water's Planning Framework. For example, since submission of the 2005 Water Plan, Melbourne Water has undertaken reviews and benchmarking studies with a view to strengthening its capital planning and delivery processes and systems:

- During 2005/06, a benchmarking study was undertaken with a leading United Kingdom water company with a specific focus on capital planning and delivery processes
- In June 2006, Melbourne Water engaged KPMG to review its capital planning and delivery process against industry 'best practice' to provide a basis for improving the process itself and the systems and other factors that support it.

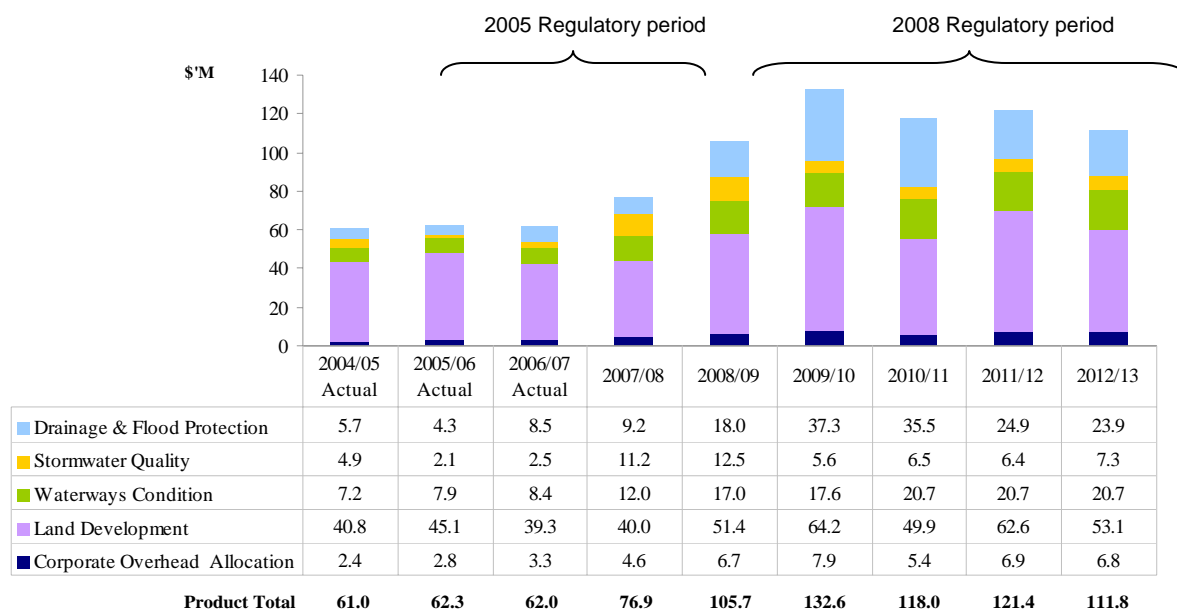
The results of these reviews are progressively being implemented. Improvements to date include:

- Strengthened governance arrangements through the establishment of a Board committee on capital planning and delivery
- A more rigorous process of review/challenge of project proposals
- A streamlined capital planning process which frees up resources for program/project review
- Improved forecasting of renewals capital expenditure on mechanical and electrical equipment
- Introduction of Triple Bottom Line guidelines for evaluating expenditure proposals
- Improved cost estimation methodologies for high value/high risk projects.

Proposed capital expenditure

Planned waterways and drainage investments total \$589.5 million over the 2008 regulatory period, which includes corporate overhead allocation of \$33.7 million (5.7% of planned investment). Figure 11 shows historical and proposed expenditure by program.

Figure 11: Waterways and drainage capital programs – 2004/05 to 2012/13

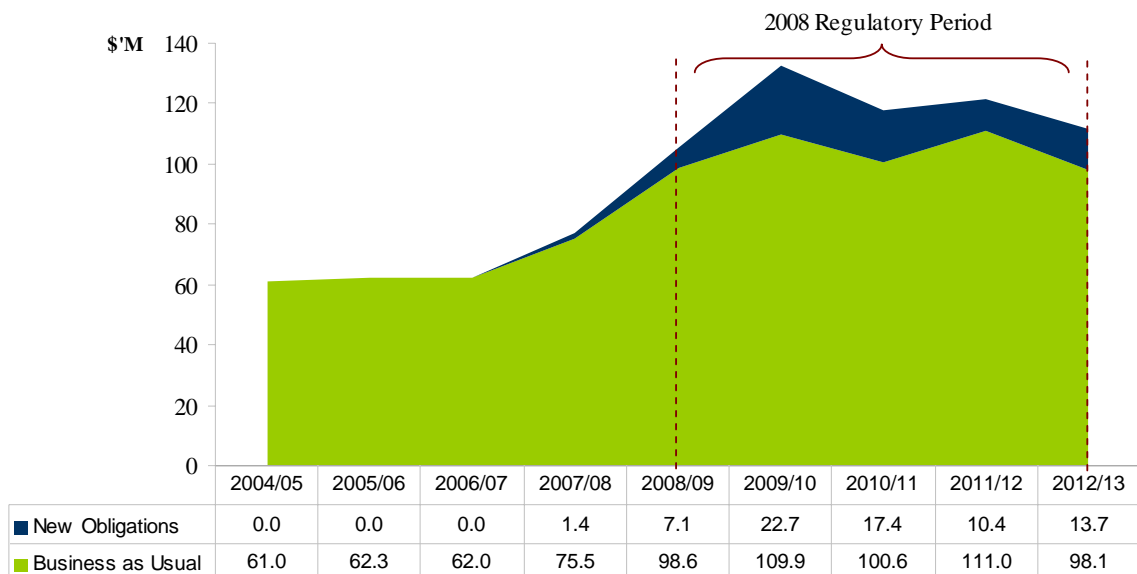


Capital expenditure is forecast to decrease after peaking in 2009/10.

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Capital investment is expected to increase over the 2008 regulatory period, on average, by approximately 8% per year relative to 2007/08. Increases are forecast for business as usual investments early in the regulatory period and additional investment is required to comply with new obligations and service standards. Figure 12 shows the profile of business as usual (88%) and new obligation (12%) investments over the 2008 regulatory period.

Figure 12: New and business as usual capital expenditure – 2004/05 to 2012/13



After an initial increase, business as usual capital expenditure is forecast to remain relatively stable. Expenditure on new obligations will fall after peaking in 2009/10.

Melbourne Water has adopted a supplementary approach to the Commission’s definition of new obligations to include obligations coming into effect within the 2005 regulatory period and which were not included in the 2005 Water Plan.

Over the 2008 regulatory period, capital expenditure on new obligations is \$71.3 million. In particular, significant capital expenditure is planned to meet the following new obligations:

- Investment in flood protection works to meet the new Operating Charter requirement of reducing intolerable flood risks in areas where flooding results in high economic and social costs (\$63.9 million)
- Program of load reduction works to remove a range of pollutants from stormwater and catchment run-off to meet new requirements in the Waterways Operating Charter and targets set out in the Waterways Water Quality Strategy (\$4.4 million)
- Managing environmental flows in line with newly established Environmental Entitlements (\$0.7 million) and works to improve estuary environments in line with new responsibilities as caretaker of river health in the Port Phillip and Westernport region (\$2.3 million).

Planned investment in Melbourne Water’s extended areas, which is business as usual expenditure, totals \$55.1 million over the 2008 regulatory period.

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Increases in business as usual investments over the 2008 regulatory period, relative to 2007/08, are primarily driven by:

- Acceleration of works to restore waterway health to meet the objectives in the Regional River Health Strategy and Waterways Operating Charter (\$18.5 million)
- Increased developer-funded growth works to meet industry and Government land development projections (\$77 million).

Melbourne Water recognises the challenge of delivering a much larger investment program (not only for waterways and drainage services but also for its water and sewerage services) in a highly competitive contracting market.

Melbourne Water has consulted waterways, water and construction industry consultants and contractors on its planned waterways and drainage, water and sewerage capital expenditure over the 2008 regulatory period. The feedback is that the proposals are ambitious, but achievable. This view is supported by industry data that shows the recent rapid growth in construction activity has been absorbed by industry growth and therefore capacity will exist to service Melbourne Water's capital program.

To deliver a significantly larger total business capital program (including waterways and drainage), Melbourne Water is making changes to the way projects are planned, contracted, resourced and delivered. Melbourne Water is confident that successful delivery of the capital program can be achieved based on:

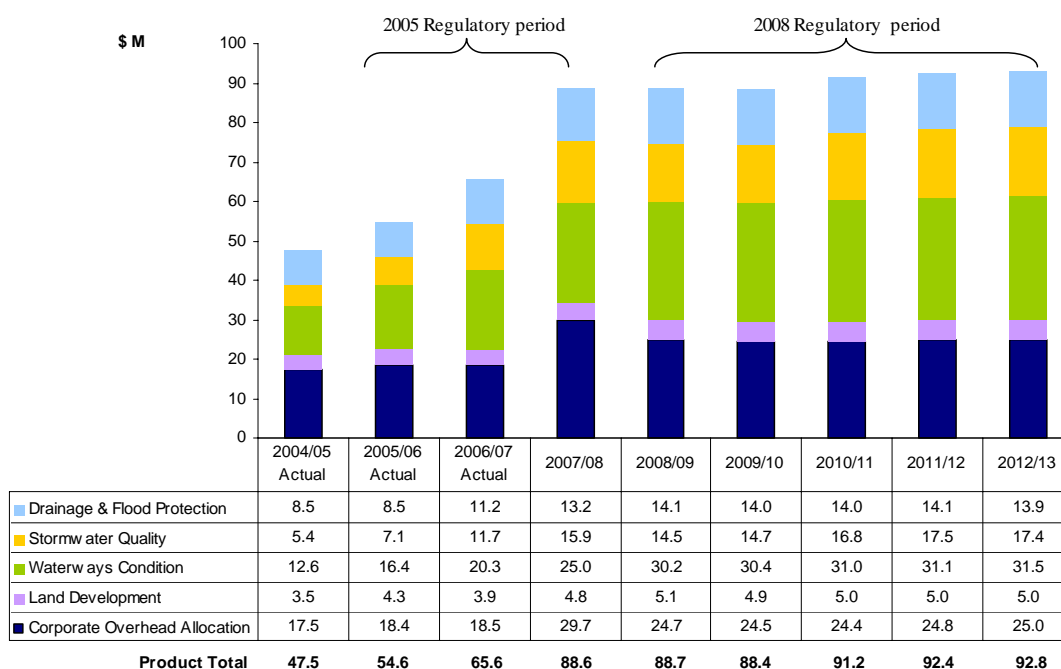
- Its successful track record in delivering its capital expenditure program over the past five years during which time capital expenditure has nearly doubled
- Approaching the market early and publicising the upcoming work widely to assist contractors and consultants with their business planning and recruitment and training of industry specialists. This is important in both attracting the right contractors and consultants with specialised skills for the projects and in ensuring that Melbourne Water establishes arrangements that have the appropriate allocation of risk and resources
- Choosing contract and delivery strategies appropriate to the size, complexity and risk of projects. A decision matrix will be used to select the delivery model best suited to each project, group of projects or program
- For the Waterways and Stormwater Program, major and medium scale projects will be delivered through collaborative contracts. For minor capital works, service provider contracts will deliver both day to day maintenance and high volume, low risk capital works
- Continuing the current panel arrangements for consultants and spreading the workload across a number of firms to underpin and assist the expansion of the water sector consulting industry in Victoria
- Considering the 'bundling' of smaller projects to improve efficiency
- Improving working relationships with key stakeholders to negotiate optimum solutions and timing for projects
- Identifying the skills required to deliver the capital program and implementing human resources initiatives to attract and retain the requisite skills. Operations and asset management teams will be supplemented with additional staff to facilitate appropriate input to the program
- Enhancing the processes and information technology systems that support the capital planning and delivery process.

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Proposed operating expenditure

Forecast operating expenditure totals \$453.5 million over the 2008 regulatory period, which includes corporate overhead allocation of \$123.4 million (27% of total operating expenditure). Figure 13 shows historical and proposed expenditure by program. The corporate overhead allocation includes costs associated with functional areas such as information technology, human resources, finance, risk management, insurance and research and technology.

Figure 13: Waterways and drainage operating expenditure by program – 2004/05 to 2012/13

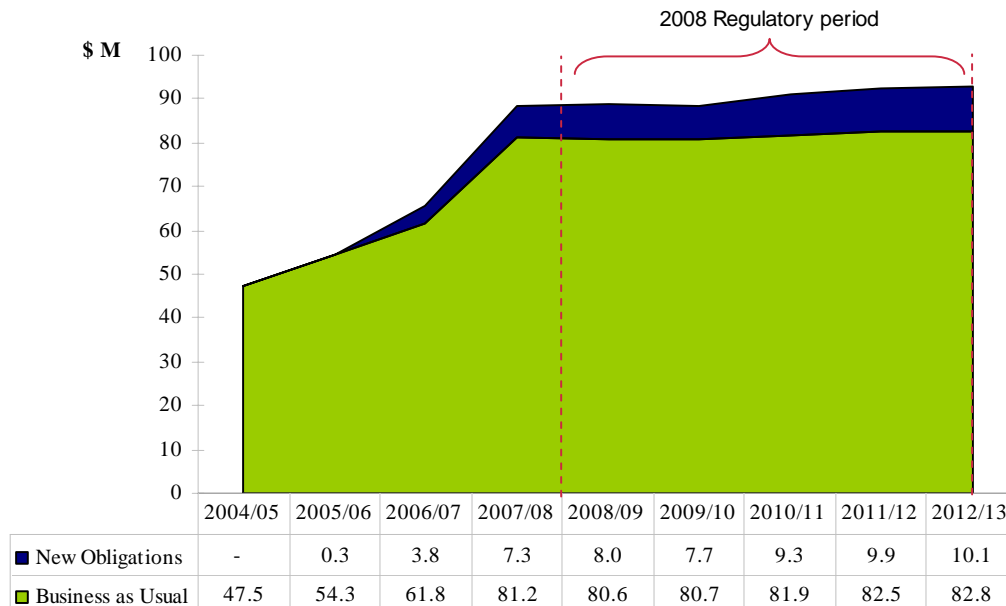


After increasing over the 2005 regulatory period overall operating expenditure is forecast to remain relatively stable.

Waterways and drainage operating expenditure is expected to increase over the 2008 regulatory period, on average, by approximately 0.9% per year relative to 2007/08. Figure 14 illustrates that a key driver of the increase in operating expenditure is due to meeting new obligations, while expenditure associated with business as usual activities will remain relatively stable relative to 2007/08.

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Figure 14: New and Business as usual Operating Expenditure – 2004/05 to 2012/13



After increasing over the 2005 regulatory period business as usual operating expenditure is forecast to remain relatively stable. Expenditure on new obligations is the key driver of the increases in operating expenditure.

The significant increase in operating expenditure for 2007/08 is mainly due to the continued phase-in of waterways management and drainage services to Melbourne Water’s extended boundary areas, one-off billings and collections costs associated with implementing rate reforms and meeting requirements under new obligations.

Melbourne Water has adopted a supplementary approach to the Commission’s definition of new obligations for the 2008 Water Plan to include obligations coming into effect within the 2005 regulatory period and which were not included in the 2005 Water Plan.

Over the 2008 regulatory period, operating expenditure planned for new obligations includes:

- Managing environmental flows in line with newly established Environmental Entitlements (\$2.9 million)
- Implementing the final stages of the Lower Yarra Stormwater Quality Program (part of the Yarra River Action Plan) to reduce the environmental impact of stormwater on waterways from nominated local government areas (\$1.2 million)
- Undertaking load reduction programs to remove a range of pollutants from stormwater and catchment run-off to meet targets in the Waterways Water Quality Strategy and the 2007 Waterways Operating Charter (\$36 million)
- Implementing flood protection measures to reduce currently known intolerable flooding risks to public health and safety, property and infrastructure as set out in the 2007 Waterways Operating Charter (\$4.9 million).

Business as usual expenditure is forecast to remain relatively stable over the 2008 regulatory period in absolute terms and, when adjusted for growth, reflects productivity savings of at least 1% per year relative to 2007/08.

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This reflects initiatives expected to yield ongoing efficiency savings and is in spite of upward pressure on costs arising from:

- Higher labour costs based on current movements in the labour market, and additional headcount required to deliver services to extended areas (\$11.5 million)
- Higher civil maintenance costs (\$20.7 million) due to the:
 - Increasing size of Melbourne Water's waterways and drainage asset base
 - Assets experiencing a periodic increase in activity (e.g. the need for de-silting recently constructed wetlands), along with increased riparian management activities to ensure that the condition of vegetation near rivers and creeks is maintained
 - Above CPI increases in contract rates influenced by market conditions.

Provision of waterway and drainage services to Melbourne Water's extended boundary area will lead to business as usual costs of \$41 million over the 2008 regulatory period.

Regulatory asset value and depreciation

The Commission's 'building block' method for calculating prices adds actual investment over the 2005 regulatory period, and forecast investment over the 2008 regulatory period, to Melbourne Water's regulated asset value. This then forms the basis for the depreciation and commercial return provisions included in prices.

In determining the regulatory asset value as at 1 July 2008, Melbourne Water considers that using actual capital expenditure, contributions and disposals for the period from 1 July 2004 to 30 June 2006 and forecasts for 2007/08 is a more appropriate basis for rolling forward its regulatory asset value than using the provisions included in the Commission's 2005 Price Determination. This is particularly important given the significant changes to Melbourne Water's operating environment over the 2005 regulatory period outlined above, including new obligations and changes to project scopes and costs. Adopting this approach would result in a rolled forward regulatory asset value as at 1 July 2008 of approximately \$861 million for waterways and drainage services.

Melbourne Water considers that the capital expenditure forecast for 2007/08 is both prudent and efficient.

Guidance provided by the Commission identifies straight line and reducing balance depreciation as options in calculating the return of capital over the regulatory period. Melbourne Water has adopted the straight line approach in preparing this Waterways Water Plan.

Cost of capital and taxation

The Commission includes a commercial return in the prices as measured by its assessment of the Weighted Average Cost of Capital (WACC). Melbourne Water has used a real post-tax WACC of 5.1%, consistent with guidance provided by the Commission, in preparing this Waterways Water Plan.

Melbourne Water and the retail water businesses commissioned consultants, the Strategic Finance Group (SFG), to provide an empirical estimate of the WACC for their businesses.

SFG developed a real, post-tax WACC mid-point estimate of 6.2% but recommended a 75th percentile figure of 6.4%, based on empirical analysis of the underlying data, financial theory and the requirement for all WACC parameters to be estimated in an internally consistent manner. Adopting the recommended value could add at least an additional 1.7% to Melbourne Water's proposed price path.

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While supporting the conclusions of the SFG consultancy, in light of stakeholders' concerns in relation to the numerous upward pressures on prices, at this point in time Melbourne Water has not used the recommended real, post-tax WACC estimate of 6.4%. Melbourne Water does, however, believe that the issue of the appropriate WACC for water businesses should be further debated particularly in relation to issues around the empirical estimates for equity beta and gamma.

The Commission makes provision for company tax in regulated prices, as it is seen to be a legitimate business cost. As a result of a large number of Melbourne Water's major assets becoming fully depreciated for tax purposes, tax payable over the 2008 regulatory period is expected to increase which will impact on the level of the proposed prices.

Proposed required revenue

Over the 2008 regulatory period, Melbourne Water's revenue requirement for waterways and drainage services is \$847 million.²⁵ This reflects the costs associated with delivering improvements in river health, reducing intolerable flood risks and consolidating the provision of services to Melbourne Water's extended boundary areas.

While the impact on individual customers will vary, for customers in Melbourne Water's existing service area, raising the required revenue will necessitate an average price increase of CPI+1% per annum. Melbourne Water also proposes to commence charging for services provided in the extended boundary areas.

Prices proposals

A number of submissions in response to Melbourne Water's Consultation Draft question whether Melbourne Water's waterway and drainage services should be funded by Government directly, as is done for waterway services outside Melbourne Water's service area. While some Government funding is received for specific programs, for the purposes of this Water Plan, Melbourne Water has assumed that the vast majority of its costs will continue to be provided on a full cost recovery basis. Consequently, Melbourne Water has focused on developing prices that recover its costs from customers in the most efficient and equitable manner practical.

To this end Melbourne Water has investigated alternatives to the current property valuation based prices for waterways and drainage services. This was done with a view to establishing prices that better reflect the cost and benefits of the services received by different customer groups, which are easier for customers to understand and that are more cost effective to administer.

Microeconomic reform has seen water authorities across Australia move away from using property values as a basis for setting water, sewerage and drainage prices.

In Melbourne, the use of property values in setting water and sewerage prices was phased out in the late 1990s. While there are some important differences with water and sewerage services, the current approach to pricing waterways and drainage services needs to be reviewed because of:

- The link between a customer's capacity to pay (the original basis for choosing property values) and their current price is questionable as:
 - There have been significant changes in property values since 1990
 - 60% of residential customers currently pay the minimum price
- The use of 1990 property values is inconsistent with values used by local governments for rating properties, creating customer confusion and complaints

²⁵ Total NPV of waterways and drainage services revenue over the 2008 regulatory period equates to \$748 million, which includes \$15 million of miscellaneous revenue.

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- The high cost of maintaining 1990 property values for billing purposes (over \$1 million per annum)
- Appropriate pricing arrangements need to be developed and implemented in Melbourne Water's extended boundary areas.

Experience with the reform of water and sewerage prices indicates that any change to valuation based prices, including updating valuations, will result in material customer impacts. Melbourne Water has considered a range of alternative pricing methodologies including:

- Catchment based prices
- Area based prices
- Updating property valuations
- A fixed annual service price for each customer category.

Following extensive analysis, a suite of annual service prices has been selected as the preferred option as it:

- Better reflects the extent to which customers impact on, or benefit from, the services provided
- Achieves a higher level of transparency and customer understanding
- Delivers significant implementation and administration cost savings
- Results in lower customer impacts relative to some other options
- Will result in more stable prices over time, compared to catchment based charges, given that expenditure across catchments is prioritised and varies significantly from one regulatory period to the next.

The challenges associated with reforming valuation based water and sewerage prices also suggest a staged approach will enable an initial focus on the areas of greatest potential gain, help manage impacts on customer bills and allow sufficient time to work through complex issues.

Melbourne Water proposes an initial round of price reform over the 2008 regulatory period commencing with the 2008/09 prices set out in Box 1 and Appendix 4.

Box 1: 2008/09 price proposals

- Commence phasing in a single service price for residential customers by increasing the minimum price to \$57 while maintaining prices for customers who currently pay above the minimum
- Decreasing reliance on property values for non-residential customers by increasing the minimum price to \$75, with further reform during the next regulatory period
- Ensuring rural customers only pay for the services they receive by replacing existing prices for rural customers located outside the Urban Growth Boundary with a lower waterways service price of \$36
- Commence charging customers in the extended area for the provision of waterways and regional drainage services by introducing a single service price of \$57 per year for residential customers, \$75 for non-residential customers and \$36 for customers located outside Urban Growth Boundary
- Continuing discussions with customer committees within the special drainage areas to move towards an improved basis for pricing.

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While price reform is proposed on a number of different fronts, and will affect customers differently, the proposed prices for customers in the existing service areas would increase on average by CPI+1% per year over the 2008 regulatory period. This increase is consistent with delivering the service outcomes discussed in earlier sections. The proposed prices for the different customer groups and associated impacts are discussed below.

Residential customers

Broadly speaking, residential customers are fairly uniform in terms of the benefits they receive and the costs they impose on waterways and drainage services. Consequently, a single price based on the average cost of providing services to residential customers is a reasonable proxy for the true costs incurred and benefits received by this group.

Melbourne Water proposes to transition residential prices to the average cost by increasing the minimum price by \$2 plus inflation each year over the 2008 regulatory period and maintaining prices for customers who currently pay above the minimum until the transitional arrangements are complete in 2012/13.

Setting the minimum price at \$57 in 2008/09 would increase customer bills by \$2 in real terms for 60% of residential customers (about 804,000) who currently pay the minimum price of \$55. Prices for 40% of customers currently paying above the minimum (about 539,000) would remain constant in real terms until 2012/13.

Table 7 outlines the proposed price path for residential customers over the 2008 regulatory period. The average price for a customer paying above the minimum in 2007/08 has been used to illustrate the price path for these customers.

Table 7: Proposed price path for residential customers – 2008/09 to 2012/13

		Current	Proposed				
		2007/08 (\$/yr)	2008/09 (\$/yr)	2009/10 (\$/yr)	2010/11 (\$/yr)	2011/12 (\$/yr)	2012/13 (\$/yr)
Residential properties	Paying minimum price	55.05	57.10	59.23	61.43	63.71	66.08
	Above minimum price (average)	88.13	88.13	88.13	88.13	88.13	66.08

Non-residential customers

In contrast to residential customers, there are significant differences between non-residential customers (who range from cafes and shopping centres to warehouses) in terms of:

- The costs they impose on services (as measured by their contribution to stormwater run-off)
- The level of benefits they receive (e.g. the level of foregone earnings as a result of flooding)
- Opportunities to change behaviour to reduce the quantity (e.g. through stormwater reuse) or improve the quality of stormwater run-off from their property.

An extensive review that commenced following the Commission's 2005 Price Determination explored a number of price reform options for non-residential customers. The review highlighted the diversity within current non residential prices and the significant potential impacts of moving to a more cost reflective approach.

As a first stage reform measure, Melbourne Water proposes that the current minimum price be increased to \$75 in 2008/09 and property values be retained pending further analysis and development of reform proposals for inclusion in the next regulatory period.

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Increasing the minimum from \$55 to \$75 in 2008/09 results in increasing the number of non-residential customers paying the minimum price from around 16,000 (14%) to approximately 27,200 (23%). This reduces reliance on property values and establishes a higher base price upon which future tariff reform can take place.

Table 8 outlines the proposed price path for non-residential customers over the 2008 regulatory period. The average price for a customer paying above the minimum in 2007/08 has been used to illustrate the price path for these customers.

Table 8: Proposed price path for non-residential customers – 2008/09 to 2012/13

		Current	Proposed				
		2007/08 (\$/yr)	2008/09 (\$/yr)	2009/10 (\$/yr)	2010/11 (\$/yr)	2011/12 (\$/yr)	2012/13 (\$/yr)
Non-residential properties	Paying minimum price	55.05	75.12	77.73	80.42	83.21	86.10
	Above minimum price (average)	455.00	470.79	487.12	504.03	521.52	539.61

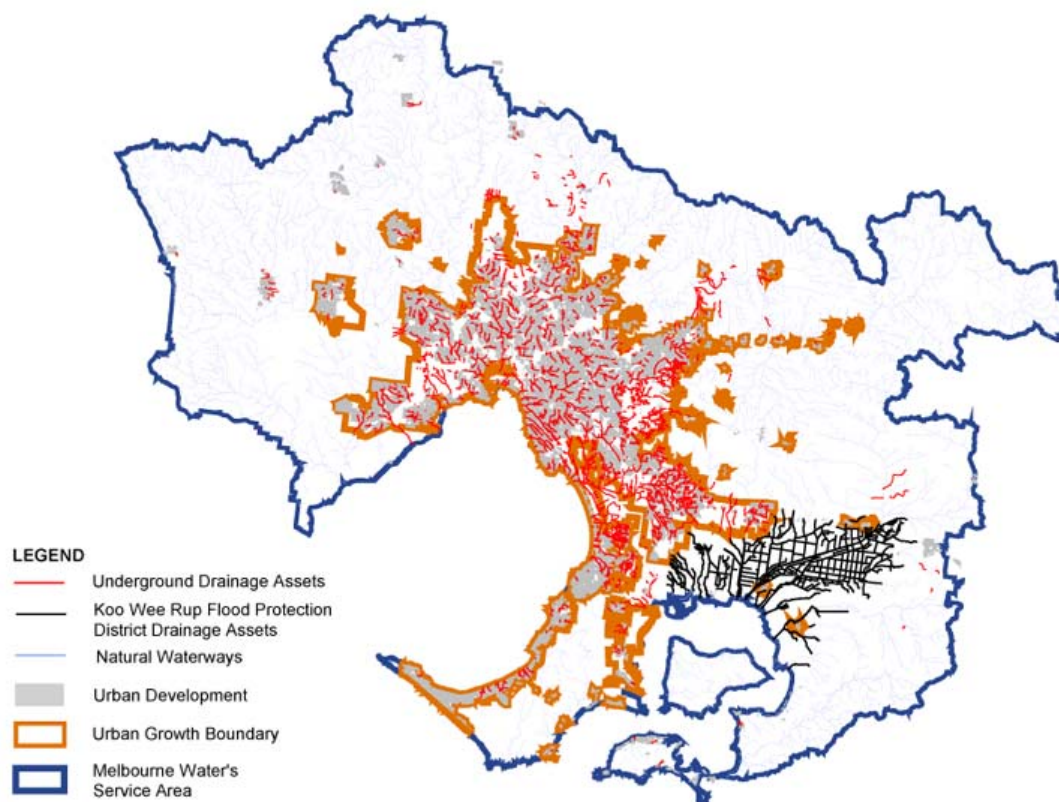
Rural customers

As illustrated by Figure 15, with the exception of the Koo Wee Rup Flood Protection District, Melbourne Water's regional drainage assets are located predominantly within urban areas which have been designated by the Urban Growth Boundary.²⁶ As customers located outside the Urban Growth Boundary (which is largely comprised of rural properties) do not receive the full benefits of Melbourne Water's regional drainage services, it is proposed that these customers pay for the cost of waterways services only. The average annual cost of providing waterways services in the greater Melbourne metropolitan area is around \$36.

²⁶ Defined in the State Government's Melbourne 2030 which indicates the long term limits of urban development and where non-urban values and land uses should prevail in metropolitan Melbourne

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Figure 15: Urban Growth Boundary and Melbourne Water assets



A lower price is proposed for customers outside the Urban Growth Boundary to reflect the fact that they do not receive drainage services.

Moving to a waterways service price of \$36 in 2008/09 for rural customers located outside the Urban Growth Boundary would result in an average \$45 decrease for about 47,000 residential and non-residential customers.

It is also proposed that historic exemptions be removed for 3,200 farm properties in the Yarra and Maribyrnong catchments which have received services following previous extensions of Melbourne Water's service area in 1981 and 1984. Of these properties, 95% are located outside the Urban Growth Boundary and would pay a price of \$36 for waterways services.

Table 9 outlines the proposed price path for rural customers over the 2008 regulatory period. The average price for a customer paying above the minimum in 2007/08 has been used to illustrate the price path for these customers.

Table 9: Proposed price path for rural customers – 2008/09 to 2012/13

		Current 2007/08 (\$/yr)	Proposed 2008/09 (\$/yr)	2009/10 (\$/yr)	2010/11 (\$/yr)	2011/12 (\$/yr)	2012/13 (\$/yr)
Rural properties	Paying minimum price	55.05	35.89	37.14	38.43	39.76	41.14
	Above minimum price (average)	112.44	35.89	37.14	38.43	39.76	41.14

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Extended areas

Given that customers within the extended areas will receive an equal level of waterways and regional drainage services to other areas within Melbourne Water's service area, it is proposed that prices be uniformly applied across the whole of the Port Phillip and Westernport catchment areas.

Introducing 1990 property values as a basis for charging residential and non-residential customers in the extended areas is expensive and likely to result in customer confusion and be difficult to explain. It is recommended, therefore, that in light of the proposal to move residential customers to a single service price over the 2008 regulatory period, a flat service price of \$57 be applied in 2008/09 for all residential customers (approx 118,000) in the extended area. Due to further investigations planned for non-residential prices and potential future reforms, it is also proposed that a flat service price of \$75 be applied in 2008/09 for all non-residential customers (approx 5,000 customers) in the extended area as an interim measure.

An estimated 54,000 customers outside of the Urban Growth Boundary would pay a fixed waterways service price of \$36.

Table 10 outlines the proposed price path for extended area customers over the 2008 regulatory period.

Table 10: Proposed price path for extended area customers – 2008/09 to 2012/13

	Current 2007/08 (\$/yr)	Proposed 2008/09 (\$/yr)	2009/10 (\$/yr)	2010/11 (\$/yr)	2011/12 (\$/yr)	2012/13 (\$/yr)
Residential properties	N/A	57.10	59.23	61.43	63.71	66.08
Non-residential properties	N/A	75.12	77.73	80.42	83.21	86.10
Rural properties	N/A	35.89	37.14	38.43	39.76	41.14

Special drainage areas

Special drainage area customers represent 0.3% of Melbourne Water's customer base. Melbourne Water sets prices for these customers in consultation with customer advisory committees. Melbourne Water has consulted on its intention to reform special drainage area prices over the 2008 regulatory period. Working with local customer advisory committees to appropriately manage any customer bill impacts will be an important consideration in this process. In the interim, it is proposed that the current approach and principles used to set prices for these customers be retained for around 3,000 customers in the Koo Wee Rup Flood Protection District and approximately 1,200 customers in the Patterson Lakes area.

Diversion services

Melbourne Water proposes to retain the existing structure for diversions prices, where a flat service price and volume-based price (peak, off-peak and non-consumptive) is levied for administering waterway diversion licences. Price proposals for the 2008 regulatory period include increasing annual service prices by an average of 4% per annum and increasing volume based price by an average of 16% per annum.

Consultation with Melbourne Water's customer advisory committees indicate that the proposed prices and service outcomes for the 2008 regulatory period are considered to be not unreasonable, with the major concern for licence holders being the security of access to water resources.

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The proposed price increases will ensure that Melbourne Water is able to effectively manage customer compliance to protect water entitlements for all diverters while respecting the needs of the environment as well as improving information services for customers.

Developer cash contributions

Melbourne Water proposes to continue using pricing principles as a basis for setting developer charges in development service schemes. Cash contributions received from these schemes are used by Melbourne Water to construct drainage works to service urban growth areas. In applying these principles, Melbourne Water has responded to issues identified by the Commission in its 2005 Price Determination and subsequent consultation with industry. Melbourne Water has also responded to legislative change in relation to accountability for water sensitive urban design.

Miscellaneous services

Melbourne Water currently charges for a variety of miscellaneous services provided to the retail water businesses, developers and the general public. The prices for these services are set to reflect the cost of the service delivered. Appendix 4 outlines the proposed prices in 2008/09.

Executive Summary

Consultation

Extensive stakeholder engagement has been critical in developing this Waterways Water Plan. The proposals included in this Waterways Water Plan have been developed in consultation with:

- The Waterways Advisory Committee
- Diversions customer advisory committees
- Department of Treasury and Finance
- Department of Sustainability and Environment
- EPA Victoria
- Port Phillip and Westernport Catchment Management Authority
- Essential Services Commission
- Retail water businesses.

This feedback has assisted Melbourne Water to:

- Clarify the outcomes to be delivered over the 2008 regulatory period
- Discuss the activities needed to deliver these outcomes and their associated cost
- Establish relative priorities given potential customer impacts
- Set the structure, level and phasing of proposed prices
- Agree appropriate planning assumptions
- Discuss the regulatory framework needed to create incentives for improved business performance and manage risks appropriately.

To facilitate broader public comment, Melbourne Water released a Consultation Draft Waterways Water Plan on 10 October 2007. Approximately 200 letters were also sent to our major stakeholders including all local members of parliament, local government CEOs and mayors, local interest groups and Landcare networks. Follow up phone calls were made to many of our key stakeholder to ensure they were aware of the release of our Consultation Draft.

Seven information sessions were advertised in Melbourne Water's extended waterways boundary area where charges are proposed to be applied for the first time in 2008/09 and media releases were also sent to all local newspapers.

Melbourne Water received 16 submissions in response to the Consultation Draft raising. Issues raised by the submissions include:

- The importance of integrated planning and effective collaboration between Melbourne Water and local government
- The importance of ongoing community engagement to feed back on performance
- The potential for alternative sources of funding for Melbourne Water's waterway services.

Additional information has been included in this Water Plan to respond to these issues, where appropriate, including a response to questions raised by EPA Victoria in relation to stormwater quality monitoring and improvement.

All parties making a submission have received a written response thanking them for their submission, and noting the next steps in the Commission's price determination process.