

Outcomes over the 2005 regulatory period

- Melbourne Water has achieved a high level of compliance with targets set as part of the Commission's 2005 Price Determination.
- Actual capital and operating expenditure is expected to be higher than forecast in the 2005 Price Determination due to emerging challenges, including:
 - New legislative and regulatory obligations
 - Extension of services to Melbourne Water's new boundary areas
 - Increased costs for existing projects and business as usual activities.

This chapter discusses Melbourne Water's progress in delivering waterway and drainage service outcomes set as part of the Commission's 2005 Price Determination. Actual and forecast capital and operating expenditures associated with delivery of these outcomes and the reasons for variances from benchmarks provided in the Price Determination are also examined, along with actual demand outcomes and progress in delivering key capital projects. The chapter also discusses the impact of changes in legislative and regulatory obligations over the 2005 regulatory period and lessons that can be applied to the 2008 regulatory period.

The service outcomes, capital and operating expenditures set as part of the Commission's 2005 Price Determination were based on the best available information at that time. Additional information and changes in circumstances have impacted on Melbourne Water's achievement of these benchmarks. As highlighted in the previous chapter, the current operating environment for Melbourne Water has shifted since the Commission made its 2005 Price Determination. This includes:

- Policy development such as the announcement of the State Government's Our Water Our Future and Yarra River Action Plan and release of the Central Region Sustainable Water Strategy (CRSWS)
- Changes in regulatory and legislative requirements (e.g. introduction of the Water (Resource Management) Act 2005).

As part of ongoing planning and risk management activities, new information continues to be used to identify the optimal manner in which to meet required outcomes. This includes asset condition, operational and cost information.

3.1 Service outcomes

The Commission's 2005 Price Determination detailed the approved service outcomes to be delivered over the 2005 regulatory period.

This section sets out relevant key performance indicators, actual results achieved in the first two years of the 2005 regulatory period and additional information relating to these results.

Tables 3.1 and 3.2 set out actual and target key performance indicator results for waterways and drainage services over the 2005 regulatory period.

Table 3.1: Percentage achievement of three year targets

Key Performance Indicator	Progress towards three year target (%)		Three year target (no.)
	2005/06	2006/07	
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 ¹
– 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

Table 3.2: Performance against annual targets

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 ²	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

¹ 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.

² The yearly targets for 2005/06 – 2007/08 were revised following discussions with the Commission.

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Waterways condition

As detailed in Table 3.1, Melbourne Water has made good progress towards achieving its end of period targets in relation to the Regional River Health Strategy³ specified in the Commission's 2005 Price Determination.

In addition, Melbourne Water has been able to meet and exceed a number of the targets in the first two years of the 2005 regulatory period by achieving better service outcomes within the expenditure approved by the Commission.

The Regional River Health Strategy assigns five year implementation targets to Melbourne Water that contribute to the ten year goal to have 50% of waterways in good or better condition. The implementation targets involve maintenance, waterway restoration works and community programs and are prioritised using an asset valuation and risk-based decision support tool.

The three year outcomes for the 2005 regulatory period were estimated from the five year implementation targets with some difficulty due to the non-linear and longer term nature of implementing and measuring results of waterway improvement works and programs. Additional monitoring, research and "hands on" experience has seen Melbourne Water's understanding of implementation actions increase compared to the initial compilation of the 2005 Water Plan. Melbourne Water's proposed targets for the 2008 regulatory period have been adjusted to reflect these learnings and achievements from the 2005 regulatory period.

Drainage and flood protection

Melbourne Water has achieved all drainage and flood protection targets specified in the Commission's 2005 Price Determination for 2005/06 and 2006/07 (see Table 3.2).

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.

Through the use of planning controls all new development is currently complying with flood protection standards⁴ and the number of flood prone properties was reduced by 250⁵ (2005/06) and 267 (2006/07) as a result of Melbourne Water placing conditions on proposals for redevelopment on flood prone land.

Stormwater quality

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 tonnes⁶. 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 as a result of 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.

³ These targets do not cover Melbourne Water's extended areas which were included in its operating area subsequent to the Commission's 2005 Price Determination.

⁴ As set out in Melbourne Water's Guidelines for Development in Flood Prone Areas.

⁵ A further 50 floors were deemed as potentially being protected through conditions placed on redevelopment. However, due to insufficient information available to determine whether the previously existing buildings were flood prone, these were not included in the 250 properties counted as meeting the target.

⁶ This is a cumulative target that was carried over into the 2005 regulatory period.

Diversion services

The target in 2005/06 for the number of licences greater than 5ML per year metered, or assessed for metering, has been 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.

3.2 Actual capital expenditure outcomes

The Commission's 2005 Price Determination outlined its assessment of the capital expenditures associated with achieving the outcomes detailed in section 3.1, as well as with delivering the complete Capital Plan for waterways and drainage services. This section sets out the reasons for variations between the capital expenditure forecasts allowed by the Commission in the 2005 Price Determination and the actual expenditures for 2005/06 and 2006/07 and revised forecasts for 2007/08 ⁷.

As noted in section 3.1, Melbourne Water has, in the main, delivered the service 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). Further information in relation to new obligations is provided in Chapter 5.

Figure 3.1 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 June 2005 Final Decision, 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 ⁸.

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.

⁷ For 2007/08 the forecasts are based on Corporate Plan forecasts.

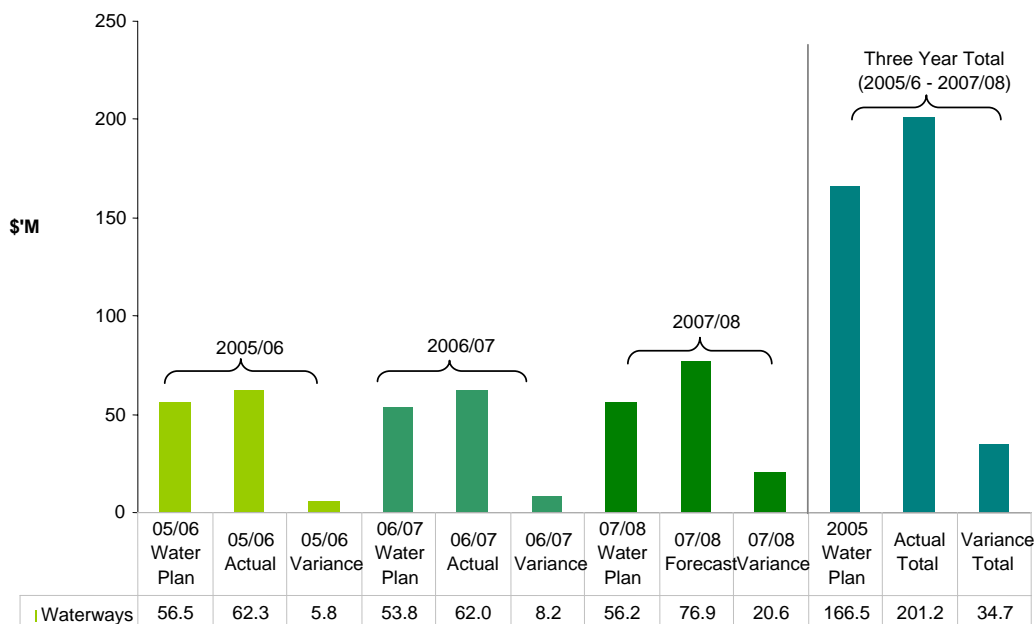
⁸ Further information in relation to these processes, and actions taken to ensure continuous improvement in processes around capital planning, estimation and delivery, is provided in Chapters 7 and 8.

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The project delays have resulted in nitrogen reduction loads falling slightly short of the 2006/07 performance target. 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.

Figure 3.1: Waterways and drainage capital expenditure – 2005/06 to 2007/08



3.3 Actual operating expenditure outcomes

The Commission’s 2005 Price Determination outlined the operating expenditure associated with achieving the outcomes detailed in the 2005 Water Plan. This section sets out the reasons for variations between the operating expenditure forecasts allowed by the Commission in the 2005 Price Determination and the actual expenditures for 2005/06 and 2006/07 and revised forecasts for 2007/08⁹.

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 3.2 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)

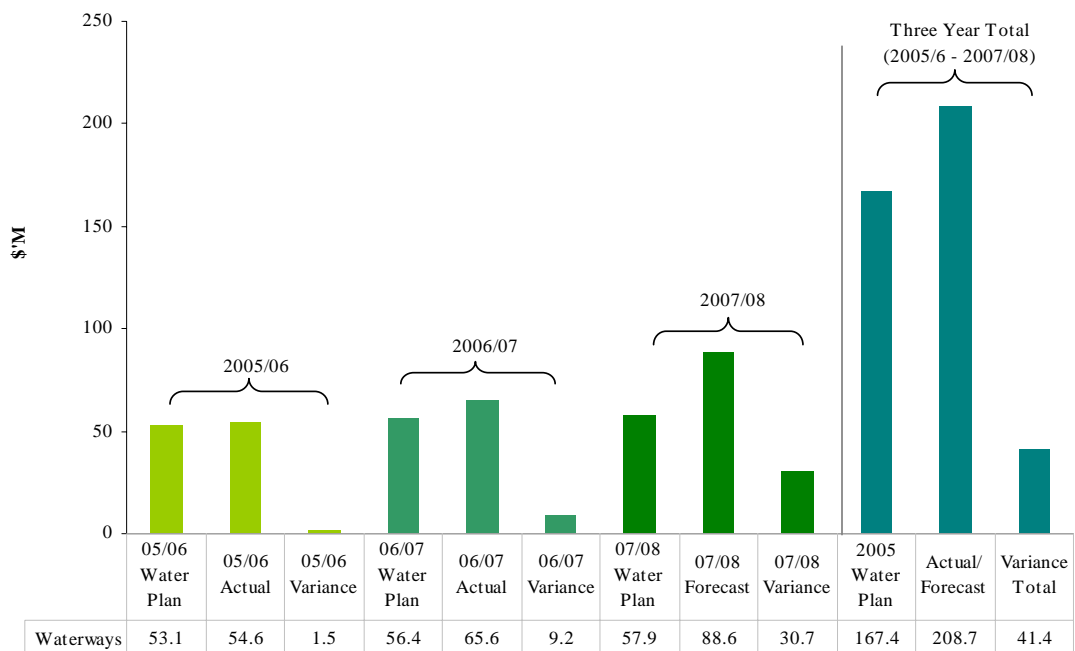
⁹ For 2007/08 the forecasts are based on Corporate Plan forecasts.

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- Additional expenditure related to the extension of Melbourne Water’s waterway boundary (\$19 million)¹⁰
- An 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)
 - 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)¹¹.

The drivers of increased operating expenditures are offset by cost savings through efficiency initiatives and project reprioritisation.

Figure 3.2: Waterways and Drainage Operating Expenditure – 2005/06 to 2007/08¹²



¹⁰ 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.

¹¹ Preliminary estimate will be revised following further consultation with retail water businesses.

¹² 2007/08 figures are based on Corporate Plan forecasts.

3.4 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 3.3 illustrates a minor difference between 2005 Water Plan forecasts and actual customer numbers over the 2005/06 to 2006/07 period.

Table 3.3: 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 \$13.7 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.

Table 3.4 outlines developer cash contribution comparisons between 2005 Water Plan forecasts and actual numbers over the 2005/06 to 2006/07 period.

Table 3.4: Actual and forecast developer cash contributions¹⁵ (2006/07 dollars)

	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 Corporate Plan forecasts.

3.5 Delivery of key capital projects

The Commission outlined in its 2005 Price Determination the key waterways and drainage capital projects that Melbourne Water would undertake over the 2005 regulatory period.

Table 3.5 summarises Melbourne Water’s progress as at March 2007 in delivering these projects over the 2005 regulatory period.

Table 3.5: Major capital projects

Product/Project	Outputs to be achieved in the 2005 regulatory period	Current status as at March 2007
Waterways and Drainage		
Waterways Restoration Program and Waterways Strategy	Progress with implementing actions from Regional River Health Strategy.	See discussion in section 5.1.1.
Bunyip River Restoration Allocation	Major reshaping and levee bank restoration of the entire 14km to be completed by the end of 2007/08. Minor instream, minor bed and bank stability work to commence. Progress review to be undertaken for implementation strategy.	Final stage of the major levee reconstruction (south bank between 11 Mile and 13 Mile Rds) will be completed by June 2008 once planning issues are resolved with the Shire of Cardinia. Review of implementation plan completed in 2006. Development of a Vegetation Management Plan has commenced.

3.6 Changes in legislative and regulatory obligations

Since the Commission made its 2005 Price Determination, there have been several changes to the legislative and regulatory obligations that apply to Melbourne Water’s waterways and drainage services. New obligations to date require additional operating expenditure of \$11.4 million and financing costs of \$0.02 million over the 2005 regulatory period. Table 3.6 sets out the nature and date of these changes, the outcomes that Melbourne Water must now deliver and the associated net operating costs.

As indicated by the Commission, these changes will be taken into account in determining prices for the 2008 regulatory period, where the net impact represents 2.5% of a business’s total revenue over the regulatory period, or \$1 million, whichever is greater.

However, at this stage it appears unlikely that when combined with other whole of business expenditures incurred to meet changes in legislative and regulatory obligations (\$25.1 million), Melbourne Water will not meet the 2.5% revenue threshold established by the Commission.

This threshold is approximately \$39.5 million, which equates to approximately 6% of Melbourne Water’s allowed return on assets (profit) in the 2005 Water Plan. Melbourne Water notes that despite delivering the outcomes required by these new obligations, it will not be able to recover these additional operating and financing costs incurred within the regulatory period. Melbourne Water considers that 6% of its profit is material and that the threshold is, therefore, too high. It believes that the current threshold does not appropriately allocate risks between itself and its users, and also adversely impacts on returns to shareholders. This is discussed further in Chapter 4.

Table 3.6: Additional waterways and drainage legislative and regulatory obligations for the 2005 regulatory period¹⁶

Additional obligations	Instrument and date of effect	Outcomes to be delivered	Operating costs (\$M)	Financing costs (\$M)
Manage environmental flows in line with new established Environmental Entitlements	Water (Resource Management) Act 2005 No. 99/2005 December 2005	Manage environmental flows to maximise ecological benefits and operate the water supply system in line with the environmental requirements	0.5	–
Undertake initiatives in the Yarra River Action Plan to reduce the environmental impact of stormwater on urban waterways	Statement of Obligations Clause 23.2 July 2007	Reduced stormwater pollution from catchments draining into the Yarra River	10.9	< 0.1
Total			11.4	< 0.1

Melbourne Water considers that the additional expenditure it has incurred, and will incur, in relation to these new obligations is efficient and reflects a least cost outcome. This expenditure was not incorporated in the 2005 Water Plan and Melbourne Water was not already meeting the higher level of service now required.

3.7 Lessons for the 2008 regulatory period

Experience over the 2005 regulatory period has established that:

- Uncertainty is created by the changing legislative and regulatory obligations, which in turn increases the difficulty associated with accurately forecasting capital and operating expenditures
- Improved information within the regulatory period can lead to changing cost estimates, reprioritisation of projects and additional projects being bought on line
- The Commission's current approach to assessing new obligations under a 2.5% revenue threshold can materially impact on a business' financial performance, as higher service standards or additional outcomes must be delivered but businesses are unable to reach the threshold and recover the associated costs
- It is realistic to expect that in the current environment, the above issues will continue in the 2008 regulatory period.

In chapter 4, Melbourne Water outlines its views in relation to the appropriate framework for economic regulation over the 2008 regulatory period. These views have been informed by the lessons learned during the 2005 regulatory period.

The proposed framework reflects the need for flexibility in a changing and uncertain environment and is consistent with the principles of optimal risk allocation, including that, where risk is unmanageable, it should be allocated to those parties best able to absorb the risk.

¹⁶ Table 5.7 does not include the additional obligations that Melbourne Water now has in relation to the extended area for waterways and drainage services. These obligations require Melbourne Water to provide its existing waterways and drainage services in these new areas (parts of the Westernport, Werribee and Maribymong catchments). As agreed with the Commission at the time of the 2005 Price Determination, these obligations and the associated additional expenditures have been ring fenced and the additional costs will be recovered during the 2008 regulatory period. Additional expenditure arising from introducing Melbourne Water's Rural Customer Charter have also been omitted from Table 3.6 as 2007/08 requirements are still being discussed with the Commission.