2018 WATER PRICE REVIEW

Guidance paper

November 2016

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KEY MESSAGES

- The Essential Services Commission will undertake a review of the maximum prices that 17 Victorian water businesses can charge for their water and sewerage services for the regulatory period from 1 July 2018 (the 2018 price review).
- The 2018 price review will be the first under the Commission's new water pricing approach.[1] The new approach places a greater emphasis on the role of customer engagement to influence price submissions. It also includes a new incentive mechanism called PREMO that links the returns earned by a water business to the ambition expressed in their price submission and successful delivery on that ambition.
- Water businesses will now have an opportunity to pursue streamlined price review processes — including the fast-tracking of price submissions through the Commission's assessment process.
- The Commission's approach allows a water business to pursue greater autonomy, and, in return, holds the businesses to greater account for the quality of their submissions. For example, the guidance requires the board of a water business to attest to the quality and accuracy of a price submission and the information and forecasts relied upon.
- The Commission expects that, because of the PREMO changes, price submissions for the 2018 price review will be different to those submitted in past reviews.
- Price submissions will more clearly and succinctly identify and explain how a business's proposals demonstrate value for money for customers — that is, what outcomes will be delivered to customers in return for the prices they pay, and how this reflects what customers value most.

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[1] Essential Services Commission 2016, *Water Pricing Framework and Approach: Implementing PREMO from 2018*, October.

- The guidance specifies the information the Commission needs to undertake the 2018 price review in a manner consistent with the Water Industry Regulatory Order 2014.
- The guidance requires extensive information to be provided by businesses. However much of this would already exist within normal business practice — for internal planning and corporate reporting, for example. Much of the detail requested in the guidance can be provided by completing the financial model (issued by the Commission) that forms part of a water business's price submission.
- As this is the first round of price submissions and price determinations to be made under the new framework, the Commission will have regard to businesses' inexperience with the new framework, provided they have demonstrated a genuine commitment to meeting the requirements of this guidance paper.
- Price submissions must be lodged with the Commission by **29 September 2017**.

CONTENTS

1 INTRODUCTION

The Essential Services Commission of Victoria (the Commission) will undertake a review of the maximum prices that 17 water businesses can charge for their water and sewerage services for the regulatory period from 1 July 2018 (the **2018 price review**).[2]

The review covers Barwon Water, Central Highlands Water, City West Water, Coliban Water, East Gippsland Water, Gippsland Water, Goulburn Valley Water, Grampians Wimmera Mallee Water, Lower Murray Water, North East Water, South East Water, South Gippsland Water, Southern Rural Water, Wannon Water, Western Water, Westernport Water and Yarra Valley Water.

Melbourne Water and Goulburn-Murray Water are the only two Victorian water businesses not included in this review, having completed price reviews in 2016.

The Commission's pricing powers and functions in Victoria's water industry are governed by the Water Industry Regulatory Order 2014 (**WIRO**),[3] which sits within the broader context of the *Water Industry Act 1994* (Vic) (**WI Act**) and the *Essential Services Commission Act 2001* (Vic) (**ESC Act**).

The Commission must make a price determination which determines the maximum prices (or the manner in which prices are to be calculated, determined or otherwise regulated) that a water business may charge for prescribed services during a regulatory period.[4]

This paper is the guidance the Commission is required to issue to water businesses under clause 13 of the WIRO (clause 13 is provided at **Attachment 1**). To comply with

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[2] Under the Commission's most recent price determinations (2013) for the 17 water businesses, approved prices are scheduled to cease on 30 June 2018.

[3] The WIRO is available at http://www.gazette.vic.gov.au/gazette/Gazettes2014/GG2014G043.pdf#page=45, pp. 41-51.

[4] WIRO, clause 10(a). The prescribed services are listed at clause 7(b) of the WIRO.

clause 13 of the WIRO, the guidance sets out the Commission's approach to the price review and information requirements for price submissions.[5]

Where possible the Commission has sought to minimise compliance costs for water businesses.[6] In considering the information required to support a price submission, much of the information should be readily available to a water business and relevant for other purposes such as corporate planning or project justification and prioritisation.

In some areas, the guidance indicates where a water business should only provide a summary in the price submission, and make supporting detailed information available at the Commission's request. Further, in some situations where a water business is proposing to maintain the status quo (such as the form of price control or tariff structures) the Commission does not require detailed justification in the price submission.

Businesses may, in the interests of brevity, choose not to include all the supporting information for the claims made in their submissions. However, they must be able to provide any supporting information requested by the Commission. For example, a business may reference a consultant's report in its submission without providing the full report as an attachment.

Clause 14 of the WIRO (provided at **Attachment 2**) requires the Commission to assess a price submission prepared by a water business, and form an opinion on whether the price submission:

- complies with the guidance issued by the Commission under clause 13 of the WIRO, and
- has adequate regard for the matters specified in clause 11 of the WIRO.

If the Commission forms a view that a price submission satisfies the guidance and WIRO criteria, then it must approve a water business's price submission — otherwise,

[5] Clause 13 of the WIRO also requires the Commission to provide guidance following consultation with the regulated entities. Over the course of 2015 and 2016, the Commission consulted on the various elements of this guidance, and its requirements have been informed by the feedback received during its review of the water pricing approach.

[6] Under section 4C (a) of the *Water Industry Act* (Vic) 1994 the Commission has an objective to ensure the costs of regulation do not exceed the benefits, wherever possible.

the WIRO affords the Commission discretion to specify maximum prices, or the manner in which prices are to be calculated, determined or otherwise regulated.[7]

In assessing compliance with the guidance, as this is the first round of price submissions and price determinations to be made under the new framework, the Commission will have regard to businesses' relative inexperience with the framework, provided they have demonstrated a genuine commitment to meeting the requirements of this guidance paper.

1.1 WATER PRICING FRAMEWORK AND APPROACH

In 2014, the Victorian Government reviewed and revised the WIRO. The changes allow the Commission greater discretion to decide on the approach used to deliver efficient pricing and service outcomes for Victorian water and sewerage customers.

The Commission began its review of the water pricing approach in April 2015 with the objective to identify the pricing approach that would produce the best outcomes for Victorian customers. Following extensive consultation, the Commission released its water pricing framework and approach paper[8] in October 2016.

The framework and approach paper sets outs all elements of the Commission's pricing approach for water price reviews conducted from 2018.

The new pricing approach introduces new financial, reputational and procedural incentives to create a better alignment between the interests of water businesses and the customers they serve. The main changes to the pricing approach are:

- a greater emphasis on the role of customer engagement to inform and influence the price submissions of water businesses

[7] WIRO, clause 14.

[8] Essential Services Commission 2016a, *Water Pricing Framework and Approach: Implementing PREMO from 2018*, October.

- a new incentive mechanism called PREMO, which links the return on equity earned by a water business to the level of ambition in its price submission for **P**erformance, **R**isk, **E**ngagement, **M**anagement and **O**utcomes
- new flexibility mechanisms to help ensure the pricing approach accounts for the diversity of the water businesses and their customers, and to allow for streamlined price review processes.

1.2 LOWER MURRAY WATER: RURAL WATER INFRASTRUCTURE

This paper ***does not*** contain the price submission information requirements for Lower Murray Water's charges for rural water infrastructure services. For water entities in the Murray-Darling Basin such as Lower Murray Water, the charges for rural activities are regulated under the Water Charge (Infrastructure) Rules 2010 (Cth) (WCIR). The Australian Competition and Consumer Commission has delegated Commonwealth jurisdiction over Lower Murray Water's regulated surface water and subsurface water infrastructure service charges to the Commission.

Separate guidance will be provided to Lower Murray Water for its rural infrastructure services. The Commonwealth Government has commenced a review of the coverage of the WCIR (among other things). The additional guidance for Lower Murray Water's rural infrastructure services will be tailored to reflect the Commonwealth's review.

1.3 AMENDMENTS TO THIS GUIDANCE

The Commission may issue additional guidance or amend this guidance during the price review. The need to issue additional guidance or amend guidance may arise from any changes to law or regulations, for example. Commission staff will consult with stakeholders where any additional guidance or amendment to the guidance is required.

1.4 STRUCTURE OF THIS GUIDANCE

The guidance is structured as follows:

- Chapter 2 sets out:
  - the manner in which the Commission proposes to regulate prices
  - the Commission's approach and methodology to assessing a price submission and making a price determination
  - the impact of PREMO on price submission information requirements
  - the Commission's approach to consultation during the review process
  - the assessment process and the 2018 price review timeline.
- Chapter 3 sets out:
  - the 'governing criteria' for each of the components of the building block methodology which will inform the nature and scope of the matters to be included in the price submission, and form the basis of the Commission's assessment of the price submission
  - the supporting information required to be included in the price submission.

2 THE COMMISSION'S APPROACH TO THE PRICE REVIEW

This chapter sets out:

- the manner in which the Commission proposes to regulate prices[9]
- the Commission's approach and methodology to assessing a price submission and making a price determination[10]
- the impact of PREMO on price submission information requirements
- the Commission's approach to consultation during the review process[11]
- the 2018 price review process and timeline.[12]

2.1 THE MANNER IN WHICH THE COMMISSION PROPOSES TO REGULATE PRICES

Clause 12(b) of the WIRO provides that a price determination may specify maximum prices, or the manner in which prices are to be calculated, determined or otherwise regulated, for regulated services in a manner consistent with section 33(5) of the ESC Act — that is, in any manner the Commission considers appropriate.

The Commission will use a building block methodology to determine the revenues that will provide a water business with a reasonable opportunity to recover a rate of return

[9] WIRO, clause 13(a)(i).

[10] WIRO, clause 13(a)(ii).

[11] WIRO, clause 13(a)(viii).

[12] WIRO, clause 13(a)(vi).

on prudent and efficient capital expenditure on assets, a return of the cost of investing in those assets (through depreciation), prudent and efficient operating costs, a benchmark tax allowance and recovery of costs required to comply with relevant health, safety, environmental, social and other regulatory obligations over the next regulatory period.

For a defined regulatory period, the building block methodology involves the following steps:

- first, outcomes that a water business proposes to deliver to its customers will be assessed to validate that they reflect government (and technical regulator) obligations or demonstrated customer needs, and
- second, the following 'building blocks' will be determined in accordance with governing criteria for each element (specified in chapter 3), to:
  - establish an efficient benchmark level of forecast operating expenditure for the next regulatory period
  - establish an efficient benchmark level of capital expenditure for the next regulatory period
  - roll-forward the regulatory asset base
  - apply a rate of return to the regulatory asset base, calculated using:
    - a benchmark cost of debt estimated using a 10-year trailing average approach, and
    - a return on equity value determined by each individual water business's PREMO rating
  - establish a return of capital through a regulatory depreciation allowance
  - establish a benchmark tax allowance.

These 'building blocks' will determine the forecast revenue that is required for a water business to deliver on its service outcomes and obligations.

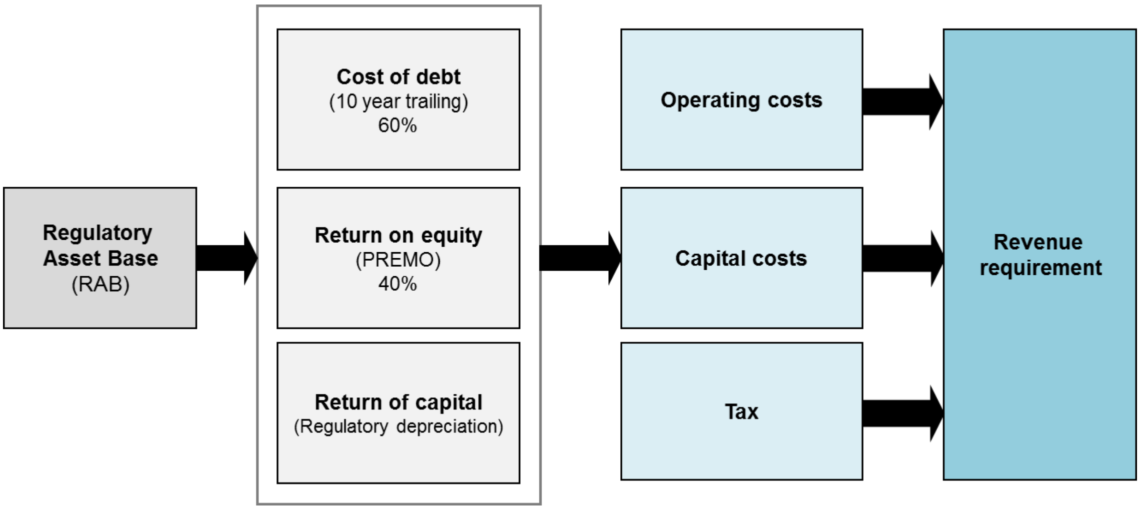
A summary of the building block methodology is shown in figure 2.1.

Once the revenue requirement for the regulatory period has been determined using building blocks, the form of price control that will be applicable to each water business specifies how this revenue is to be translated into customer prices.

The prices charged by Victorian water businesses have previously been regulated under various forms of price control, including price caps (that is, fixed maximum prices), revenue caps (which allow prices to vary with changes in demand during the period to recover the maximum revenue), tariff baskets and hybrid forms of control. The Commission will continue to provide water businesses with discretion to propose the form of price control to be applied for a regulatory period.

The Commission's final determination will specify the prices that are to apply for the year commencing 1 July 2018, and the prices or the manner in which prices will be calculated for the remaining years of the regulatory period.

FIGURE 2.1 REVENUE UNDER BUILDING BLOCKS



2.2 APPROACH AND METHODOLOGY FOR ASSESSING THE PRICE SUBMISSIONS

The Commission's regulatory task is to assess a water business's price submission and form a view about whether or not the price submission:[13]

- has adequate regard for the matters specified in clause 11 of the WIRO, and
- complies with guidance issued by the Commission issued under clause 13 of the WIRO.

2.2.1 ASSESSING THE EXTENT TO WHICH THE PRICE SUBMISSION HAS REGARD FOR MATTERS SPECIFIED IN CLAUSE 11

Clause 11 of the WIRO refers to matters specified in the ESC Act, the WI Act, the Commission's guidance issued under clause 13 of the WIRO, and a number of pricing principles (at clause 11(d)) that the Commission must have regard to in making a price determination.[14]

To facilitate the Commission's assessment, a water business is required to support the proposals in its price submission by reference to the matters in clause 11 of the WIRO. In doing so, a water business is required to place particular emphasis on the matters in clause 8(b) of the WIRO which primarily relate to the promotion of various types of efficiency.[15] Chapter 3 sets out a number of discrete considerations that a price submission must address in order to demonstrate that a water business has fully and meaningfully addressed the clause 11 matters.

[13] WIRO, clause 14(b)(i).

[14] The matters referred to in clause 11 of the WIRO have been grouped into themes in Attachment 3.

[15] In summary, clause 8(b) of the WIRO provides that in having regard to the overarching objectives in the ESC Act and the WI Act, particular emphasis is to be placed on:

(i) the promotion of efficient use of prescribed services by customers;

(ii) the promotion of efficiency in regulated entities as well as efficiency in, and the financial viability of, the regulated water industry; and

(iii) the provision to regulated entities of incentives to pursue efficiency improvements.

2.2.2 ASSESSING COMPLIANCE WITH THIS GUIDANCE

A water business must lodge its price submission with the Commission by **29 September 2017**. The Commission's expectation is that a price submission (including the financial model provided by the Commission) will comply with chapter 3 of this guidance. The Commission will assess whether a water business has sufficiently justified its proposals in accordance with the governing criteria in chapter 3, and satisfied all of the information requirements.

2.2.3 CONSEQUENCES

Consistent with clause 14 of the WIRO, if the Commission forms a view that a price submission complies with the Commission's guidance, and has adequate regard for the matters specified in clause 11 of the WIRO, then it must approve the proposals in a price submission. Otherwise, clause 14 of the WIRO allows the Commission discretion to specify maximum prices, or the manner in which prices are to be calculated, determined or otherwise regulated.[16] This may include the Commission specifying prices for a shorter regulatory period than proposed by a water business.

While expecting that a water business's price submission will comply with the requirements of guidance, the Commission's review will generally focus on matters that have a material impact on the prices customers pay or the services customers receive. The Commission will work with water businesses to facilitate this outcome.

In practice, where a price submission has not fully complied with the guidance, the Commission's intention is to provide the water business with an opportunity to provide the required information before it makes a draft decision.

[16] WIRO, clause 14(b)(i).

2.3 IMPACT OF PREMO ON PRICE SUBMISSION INFORMATION REQUIREMENTS

A major change for the 2018 price review is the introduction of PREMO, an incentive mechanism linking the return on equity reflected in approved prices to the level of ambition expressed in a price submission. The return on equity will depend on whether the price submission is rated as 'Leading', 'Advanced', 'Standard' or 'Basic'.

Section 3.9.4 discusses the manner in which a water business should assess its price submission to decide on the submission's PREMO rating, and therefore the return on equity to be reflected in its proposed prices. Attachment 5 includes a PREMO assessment tool that water businesses must use to inform their PREMO ratings.

The tool includes examples of what might constitute a 'Leading', 'Advanced', 'Standard' or 'Basic' rating for each element of PREMO. For the 2018 price review, the ambition expressed in a price submission will be rated according to four elements of PREMO — Risk, Engagement, Management and Outcomes.[17]

Informed by its assessment for the four elements of PREMO, a business must propose an overall PREMO rating for its price submission. The assessment tool guides a water business to consider its level of ambition in relation to matters covered in its price submission, such as proposals related to operating and capital expenditure, form of price control, tariffs, and demand.

All guidance material for establishing a PREMO rating is presented or referenced in section 3.9.4. The other sections of chapter 3 do not include specific information to assist with PREMO ratings.

[17] The Performance element of PREMO will be assessed at price reviews subsequent to the 2018 review. For more information, see Essential Services Commission Staff Paper 2016b, *Assessing and rating PREMO price submissions*, October, pp. 27–9.

2.4 CONSULTATION BY THE COMMISSION

A greater focus on customer engagement by a water business under the new pricing approach should result in less need for direct engagement by the Commission with customers. This is consistent with the Commission's objectives to emphasise the business and customer relationship, and to provide businesses with greater autonomy.

Compared with past price reviews the Commission expects price submissions to be more heavily informed by customer engagement. Reflecting this, the Commission does not intend to host public meetings (as it has in the past) to test the proposals of a water business before issuing a draft decision. As in past price reviews, the Commission will invite submissions from interested parties on the proposals contained in a water business's price submission prior to making a draft decision.

Following the release of its draft decision, the Commission will invite submissions and intends to hold public meetings before it makes a final decision and issues a price determination.[18]

The Commission will consult with agencies such as the Department of Environment, Land, Water and Planning, the Department of Health and Human Services, and the Environment Protection Authority Victoria.

The Commission will make its papers (including the reports of consultants assisting with its review), water businesses' submissions, and submissions from other interested parties, available on its website (www.esc.vic.gov.au) subject to any confidentiality issues.

If there is information that a water business or customer does not want disclosed publicly, because it is confidential or commercially sensitive, the matter should be discussed with Commission staff before lodging the submission.

[18] WIRO, clause 16(b).

2.5 PROCESS AND TIMELINE

A water business must lodge its price submission with the Commission by **29 September 2017**.[19] The Commission proposes to assess price submissions using a three-stage review process:

- **Stage 1** — Evaluation of all price submissions to verify the quality and strength of the submission and the proposed outcomes for customers, and to establish what further verification work, if any, is needed to inform the Commission's draft decision. If further review is not necessary, the Commission can fast track those submissions through the assessment process and make an earlier draft decision to accept prices, or propose relatively minor changes, effectively bypassing stage 2.
- **Stage 2** — Verification work is tailored to the quality of each price submission that is not fast tracked, which may range from simple requests for further information through to a full review of cost forecasts by an expert consultant. The Commission may make its draft decision for these businesses when it has completed the additional review. In certain cases, the Commission may reject the price submission if it considers it is unable to reach a draft decision based on the information submitted.
- **Stage 3** — Public consultation on the Commission's draft decision, leading to its final decision and a price determination for each business. Earlier final decisions for the fast tracked businesses would be made where consultation did not result in further review being required after the draft decision.

2.5.1 FAST TRACKING PRICE SUBMISSION ASSESSMENTS

As highlighted above, to facilitate a quick and simple stage 1 assessment (and the possibility of fast tracking), a price submission must clearly convey its key messages and data to the Commission. This guidance informs businesses on what to include in their price submissions, consistent with this stage 1 assessment. The financial model (section 3.17.3) must also be accurately completed for a water business to be eligible for fast tracking.

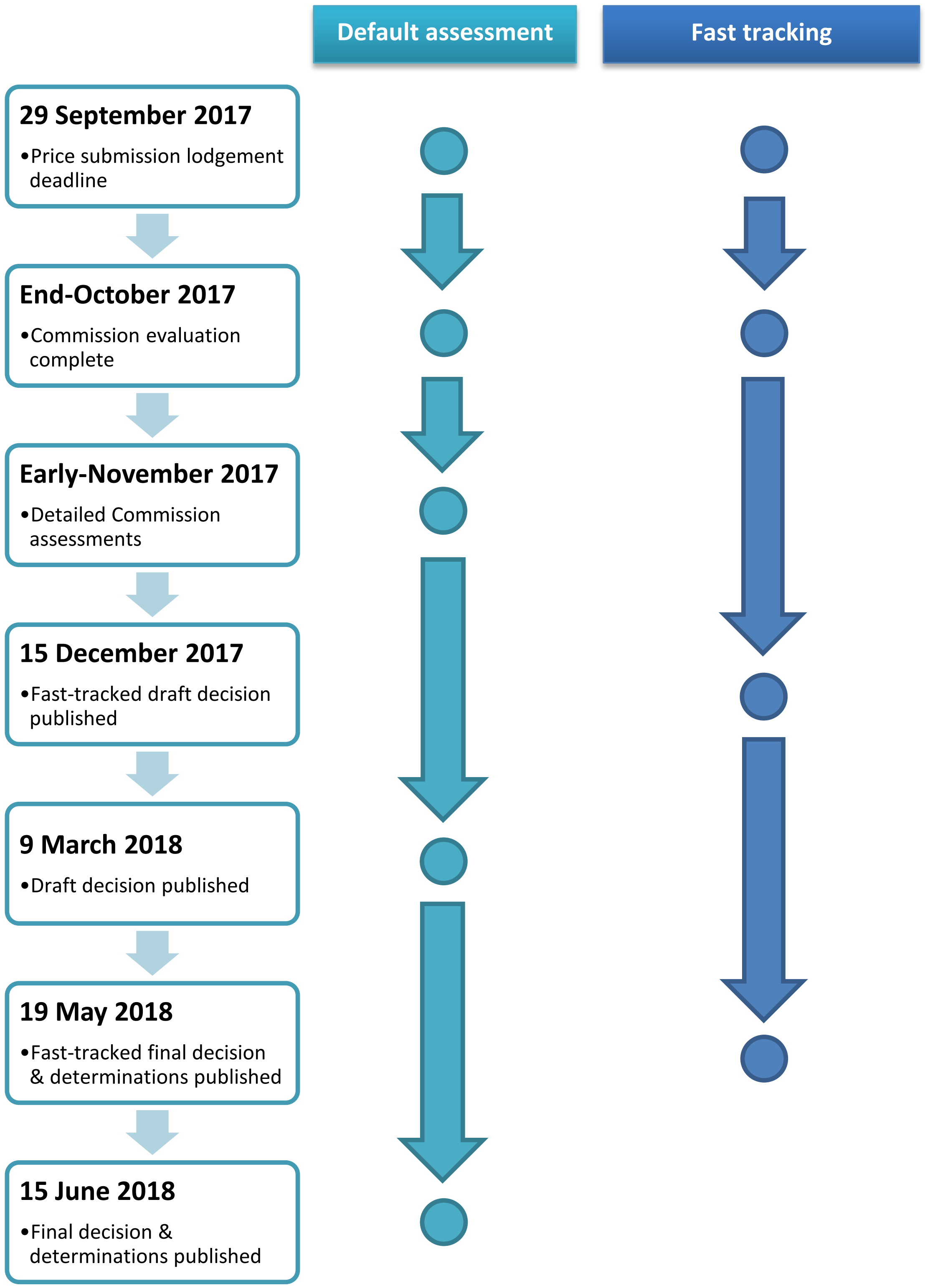
[19] Clause 13(vi) of the WIRO requires the Commission to provide guidance on the timing and processes it proposes to follow in making a price determination. Clause 13(vii) also requires the Commission to specify the date by which the water businesses are to deliver their price submissions to the Commission.

The decision to fast track a price submission is at the Commission's discretion, taking into account the quality of the submission and any other matter the Commission considers relevant.

Figure 2.2 sets out the Commission's assessment process and timeline for the 2018 price review. All dates other than the price submission due date (29 September 2017) are indicative and will be confirmed later in the price review.

Following the release of a fast-tracked draft decision, if the Commission's review process finds there are issues that need to be further explored, the Commission may revert a price submission back to the default assessment process described in figure 2.2.

FIGURE 2.2 PRICE REVIEW TIMELINE AND ASSESSMENT PROCESS



3 REQUIRED CONTENTS OF A PRICE SUBMISSION

Pursuant to clause 13(a)(iii) and clause 13(a)(v) of the WIRO, this chapter sets out the governing criteria and supporting information requirements for the major components of a water business's price submission, covering the regulatory period commencing 1 July 2018 (the **next regulatory period**).

A water business should prepare its price submission with the Commission as its target audience. Although the price submission will be released publicly, it is expected that the content and language will be tailored to facilitate the Commission's review. A business should develop its own separate tools for engaging with its customers and stakeholders on its price and service proposals. The Commission may request copies of customer focused material supporting a price submission.

Price submissions must clearly and succinctly identify and explain how a business's proposals demonstrate value for money for customers — that is, what outcomes will be delivered to customers in return for the prices they pay, and how this reflects what customers value most.

The information requirements specified in this chapter reflect the information the Commission needs to undertake the 2018 price review consistent with the WIRO. Much of the information requested would already exist within normal business practice — for internal planning and corporate reporting, for example. Also, much of the detail can be provided by completing the financial model (issued by the Commission) that forms part of a water business's price submission (see section 3.17.3).

Businesses may, in the interests of brevity, choose not to include all the supporting information for the claims made in their submissions. However, they must be able to provide any supporting information requested by the Commission. For example, a business may reference a consultant’s report in its submission without providing the full report as an attachment.

The Commission expects businesses’ price submissions will focus on those matters having a material impact on the prices customers pay or the services customers receive.

3.1 MANAGING RISK

The WIRO requires the Commission to place particular emphasis on matters relating to various efficiencies in undertaking its regulatory functions in Victoria’s water sector.[20]

Efficiency is promoted when risk is adequately identified, quantified, allocated and, where appropriate, managed by a water business. Prices should reflect the costs incurred in delivering services, incorporating reasonable assumptions about risk. A water business’s price submission must be informed by a robust risk identification process. A water business’s proposals should allocate risk appropriately, and where a business is best placed to do so, specify the mechanisms it will use to manage risk.

Attachment 4 summarises some of the major risks facing a water business, and potential approaches that a water business may propose to deal with risk.

In the past, the Commission has observed many water businesses adopting overly risk-averse assumptions in their price submissions, which implies that customers are expected to bear more than an efficient allocation of risk (one result of this is that proposed prices are higher than they need to be).

For example, in past price submissions some water businesses have:

- proposed to include the costs for highly uncertain projects and large contingencies in capital expenditure forecasts (and therefore, prices)

[20] WIRO, section 8(b)

- sought to justify price increases on the basis of financial viability concerns, without providing evidence they have fully explored other avenues to manage financial performance.

Rather than including upfront allowances for uncertain projects and contingencies, water businesses should seek alternative ways to mitigate construction and capital forecasting risk, such as through better project or contract management. Alternatively, businesses could exclude planned but not fully scoped projects from upfront cost recovery, noting that actual prudent and efficient capital expenditure will be rolled into their asset bases at the end of the regulatory period.

Businesses concerned about financial viability should demonstrate their financial risks through credit rating assessments undertaken by an independent credit rating agency. Water businesses should also demonstrate that they have sought to manage their financial risks before transferring them to customers.

In later sections of chapter 3, the Commission has specified where it requires information on a water business's consideration of risk to support the business's proposals in specific areas including length of the regulatory period, expenditure, form of price control, and tariffs.

However, the Commission is also seeking evidence that a business has given strategic consideration to risk, and identified risks that may have a material impact on the prices customers pay, or the services they receive (taking into account a long-term planning horizon). This is the focus of the information requirements in section 3.1.1.

3.1.1 SUPPORTING INFORMATION

In its price submission a water business must:

- identify any significant risks that may impact on customer prices or services, and if requested, make available to the Commission scenario analysis for each risk including an assessment of the nature and scale of the risk and its probability of occurring
- identify how it has addressed significant risks through its proposals, explain how the business considered the allocation of risk, and demonstrate how its proposals support efficiency

- provide evidence that the business has given strategic consideration to the allocation and management of risk in developing its price submission — this may involve providing references and making available to the Commission material on the business's risk identification and management framework or processes, rather than including detail in a price submission.

Upon request, a water business must also make available to the Commission the following information about significant risks the water business proposes to manage that require cost allowances:

- the categorisation of the risk (as operational or financial risk, for example)
- measurement of the risk including:
  - the nature and scale of the risk
  - the probability of the risk event occurring
  - factors influencing the probability of the risk event occurring
  - the financial or service impact of the risk if it occurs
- options considered for allocating the risk
- rationale for the allocation of the risk, given alternative options
- an explanation of why the regulatory risk mitigation tools listed in Attachment 4 do not adequately mitigate the risk
- the role customers will be expected to play in dealing with these risks and how customers will be engaged in this process.

3.2 REGULATORY PERIOD

3.2.1 CRITERIA

The Commission is required to set the term of the regulatory period over which a water business's price determination will apply.[21] The Commission proposes to set a five year regulatory period term starting 1 July 2018, but remains open to alternatives proposed in a price submission.

A default five year regulatory period provides the following benefits:

- a relatively long period of certainty for a water business's customers about the outcomes to be delivered and prices to be charged
- sufficient time for a water business to focus on service delivery and for the incentive mechanisms within the pricing framework to be implemented.

A risk associated with a longer regulatory period than proposed by the Commission is that revenue or expenditure outcomes could diverge significantly from the benchmarks used to establish prices (possibly resulting in customers paying prices which are significantly above, or below, those required to recover efficient costs).

Accordingly, a business that proposes a regulatory period longer than five years is required to demonstrate that the benefits of a longer period outweigh the potential risks. The level of justification required to support a proposed regulatory period will be greater for a price submission proposing a period longer than five years. The submission should propose checks and balances that will apply during the longer period to ensure customers are receiving value for money.

A water business considering a regulatory period other than five years should engage with the Commission as soon as possible.

[21] WIRO, clause 9.

3.2.2 SUPPORTING INFORMATION

If a water business proposes a five year regulatory period, it needs only to state this in its price submission. If a business proposes a different term, then the submission must:

- provide reasons for the regulatory period, having regard to the benefits and risks identified in section 3.2.1, including demonstrating that the benefits of a longer or shorter period outweigh the risks and costs from a customer's perspective
- outline the results of customer engagement on the length of regulatory period, and how feedback has been taken into account.

In addition, for proposed regulatory periods longer than five years, a price submission must:

- Demonstrate that the expenditure forecasts and asset management plans underpinning the price submission are sufficiently robust, particularly having regard to the capacity of the assets and demand forecasts towards the end of the proposed regulatory period.
- Include details of mechanisms that will provide customers and the Commission with confidence that prices reflect value for money and efficient service delivery after year five of the proposed regulatory period.
- Describe how the business will keep customers engaged throughout the longer regulatory period, including how it will update customers on performance.
- Describe how the business will adapt to changing customer needs during the regulatory period, within the constraints of the determination. For example, the approach to re-aligning capital programs in response to customer preferences.
- Outline the business's approach to dealing with uncertainty and risk during the regulatory period, particularly financial viability risk, having regard to the mechanisms for mitigating risk outlined in Attachment 4.

3.3 CUSTOMER ENGAGEMENT

The WIRO requires the Commission to set out its expectations regarding customer consultation by a water business in developing its price submission.[22] A water business must engage with its customers to inform its price submission. The Commission has not prescribed the manner in which water businesses should engage with their customers. Each business is able to design its own engagement strategy according to its own context.

The following key principles should guide the customer engagement undertaken by water businesses:

- The form of customer engagement undertaken by a water business should be tailored to suit the content on which it is seeking to engage, and to the circumstances facing the water business and its customers.
- A water business must provide customers with appropriate information, given the purpose, form and the content of the customer engagement, and a reasonable and fair opportunity to participate as part of the process.
- A water business's customer engagement should give priority to matters that have a significant influence on the services provided and prices charged by the business.
- A water business should start customer engagement early in its planning. The engagement should be ongoing, to keep testing proposals with customers.
- A water business should demonstrate in its price submission how it has taken into account the views of its customers.

3.3.1 CRITERIA

The Commission will not assess the effectiveness of a water business's customer engagement. For example, the Commission will not "second guess" the form of

[22] WIRO, clause 13(a)(iv)

engagement decided on by a water business. The Commission will focus on the justification provided by a business for undertaking its engagement in the way it did.

The Commission's assessment will consider:

- the business's justification for its decisions on how and when to engage, and the matters that it decided to engage on
- whether customers were given a reasonable and fair opportunity to participate
- how feedback received through customer engagement was taken into account by the business in reaching its proposals (and what feedback was provided to customers)
- the business's justification for how it will address customer expectations that will not or cannot be met.

3.3.2 SUPPORTING INFORMATION

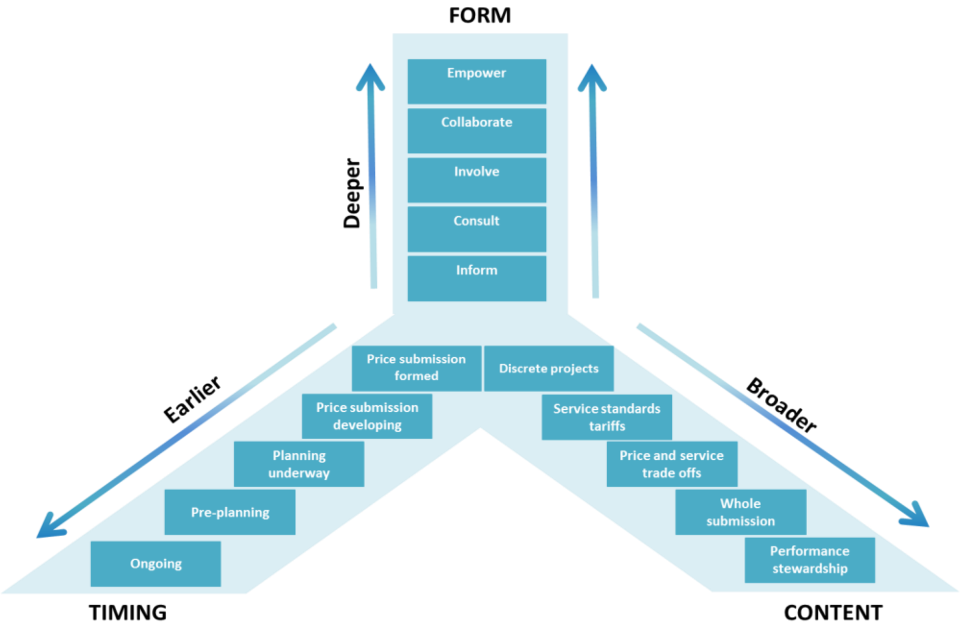
A price submission must:

- describe and justify how and when the business engaged with its customers
- describe and justify the matters covered by customer engagement
- explain what the business learned from customer engagement, and how it satisfied itself that customers were given a reasonable and fair opportunity to participate and that any views expressed were sufficiently representative of its customers
- explain how feedback was taken into account by the business in reaching its proposals
- explain how the business will address customer expectations that will not or cannot be met.

A business must make available, or provide on request, resources and materials provided to customers during its engagement, and any customer feedback about the engagement program.

A water business may use the customer engagement diagram (figure 3.1) as a descriptive tool of its overall program, or of individual activities.

FIGURE 3.1 CUSTOMER ENGAGEMENT DIAGRAM



3.4 OUTCOMES

A water business must propose a set of outcomes that its customers will receive during the next regulatory period. A business must define measurable outputs and deliverables, and associated targets that will be monitored during the next regulatory period to demonstrate the achievement of each outcome.

A water business must report at least annually to its customers on its performance against the specified outputs and deliverables for each outcome.

3.4.1 CRITERIA

Proposed outcomes must demonstrate linkages to customer preferences, as revealed through the business's customer engagement program.

3.4.2 SUPPORTING INFORMATION

A price submission must:

- present a set of customer outcomes, each with measurable outputs and deliverables and associated targets
- explain how the outcomes were informed by the business's customer engagement program
- specify the key actions, activities and programs that the business will undertake to meet its targets (and consequently outcomes)
- demonstrate the connection between the outputs, key actions, activities and programs proposed and achievement of a specified outcome
- present and explain any cost increases or cost savings for operating or capital expenditure that correspond to each outcome (sections 3.7 and 3.8)
- explain how the cost increases or cost savings are reflected in prices charged to customers.

An example of how an outcome links to outputs and deliverables, programs and activities, and inputs is provided in table 3.1.

TABLE 3.1 OUTCOME EXAMPLE
Safe clean drinking water for all customers

Outcome • What the customer will receive	**Safe clean drinking water for all customers**
Outputs and deliverables • Measures and targets • Key projects • Derived with customers	• Compliance with E. coli and turbidity standards • No boil water notices required • Water quality complaints per 100 customers • Percentage of customers that trust the safety of water supply • Completion of specific water quality related capital projects • Publish annual water quality report
Activities and processes • Business programs • Specific actions to be developed/implemented	• Catchment to tap water quality management • Upgrade treatment plant to implement dual barrier protection in accordance with *Safe Drinking Water Act 2003* • Water mains cleaning program • Protections to avoid down time at water treatment plants • Hazard Analysis and Critical Control Points (HACCP) certification • Pass water quality regulator's audit (*Department of Health and Human Services*) • Undertake water quality testing in accordance with regulations • Investigate water quality complaints
Inputs • Costs and/or cost movements • Resources required • Price impact	• $ - opex and capex costs, or cost changes, to deliver or improve the specific programs • Resources • Business unit responsibility

Source: ESC 2016, *Water Pricing Framework and Approach*, October, p. 20.

A business may also choose to describe in its price submission:

- how the business proposes to report on performance against the delivery of its outcomes to customers during the next regulatory period, including:
  - its proposed strategy for communicating its performance to customers
  - how the business might respond to underperformance on outcome delivery
- how the business might adapt its outcomes to respond to changing customer preferences, including an ongoing customer engagement program to inform business priorities throughout the next regulatory period.

Describing the business's proposed customer reporting process may support a water business's PREMO rating.

3.5 GUARANTEED SERVICE LEVELS

The Commission requires each urban water business to propose guaranteed service levels (**GSLs**) for the regulatory period from 1 July 2018 (**a GSL scheme**).[23] GSLs define a business's commitment to deliver a specified service level to individual customers. For each GSL, a business commits to a payment or a rebate on bills to those who have received a level of service below the guaranteed level.[24]

Given the current set of GSLs was most recently established in the Commission's 2013 water price review, the 2018 price review presents a timely opportunity for businesses to review the nature of GSLs, and the payment or rebate amount that will apply in the event of a breach of a GSL. The rebate amounts should be reviewed in consultation with customers given the changes in prices since 2013.

A water business may use its proposed GSL scheme to support its rating for the 'Risk' element of PREMO. The customer payment or rebate amounts established under the GSL scheme can indicate the extent to which a business is taking on revenue risk to provide incentives for it to deliver efficient levels of service to customers.

3.5.1 CRITERIA

A GSL scheme will:

- reflect the main service priorities and concerns of customers, informed by a water business's customer engagement
- provide incentives for the business to provide efficient service levels to all customers.

Each GSL must be objectively defined, easily understandable, and able to be reported.

[23] Southern Rural Water should engage with its customers to ascertain whether a GSL scheme is appropriate.

[24] Essential Services Commission 2016a, *op. cit.*, p. 21.

The GSL scheme must include the payment difficulty information disclosure GSL that has been in place since 2010.[25] That is, a payment or rebate will be made available to customers if a business breached its service level obligation by:

> *Restricting the water supply of, or taking legal action against, a residential customer prior to taking reasonable endeavours to contact the customer and provide information about help that is available if the customer is experiencing difficulties paying.*

3.5.2 SUPPORTING INFORMATION

A price submission must specify each GSL and the corresponding payment or rebate amount that will apply where a customer has received a level of service below the guaranteed level. A price submission must identify and justify any changes to the GSL scheme compared with those approved for the current regulatory period.

For any new or amended GSL, a price submission must:

- explain the basis for the GSL, including how it has been informed by customer engagement
- specify whether benefits to customers will take the form of payments or rebates
- explain the reasons for the proposed size of the customer payment or rebate that applies to each GSL.

[25] Previously known as the hardship related GSL, refer to: Essential Services Commission 2012, *Hardship Related Guaranteed Service Level Scheme Review – Final Decision*, May. The latest (3 February 2015) check-list for minimum "reasonable endeavours" at the time of this paper can be found at http://www.esc.vic.gov.au/water/codes-guidelines/hardship-related-guaranteed-service-level/

3.6 REVENUE REQUIREMENT

The Commission's decision on a water business's revenue requirement for the next regulatory period must meet the WIRO objectives of promoting and providing incentives for efficiency in the regulated entities, as well as efficiency in, and the financial viability of, the regulated water industry.[26]

3.6.1 CRITERIA

The required revenue for a water business for the next regulatory period must be determined using the building block methodology, under which the building blocks are:

- prudent and efficient forecast operating expenditure — determined in accordance with section 3.7
- prudent and efficient forecast capital expenditure — determined in accordance with section 3.8
- return on the regulatory asset base (RAB) — determined in accordance with the sections below:
  - the 'roll forward' of the RAB — determined in accordance with section 3.9.1
  - the cost of debt — determined in accordance with section 3.9.3
  - return on equity — determined in accordance with section 3.9.5
- return of capital through a regulatory depreciation allowance — determined in accordance with section 3.9.2.
- a benchmark tax allowance — determined in accordance with section 3.10.

The revenue requirement is net of any additional revenue earned from regulated assets, outside of scheduled tariffs — revenue from the sale of water entitlement allocations, for example. The revenue requirement is also net of any revenue earned from non-prescribed services (discussed at section 3.17.8).

[26] WIRO, section 8(b).

3.6.2 SUPPORTING INFORMATION

The price submission must specify a water business's forecast total revenue required for the next regulatory period. The forecast revenue required must also be provided for each year of the next regulatory period.

The price submission must also provide an estimate of the required revenue for each year after the next regulatory period to at least 2027-28, providing a brief explanation of the reasons for the trend in the forecast over the ten year period from 1 July 2018.

3.7 FORECAST OPERATING EXPENDITURE

3.7.1 CRITERIA

The forecast operating expenditure to be included for the purposes of determining the required revenue is operating expenditure which would be incurred by a prudent service provider acting efficiently to achieve the lowest cost of delivering on service outcomes over the regulatory period, taking into account a long-term planning horizon (**prudent and efficient forecast operating expenditure**).

The Commission considers that a prudent and efficient operating expenditure forecast has the following characteristics:

- baseline year expenditure is reflective of efficient operating costs and is used as a basis to forecast expenditure
- forecast operating expenditure incorporates expectations for a reasonable rate of improvement in cost efficiency
- expenditure requirements above the baseline year (adjusted for growth and efficiency improvements) are fully explained and justified.

3.7.2 SUPPORTING INFORMATION

A price submission must include a forecast of total prudent and efficient operating expenditure for the next regulatory period, including a forecast for each year of the next regulatory period. Forecast operating expenditure is to be presented separately for each major service category.[27]

For total and annual forecast operating expenditure and for each major service category, forecast operating expenditure for each year of the next regulatory period, and beyond to at least 2027-28, must be further broken down where relevant, in the financial model for:

- operations and maintenance
- bulk charges (further broken down into bulk charges by type and system, for example, transfer charges, Greater Yarra System – Thompson River fixed charges, Victorian Desalination Plant – Water Order variable charges)
- treatment
- customer service and billing
- GSL payments
- licence fees (Essential Services Commission, Department of Health and Human Services, and EPA Victoria)
- corporate costs, and
- other operating expenditure.

Forecasts for the environmental contribution must also be provided in the financial model.

A business must also provide actual operating expenditure for the current regulatory period (using forecasts for 2017-18), categorised in the same way as above, in the financial model.

Forecast operating expenditure must be presented relative to a reference or baseline operating year (box 3.1), with allowance for customer growth and cost efficiency improvements over the next period. Any significant changes in the forecast years' costs relative to this baseline year must be clearly presented and explained, including how

[27] Depending on the business, the major service categories may include water, sewerage, recycled water, bulk water, rural water, irrigation, drainage, domestic and stock, and diversions.

they are reflected in the proposed customer outcomes and how they represent improved customer value (section 3.4).

The Commission's financial model sets out the forecast operating costs consistent with this methodology.

BOX 3.1 BASELINE CONTROLLABLE OPERATING EXPENDITURE

In preparing forecast operating expenditure, a price submission must establish a baseline controllable operating expenditure which comprises efficient recurring controllable costs from the last full year of actual data (2016-17) for those activities and services that are expected to be incurred throughout the next regulatory period.

The baseline is established from the actual prescribed operating expenditure for 2016-17, adjusted as follows:

- remove any non-controllable expenditure[28]
- remove any one-off or non-recurring expenditure items incurred in that year, or add any normally occurring items that did not occur in that year
- remove any further ongoing cost savings or efficiency commitments that will be realised in the final year of the current regulatory period (2017-18), for example commitments made by a water business following its efficiency review in 2014.[29]

A price submission must justify the adjustments proposed to the baseline year in order to establish the baseline controllable operating expenditure, and demonstrate that this represents efficient ongoing operating costs (consistent with any efficiency targets for the current regulatory period[30]).

[28] Controllable costs are those that can be directly or indirectly influenced by a water business's operational decisions. Examples of non-controllable costs include: bulk water costs (where prices are set by the Commission), regulatory licence fees, and the environmental contribution.

[29] All Victorian water businesses undertook an efficiency review in 2014 as part of Fairer Water Bills.

[30] The Commission required businesses achieve a 1 per cent per year efficiency improvement on their controllable operating expenditure over the 2013–18 regulatory period.

Using the 2016-17 baseline controllable operating expenditure, a water business must propose and justify:

- its forecast customer growth rate assumptions (for each year)[31]
- its annual cost efficiency improvement rate (for each year)
- how proposed cost changes deliver improved customer value.

A price submission must also:

- demonstrate how proposed cost changes relate to the proposed customer outcomes and the associated outputs and deliverables (section 3.4), and in particular:
  - identify and explain operating expenditure savings or new operating expenditure arising from capital expenditure and projects
  - explain any trend or major annual variations in forecast operating expenditure (including identifying cost items[32] that are having an upward or downward influence on operating expenditure) compared with historic operating expenditure.
- demonstrate that proposed costs associated with new or revised regulatory obligations and policy requirements are prudent and efficient
- set out and where relevant, justify the non-controllable cost forecasts including:
  - bulk water purchases from other water businesses
  - regulatory licence fees
  - environmental contribution
  - any other proposed non-controllable costs

The price submission should explain the business's approach to allocating shared costs, or reference documentation that may be requested by the Commission to verify the business's approach.

[31] Businesses should draw on Victoria in Future forecasts, Australian Bureau of Statistics data, and other information as required.

[32] Including, but not limited to, assumptions and trends relating to:

- wage and salary escalations, total labour costs and employee number assumptions
- electricity and energy costs, and underlying volume and load assumptions
- information technology costs.

3.8 FORECAST CAPITAL EXPENDITURE

Capital expenditure forecasting essentially involves anticipating the scope, timing and costs for a large number of various sized projects, ranging from the replacement of existing assets at the end of their lives to the construction of major new assets and facilities.

In preparing capital forecasts, water businesses should avoid including speculative capital expenditure in their price submission forecasts. Where capital projects are not fully scoped, costed or internally approved (via an approved business case, for example) at the time of preparing the price submission, a business should consider the following options so that customers are not asked to bear the full cost should the project scope or timing change:

1. Include sufficient expenditure to cover only the development costs of the project, with efficient actual construction costs incurred during the period to be rolled into the RAB at the end of the period, along with any accumulated interest. This provides sufficient revenue allowance for the project to proceed during the next regulatory period, with cost recovery to commence in the following regulatory period at no net loss to the business.
2. Include development costs and a notional allowance for construction, with the balance of efficient construction costs (plus associated interest) to be rolled into the RAB at the end of the period. This allows a reasonable portion of the project, based on the various options and cost estimates at the time of preparing the price submission, to be included in prices.
3. Identify the project as a possible 'uncertain and unforeseen event' to be addressed via the mechanisms outlined in section 3.14 during the regulatory period.

3.8.1 CRITERIA

The forecast capital expenditure to be included for the purposes of determining the required revenue is capital expenditure that would be incurred by a prudent service provider acting efficiently to achieve the lowest cost of delivering service outcomes, taking into account a long-term planning horizon (**prudent and efficient forecast capital expenditure**).

The Commission considers that prudent and efficient capital expenditure has the following characteristics which reduce the risk borne by customers:

- required expenditure is based on a P50 estimate, in which there is an equal likelihood of project costs being higher or lower than forecast (noting a P50 estimate may not be appropriate where a business's proposed capital program is dominated by one or two major projects)
- contingency allowances are optimised
- forecast capital expenditure for renewals incorporates expectations for a reasonable rate of improvement in cost efficiency
- risks of project delays and cost overruns are managed through contractual agreements with service providers.

Where actual construction costs are found to exceed their efficient level, the Commission will not roll these inefficient expenditures into the regulatory asset base. Inefficient costs will be worn by the business and will not be recovered from customers.

3.8.2 SUPPORTING INFORMATION

A price submission must include a forecast of total prudent and efficient capital expenditure for the next regulatory period, including forecast capital expenditure for each year of the next regulatory period.

Forecast capital expenditure is to be presented by major service category[33] and by the following cost drivers:

- forecast capital expenditure to maintain service standards — that is, renewals
- forecast capital expenditure to expand or improve services — that is, growth and improvements/compliance (improvements or upgrades to existing services or to comply with existing or changed government or regulator obligations).

[33] Depending on the business, the major service categories may include water, sewerage, recycled water, bulk water, rural water, irrigation, drainage, domestic and stock, and diversions.

The business's financial model must also specify actual capital expenditure for the current regulatory period (including a forecast for 2017-18), categorised in the same way as above.

Capital expenditure will fall into one of three key types:

- Major capital projects — large, discrete capital investment projects (may be completed within a regulatory period, or may span more than one period)
- Capital programs — ongoing programs of capital expenditure allocation, containing multiple works or projects (for example; water main renewals, sewer odour management, ICT equipment upgrades, etc.)
- Other capital expenditure — typically smaller discrete projects and programs.

A price submission must present the capital expenditure forecasts set out according to these three key types, as follows:

Major capital projects — comprising the 'top 10' discrete capital projects, by total capital cost, to be started or completed during the next regulatory period. A business may also include significant discrete projects that fall outside the top 10 by cost — those large but uncertain projects to be addressed by the alternative options described above, for example. For each of these major projects, provide:

- the project name and scope, and relevant major service and asset category
- justification for the project, including the cost driver
- start and completion dates
- total capital cost (itemising any government or customer contributions), and expenditure by year
- objectives of the project, including how the project aligns with the various customer outcomes proposed (section 3.4)
- and have available:
  - a business case outlining the options considered for achieving the identified objectives and the approach to identifying the optimal solution[34]

[34] This should also include an assessment of a 'do nothing' option. Cost comparisons of various options should consider P5, P50 and P95 estimates. Forecasts for capital expenditure must be based on the P50 estimate.

- risk analysis of the selected option and plans to mitigate the identified risks to ensure the project can be delivered on budget and on time
- the incentive and penalty payment arrangements with contractors[35]
- information to identify whether the project has (or will be) the subject of competitive tendering.

Capital programs — all key capital expenditure programs or allocations that will be ongoing throughout the regulatory period (excluding any discrete projects separately specified in the 'top 10' above). For each program, provide:

- the program (or cost allocation) name, and relevant major service category
- the cost driver
- total capital cost (itemising any contributions), and expenditure by year
- objectives of the program, including how the program aligns with the various customer outcomes proposed (section 3.4)
- historical annual costs, and an explanation for significant increases or decreases in the forecast average annual expenditure
- and have available:
  - the list of projects included within the program or cost allocation for the next regulatory period, and business cases and options analyses
  - a description of the methodology for assessing risk and prioritising projects within the program
  - the cost estimation basis.

Other capital expenditure — all other capital expenditure not associated with a defined major project or major capital program should be grouped into one or more programs as appropriate, to be included under the capital programs list, as above.

[35] A business's proposed prices must reflect incentive and penalty payment arrangements that are based on a symmetrical sharing of risk for delivery or non-delivery of projects.

Consistent with the above capital expenditure breakdowns (by type and major service category) in the price submission or financial model where appropriate, a water business must also:

- for each year of the next regulatory period, and beyond to at least 2027-28, provide annual forecasts for capital expenditure separately identifying (where appropriate) and reconciling:
  - total capital expenditure
  - contributions (government and customer)
  - gifted assets
  - proceeds from asset sales
  - written down value of assets disposed, and
  - net capital expenditure.
- explain the methodology used to estimate forecast capital expenditure
- identify and explain the key assumptions which underpin the capital expenditure forecasts by each major service category, and how any risks or uncertainties have been addressed
- justify the timeframe for delivering the proposed new capital expenditure given the business's delivery of major projects in the past
- explain the reasons for the trend or any major annual variations in forecast capital expenditure (including identifying cost items that are having an upward or downward influence on capital expenditure), compared with historic capital expenditure
- justify the total forecast capital expenditure against the criteria in section 3.8.1, taking into account:
  - forecast demand
  - any relevant industry or economy-wide benchmarks of expenditure
  - the substitution possibilities between forecast operating expenditure and forecast capital expenditure.

The Commission's financial model sets out the forecast capital expenditure consistent with the breakdowns and methodology described above.

3.9 RETURN ON THE RAB

A regulatory rate of return is applied to the RAB to calculate the annual return on the RAB to be included in the revenue requirement. The regulatory rate of return comprises two components: a return on equity and a cost of debt.

A key feature of the Commission's new pricing approach is that the return on equity reflected in prices will be established via the PREMO rating process (detailed in section 3.9.4).

The benchmark cost of debt is determined based on a trailing average approach. A benchmark gearing level of 60:40 debt to equity will apply.

The formula for the regulatory rate of return is therefore:

> Regulatory rate of return = Re 0.4 + Rd 0.6
>
> Where:
>
> Re = PREMO rate of return on equity
>
> Rd = benchmark 10 year trailing average cost of debt.

The benchmark regulatory rate of return must be calculated in nominal terms, and then converted to real terms.[36]

3.9.1 FORECAST REGULATORY ASSET BASE

CRITERIA

The regulatory asset base (**RAB**) calculated for the purposes of determining the required revenue must reflect capital expenditure (less regulatory depreciation,

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[36] The Fisher equation will be used to convert from nominal to real estimates; that is:

(1 + nominal rate) = (1 + real rate) * (1 + inflation rate)

The Commission will use a market based inflation estimate (based on the Australian Bureau of Statistics Consumer Price Index – weighted average of eight capital cities, all groups) and specify the applicable inflation rate in the financial model.

contributions and/or asset disposals) which would be incurred by a prudent service provider acting efficiently to achieve the lowest cost of delivering on service outcomes, taking into account a long-term planning horizon (**prudency criteria**).

The opening RAB must be calculated as follows:

Opening RAB 1 July 2018 = RAB at 1 July 2013 $_{\text{(adjusted to reflect 2012-13 actual)}}$

+ Actual capital expenditure (gross) $_{\text{2013-14 to 2016-17}}$

+ Forecast capital expenditure (gross) $_{\text{2017-18*}}$

– Actual contributions $_{\text{2013-14 to 2016-17}}$

– Forecast contributions $_{\text{2017-18**}}$

– Forecast regulatory depreciation $_{\text{2013-14 to 2017-18*}}$

– Proceeds from disposal of assets $_{\text{2013-14 to 2016-17}}$

– Forecast proceeds from disposal of assets $_{\text{2017-18**}}$

(*denotes the forecast used in the 2013 price determination)

(** denotes the latest available forecast for 2017-18)

Where the up-to-date 2017-18 gross capital expenditure forecast is lower than the forecast benchmark for that year in the 2013 price determination, then the business must use the lower amount.

The same approach must be used to determine the opening value on 1 July for each subsequent year in the next regulatory period, using the forecasts for capital expenditure, customer and government contributions, regulatory depreciation and asset disposals.

In addition, the opening RAB (at 1 July 2013) must be adjusted for inflation (based on the Consumer Price Index – all Groups, Australia) over the current regulatory period.

SUPPORTING INFORMATION

A price submission must propose:

- the closing value for the RAB at 30 June 2017 (using actual data)
- the opening value of the RAB at 1 July 2018 (calculated according to the criteria above)
- the forecast value of the RAB for each year of the next regulatory period, in accordance with the prudency criteria set out above
- the forecast value of the RAB for each year after the next regulatory period until at least 2027-28.

A price submission must also:

- provide estimates for regulatory depreciation (section 3.9.2)
- provide separate data and justify estimates for:
  - government contributions — federal, state and local government contributions towards the capital cost of a project
  - customer contributions — upfront cash payments made by new customers
  - the value of gifted assets — assets constructed and then handed over to the water business to operate and maintain
- include estimates of revenue expected from disposal of assets for each year from 1 July 2018, to be deducted from the roll forward of the RAB.

To assist with its review, the Commission may seek further information on a water business's justification for capital expenditure in 2012-13 and in the period 2013-14 to 2016-17. The Commission may also request a reconciliation of actual net capital expenditure against the benchmarks allowed in the water business's 2013 price determination.

3.9.2 REGULATORY DEPRECIATION

The Commission recognises a return of capital expenditure (regulatory depreciation), commencing when the asset enters service. The Commission prefers a straight line depreciation profile.

The estimates and profiles for regulatory depreciation should reflect reasonable assumptions about asset life and utilisation.

Water businesses can propose an alternative approach to straight line depreciation having regard to the following assessment principles:

- the depreciation rate should account for technological change, projected future demand and any other factors that may affect the value of the assets in the future
- the technical lives of assets, and
- impact on prices over the long-term.

3.9.3 COST OF DEBT

The Commission will use a 10 year trailing average approach to estimate the benchmark cost of debt. The trailing average approach will determine the whole cost of debt (risk free rate and debt risk premium). The averaging period will be the 10 years preceding the year in which the rate applies.

Each year, the 10 year trailing average cost of debt will be updated by rolling forward the data series by one year, such that:

- the cost of debt for the roll-forward (previous) year reflects the yields of the RBA 10 year BBB rated corporate bond – Reserve Bank of Australia Table F3 series FNFYBBB10M
- the annual update is a simple average of 12 months of the RBA 10 year BBB rated corporate bond over 1 April to 31 March
- the trailing average is a simple average of 10 years of cost of debt, and
- the cost of debt is calculated in nominal terms.

The historical data series for the cost of debt calculated using the method described above is set out in table 3.2.

TABLE 3.2 HISTORICAL COST OF DEBT
Nominal

	2008-09	2009-10	2010-11	2011-12	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18
Cost of debt	6.9%	7.4%	7.0%	6.3%	5.3%	7.1%	5.4%	5.3%	5.3%[a]	5.3%[a]

[a] The cost of debt for 2016-17 and 2017-18 will be updated to reflect annual averages based on actual data, prior to the final decision.

Data source: Treasury Corporation Victoria and the Essential Services Commission

A business is not required to submit information on the cost of debt in its pricing proposals, as the cost of debt will be determined on the basis of the external data outlined above. However, the business must use the values above to estimate its revenue requirement and prices (the values in table 3.2 will be reflected in the financial model).

The cost of debt specified in a price determination for each year of the next regulatory period will be the rate calculated for the ten years up to and including 2017-18. During the next regulatory period, the cost of debt will be updated annually as outlined above. In section 3.14, the guidance notes that businesses must propose an annual adjustment mechanism to allow prices to adjust due to changes in the cost of debt.

3.9.4 PREMO RATING

The return on equity to be reflected in prices will be established via the PREMO incentive mechanism,[37] under which a water business's return on equity will be linked to the level of ambition expressed in its price submission.

Under PREMO, a water business must self-assess the level of ambition of its price submission as either 'Leading', 'Advanced', 'Standard' or 'Basic'. The Commission will also independently assess the price submission and also rate it as 'Leading', 'Advanced', 'Standard' or 'Basic'. This two stage PREMO assessment and rating process will determine the return on equity to be reflected in approved prices.

[37] For more detail, see Essential Services Commission 2016a, *op. cit.*, pp. 9–13.

The range of possible outcomes (in real terms) for the return on equity resulting from the two stage assessment and rating process is provided in figure 3.2.

FIGURE 3.2 REGULATED RETURN ON EQUITY (REAL)

ESC assessment of submission \ Water business self-assessment	Leading	Advanced	Standard	Basic
Leading	5.3			
Advanced	4.7	4.9		
Standard	4.1	4.3	4.5	
Basic			3.9	4.1

The best outcomes for a water business in terms of the return on equity will be achieved when the Commission and the business align in their respective assessments. Situations of aligned assessments are represented by the upper diagonal of the matrix shown in figure 3.2. The more ambitious the submission according to both the business and the Commission, the greater will be the allowed return on equity.

The grey shaded area above this diagonal indicates the Commission will not assess a price submission more favourably than the water business's self-assessment. This provides an incentive for the business to put forward its best offer, and to provide an honest assessment of the appropriate price submission rating.

If the Commission finds a water business has overstated its ambition, then the return on equity will be lower than had the water business accurately assessed itself. This can be seen in the diminishing values moving left along each row in figure 3.2.

Consistent with the WIRO, the Commission considers that the incentives embedded in the return on equity matrix at figure 3.2 are in the best interests of Victorian water customers, as it reduces the likelihood of water businesses being allowed rates of return that are not commensurate with the outcomes it proposes to achieve. It also supports an incentive-based framework that will deliver better consumer outcomes.

The (red) shaded zone at the bottom of the matrix represents an area within which the Commission will reserve its discretion. For example, it may require the water business to resubmit its proposal, or approve a shortened pricing period if it rates a business's submission to be in this part of the matrix.

Together, the design features of the matrix provide the businesses with a strong incentive to assess their price submissions accurately and honestly.

For the 2018 price review, the ambition expressed in a price submission will be rated according to four elements of PREMO — Risk, Engagement, Management and Outcomes.[38]

A water business must self-rate its price submission for each of these four elements, and use these ratings to arrive at its overall PREMO rating and corresponding return on equity.

CRITERIA

A price submission must identify the water business's self-rating of its submission as 'Leading', 'Advanced', 'Standard' or 'Basic'. A price submission must also identify the rating for the Risk, Engagement, Management and Outcomes elements of PREMO.

The Commission will agree with a water business's self-ratings where the business provides transparent and credible evidence to justify the ratings. The guiding questions

[38] The Performance element of PREMO will be assessed at price reviews subsequent to the 2018 review. For more information, see Essential Services Commission Staff Paper 2016b, *Assessing and rating PREMO price submissions*, October, pp. 27–9.

in table 3.3 set out the matters the Commission will consider in assessing a water business's proposed PREMO ratings.

Attachment 5 includes a PREMO assessment tool that water businesses must use to inform their PREMO ratings. The tool includes examples of what might constitute a 'Leading', 'Advanced', 'Standard' or 'Basic' rating for each element of PREMO. Informed by the assessment for each element of PREMO, a business must propose an overall PREMO rating for its price submission. Attachment 5 also includes a scoring methodology to assist businesses with this rating process.

TABLE 3.3 GUIDING QUESTIONS FOR PREMO ASSESSMENT

PREMO Element	Guiding questions
Outcomes	Has the business provided evidence that the outcomes proposed have taken into account the views, concerns and priorities of customers? Has the business provided sufficient explanation of how the outcomes it has proposed align to the forecast expenditure requested? Has the business proposed outputs to support each of its outcomes, which are measurable, robust and deliverable? Has the business provided evidence that the outputs it has proposed are reasonable measures of performance against stated outcomes? Has the business demonstrated a process to measure performance against each outcome and to inform customers?
Management	To what extent has the business demonstrated how its proposed prices reflect only prudent and efficient expenditure? To what extent has the business justified its commitment to cost efficiency or productivity improvements? To what extent have senior management, including the Board, demonstrated ownership and commitment to the proposals in its submission? To what extent has the business justified or provided assurance about the quality of the submission, including the quality of supporting information on forecast costs or projects? To what extent has the business provided evidence that there is senior level, including Board level, ownership and commitment to its submission and its outcomes?
Engagement	To what extent has the business justified how the form of engagement suits the content of consultation, the circumstances facing the water business and its customers? To what extent has the business demonstrated that it provided appropriate instruction and information to customers about the purpose, form and content of the customer engagement? To what extent has the business demonstrated that the matters it has engaged on are those that have the most influence on the services provided to customers and prices charged? To what extent has the business explained how it decided when to carry out its engagement? To what extent has the business demonstrated how its engagement with customers has influenced its submission?
Risk	To what extent has the business demonstrated a robust process for identifying risk, and how it has decided who should bear these risks? To what extent does the proposed guaranteed service level (GSL) scheme provide incentives for the business to be accountable for the quality of services delivered, and provide incentives to deliver valued services efficiently?

SUPPORTING INFORMATION

A price submission must provide information that satisfies the procedural requirements set out in the criteria above. The price submission must also:

- identify the reasons for the self-ratings for the Risk, Engagement, Management and Outcomes elements of PREMO, with reference to the guiding questions above
- identify the reasons for the price submission's overall PREMO rating.

The Commission intends to hold workshops in 2017 to provide further guidance on the PREMO price submission ratings.

3.9.5 RETURN ON EQUITY

The price submission PREMO rating proposed by a water business will correspond with a value for a return on equity to be reflected in its price submission (table 3.4).

TABLE 3.4 MAXIMUM RETURN ON EQUITY FOR EACH PREMO RATING
Real per annum rate

	Leading	Advanced	Standard	Basic
Maximum return on equity to be reflected in business's proposed revenue requirement	5.3	4.9	4.5	4.1

CRITERIA

A water business's proposed revenue requirement must incorporate a value for the return on equity that is no higher than the value specified in table 3.4 for its proposed price submission rating. For example, an 'Advanced' rating will correspond with a maximum return on equity of 4.9 per cent. No further supporting information regarding the water business's return on equity is required.

3.10 TAX ALLOWANCE

3.10.1 CRITERIA

The tax allowance included for the purposes of determining the required revenue must reflect an estimate of the corporate income tax to be paid, less the imputation credits that would be received by a hypothetical private investor in the water business. In estimating the value of imputation credits the water business must multiply the annual estimated corporate income tax bill by an imputation factor.

This is consistent with the income tax calculation in the financial model.

3.10.2 CALCULATING THE TAX ALLOWANCE

Once populated by the water business, the financial model will include an estimate of the business's future nominal tax allowance based on the following formula:

$ETC_t = (ETI_t \times r_t)\,(1 - \gamma)$, where:

- ETC_t is an estimate of the future nominal tax allowance
- ETI_t is an estimate of the taxable income for each regulatory year
- r_t is the expected statutory income tax rate for each regulatory year
- γ is the value of imputation credits (which will be at the rate of $0.50 for every $1 of company tax paid, as in past price reviews).

In relation to the estimate of ETI_t for each year of the next regulatory period:

- the revenue and expenditure estimates used in the calculation are the same revenue and expenditure estimates used to establish maximum prices (except that customer contributions and gifted assets are treated as revenue)
- the interest expenses (deductions) reflect the nominal cost of debt and the assumed stock of debt (that is, gearing multiplied by the regulatory asset base)[39]

[39] The nominal cost of debt will be calculated using a 10 year trailing average (section 3.9.2). The tax allowance will be kept constant for the regulatory period consistent with the values in the price determination and will not vary with the cost of debt

- the calculation allows for an adjustment to reflect tax depreciation.

The financial model provides an adjustment to the nominal tax allowance for inflation, in order to derive the real tax allowance for each regulatory year. This estimate must be used by the water business as the basis for its tax allowance forecasts. The forecast tax allowance may also be informed by the business's latest estimate of tax to be paid over the next regulatory period.

While in past price reviews the statutory tax rate has been fixed in the financial model at 30 per cent, the financial model now allows the rate to be entered for each year of the next regulatory period, to allow a business to reflect any expected changes in the applicable tax rate. Businesses should estimate the applicable tax rate and include it in the relevant input fields in the financial model.

3.10.3 SUPPORTING INFORMATION

The price submission must propose a total tax allowance for the next regulatory period. An estimate must also be provided for each year of the next regulatory period.

The price submission must also:

- state the basis on which the tax allowance for the next regulatory period has been calculated
- provide an estimate of the income tax for each year after the next regulatory period up until at least 2027-28
- provide the business's latest corporate forecasts for annual tax payments for the next regulatory period, and make available to the Commission the basis for the forecasts.

3.11 DEMAND

3.11.1 CRITERIA

Demand forecasts proposed by a water business must represent the best available estimates derived from an appropriate forecasting methodology. Assumptions on the key drivers of demand over the next regulatory period must be well explained and reasonable.

3.11.2 SUPPORTING INFORMATION

A price submission must summarise a business's demand forecasts, including expected trends for the next regulatory period, as well as outline the key assumptions adopted to develop those forecasts. A business should use at least a 10 year horizon for demand forecasting and scenario work, and reflect this in its price submission.

A price submission must also include:

- a description of the key demand forecasting issues that lists and justifies the most important assumptions adopted in generating the forecasts — demand forecasts should be based on the latest Victoria In Future forecasts issued by the Victorian Government
- a description of the forecasting methodology used, and the justification for using the methodology
- reference to any external reports or information relied upon
- a description of how forecasts have accounted for the impact of any proposed changes to tariff structures or form of price control expected in the next regulatory period
- details on the levels of restrictions or nature of any permanent water conservation measures reflected in the forecast
- written information on where price elasticity was applied, the input assumptions used, and how the assumptions were translated into the business's demand forecasts

- an explanation of how demand forecasts are consistent with proposed expenditure (in terms of the level and nature of expenditure).

A water business must also make available on request by the Commission, evidence that a range of supply and demand scenarios were modelled, including low, normal and high water inflow scenarios, and written justification for the selection of the modelled scenario.

The financial model will require a water business to provide detailed demand forecasts for every tariff and tariff category, by residential and non-residential customers. If detailed forecasts at this level are unavailable, a business must explain why and provide estimated demand for these services. The detail in the model does not need to be reproduced in the price submission.

3.12 FORM OF PRICE CONTROL

The Commission's framework and approach paper noted various options for water businesses to consider in terms of the form of price control.[40] Most businesses currently use a price cap, revenue cap, or tariff (or price) basket form of price control. A different form of price control may be used for the different services delivered by a water business.

In considering whether to approve a proposed price control, the Commission will have particular regard to whether the proposal involves a continuation of an existing structure or the introduction of a new price control.

Where an existing price control structure is being continued, the justification requirements below may be satisfied more easily. Where a change is proposed, however, the water business will need to provide evidence to demonstrate that the new price control better satisfies the requirements in clause 11 of the WIRO than the existing structure.

[40] Essential Services Commission 2016a, *op. cit.*, p. 33.

3.12.1 CRITERIA

The Commission will assess proposals against the following factors:

- the business's justification for the proposed form of control, including its consideration of efficiency and risk allocation and management
- the business's approach to consultation on the form of control and how the views of customers were taken into account
- whether the business has considered and demonstrated that appropriate transition strategies will be implemented for affected customers
- the administrative complexity of the proposed form of control
- the ability of customers to understand the resulting tariffs and tariff movements throughout the regulatory period.

In assessing a business's proposed form of price control, in particular where a change is proposed, the Commission will place a strong weighting on the feedback a water business receives from customers.

3.12.2 SUPPORTING INFORMATION

A price submission must clearly state the proposed form of price control to apply to each service over the next regulatory period.

If changes to the form of price control are proposed, then a price submission must:

- explain how the proposed form of control would operate and services affected
- demonstrate the business has consulted with potentially affected customers, and explain how the feedback from customers informed its proposals, and how the change benefits customers
- provide data and supporting information that describes how the proposed form of price control is consistent with providing signals about the efficient cost of delivering services and how it is likely to impact on price stability
- explain how the business considered risk allocation and management (including demand and financial risk)

- explain how a transition to a new form of price control may impact customers and the water business's approach to minimising any adverse impacts.

3.13 PRICES AND TARIFF STRUCTURES

The Commission has typically given businesses a large degree of discretion to decide on tariff structures. This recognises that businesses are often best placed to consider the interests of their customers in designing tariffs and that existing tariff structures have been developed over time to deal with a variety of local circumstances. The Commission intends to continue this approach.

A price submission must list each of its proposed tariffs to apply in the next regulatory period. This must include each element of a multi-part tariff structure. A price submission must also list a price for each tariff, or specify the pricing principles that it proposes to apply in setting prices.

The Commission anticipates pricing principles will be used for recycled water, unique services such as trade waste, and miscellaneous services. The pricing principles that the Commission proposes to approve for the next regulatory period are listed in the Commission's framework and approach paper.[41] There may be instances where tariffs are proposed that relate to a very small proportion of revenue or are applicable to very few customers (for example, for some rural tariffs). In these cases, a water business may propose specific pricing principles.

In developing their proposals, the Commission encourages water businesses to consider the tariff assessment principles listed in table 3.5.

[41] Essential Services Commission 2016a, *op. cit.*, pp. 37–9.

TABLE 3.5 TARIFF PRINCIPLES

Sustainable revenue	Tariff structures, levels and the form of price control should ensure an economically sustainable revenue stream over the regulatory period.
Subsidy free pricing and inefficient bypass	For each tariff class, the revenue expected to be recovered should lie on or between an upper bound representing the stand alone cost of serving the customers in that class and a lower bound representing the avoidable cost of not serving those customers.
Tariff structures	Tariff structures should be simple, understandable and cost reflective. *Bulk Water Charges Structure* — A two part charge comprising a fixed charge and a volumetric component to recover a bulk supplier's revenue requirement from its customers for each bulk water service. *Retail Water Tariffs Structure* — A two part tariff comprising a fixed charge and a volumetric component to recover a water business's revenue requirement from each tariff class. *Sewerage Charges* — The tariff structure should reflect the cost structure - and may comprise a one or two part tariff (all fixed, all volumetric or a fixed charge and a volumetric component). *Trade Waste* — Trade waste charges should be load-based where measurement is feasible and where the benefits outweigh the costs.
Determining fixed charges	Fixed charges should be calculated to recover the difference between the total revenue requirement for a tariff class and the revenue recovered through volumetric charges.
Determining volumetric charges	The volumetric charge should have regard to the long run or short run marginal costs, where appropriate.
Customer focus and equity	Retail tariff and service offerings, and the form of price control, should have regard to the ability of customers to understand the tariff and service offering and respond to price signals, customer preferences and needs in relation to service standards or new services, the costs of implementing the tariff offering, including administration and marketing costs and price path stability.
Locational and postage stamp pricing	Postage stamp pricing comprises retail tariffs that do not reflect any differences in costs of distribution systems by time or location. Postage stamp pricing should be applied when water supply is predominantly interconnected and/or is more equitable and administratively simple. Locational pricing comprises tariffs that vary by location – reflecting the cost structure of water supply, transport and treatment across the business. Locational pricing should be applied when water supply is less integrated and where there are material differences in costs between water networks. The WIRO does not specify whether a business should use locational or postage stamp pricing. It is up to the business to make the case for which is most appropriate.

The principles in table 3.5 provide guidance for businesses to check their proposed tariffs are consistent with the WIRO, including that tariffs provide signals to customers about the efficient costs of providing services. Compliance with the tariff assessment principles may also support a water business's proposed PREMO rating.

The Commission recognises that rural water businesses face issues in setting tariff structures and pricing which differ from urban businesses. However, the tariff assessment principles outlined in its framework and approach paper are also relevant to rural tariffs.

The Commission encourages water businesses to continue unbundling and disaggregating their costs to reflect the different elements of the supply chain (that is, storage, transport and retail costs). Unbundled tariffs provide better price signals to customers and assist with benchmarking of costs.

Further, the Commission considers the current variable sewerage tariffs for residential customers of the metropolitan water businesses are difficult for customers to understand, and not cost reflective. Given the low marginal cost of residential sewage treatment, the Commission will consider proposals for a single fixed charge for retail sewage disposal for residential customers favourably.

3.13.1 CRITERIA

The Commission will assess proposals against the following factors:

- the business's consideration of risk and efficiency — particularly how proposed tariffs are consistent with providing signals about the efficient cost of delivering services
- the business's approach to consultation on the tariff structures and how the views of customers were taken into account
- whether the business has considered and demonstrated that appropriate transition strategies will be implemented for any materially affected customers
- the ability for customers to understand the resulting tariffs and tariff movements throughout the regulatory period.

For price levels, the Commission will assess proposals against the following factors:

- the business's justification for the proposed prices, particularly how proposed prices are consistent with providing signals about the efficient cost of delivering services, and providing incentives for the business to pursue efficiency improvements
- how the business has taken into account the interests of customers, in particular low income and vulnerable customers
- whether the business has adequate transition strategies in place to manage the impacts of significant price shocks for affected customers.

In making a decision under clause 11 of the WIRO, the Commission will have particular regard to whether tariffs are continuing in the same form as applied during the last period, or whether changes are proposed.

The Commission recognises that an important objective includes avoiding price shocks for customers where possible. Where an existing tariff structure is being continued, this may be satisfied more easily. Where changes are proposed, however, the water business will need to provide evidence to demonstrate that the amended tariff structure better satisfies the requirements in clause 11 of the WIRO than the existing structure.

3.13.2 SUPPORTING INFORMATION

A price submission must:

- Include a tariff schedule listing each tariff and the price (or principles) proposed, including each element of a multi-part tariff structure.
- For any changes in tariff structures and principles, or new tariffs:
  - state how each tariff is to be applied — for example, frequency of charging, customer class, applying prices through connection or meter size
  - describe the relationship between the proposed price for a service and the associated short run or long run marginal cost

- provide data and supporting information that describes how proposed tariffs are consistent with providing signals about the efficient cost of delivering services[42]
    - justify how the proposed change delivers better signals to customers about the efficient costs of service provision
    - describe how the business considered risk and its allocation and management
    - provide a summary of the business's approach to consultation and how the views of customers informed the price submission.
- For price changes of more than 10 per cent for any tariff in any year for the next regulatory period:[43]
    - describe the relationship between the cost of service provision and the proposed price
    - provide a summary of the business's approach to consultation (including the approach to identifying affected customers)
    - summarise the customer feedback received on the proposed price increase
    - describe the transition arrangements considered, and ultimately proposed, for affected customers.
- Provide estimated tariffs for each service for each year beyond the next regulatory period up until at least 2027-28, in the financial model.

3.14 ADJUSTING PRICES

A price submission must specify any proposed price adjustment mechanisms to apply in the next regulatory period. The 2013 price determinations include mechanisms that allow for prices to adjust in order to take into account:

- uncertain and unforeseen events

[42] The Commission requires price submissions to propose prices that seek to reduce and minimise cross-subsidies. The extent to which this may be achieved will depend on a range of factors, including how well any adverse customer impacts may be managed. These issues will need to be explored in price submissions.

[43] Clause 11(d)(ii) of the WIRO requires the Commission to have regard to the principle that prices should provide signals about efficient costs of providing services, while avoiding 'price shocks' where possible. For the purposes of the 2018 price review, the Commission has defined a price shock as an increase of greater than 10 per cent in any year for any individual tariff. This is consistent with the Commission's approach to rural tariffs and Melbourne Water's tariffs. For any proposed price increases of greater than 10 per cent in any year, it will consider the merits of the increase while having regard to the cost of delivering the particular service (that is, cost reflectivity) and the impacts on customers.

- differences between forecast and actual desalination costs (covering desalination security payments and the cost of any water ordered)
- a 'pass through' of changes in some costs (such as taxes) during the regulatory period.

The Commission's view is that these adjustment mechanisms have worked well, and it proposes these arrangements will continue.

The proposed price control formulas must continue to include a mechanism to allow for price adjustments to occur on an annual basis, including desalination water orders for those relevant businesses.

Where a business proposes to continue with the existing adjustment mechanisms, the supporting information requirements will be easily satisfied. Where a change is proposed, however, the water business will need to provide evidence to demonstrate how the new adjustment mechanism satisfies the requirements in clause 11 of the WIRO.

As part of the transition to a 'trailing average' approach to estimating the cost of debt (as outlined in section 3.9.3), each water business must also propose a price adjustment mechanism (including price control formulas) that allows for prices to adjust on an annual basis to reflect movements in the cost of debt.

The Commission will consider proposals addressing other events that may require a pass through to adjust prices during the regulatory period, provided a clearly articulated justification is included in the submission. Where there is a potential policy or regulatory change that is known but uncertain in its impact on a business's costs, the change may be nominated in a business's price submission as a potential pass through, or uncertain or unforeseen event. Capital projects which are anticipated, but have not been fully scoped or costed (as described in section 3.8) may be nominated as an uncertain and unforeseen event.

3.14.1 CRITERIA

In approving proposed pass through or uncertain or unforeseen events nominated in price submissions, the Commission will consider:

- the extent to which the event is outside the business's control and poses significant risk of cost changes during the period
- the extent to which the nominated event is uncertain in its impacts and timing
- whether it is reasonable that customers should bear risk associated with the nominated event
- the impact of the nominated event on efficiency incentives for the water business
- the ability for the business to otherwise manage the risk posed by the event — for example, in its form of price control, tariff structures or approach to contracting.

3.14.2 SUPPORTING INFORMATION

A price submission must:

- specify any proposed price adjustment mechanisms to apply in the next regulatory period, and specify the proposed process and/or formula for adjusting prices
- if proposing new or changed price adjustment mechanisms, then the price submission must:
  - clearly specify and explain how the adjustments would work
  - demonstrate the business has sought to appropriately balance revenue and cost risk between the business and its customers, without materially impacting on price stability
  - justify any proposal against relevant matters in clause 11 of the WIRO and consistency with proposed outcomes.

For any identified pass through or uncertain and unforeseen events, a price submission must also:

- describe each proposed event, and explain why it is uncertain in its timing or impacts on the business or customers
- explain why it is appropriate that customers should bear risk associated with the event
- explain how the business considered the impacts on its incentives to pursue efficiencies
- propose a price adjustment mechanism to implement the pass through.

3.15 NEW CUSTOMER CONTRIBUTIONS

New Customer Contributions (NCC) are a prescribed service for urban water businesses (also known as developer charges). The Commission introduced a principles-based NCC charging framework which came into effect from 1 July 2013. For detailed guidance on NCC, businesses should continue to refer to the Commission's explanatory note, released in December 2013.[44]

3.15.1 CRITERIA

Water businesses must use approved pricing principles (outlined in box 3.2) to calculate the net incremental cost of connections. NCC will be either standard NCC, which are approved by the Commission in each water business's determination, or negotiated NCC, which are agreed between a developer and water business.

BOX 3.2 NCC PRICING PRINCIPLES

Standard and negotiated NCC charges will:

- have regard to the incremental infrastructure and associated costs in one or more of the statutory cost categories attributable to a given connection[45]
- have regard to the incremental future revenues that will be earned from customers at that connection
- be greater than the avoidable cost of that connection and less than the standalone cost of that connection.

Source: ESC 2013, *New Customer Contributions: Explanatory Note*, December, p. 2.

[44] Essential Services Commission 2013, *New Customer Contributions: Explanatory Note*, December.

[45] Statutory cost categories means costs for works imposed under Division 6 of Part 13 of the Water Act 1989.

3.15.2 SUPPORTING INFORMATION

A price submission must specify the NCC charges proposed to apply, and provide sufficient evidence for the Commission to assess that proposed NCC have been established in accordance with the NCC pricing principles (box 3.2).

3.16 FINANCIAL POSITION

The financial model will calculate estimates for the four financial indicators specified in table 3.6 for each year to 2027-28. A water business must populate the financial model to enable the Commission to assess the business's financial position in the context of the prices proposed in its price submission.

A water business must also provide the Commission with the findings of any independent ratings assessments conducted by an independent credit ratings agency since 1 July 2013.

TABLE 3.6 FINANCIAL INDICATORS

Indicator	Calculation	Benchmark Range	Description
Primary indicator — used to determine size of any viability adjustments			
FFO interest cover	(FFO + net interest) / net interest	> 1.5 times < 1.8 times used as a caution	Measures the extent of the cash flow buffer a business has to meet its debt obligations.
Secondary indicators — used only as contextual information to determine whether an adjustment is necessary			
Net Debt / Regulatory Asset Value (%) (Gearing)	(Interest bearing liabilities – cash) / RAV	< 70 per cent	Measures the debt component of the regulatory capital structure.
FFO / Net debt (%)	FFO / (Interest bearing liabilities – cash)	> 10 per cent	Measures the extent to which the serviceability of debt is improving, remaining stable, or declining.
Internal financing ratio (%)	(FFO – dividends) / net capital expenditure	> 35 per cent	Measures the extent to which an entity has cash remaining to finance a prudent portion of capital expenditure after making dividends.

Notes:

1) FFO refers to 'funds from operations' and RAV refers to the 'regulatory asset value'.
2) Regarding FFO interest cover, the Commission believes the 1.8 times benchmark signals a need for caution from businesses and closer observation by the Commission in its price reviews and performance reporting. But until a business breaches or is forecast to breach the benchmark of 1.5 times, it is unlikely the Commission would make a viability adjustment.

3.17 ADDITIONAL REQUIREMENTS

3.17.1 EXECUTIVE SUMMARY

A price submission must contain a summary which outlines and brings together the key elements of its proposals. The summary should include:

- an overview of proposed prices
- indicative bill impacts of the proposed prices, by key customer group
- an overview of the outcomes proposed for customers, including how services will change from previous levels
- the business's nominated PREMO rating

- an attestation from the board on the quality and accuracy of information provided in the price submission.

3.17.2 BOARD ASSURANCE

The board of a water business is required to attest to the quality and accuracy of the information included in its price submission, and that the price submission complies with the Commission's guidance in all material respects. This attestation, endorsed by a resolution of the board of directors of a water business, must be included in the price submission.

The form of the required assurance is below:

> As at [insert date], the directors of [name of water business], having made such reasonable inquiries of management as we considered necessary (or having satisfied ourselves that we have no query), attest that, to the best of our knowledge, for the purpose of proposing prices for the Essential Services Commission's 2018 Water Price Review:
>
> - information and documentation provided in the price submission and relied upon to support [name of water business]'s price submission is reasonably based, complete and accurate in all material respects;
> - financial and demand forecasts are the business's best estimates, and supporting information is available to justify the assumptions and methodologies used; and
> - the price submission satisfies the requirements of the 2018 Water Price Review Guidance paper issued by the Essential Services Commission in all material respects.

To support its PREMO rating, a water business may wish to make available to the Commission information on the procedures implemented to ensure its price submission reflects the requirements of the Commission's guidance.

3.17.3 FINANCIAL MODEL

A water business must complete the financial model prepared by the Commission to accompany its price submission. A water business's price submission must be consistent with the data provided in the financial model.[46] The financial model will clearly identify the cells for which a water business must provide data. A water business must not amend any other cells in the financial model — this includes adding rows, columns, or information not requested by the Commission.

The model will include a forecast inflation rate (based on the Consumer Price Index – All Groups, Australia). The inflation rate will be used to estimate components of the regulatory rate of return (see section 3.9) and estimates for financial indicators (see section 3.16). The Commission will use the latest market forecasts for inflation.

The Commission intends to release for public comment and consultation the populated financial model that is used to inform the prices approved in the determination for each water business.

3.17.4 REQUIREMENT FOR REASONABLY-BASED INFORMATION

All information contained in the price submission (and financial model — see section 3.17.3) must be reasonably-based. All financial and demand related information must represent the best available estimates at the time of finalising the submission.

3.17.5 BASIS UPON WHICH INFORMATION IS PROVIDED

All financial information (including prices, operating and capital expenditure) in a water business's price submission (and financial model) must be in 2017-18 dollars (with the March quarter 2017 CPI as the base).

[46] The financial model requires the water business to provide detailed information on key assumptions underpinning its prices (such as expenditure estimates) so the Commission can assess the water business's proposal. The model also provides a mechanism for a water business to estimate its revenue allowance and prices. The model will require both historic and forecast data.

All reports, studies or any other materials (for example, research reports, policy documents, and cost benefit analysis or studies) which are relied upon in the price submission must be made available to the Commission.

3.17.6 CONFIDENTIALITY

The Commission's normal practice is to make submissions publicly available on its website. If there is information that a water business does not want disclosed publicly, because it is confidential or commercially sensitive, then the water business should discuss the matter with Commission staff before lodging the price submission.

3.17.7 NOTIFICATION OF CHANGES TO ASSUMPTIONS

During the price review, a water business must promptly advise the Commission if it becomes aware of any substantial changes to the assumptions underpinning the proposals in its price submission. A water business must also explain the basis for the changed assumptions, and explain the impact on its proposals (if any).

In the event of any changes, a water business must promptly provide the Commission with an updated financial model, reconciling changes to the financial model provided to the Commission with its price submission on **29 September 2017**.

3.17.8 NON-PRESCRIBED SERVICES

While the Commission has no role in regulating prices for non-prescribed services, it needs to be satisfied that these services have been correctly classified as not related to regulated services, and that the costs of these services are accurately identified and excluded from the regulated cost base. A water business's price submission must provide or reference information that demonstrates that the costs of non-prescribed services have been excluded from its expenditure and price calculations.

ATTACHMENT 1

MATTERS TO INCLUDE IN GUIDANCE

WIRO CLAUSE 13(A)

Before making a price determination and following consultation, including with the relevant regulated entity, the Commission must provide guidance to the regulated entity setting out:

i. the manner in which the Commission proposes to regulate the prices which the regulated entity may charge for prescribed services for the regulatory period consistent with section 33(5) of the ESC Act and this Order;

ii. the approach and methodology which the Commission proposes to adopt to assess a price submission and make a price determination for the regulatory period consistent with section 33(2) of the ESC Act and this Order;

iii. the Commission's expectations of the nature and scope of matters to be addressed by the regulated entity in its price submission;

iv. the Commission's expectations regarding customer consultation by the regulated entity in developing its price submission;

v. the Commission's expectations of the information required to be provided by the regulated entity to enable the Commission to make a price determination;

vi. the timing and processes the Commission proposes to follow in making a price determination consistent with section 35 of the ESC Act and the Commission's Charter of Consultation and Regulatory Practice;

vii. the date by which the regulated entity is to deliver its price submission to the Commission; and

viii. any other matter that the Commission considers should be included in the guidance provided to the regulated entity or in the regulated entity's price submission.

ATTACHMENT 2

APPROACH FOR MAKING A PRICE DETERMINATION

WIRO CLAUSE 14

a) In making a price determination the Commission may either:

   i. approve the maximum prices the regulated entity may charge for prescribed services, or the manner in which the regulated entity's prices are to be calculated, determined or otherwise regulated, as proposed by the regulated entity in its price submission; or

   ii. specify the maximum prices the regulated entity may charge for prescribed services, or the manner in which the regulated entity's prices are to be calculated, determined or otherwise regulated.

b) The Commission may only specify the maximum prices, or the manner in which prices are to be calculated, determined or otherwise regulated, if:

   i. the price submission of the regulated entity does not, in the Commission's opinion, comply with the guidance provided by the Commission under clause 13 or have adequate regard for the matters specified in clause 11; or

   ii. the regulated entity failed to submit a price submission to the Commission within the time period specified for this by the Commission.

ATTACHMENT 3

MATTERS THAT WATER BUSINESSES AND THE COMMISSION MUST HAVE REGARD TO

Economic efficiency and viability matters	Industry/business specific matters	Customer matters
• promotion of efficient use of prescribed services by customers [cl 8(b)(i), WIRO] • promotion of efficiency in regulated entities as well as efficiency in, and the financial viability of, the regulated water industry [cl 8(b)(ii), WIRO] • provision to regulated entities of incentives to pursue efficiency improvements [cl 8(b)(iii), WIRO] • efficiency in the industry and incentives for long term investment [s 8A(1)(a), ESC Act] • efficient costs of producing or supplying regulated goods or services and of complying with relevant legislation and relevant health, safety, environmental and social legislation applying to the regulated industry [s 33(3)(b), ESC Act] • financial viability of the industry [s 8A(b)(1), ESC Act]	• particular circumstances of the regulated industry and the prescribed goods and services for which the determination is being made [s 33(3)(a), ESC Act] • return on assets in the regulated industry [s 33(3)(c), ESC Act] • ensure that regulatory decision making and regulatory processes have regard to any differences between the operating environments of regulated entities [s 4C(b), WI Act]	• in performing its functions and exercising its powers, the objective of the Commission is to promote the long term interests of Victorian consumers [s 8(1), ESC Act] without derogating from that objective. The Commission must in seeking to achieve the objective have regard to the price, quality and reliability of essential services [s 8(2), ESC Act] • enable customers or potential customers of the regulated entity to easily understand the prices charged by the regulated entity for prescribed services or the manner in which such prices are calculated, determined or otherwise regulated [cl 11(d)(i), WIRO] • provide signals about the efficient costs of providing prescribed services to customers (either collectively or to an individual customer or class of customers) while avoiding price shocks where possible [cl 11(d)(ii), WIRO] • take into account the interests of customers of the regulated entity, including low income and vulnerable customers [cl 11(d)(iii), WIRO]

Benchmarking	Health, safety and social obligations	Other
• any relevant interstate and international benchmarks for prices, costs and return on assets in comparable industries [s 33(3)(d), ESC Act]	• the relevant health, safety, environmental and social legislation applying to the industry [s 8A(1)(d), ESC Act] • to ensure that regulatory decision making has regard to the health, safety, environmental sustainability (including water conservation) and social obligations of regulated entities [s 4C(c), WI Act]	• the degree of, and scope for, competition within the industry, including countervailing market power and information asymmetries [s 8A(1)(c), ESC Act] • consistency in regulation between States and on a national basis [s 8A(1)(f), ESC Act] • the benefits and costs of regulation (including externalities and the gains from competition and efficiency) for—(i) consumers and users of products or services (including low income and vulnerable consumers) (ii) regulated entities [s 8A(1)(e), ESC Act] • wherever possible, to ensure that the costs of regulation do not exceed the benefits [s 4C(a), WI Act]

ATTACHMENT 4

TYPES OF RISK

Water businesses face a range of risks, both within and outside of their control, for example:

- Inflow risk, which presents as an inability for water businesses to meet customer demand due to extended low rainfall and inflows.
- Demand forecasting risk results where actual customer demand during a regulatory period differs materially from the forecasts. It can be mitigated through effective demand forecasting and variable tariff structures.
- Operational risks, such as a water business experiencing a breach of health, environmental or customer performance standards, can result from inadequate processes within water businesses, asset failures or external factors. Water businesses manage these risks through managing operating policies, capital investment, maintenance policies, contracts and insurance.
- Construction risks arise from underestimating costs or project delays. Water businesses can manage these risks through effective forecasting and contract management, as well as including contingency allowances in cost forecasts. Including cost contingencies in water revenue allowances transfers risk of project cost overruns to customers.
- Regulatory and policy risks result from changes in laws and regulations that materially affect a water businesses' costs or revenue potential, and are typically mitigated via a pass through mechanism.
- Financial risks are those arising from factors which affect the whole economy, such as rising interest rates or economic downturn. These risks are reflected in the cost of debt which forms part of the regulatory rate of return.
- Business risks result from a loss of revenue due to new technology or a change in the competitive landscape. Water businesses can mitigate some of these risks through innovative business practices and continually seeking cost efficiencies.

REGULATORY RISK MITIGATION TOOLS

The regulatory regime established through the WIRO and developed in detail through previous reviews generally identifies, categorises and allocates risk in accordance with standard principles and seeks to provide efficiency incentives to the water businesses. The regulatory framework provides the following tools to mitigate or manage risk:

- Recovery of forecast operating and capital expenditure — The forecast expenditure contained within price submissions must be consistent with the risk allocation and incentives provided within the regulatory framework. Therefore, it is important that forecasts are prepared on this basis. Where the water businesses seek recovery of costs for managing risks, the Commission expects them to demonstrate the need for this and provide supporting information in price submissions (sections 3.7 and 3.8).
- Indexation of prices — This ensures that water businesses remain fully responsible for management of their controllable costs, and that businesses do not need to bear the full risk associated with general price inflation.
- Cost of capital — This provides compensation for nondiversifiable risk (section 3.9).
- Form of the price control — This provides a mitigating tool for the water businesses. Section 3.12 contains the Commission's views on the form of the price control for the next regulatory period. The Commission also notes that the form of price control can assist in managing the risk that actual demand varies from forecast demand.
- Tariff structures — Section 3.13 sets out the guiding pricing principles for new tariff structures. The impacts of any shift in the mix of service and variable charges in tariffs on risk sharing between businesses and customers will need to be addressed in price submissions.
- Length of the regulatory period — A shorter regulatory period can reduce the risk of forecasting uncertainty (see section 3.2).
- Pass through mechanisms — Significant uncertainties that materially affect water businesses and that occur within the regulatory period are generally treated as pass through events. These events must be clearly identified in the price determination. The uncertain and unforseen events mechanism established by the Commission for the 2008 and 2009 water price reviews provides another option for managing and mitigating risks, subject to certain criteria (see section 3.14).

ATTACHMENT 5

PREMO RATING PROCESS

The steps for a water business and the Commission to establish the PREMO rating for the business's price submission is outlined in figure A below.[47]

FIGURE A PROCESS FOR RATING A PRICE SUBMISSION

1. • Business prepares its price submission in accordance with guidance issued by the Commission
2. • Business self-assesses the rating for each element of PREMO informed by the PREMO assessment tool
3. • Business rates its overall price submission as 'Leading', 'Advanced', 'Standard', or 'Basic', guided by the Commission's scoring methodology
4. • The price submission includes the business's PREMO ratings and its nominated return on equity, with supporting justification
5. • The Commission assesses the price submission informed by the PREMO assessment tool, assigning a rating to each element
6. • The Commission derives an overall PREMO rating and verifies the return on equity figure to be used to determine maximum prices
7. • The Commission releases its draft decision, including PREMO rating and return on equity, and its reasoning
8. • Business and other interested parties may respond to the Commission's draft decision PREMO rating
9. • The Commission will review submissions before releasing its final decision on the PREMO rating and the return on equity that is reflected in approved prices

[47] For further information, see Essential Services Commission Staff Paper 2016b, *Assessing and rating PREMO price submissions*, October, pp. 5–7.

PREMO ASSESSMENT TOOL

The PREMO assessment tool provides:

- A set of guiding questions for rating price submissions. These will help businesses understand what evidence and justification the Commission expects.
- Examples to demonstrate what might constitute 'Leading', 'Advanced', 'Standard' or 'Basic' ambition for the PREMO elements.

The assessment tool ***does not*** provide an exhaustive list of what may be taken into account by a water business or the Commission in arriving at a price submission rating. Businesses may provide further arguments to support their ratings. Further, if a business considers that it does not meet one of the examples in the tool for a given rating, this does not mean it cannot achieve that overall rating, as a business should consider on-balance how it meets the guiding questions.

In addition, the assessment tool ***does not*** preclude a water business from making a case for its existing level of ambition to be recognised in the PREMO rating. It will be up to the water business to explain in its price submission why the PREMO rating should take into account past achievements. One example might be where a water business can clearly demonstrate it is already an industry leader on operating cost efficiency (by using externally validated benchmarking studies, for example).

The PREMO assessment tool is provided in the following pages for the Risk, Engagement, Management and Outcomes elements of PREMO.

OUTCOMES

Guiding questions	Examples for a Standard submission	Examples for an Advanced submission	Examples for a Leading submission	Examples for a Basic submission
Has the business provided evidence that the outcomes proposed have taken into account the views, concerns and priorities of customers? Has the business provided sufficient explanation of how the outcomes it has proposed align to the forecast expenditure requested? Has the business proposed outputs to support each of its outcomes, which are measurable, robust and deliverable? Has the business provided evidence that the outputs it has proposed are reasonable measures of performance against stated outcomes? Has the business demonstrated a process to measure performance against each outcome and to inform customers?	The outcomes proposed are broadly consistent with existing levels of service provided to customers.	The outcomes proposed reflect a significant improvement in customer value delivered. This might be demonstrated by significant improvements in output targets (or performance measures) for outcomes that matter most to most customers. The business proposes outcomes that are well ahead of the industry average or past performance (measured by reference to output targets).	The outcomes proposed reflect a very significant improvement in customer value delivered. The business proposes outcomes that lead the industry.	The business has proposed degradation in customer outcomes, not justified or supported by customer feedback.
	The outcomes proposed have mostly been defined in ways that reflect the customer service experience (e.g. safe, clean water supply).	All outcomes proposed have been defined in ways that reflect the customer service experience.		Most outcomes are defined as outputs (that is, at a granular level consistent with practice in the 2013 water price review).
	The business has proposed outputs that are appropriate measures of performance for each outcome proposed.			The business has proposed outputs that are not appropriate measures of performance for each outcome proposed.
	The outcomes proposed generally reflect customer preferences and priorities revealed through engagement.	The outcomes proposed have been prioritised by a water business in terms of importance to customers as revealed through customer engagement. The business's expenditure forecasts reflect the prioritisation of outcomes.		The outcomes proposed do not clearly reflect customer preferences and priorities revealed through engagement.

Continued on the following page

OUTCOMES

Guiding questions	Examples for a Standard submission	Examples for an Advanced submission	Examples for a Leading submission	Examples for a Basic submission
	Where applicable, the business has explained or justified why outcomes proposed are not consistent with customer preferences and priorities.			Where applicable, the business has not explained or justified why outcomes proposed are not consistent with customer preferences and priorities.
	The level and composition of forecast expenditure is consistent with the outcomes proposed. The expenditure profile has changed where required to reflect customer priorities.			The level and composition of forecast expenditure is inconsistent with the outcomes proposed. The expenditure profile has not changed to reflect customer priorities.
	The business has committed to a process for monitoring and reporting to customers on their performance against outcomes.	Engagement with customers has led to the development of a customer performance reporting approach that is targeted to customer needs, including across different regions and customer types. The performance reporting approach is justified as being well ahead of peers in terms of accessibility, transparency and information provided to customers on performance.		The business has not committed to a process for monitoring and reporting to customers on their performance against outcomes.

MANAGEMENT

Guiding questions	Examples for a **Standard** submission	Examples for an **Advanced** submission	Examples for a **Leading** submission	Examples for a **Basic** submission
To what extent has the business demonstrated how its proposed prices reflect only prudent and efficient expenditure? To what extent has the business justified its commitment to cost efficiency or productivity improvements? To what extent have senior management, including the Board, demonstrated ownership and commitment to the proposals in its submission? To what extent has the business justified or provided assurance about the quality of the submission, including the quality of supporting information on forecast costs or projects? To what extent has the business provided evidence that there is senior level, including Board level, ownership and commitment to its submission and its outcomes?	Forecast operating expenditure incorporates a rate of efficiency improvement at least equivalent to the Commission's one per cent efficiency hurdle used in 2013 water price review.	The business has proposed a significant improvement in the cost efficiency of the services delivered. Forecast operating expenditure incorporates a rate of efficiency improvement significantly above the Commission's one per cent efficiency hurdle used in 2013 water price review. Forecast operating expenditure incorporates a rate of efficiency improvement that is clearly above the industry benchmark. The operating expenditure forecast places the business well ahead of the industry average in terms of cost efficiency.	The business has proposed a very significant improvement in the cost efficiency of the services delivered. Forecast operating expenditure incorporates a rate of efficiency improvement that is very significantly above the Commission's one per cent efficiency hurdle used in 2013 water price review). Forecast operating expenditure incorporates a rate of efficiency improvement that places the business as a leader in the industry. The operating expenditure forecast places the business as a leader in the industry in terms of cost efficiency.	The business has not proposed productivity improvements. Forecast operating expenditure incorporates a rate of efficiency improvement that is below the Commission's one per cent efficiency hurdle used in 2013 water price review.
	The business can provide business cases and justification for all major projects and capital programs, including evidence that a range of options have been considered.	The business has proposed a significant improvement in the efficiency of its capital program. Forecast regulatory depreciation aligns with asset utilisation.	The business has proposed a very significant improvement in the efficiency of its capital program. The rate of improvement in capital expenditure efficiency places the business as a leader in the industry.	The business has not provided timely access to robust business cases that validate the basis for all major projects and capital programs. The business has not proposed efficiency improvements in relation to its capital renewals program.

Continued on the following page

MANAGEMENT

Guiding questions	Examples for a **Standard** submission	Examples for an **Advanced** submission	Examples for a **Leading** submission	Examples for a **Basic** submission
	The Board of Directors has attested that it has undertaken appropriate internal procedures to assure themselves of the quality and accuracy of their price submission. The attestation is included with the price submission.			The Board of Directors has not attested that that it has undertaken appropriate internal procedures to assure themselves of the quality and accuracy of their price submission. The attestation is not included with the price submission.
	The price submission addresses all requirements specified in the Commission's Guidance Paper.			The price submission does not address all requirements set out in the Commission's Guidance Paper
	The price submission and its supporting documents contain no material or obvious errors or omissions.			The price submission and its supporting documents contain errors and/or omissions of sufficient concern to the Commission.
	The financial model provided to the Commission is completed with no missing information, and is consistent in every respect with the written price submission.			The financial model is incomplete and/or inconsistent with the price submission.
	The price submission and supporting information are provided to the Commission by the time requested.			The price submission and supporting information are provided to the Commission after the time requested.
	The price submission is internally consistent, demonstrating alignment between different elements of the price submission (e.g. there is consistency between the outcomes proposed, and demand and expenditure forecasts).			The price submission is contradictory across main elements of the submission (e.g. there is inconsistency between the business's demand forecasts and capital works program for example).

Continued on the following page

MANAGEMENT

Guiding questions	Examples for a **Standard** submission	Examples for an **Advanced** submission	Examples for a **Leading** submission	Examples for a **Basic** submission
	Forecasts for expenditure (including benchmarks for labour, energy and construction costs) and demand are based on sound methodologies and assumptions.			Forecasts for expenditure (including benchmarks for labour, energy and construction costs) and demand are not based on sound methodologies and assumptions.
	The business can demonstrate that it has actively sought to reprioritise its expenditure plans to mitigate the cost and price impacts of any new obligations (whether imposed by government or technical regulator, or to address a new service priority revealed through engagement).			The business has not provided evidence that it has actively sought to reprioritise its expenditure plans to mitigate the cost and price impacts of any new obligations (whether imposed by government or technical regulator, or to address a new service priority revealed through engagement).
	The business has proposed adequate mitigation strategies to avoid any price shocks.			The business has not proposed adequate mitigation strategies to avoid any price shocks.
	The business retains meaningful and robust supporting documentation to justify its proposals, with ongoing access available to the Commission.			The business has not provided timely access to meaningful and robust supporting documentation, on request from the Commission.

ENGAGEMENT

Guiding questions	Examples for a **Standard** submission	Examples for an **Advanced** submission	Examples for a **Leading** submission	Examples for a **Basic** submission
To what extent has the business justified how the form of engagement suits the content of consultation, the circumstances facing the water business and its customers? To what extent has the business demonstrated that it provided appropriate instruction and information to customers about the purpose, form and content of the customer engagement? To what extent has the business demonstrated that the matters it has engaged on are those that have the most influence on the services provided to customers and prices charged? To what extent has the business explained how it decided when to carry out its engagement? To what extent has the business demonstrated how its engagement with customers has influenced its submission?	The form of customer engagement is justified as being fit for purpose given the content and circumstances facing the business and its customers.	The onus is on each water business to make the case as to why they might rate their customer engagement as Advanced or Leading. This justification could be based on: • Unbiased feedback from a representative group of customers about the business's choice of engagement method and the quality of the engagement program it delivered. For example, do customers believe they were given appropriate information and time to learn about the issues, form opinions, and influence the business's proposals? • Participants in the engagement program provide feedback that the business has delivered on the engagement commitments given by the business (e.g. on what matters would participants provide feedback on, and the influence they would have on the decisions of the business). • The level of customer influence on proposals. A strong alignment between a business's proposals and the preferences and interests elicited in its engagement program would correspond to a higher rating.		The form of customer engagement is not justified as being fit for purpose given the content and circumstances facing the business and its customers.
	The business demonstrates that the information provided to customers was appropriate given the purpose, form and content of customer engagement.			Information provided to customers was written in technical jargon, and/or was not appropriate for customer use. The business provided selective or incomplete information to customers that biased the responses or did not provide sufficient context for customer input.
	The business demonstrates that engagement has occurred on matters that customers reveal are the most important to them.			Engagement has not occurred on matters that are important to customers or significant to the outcomes they receive and prices they are charged.

Continued on the following page

ENGAGEMENT

Guiding questions	Examples for a **Standard** submission	Examples for an **Advanced** submission	Examples for a **Leading** submission	Examples for a **Basic** submission
	A business demonstrates that engagement was undertaken early, prior to locking in key strategies and priorities. A business demonstrates it used engagement methodologies that elicit views that are representative of the customer base. A business demonstrates that the business re-tested its position and proposals with customers as it developed its price submission.			Engagement was undertaken late, after the business had developed its key strategies and priorities. The business has failed to demonstrate that its engagement program elicited information that it could use to shape the strategic direction and priorities in its price submission. The business has not retested its position and proposals with customers as it developed its price submission.
	The price submission describes what was learned from customer engagement, and how this influenced its proposed outcomes, expenditure (composition and level) and prices.			The price submission does not clearly link the outcomes of engagement to the outcomes proposed, and the alignment of outcomes to expenditure and prices.
	In any instances where outcomes proposed are not consistent with customer views, the business provides reasonable justification.			The business has not provided reasonable justification for instances where its proposed outcomes are not consistent with customer views.

RISK

Guiding questions	Examples for a **Standard** submission	Examples for an **Advanced** submission	Examples for a **Leading** submission	Examples for a **Basic** submission
To what extent has the business demonstrated a robust process for identifying risk, and how it has decided who should bear these risks? To what extent does the proposed guaranteed service level (GSL) scheme provide incentives for the business to be accountable for the quality of services delivered, and provide incentives to deliver valued services efficiently?	The business meets the requirements of the Commission's Guidance Paper in relation to risk.	The business has implemented a new approach that reduces prices through better risk management.	The business has implemented an approach that reduces costs through better risk management, to a level that sets it apart from industry peers.	The business has not met the requirements of the Commission's Guidance Paper in relation to risk. The business has sought to transfer risk to customers which is not supported by customer views. The business has not sought to minimise cost and/or price impacts from risk management.
	The business demonstrates compliance with risk standards specified in the Statement of Obligations (e.g. ISO 55000).	The business has been accredited for compliance with risk standards specified in the Statement of Obligations.		The business cannot demonstrate compliance with risk standards specified in the Statement of Obligations.
	The business can demonstrate that it has thoroughly evaluated the feasibility of commencement and completion dates for major projects. Business cases are available for all major projects.	The business can demonstrate a robust optimisation process that has informed what projects need to be completed, and the timing of those projects. For example, real options analysis has informed planning.		Projects are proposed that have incomplete scope, no business cases, or are not feasible in terms of timelines for delivery.
	The business has undertaken a Monte Carlo analysis for all major projects. The business can demonstrate that its aggregate capital expenditure forecasts are consistent with a P50 estimate (noting this is likely to be inappropriate where a program is dominated by one or two projects). The estimate must be based on the latest credible information on costs.	The business uses regulatory tools such as the pass through and uncertain and unforeseen events mechanisms where appropriate for projects with uncertain timing or costs. The business has evaluated whether major projects should be funded via capital or operating expenditure for pricing purposes.		The business cannot demonstrate that its aggregate capital expenditure forecasts are consistent with a P50 estimate (noting this is likely not to be appropriate where a business's capital program is dominated by one or two projects).

Continued on the following page

RISK

Guiding questions	Examples for a **Standard** submission	Examples for an **Advanced** submission	Examples for a **Leading** submission	Examples for a **Basic** submission
			In its price submission, the business proposes correction mechanisms to adjust the return on equity where its performance does not meet the outcomes established at the price review.	
	The business has proposed a GSL scheme that reflects the main service concerns and priorities of customers.	The business has refined its GSL scheme to provide greater service accountability to customers, or to provide increased incentives to deliver services efficiently. The business has proposed a GSL scheme that compares favourably to industry peers in terms of incentives to deliver services efficiently.		The business has not proposed a GSL scheme that reflects the main service concerns and priorities of customers.
	The unit rates used to evaluate projects and options reflect recent historical trends, and/or independently verified market forecasts.			The business adopts assumptions that seek to maximise unit rates proposed.
	The business can support its assessment of financial viability by reference to cash flow projections and independent benchmarks (e.g. credit rating metrics).	The water business has had its financial position review by an independent credit ratings agency.		The business cannot support its assessment of financial viability by reference to cash flow projections and independent benchmarks (e.g. credit rating metrics).
	Through the form of price control and tariffs proposed, the submission appropriately balances revenue and cost risk between the business and its customers, without materially impacting on price stability.			The form of price control and/or tariffs over allocates risk to customers.

SCORING METHODOLOGY TO ESTABLISH A PREMO RATING

The Commission has developed a scoring methodology to assist businesses to rate their price submission against the four elements of PREMO and to rate their overall price submission. The Commission provides the following scoring methodology as a guide to accompany the PREMO assessment tool — in other words, it is not mandatory that a water business uses the scoring methodology below to rate its price submission.

WEIGHTING

The four elements — Risk, Engagement, Management and Outcomes — will be weighted evenly to establish a PREMO price submission rating.

SCORING AND THE ASSESSMENT TOOL

It is not an expectation that businesses rate or allocate a score against all the matters listed in the PREMO assessment tool, as these are provided as examples of the matters that should be taken into account. Rather, these examples should be used to guide the rating or score for each of the four PREMO elements.

The scoring methodology is predicated on the level of confidence with which a business or the Commission considers an element of PREMO meets a particular ambition rating.

Table A summarises possible scores for each element of PREMO graded by confidence level. The component scores for each element of PREMO would be aggregated to inform an overall price submission rating.

Further to the above, to achieve a given PREMO price submission rating, no individual element should be rated lower than 'very confident' in a lower rating category, if applicable. For example, a price submission should not be rated 'Standard' if any element is scored lower than 1.5 (very confident the element is 'Basic'). The same principle would apply to other levels of ambition.

TABLE A SCORING SYSTEM FOR A PREMO RATING

Rating	Possible scores for each element of PREMO		Aggregated score for overall PREMO rating
Leading	4	Very confident the element is 'Leading'	15.5 to 16
	3.75	Confident the element is 'Leading'	
Advanced	3.5	Very confident the element is 'Advanced'	11.5 to 15.25
	3.25	Confident the element is 'Advanced'	
	3	Satisfied the element is 'Advanced'	
	2.75	Reasonably confident the element is 'Advanced'	
Standard	2.5	Very confident the element is 'Standard'	7.5 to 11.25
	2.25	Confident the element is 'Standard'	
	2	Satisfied the element is 'Standard'	
	1.75	Reasonably confident the element is 'Standard'	
Basic	1.5	Very confident the element is 'Basic'	4 to 7.25
	1.25	Confident the element is 'Basic'	
	1	Satisfied the element is 'Basic'	

To reiterate, the scoring methodology outlined here is only a guide. The Commission will assess a water business's reasoning for its price submission PREMO rating. In other words, the score on its own is not justification for a particular price submission rating. Similarly, businesses ultimately have the discretion to select any PREMO price submission rating, even if it may not correspond with an aggregated score.