

Central Highlands Water draft decision

2018 Water Price Review

28 March 2018



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Summary

In September 2017, Central Highlands Water provided a submission to us proposing prices for a five year period starting 1 July 2018

This draft decision sets out our preliminary views on Central Highlands Water's price submission.^{1 2}

We invite interested parties to comment on our preliminary views in this draft decision before we make a final decision and issue a price determination in June 2018. Details on how to make a submission on our draft decision are provided in Chapter 4.

Central Highlands Water will improve service outcomes

Our draft decision proposes to approve a revenue requirement that will allow Central Highlands Water to deliver on its customer service commitments, government policy, and obligations monitored by Environment Protection Authority Victoria and Department of Health and Human Services.

Some of the ways Central Highlands Water plans to improve outcomes for customers are by:

- improving water quality (particularly in relation to taste) for a number of towns
- working with customers to help them use water more efficiently
- limiting most price increases to inflation with some reduction in the first two years to sewerage.

Overall, our view is that Central Highlands Water has demonstrated its proposals will deliver better value to its customers. In particular, it has proposed to increase service levels, focusing on areas of most importance to its customers (such as improvements to water quality). As well, its prices are generally stable or falling, implying customers generally will receive more for less.

Our draft decision proposes to approve a lower revenue requirement than proposed by Central Highlands Water, reflecting our review of efficient costs

Our draft decision approves a revenue requirement of \$445.6 million for Central Highlands Water over the five year period starting 1 July 2018, for the purpose of approving maximum prices.³ This

¹ Clause 16 of the Water Industry Regulatory Order 2014 requires us to issue a draft decision.

² Central Highlands Water's price submission is available on our website at www.esc.vic.gov.au.

³ The revenue requirement is the forecast amount a water corporation needs to deliver on customer outcomes, government policy, and obligations monitored by technical regulators including Environment Protection Authority Victoria

is \$6.7 million or 1.5 per cent lower than proposed by Central Highlands Water. This means (on average) Central Highlands Water's prices over 2018-19 to 2022-23 will be 1.5 per cent lower than its original proposal.⁴

While we have accepted Central Highlands Water's capital expenditure forecasts (see from page 18), we have adopted a lower assumption for its operating expenditure.

Central Highlands Water proposed an increase in labour costs above inflation. Our view is that these increases should instead be managed through efficiency improvements, or funded via higher revenue generated from the customer growth forecast by the corporation. We have also adopted a lower forecast for Central Highlands Water's electricity costs. The operating expenditure section (page 9) provides more information on our review of Central Highlands Water's operating expenditure.

Central Highlands Water must respond to our draft decision and propose individual tariffs that reflect our initial views on the revenue requirement. Central Highlands Water's response will determine the price and bill impact of our draft decision on individual tariffs and customers.

We have accepted Central Highlands Water's tariff structures

We propose to accept Central Highlands Water's proposed price cap form of price control. This means its maximum prices are fixed subject to updates for inflation and the cost of debt, and any other price adjustments we approve in our price determination. Central Highlands Water currently uses a price cap. See from page 23 for more information.

Our draft decision also accepts Central Highlands Water's proposed tariff structures, which are the same as its current tariff structures. For water services, Central Highlands Water proposed a fixed service charge and a variable component that depends on water used. For residential customers, the variable component includes an inclining block structure where prices increase as higher amounts of water are used. For residential sewerage services, Central Highlands Water proposed a fixed service charge only. For non-residential sewerage services, Central Highlands Water proposed a fixed service charge and a variable usage charge.

The tariff structure section from page 24 provides more information on our assessment.

and the Department of Health and Human Services. Along with forecast demand, it is an input to calculating the prices to be charged by a water corporation.

⁴ This is an indicative percentage change on prices based on the percentage change in draft decision revenue requirement compared to the proposed revenue requirement.

Central Highlands Water’s price submission is rated as ‘Advanced’ under PREMO

Our draft decision is to accept Central Highlands Water’s PREMO self-rating of its price submission as ‘Advanced’ (Table A). As noted above, our view is that Central Highlands Water will deliver better value to its customers through improvements in service outcomes, such as through improvements to water quality, and setting improved targets for a number of service indicators. It has also proposed prices that are generally stable or falling, implying many customers will get more for less. This is consistent with an ‘Advanced’ rating for PREMO. We also found Central Highlands Water’s price submission was well presented and provided good justification for its proposals. Our assessment of PREMO is set out from page 29 of this draft decision.

Our PREMO rating is an assessment of the water corporation’s price submission. It is not an assessment of the water corporation itself.

Table A **PREMO Rating**

	Overall PREMO rating	Risk	Engagement	Management	Outcomes
Central Highlands Water’s rating	Advanced	Advanced	Advanced	Advanced	Advanced
Commission’s rating	Advanced	Advanced	Advanced	Advanced	Advanced

Among the 15 draft decisions we have released so far, Central Highlands Water is one of eight corporations for which we propose to approve an ‘Advanced’ rating (Table B).

Table B Draft decision on PREMO – overall rating

Leading	Advanced	Standard	Basic
Goulburn Valley Water	Barwon Water	Coliban Water	Wannon Water
	Central Highlands Water	East Gippsland Water	
	City West Water	Gippsland Water	
	GWMWater	Lower Murray Water (urban)	
	North East Water	Westernport Water	
	South East Water		
	Southern Rural Water		
	Yarra Valley Water		

1. Our role and approach to water pricing

We are Victoria's independent economic regulator

Our role in the water industry is based on the Water Industry Regulatory Order 2014 (WIRO) which is made under the *Water Industry Act 1994* (Vic) (WI Act) and sits within the broader context of the *Essential Services Commission Act 2001* (Vic) (ESC Act). Our role under the WIRO includes regulating the prices and monitoring service standards of the 19 water corporations operating in Victoria.

We are reviewing the prices 17 water corporations propose to charge customers from 1 July 2018

Our review of the prices proposed by the water corporations covers the prescribed services listed in the WIRO.⁵ The prescribed services include retail water and sewerage services, and bulk water and sewerage services delivered by the water corporations.⁶

In September 2017, Central Highlands Water provided a submission to us proposing prices for a five year period starting 1 July 2018. Our task is to assess the price submission against the legal framework that governs our role, and make a price determination that takes effect from 1 July 2018. The price determination will specify the maximum prices Central Highlands Water may charge for prescribed services, or the manner in which prices are to be calculated, determined or otherwise regulated. We also issue a final decision that explains the reasons for our price determination.

We assess prices against the WIRO and other legal requirements

Clause 11 of the WIRO specifies the mandatory factors we must have regard to when making a price determination, including matters set out in the WIRO, the WI Act and the ESC Act. In reaching this draft decision we have had regard to each of the matters required by clause 11 of the WIRO, including:

- the objectives and matters specified in clause 8 of the WIRO, which include economic efficiency and viability matters, industry specific matters, customer matters, health, safety, environmental

⁵ The review excludes Melbourne Water and Goulburn-Murray Water. In 2016 we approved prices for Melbourne Water to 30 June 2021 and for Goulburn-Murray Water to 30 June 2020.

⁶ The prescribed services are listed at clause 7(b) of the WIRO.

and social matters, and other matters which are specified in sections 8 and 8A of the ESC Act and section 4C of the WI Act

- the matters specified in our guidance⁷
- the principle that prices should be easily understood by customers and provide signals about the efficient costs of providing services, while avoiding price shocks where possible
- the principle that prices should take into account the interests of customers of the regulated entity, including low income and vulnerable customers.

A separate document lists the specific objectives and the various matters the commission must have regard to when making a price determination and provides a guide to where the commission has done so in this draft decision.⁸

In 2016, we issued guidance to Central Highlands Water to inform its price submission. The guidance set out how we will assess Central Highlands Water's submission against the matters we must consider under clause 11 of the WIRO.

If we consider the price submission has adequate regard for the matters in clause 11 of the WIRO and complies with our guidance, we must approve Central Highlands Water's proposed prices.⁹

If we consider the submission does not have adequate regard for the matters specified in clause 11 of the WIRO or comply with our guidance, we may specify maximum prices, or the manner in which prices are to be calculated, determined or otherwise regulated.¹⁰

The 2018 price review is the first we've undertaken under our new water pricing approach

In 2014, the Victorian Government reviewed and revised the WIRO. The changes allowed us more flexibility to decide on the pricing approach we use in Victoria's water sector. In April 2015 we released a consultation paper to start reviewing our pricing approach.¹¹

Over 2015, we held a series of workshops and hosted a conference (in November) to hear from stakeholders and explore alternative ways to approach water pricing.

⁷ Essential Services Commission 2016, *2018 Water Price Review, Guidance paper*, November.

⁸ Essential Services Commission 2018, *Central Highlands Water draft decision, 2018 Water Price Review – commission's consideration of legal requirements*, 28 March. This is located on our website at www.esc.vic.gov.au

⁹ This is a requirement of the WIRO, clause 14(b).

¹⁰ This is provided for under the WIRO, clause 14(b)(i).

¹¹ Essential Services Commission 2015, *Review of Water Pricing Approach, Consultation paper*, April.

In May 2016, we released a position paper setting out our proposed new pricing approach, and invited submissions.¹² We met with each water corporation and other interested parties to help inform their submissions. Submissions were supportive of the overall proposal, in particular the greater focus on customer engagement and value.

We finalised our new approach to water pricing in October 2016.¹³

Our new pricing approach builds on many aspects of the previous approach. We continue to use the building blocks to estimate the revenue requirement for a water corporation.¹⁴ Our guidance explains the building blocks and how we use it to estimate the revenue requirement.¹⁵

Among the key changes, the new approach introduces new incentives to help ensure water corporations deliver the outcomes most valued by customers. Our new PREMO framework rewards stronger customer value propositions in price submissions, and an early draft decision is available for price submissions we can assess in a short timeframe.¹⁶ The PREMO incentive is described next.

Our consultation on the pricing approach informed the guidance we issued water corporations in November 2016 to inform price submissions for the 2018 water price review.

PREMO

PREMO stands for **P**erformance, **R**isk, **E**ngagement, **M**anagement, and **O**utcomes. The purpose of PREMO is to provide an incentive for water corporations to deliver outcomes most valued by customers. It includes incentives for a water corporation to engage with customers to understand their priorities and concerns, and take these into account.

PREMO links the return on equity allowed in the revenue requirement to the value delivered by a water corporation to its customers. Under PREMO, a higher level of ambition in terms of delivering customer value results in a higher return on equity.

¹² Essential Services Commission 2016, *A new model for pricing services in Victoria's water sector, Position paper*, May.

¹³ For more detail on the new water pricing approach see: Essential Services Commission 2016, *Water Pricing Framework and Approach: Implementing PREMO from 2018*, October.

¹⁴ The revenue requirement is the forecast amount that a water corporation needs to deliver on customer outcomes, government policy, and obligations monitored by technical regulators including Environment Protection Authority Victoria and the Department of Health and Human Services.

¹⁵ Essential Services Commission 2016, *Guidance Paper*, op. cit., pp. 8-9.

¹⁶ In December 2017 we issued early draft decisions for East Gippsland Water, South East Water, Westernport Water and Yarra Valley Water.

Our PREMO rating is an assessment of the water corporation's price submission. It is not an assessment of the water corporation itself.

The 2018 water price review is the first time we've applied our PREMO incentive mechanism.

For the 2018 water price review, a water corporation's ambition in terms of delivering customer value is being assessed against four elements of PREMO – Risk, Engagement, Management and Outcomes.¹⁷

A water corporation must self-assess and propose a rating for its price submission as 'Leading', 'Advanced', 'Standard' or 'Basic'. Its proposed return on equity will then reflect its PREMO rating. A 'Leading' submission has the highest return on equity, and a 'Basic' submission the lowest. We assess the justification for the PREMO rating, and also rate the price submission. This process determines the return on equity reflected in the revenue requirement.¹⁸

¹⁷ The Performance element of PREMO will be assessed at the review following the 2018 water price review.

¹⁸ Essential Services Commission 2016, *Guidance paper*, op. cit., pp. 45–49.

2. Our assessment of Central Highlands Water's price submission

We have made our draft decision on Central Highlands Water's price submission after considering: Central Highlands Water's price submission, its responses to our further queries during our assessment, and written submissions from interested parties (a list of submissions is provided in Appendix A).

Any reports, submissions, or correspondence provided to us which are material to our consideration of Central Highlands Water's price submission are available on our website (to the extent the material is not confidential).

Our guidance included a number of matters water corporations must address in their price submissions. Central Highlands Water's price submission addressed each of these matters. Our preliminary assessment of these matters is provided in this chapter.

We consider Central Highlands Water's price submission presented clear and comprehensive information to support its proposals. Central Highlands Water also provided evidence that its engagement sought to capture the main priorities and concerns of customers, and that it has taken this feedback into account (see the customer engagement section on page 6).

Central Highlands Water must submit a response to our draft decision and provide an updated financial model by 8 May 2018 (via email to water@esc.vic.gov.au). The response will be published on our website. We also invite other interested parties to make a submission.

We intend to make a price determination for Central Highlands Water in June 2018.

All financial values referred to in this chapter are in \$2017-18.

Regulatory period

Central Highlands Water proposed a five year regulatory period. Our draft decision accepts Central Highlands Water's proposal as it is consistent with our guidance. Our guidance proposed to approve a five year regulatory period, subject to any alternative and justified proposal.¹⁹

Customer engagement

Our guidance required Central Highlands Water to engage with customers to inform its price submission.

The engagement by Central Highlands Water:

- took place between July 2016 and August 2017
- included a range of methods such as online and phone surveys, customer drop in sessions, community forums and focus groups across its region
- involved a customer reference group, established by Central Highlands Water to explore proposals in more detail and shape its engagement approach
- covered billing accuracy, the nature of online services, water quality, waste water service quality, tariff structure, performance levels and customer payment difficulty.

More detail on Central Highlands Water's engagement is available in its price submission.²⁰

Evidence that Central Highlands Water's engagement influenced its proposals includes:

- improving water quality in response to feedback from customers in a number of towns
- drawing on feedback to shape the business's approach to tariff structures
- introducing SMS and email alerts in response to feedback that customers would like improved communication relating to service interruptions
- improving its website to make it easier for customers to interact with the business, in response to feedback that customers valued greater online access.

The influence of Central Highlands Water's engagement on its proposals supports the objectives in our pricing framework relating to efficiency and the interests of consumers.²¹

¹⁹ For detail on the reasons for using five years as the default regulatory period, see: Essential Services Commission 2016, *Guidance paper*, op. cit., p. 21.

²⁰ Central Highlands Water's price submission is available on our website at www.esc.vic.gov.au. See pages 14 to 32.

Outcomes

The outcomes Central Highlands Water proposes to deliver over the five year period starting 1 July 2018 are:

- better customer service
- safe clean drinking water that tastes great
- reliable and sustainable water and sewer systems
- more efficient water use
- increased value for money.

Central Highlands Water proposed measures and activities it will use to report on progress against achieving each outcome. These are set out at pages 33 to 38 of its price submission. To report on its performance Central Highlands Water proposes to publish an annual 'dashboard'. This report will be available on its website, and communicated through various channels, including social media, bill inserts and email.

We will engage with Central Highlands Water to finalise the measures and targets used to assess performance against its outcomes, and how it will report this publicly. Performance against these measures will inform our assessment during future price reviews.

Guaranteed service levels

Guaranteed service levels (GSLs) define a water corporation's commitment to deliver a specified level of service. For each GSL, a water corporation commits to a payment or a rebate on bills to those who have received a level of service below the guaranteed level.

Central Highlands Water's proposed GSLs are set out on pages 41 and 42 of its price submission. It has made no changes to its existing hardship GSL, and proposed to modify some existing GSLs. New GSLs relate to water quality and compensation for a sewer spill within a customer's house which it caused.

The GSLs proposed by Central Highlands Water were informed by customer feedback, including input from a customer forum and its customer reference group. On this basis, our draft decision proposes to accept Central Highlands Water's proposed GSLs. Final GSLs will be subject to our consideration of any feedback following the release of our draft decision.

²¹ See for example, WIRO clauses 8(b)(i), 8(b)(ii), 8(b)(iii), 11(d)(iii), and ESC Act Sections 8(1), 8A(1)(a).

Revenue requirement

The revenue requirement is the forecast amount a water corporation needs to deliver on customer outcomes, government policy, and obligations monitored by technical regulators including Environment Protection Authority Victoria and the Department of Health and Human Services. Along with forecast demand, it is an input to calculating prices.²²

Central Highlands Water proposed a revenue requirement of \$452.3 million over a five year period starting 1 July 2018. Our draft decision proposes to reject the revenue requirement in Central Highlands Water's submission and instead approve a revenue requirement of \$445.6 million, 1.5 per cent lower than proposed by Central Highlands Water. This reflects our assessment of each element that comprises the revenue requirement, including forecast expenditure.

Our draft decision on the revenue requirement is set out at Table 2.1.

Table 2.1 Draft decision – revenue requirement
\$ million 2017-18

	2018-19	2019-20	2020-21	2021-22	2022-23	Total
Operating expenditure	57.8	57.5	55.9	55.6	55.5	282.4
Return on assets	14.6	15.0	15.4	15.6	15.8	76.3
Regulatory depreciation	16.2	17.0	17.4	18.0	18.3	86.9
Draft decision – revenue requirement	88.6	89.5	88.7	89.3	89.6	445.6

Note: Numbers have been rounded

The main adjustments we've proposed in our draft decision on the revenue requirement relate to different assumptions for Central Highlands Water's operating costs, and particularly, labour and electricity costs. Table 2.2 summarises proposed changes to the revenue requirement.

Our final decision will be based on the latest available information. Accordingly, as well as responding to our draft decision and providing an updated price schedule, Central Highlands Water

²² We met with officers of the Department of Environment, Land, Water and Planning, Department of Health and Human Services, and Environment Protection Authority Victoria, to discuss their expectations of Central Highlands Water in the regulatory period from 1 July 2018. We had regard to their views in our draft decision.

must update its revenue requirement and prices to reflect our April 2018 updates to estimates for the cost of debt and inflation.

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

Table 2.2 Adjustments to revenue requirement
\$ million 2017-18

	2018-19	2019-20	2020-21	2021-22	2022-23	Total
Proposed revenue requirement	88.9	90.1	90.4	91.2	91.7	452.3
Operating expenditure	-0.3	-0.5	-1.6	-1.9	-2.1	-6.4
Return on assets	-0.1	-0.1	-0.1	-0.1	-0.1	-0.3
Total adjustments	-0.3	-0.6	-1.7	-1.9	-2.2	-6.7
Draft decision revenue requirement	88.6	89.5	88.7	89.3	89.6	445.6

Note: Numbers have been rounded

Operating expenditure

Operating expenditure is an input to the revenue requirement. Central Highlands Water’s price submission provides detail on its forecast operating expenditure from pages 45 to 54.

We assess both:

- controllable costs – those that can be directly or indirectly influenced by a water corporation’s decisions
- non-controllable costs – those that cannot be directly or indirectly influenced by a water corporation’s decisions.

For controllable operating expenditure, our assessment process first confirms an efficient baseline, based on the last year of actual costs prior to our price review (that is, 2016-17). We then consider

Our assessment

the forecast costs relative to this baseline, including the proposed efficiency improvement rate and forecast growth, and any proposed cost changes relative to the baseline. We engaged Deloitte Access Economics to provide expert advice to inform our assessment of controllable operating expenditure. Deloitte's report on its assessment of Central Highlands Water's expenditure forecast is available on our website.²³

For non-controllable expenditure (including bulk water and sewerage services, government charges and licence fees) we confirm the proposed forecasts, with reference to the relevant regulatory body where appropriate.

Table 2.3 sets out our draft decision on Central Highlands Water's forecast operating expenditure, for the purpose of establishing the revenue requirement (Table 2.1). Details of our assessment and reasons for our proposed adjustments to Central Highlands Water's proposal follow, with a summary of our adjustments shown at Table 2.4.

We consider our proposed operating expenditure in this draft decision reflects the expenditure that a prudent service provider would incur when acting efficiently to achieve the lowest cost in delivering the outcomes specified in Central Highlands Water's price submission.

The benchmark operating expenditure that we propose to adopt for Central Highlands Water does not represent the amount that Central Highlands Water is required to spend or allocate to particular operational, maintenance and administrative activities. Rather, it represents assumptions about the overall level of operating expenditure (to be recovered through prices) that we consider sufficient to operate the business efficiently and to maintain services over the regulatory period.

²³ Deloitte Access Economics 2018, *Central Highlands Water – expenditure review for 2018 water price review*, February.

Table 2.3 Draft decision – operating expenditure

\$ million 2017-18

	2018-19	2019-20	2020-21	2021-22	2022-23	Total
Controllable costs	52.9	52.7	51.2	51.0	50.9	258.6
Non-controllable costs	4.9	4.8	4.8	4.7	4.6	23.8
Bulk services ^a	0.8	0.8	0.8	0.8	0.8	3.9
Environmental contribution ^b	3.9	3.8	3.7	3.6	3.5	18.5
Licence fees - ESC ^c	0.050	0.050	0.050	0.050	0.077	0.277
Licence fees - DHHS ^c	0.030	0.030	0.030	0.030	0.030	0.150
Licence fees - EPA ^c	0.187	0.187	0.187	0.187	0.187	0.937
Draft decision – operating expenditure	57.8	57.5	55.9	55.6	55.5	282.4

^a Bulk services covers the supply of bulk water and sewerage services

^b The Environmental Contribution collects funds from water corporations under the WI Act

^c License fees are paid to cover costs incurred by Department of Health and Human Services, Environment Protection Authority Victoria, and the Essential Services Commission in their regulatory activities related to the water corporation

Note: Numbers have been rounded

Central Highlands Water proposed a total forecast controllable operating expenditure of \$266.0 million over a five-year regulatory period. For the reasons set out below, we propose to reduce this by \$7.4 million to establish a benchmark controllable operating expenditure of \$258.6 million.

Baseline controllable operating expenditure:

- Central Highlands Water did not propose any adjustments to its actual 2016-17 baseline year controllable operating expenditure. The starting point for forecast annual operating expenditure of \$50.36 million is 4.1 per cent lower than the benchmark of \$52.52 million allowed for 2016-17 in the previous price determination. Central Highlands Water has achieved this by introducing

Our assessment

efficiency measures as part of the government's water rebate program. Deloitte considers the 2016-17 baseline figure reflects an efficient baseline cost and no adjustment is necessary.²⁴ We agree with Deloitte's assessment and consider this is a reasonable starting point for forecasting annual operating expenditure.

Efficiency improvement:

- Central Highlands Water's proposed efficiency improvement rate on controllable operating costs is 1.6 per cent per annum. This is relatively high compared to its past performance (where it met our mandated 1 per cent efficiency rate). Central Highlands Water's proposed efficiency improvement rate is the seventh highest rate proposed by water corporations in their price submissions. It is the same as Central Highlands Water's forecast connection growth rate of 1.6 per cent per annum, giving a flat annual growth-adjusted baseline operating cost.

Proposed cost changes:

- Central Highlands Water has sought additional operating expenditure of \$12.71 million (5.0 per cent) above the growth-adjusted baseline, the fifth highest of all regional water corporations, and the sixth highest state-wide.
- The largest component of this proposed increase was for electricity, with a net additional cost of \$5.49 million. This includes an increase of \$7.50 million due to higher retail electricity prices, offset by a decrease of \$2.01 million due to reduced electricity consumption due to its proposed renewal energy projects. Deloitte reviewed forecast electricity costs above the baseline and compared these with its latest forecasts for electricity prices. Deloitte recommended an indicative reduction of \$2.50 million as it did not agree with Central Highlands Water's forecasted higher electricity prices continuing beyond 2019-20 through to 2022-23, particularly considering the investment that Central Highlands Water has proposed for emissions reductions.²⁵ This adjustment removes both the increase from forecast higher electricity prices (\$4.50 million) and the proposed savings from the solar energy projects. We accept Deloitte's recommendation as we consider it reflects a more accurate forecast of efficient electricity costs during the 2018–23 regulatory period. However we do acknowledge that there is currently uncertainty in forecasting electricity prices and Central Highlands Water's electricity contract expires in July 2018. We request that Central Highlands Water proposes a revised electricity forecast based on its new contract prices in response to our draft decision.

²⁴ Deloitte Access Economics, op. cit., p. 13.

²⁵ Deloitte Access Economics, op. cit., pp. 16-19.

Our assessment

- Central Highlands Water sought additional expenditure of \$3.80 million for labour costs, for wage increases above inflation resulting from its enterprise agreement. Deloitte’s assessment of wage increases above inflation is that these should be managed by the water corporation through productivity improvements or through the growth allowance applied to the baseline, as most other water corporations have proposed.²⁶ We agree with Deloitte’s view, and do not accept this as prudent additional operating expenditure.
- Central Highlands Water has proposed \$3.43 million additional expenditure for new initiatives. This comprises:
 - \$0.25 million to support increased capacity of the Ballarat North recycled water plant that cannot be funded within the growth-adjusted baseline. Deloitte considered this was reasonable and was well supported by the community, Government and other stakeholders as part of Central Highlands Water’s integrated water management program.²⁷ We agree that this is prudent additional operating expenditure.
 - \$0.85 million additional costs during the early years of the proposed digital metering program roll-out (see our discussion on this program in the capital expenditure section). Consistent with its recommendation on the roll-out of the program, Deloitte recommended allowing this expenditure. We accept Deloitte’s recommendation as it reflects prudent expenditure.
 - \$2.0 million for water efficiency programs, including \$0.9 million for tank rebates, \$0.7 million for a behavioural change program and \$0.4 million for community rebates. Deloitte reviewed these and found that customers strongly supported the tank rebate program. However, Deloitte considered the costs associated with the behavioural change program and community rebates should be able to be managed within the growth-adjusted baseline, and recommended removing \$1.10 million from the additional expenditure for new initiatives. We have accepted Deloitte’s recommendation for our draft decision. However we would consider further information from Central Highlands Water to demonstrate how these are additional to activities normally undertaken by a water corporation as part of its water efficiency program.

We consider applying our proposed adjustment of \$7.39 million to Central Highlands Water’s total proposed controllable operating expenditure forecast better meets the requirements of the WIRO and the criteria for prudent and efficient expenditure outlined in our guidance.²⁸ This will bring about a greater decrease (in real terms) in controllable operating expenditure per connection relative to the baseline year, placing Central Highlands Water ahead of the industry average, as shown in Figure 2.1.

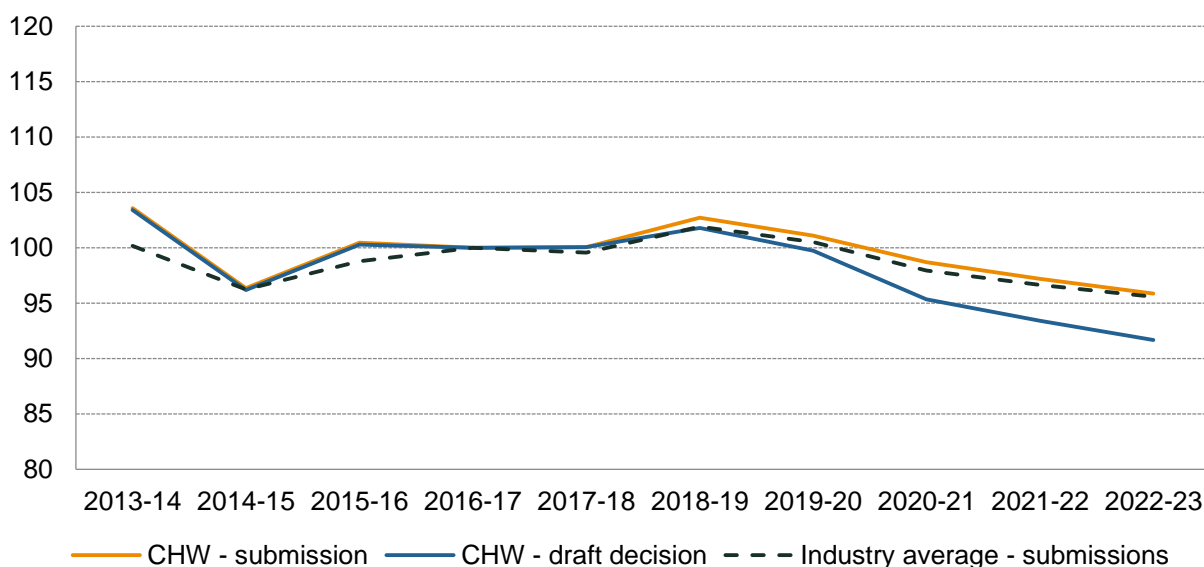
²⁶ Deloitte Access Economics, op. cit., pp. 15-16.

²⁷ Deloitte Access Economics, op. cit., pp. 20-21 and p. 26.

²⁸ Essential Services Commission 2016, *Guidance paper*, op. cit., p. 31.

Figure 2.1 Controllable operating expenditure per water connection

Index: 2016-17=100



Submission – based on actual historical and forecast values provided by the water corporation in its price submission.
 Draft decision – includes any corrections or adjustments to historical and forecast values arising from our assessment.
 Industry average – drawn from the price submissions for all urban water corporations (excludes rural expenditure).

For non-controllable operating expenditure, we have adjusted Central Highlands Water’s forecasts where required based on the latest information received from the relevant regulatory authorities on their licence fees and the environmental contribution. The values we have adopted for our draft decision are set out in Table 2.3 above.

For the environment contribution, we have used the 2018-19 value provided by the Department of Environment, Land, Water and Planning and assumed that this will remain flat in nominal terms (decline in real terms) across the 2018–23 regulatory period.

We have assumed the licence fees for the Department of Health and Human Services, the Environment Protection Authority Victoria and the Essential Services Commission remain flat in real terms across the period, but with a 50 per cent increase for our commission fee in 2022-23 to align with our regulatory review cycle.²⁹

We have increased Central Highlands Water’s forecast non-controllable operating expenditure by \$0.96 million across the 2018–23 period, resulting from our adjustments to:

²⁹ The Department of Health and Human Services and the EPA Victoria provided their latest 2016-17 licence fees for making our draft decision. We have also based our forecast on our 2016-17 commission licence fee.

- include the Environment Protection Authority licence fee of \$0.187 million per year (a total increase of \$0.937 million)
- increase our commission licence fee by \$0.027 million in 2022-23.

Overall, non-controllable operating expenditure will increase by \$0.73 million from 2017-18 to 2018-19, due to the increase in the environment contribution from \$3.12 million to \$3.88 million, partly offset by a decrease in our commission license fee from \$0.29 million to \$0.27 million.

Prior to making our final decision, we will adjust Central Highlands Water's forecast non-controllable operating expenditure for the latest inflation and external bulk charges data. We will verify Central Highlands Water's forecast external bulk water charges against the current price determination for Goulburn-Murray Water.

Table 2.4 sets out our proposed adjustments to both controllable and non-controllable operating expenditure.

Table 2.4 Adjustments to operating expenditure
\$ million 2017-18

	2018-19	2019-20	2020-21	2021-22	2022-23	Total
Proposed total operating expenditure	58.1	58.1	57.5	57.5	57.6	288.8
Labour	-0.3	-0.5	-0.8	-1.0	-1.3	-3.8
Electricity	0.0	0.0	-0.8	-0.8	-0.8	-2.5
New initiatives	-0.2	-0.2	-0.2	-0.2	-0.2	-1.1
Total adjustments to controllable costs	-0.5	-0.7	-1.8	-2.1	-2.3	-7.4
Licence fees	0.187	0.187	0.187	0.187	0.214	0.964
Total adjustments to non-controllable costs	0.187	0.187	0.187	0.187	0.214	0.964
Draft decision - total operating expenditure	57.8	57.5	55.9	55.6	55.5	282.4

Note: Numbers have been rounded

Our assessment

Regulatory asset base

The regulatory asset base is used to estimate the return on assets and regulatory depreciation in the revenue requirement. Our guidance required Central Highlands Water to propose its:

- closing regulatory asset base at 30 June 2017
- forecast regulatory asset base for each year of the regulatory period from 1 July 2018.

Closing regulatory asset base

We update the regulatory asset base to reflect actual gross capital expenditure, less government and customer contributions, and asset disposals for the period to 30 June 2017. This helps to ensure prices reflect the actual net expenditure of a water corporation.³⁰

Central Highlands Water's proposed closing asset base at 30 June 2017 and supporting calculations are set out at page 69 of its price submission.

We compared Central Highlands Water's actual net capital expenditure for 2012-13 to 2016-17 with the forecast used to approve maximum prices for the period from 1 July 2013. We undertake a prudence and efficiency review where a water corporation's net capital expenditure is more than 10 per cent above the forecast used to approve maximum prices for the period from 1 July 2013. We believe this approach is reasonable given capital expenditure can be relatively 'lumpy' in nature.

In its price submission, Central Highlands Water assumed \$85.8 million net capital expenditure over the period from 2012-13 to 2016-17. We identified some minor corrections required, which reduced this to \$84.5 million. This figure is 20.5 per cent lower than the forecast used to approve maximum prices for the period from 1 July 2013. This is well below the 10 per cent threshold identified above, so we have not undertaken a prudence and efficiency review of its past net capital expenditure.

Other than this correction for past net capital expenditure, Central Highlands Water calculated its closing regulatory asset base in accordance with the requirements of our guidance. For these reasons, our draft decision proposes to approve a closing regulatory asset base for 30 June 2017 of \$335.0 million.

Table 2.5 sets out our draft decision on Central Highlands Water's regulatory asset base at 30 June 2017.

³⁰ Net capital expenditure is calculated by deducting government and customer contributions from gross capital expenditure. Customer contributions reflects revenue earned from new connections made to the water corporation's water, sewerage or recycled water networks.

Table 2.5 Closing regulatory asset base
\$ million 2017-18

	2012-13	2013-14	2014-15	2015-16	2016-17
Opening RAB 1 July	319.2	321.6	322.0	324.7	328.7
Plus gross capital expenditure	17.0	16.8	20.8	22.0	23.1
Less government contributions	2.2	0.8	0.8	2.2	0.5
Less customer contributions	2.3	1.9	1.9	1.4	1.4
Less proceeds from disposals	0.2	0.2	1.5	0.2	0.5
Less regulatory depreciation	10.0	13.5	13.9	14.2	14.6
Closing RAB 30 June	321.6	322.0	324.7	328.7	335.0

Note: Numbers have been rounded

Forecast regulatory asset base

The forecast regulatory asset base is calculated having regard to the closing asset base, and forecasts for capital expenditure, government and customer contributions, and asset disposals.

Table 2.6 sets out our draft decision on Central Highlands Water's forecast regulatory asset base from 1 July 2018.³¹ Our assessment of the components of the forecast regulatory asset base is set out below.

³¹ Our guidance required water corporations to provide an estimate of the components of its regulatory asset base for 2017-18. This is so we can assess the opening asset base for 1 July 2018. Our guidance noted that where the 2017-18 forecasts for net capital expenditure (gross capital expenditure less government and customer contributions) is lower than the forecast benchmark for that year in its 2013 price determination, the lower amount must be used (otherwise the 2013 determination forecast applies). The estimates for 2017-18 will be confirmed at the price review following the 2018 water price review.

Table 2.6 Forecast regulatory asset base
\$ million 2017-18

	2017-18	2018-19	2019-20	2020-21	2021-22	2022-23
Opening RAB 1 July	335.0	342.2	351.4	362.5	369.5	374.9
Plus gross capital expenditure	24.1	27.2	29.9	26.2	25.4	21.2
Less government contributions	0.03	0.0	0.0	0.0	0.0	0.0
Less customer contributions	1.4	1.5	1.6	1.6	1.7	1.7
Less proceeds from disposals	0.4	0.3	0.3	0.3	0.3	0.3
Less regulatory depreciation	15.0	16.2	17.0	17.4	18.0	18.3
Closing RAB 30 June	342.2	351.4	362.5	369.5	374.9	375.8

Note: Numbers have been rounded

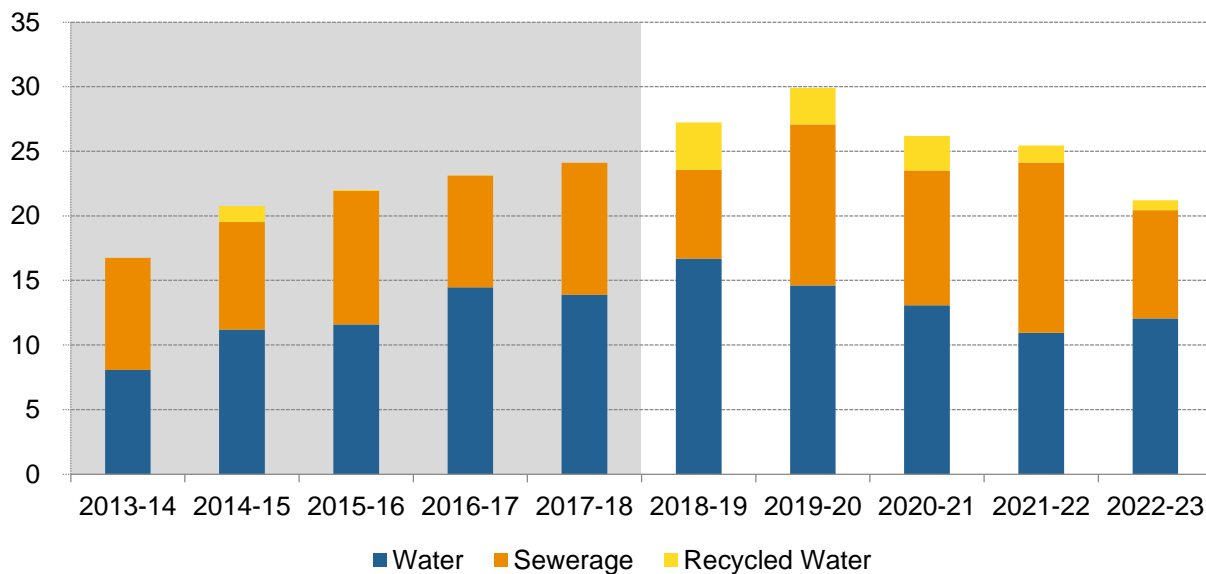
Capital expenditure

Capital expenditure is an input to estimating the regulatory asset base. Central Highlands Water's forecast capital expenditure and supporting information is provided at pages 55 to 67 and 103 to 135 of its price submission. This is summarised in Figure 2.2, for the current 2013–18 period, and as proposed by the water corporation for the 2018–23 period.

We engaged Deloitte Access Economics to provide expert advice to inform our assessment of capital expenditure. Deloitte's report on its assessment of Central Highlands Water's expenditure forecast is available on our website.³²

³² Deloitte Access Economics, op. cit.

Figure 2.2 Gross capital expenditure by service category
\$ million 2017-18



Note: actuals for 2013-14 to 2016-17 and water corporation forecasts for 2017-18 to 2022-23

For the reasons set out below, we have accepted the forecast capital expenditure proposed by Central Highlands Water for our draft decision on its revenue requirement:

- Central Highlands Water’s price submission provided evidence that its forecasts for capital expenditure are efficient. Central Highlands Water’s proposed capital expenditure is \$23.23 million (22 per cent) higher than the current regulatory period, driven by a large increase in renewals, a full rollout of a digital metering project following on from a trial project, and a focus on improvements and compliance projects.
- Deloitte requested selected documents from Central Highlands Water as a representative sample to demonstrate its asset management processes and justification for its capital expenditure program. Based on the sample of documents reviewed, these demonstrate that Central Highlands Water has a robust approach for developing project scope, the timing of works and cost estimates.
- Deloitte reviewed information for the renewals expenditure program, which represents over 45 per cent of the total capital expenditure for the fourth regulatory period. Deloitte also reviewed information on the digital metering project, Maryborough wastewater reuse scheme, and the integrated water management and recycled water program.
- Central Highlands Water has proposed a large increase in renewals expenditure of almost 70 per cent compared with previous pricing periods, predominantly to address the progressive deterioration of its ageing gravity sewer system. Deloitte was satisfied that the proposed increase is well supported by a combination of age profiles, failure analysis and condition

Our assessment

monitoring, and that Central Highlands Water’s renewals program approach is sound. Accordingly, Deloitte has proposed no adjustments to the proposed renewals expenditure.

- Central Highlands Water is proposing a full roll-out of digital meters across its entire water supply network, to be completed within the 2018–23 period. It has completed a proof-of-concept trial, and has demonstrated strong customer support for digital metering. The business case for the full roll-out shows a net present value close to zero, which makes it very sensitive to changes in input assumptions. While Deloitte had some reservations about the project and the level of detail in the supporting justification report and model, it accepted Central Highlands Water’s confidence in the project costings, noting it would have limited impact on customer bills. We accept Deloitte’s assessment of this project, and will retain the proposed funding for the full roll-out, noting the following:
 - We expect Central Highlands Water to manage customer expectations and concerns with digital metering.³³
 - We request Central Highlands Water develop some measures and customer reporting protocols to assess the success of each phase of the roll-out, to inform its decision to proceed to the next phase.
 - We expect Central Highlands Water to manage all risks associated with this roll-out, including costs and customer bill impacts.
- We consider the planned capital expenditure program is achievable, given Central Highlands Water’s past track record delivering its capital expenditure program. Over the current 2013–18 regulatory period, Central Highlands Water is expected to deliver all eight of its planned major projects.³⁴
- Where there is uncertainty in timing, cost, scope and benefits of capital expenditure, Central Highlands Water has excluded over \$30 million of speculative projects from its price submission, but has included planning costs where appropriate to inform projects needed from 2023. This is consistent with our guidance for managing uncertain expenditure. For our draft decision, we accept Central Highlands Water’s proposal for addressing uncertainty, noting the following:
 - Central Highlands Water will need to demonstrate the prudence and efficiency of these costs if they are indeed incurred during the 2018–23 period if seeking to include them in the regulatory asset base.

³³ We received a number of submissions relating to digital metering from Coliban Water stakeholders. We recommend Central Highlands Water take into account the matters raised in these submissions.

³⁴ Essential Services Commission 2018, *Status of major projects supplement: Water performance report 2016-17*, 1 March, pp. 13–14.

- Variations in capital expenditure from forecast during the 2018–23 period will form a key part of our assessment of the Performance element of PREMO at the next price review.
- We consider Central Highlands Water’s approach to forecasting its capital expenditure is consistent with the requirements of our guidance.

Our draft decision for total gross capital expenditure is to accept Central Highlands Water’s proposed benchmark, as set out in Table 2.6.

The benchmark that we adopt for Central Highlands Water does not represent the amount that the water corporation is required to spend or allocate to particular projects. Where we have made an adjustment to exclude a project’s capital expenditure from Central Highlands Water’s revenue requirement, we are not requiring the corporation to remove that project. Rather, it represents assumptions about the overall level of expenditure (to be recovered through prices) that we consider sufficient to operate the business and to maintain or improve services over the regulatory period. Central Highlands Water determines how to best manage the allocation of its revenue and priority of its expenditure within a regulatory period.

Customer contributions

Revenue from customer contributions is deducted from gross capital expenditure so it is not included in the regulatory asset base.³⁵

We compared Central Highlands Water’s forecast for customer contributions with past outcomes, and its forecasts for growth in customer connections.³⁶ We consider Central Highlands Water’s forecast contributions are reasonable, having regard to past trends and its growth forecasts.

Our draft decision proposes to accept Central Highlands Water’s forecasts for customer contributions.

Cost of debt

Our guidance required Central Highlands Water to use estimates of the cost of debt provided by the commission to estimate its revenue requirement. Central Highlands Water used the cost of debt values we specified to calculate its revenue requirement. For this reason, our draft decision accepts the cost of debt proposed by Central Highlands Water, as set out in Table 2.7.

³⁵ Revenue from new customer contributions reflects revenue raised from new connections made to a water corporation’s water, sewerage or recycled water networks.

³⁶ Growth in customer connections can be used as an indicator of growth in customer contributions.

Table 2.7 Trailing average cost of debt

	2008-09	2009-10	2010-11	2011-12	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18
Cost of debt (nominal)	6.9%	7.4%	7.0%	6.3%	5.3%	7.1%	5.4%	5.3%	4.9%	4.9%*

* Estimated cost of debt – we will update the 2017-18 figure before the final decision and price determination.

Note: Numbers have been rounded

From 2016, we accepted a ten-year trailing average approach to estimating the benchmark cost of debt, changing from an on-the-day approach. The trailing average approach better aligns the actual cost of debt for an efficient business to the regulated benchmark, compared with an on-the-day approach.³⁷ We consider the ten year trailing average approach helps to minimise risk to water corporations and provides better incentives for long-term investment.

Return on equity – PREMO rating

Central Highlands Water rated its price submission as ‘Advanced’. Based on its PREMO self-rating, Central Highlands Water proposed a rate of return on equity of 4.9 per cent per annum. This reflects the maximum return rate allowed in our guidance for a price submission rated as ‘Advanced’.³⁸

The return on equity is similar to rates we have approved in past reviews for the water industry. We have also had regard to the return on equity allowed or estimated by regulators in other Australian jurisdictions recently for the water industry.³⁹

Our draft decision accepts Central Highlands Water’s PREMO self-rating and proposed return on equity of 4.9 per cent per annum. Our assessment of Central Highlands Water’s proposed PREMO rating is set out in Chapter 3.

Regulatory depreciation

Regulatory depreciation is an input to calculating the regulatory asset base. Central Highlands Water’s forecast regulatory depreciation was calculated using a straight line depreciation profile.⁴⁰ We noted in our guidance that we prefer a straight line depreciation profile.⁴¹

³⁷ For more detail on the trailing average and on the day approaches to the cost of debt, see Essential Services Commission 2016, *Water pricing framework and approach*, op. cit., p.27.

³⁸ Essential Services Commission 2016, *Guidance paper*, op. cit., p. 49.

³⁹ Essential Services Commission of South Australia 2016, *SA Water regulatory determination 2016, Final determination*, June; Independent Pricing and Regulatory Tribunal 2017, *WACC biannual update*, August.

Our draft decision on regulatory depreciation differs from Central Highlands Water's proposal due to our proposed adjustments to capital expenditure. Our final decision will confirm the regulatory depreciation to be reflected in the forecast regulatory asset base.

Our draft decision on regulatory depreciation is shown in Table 2.5.

Tax allowance

The tax allowance is an input into the revenue requirement. Central Highlands Water has proposed no allowance for tax in its revenue requirement. Our draft decision is to accept the forecast as it was calculated consistently with the method required by our guidance.⁴²

Demand

Along with the revenue requirement, demand forecasts are an input to calculating prices.

Central Highlands Water's demand forecasts are set out at pages 79 to 81 of its price submission, and are also provided in its financial model.⁴³ Our draft decision proposes to accept Central Highlands Water's demand forecasts for the purpose of approving maximum prices as we consider they were estimated in a manner that is consistent with the requirements of our guidance. This includes basing demand forecasts on the latest *Victoria In Future* population growth forecasts issued by the Victorian Government.

Form of price control

Central Highlands Water proposed a price cap form of price control. It currently uses a price cap.

Our draft decision is to accept Central Highlands Water's proposed form of price control. A price cap will allow Central Highlands Water to recover sufficient revenue to cover the forecast efficient costs of providing services, and for it to deliver any health, safety and environmental obligations.

⁴⁰ For the period from 2018-19 to 2022-23, Central Highlands Water proposed a regulatory depreciation of \$86.9 million.

⁴¹ Essential Services Commission 2016, *Guidance paper*, op. cit., p. 42.

⁴² Essential Services Commission 2016, *Guidance paper*, op. cit., pp. 50-51.

⁴³ The financial model is also available on our website at www.esc.vic.gov.au

A price cap also provides customers with price certainty, and means a water corporation is managing demand risk on behalf of its customers. We consider demand risk is more efficiently managed by a water corporation, rather than its customers.⁴⁴

Prices and tariff structures

Central Highlands Water's proposed maximum tariffs are set out at pages 82 of its price submission. Central Highlands Water proposed stable prices for most customers from 2018-19.

Our draft decision revenue requirement is 1.7 per cent lower than Central Highlands Water's proposed revenue requirement. On average, this will result in a further reduction in prices from 2018-19 to 2022-23 by approximately the same amount. Central Highlands Water must provide updated prices in response to our draft decision revenue requirement.

Because of this, our draft decision does not approve maximum prices. We will provide final maximum prices in our final decision.⁴⁵ However, we have considered Central Highlands Water's proposals relating to changes in tariff structures. We have also considered submissions relating to the level of prices or bills.

As outlined in our guidance, we have provided the water corporations with a large degree of discretion to decide on individual tariff structures.⁴⁶ This recognises water corporations are often best placed to consider the interests of customers in designing tariffs, and that existing tariff structures have been developed over time to deal with a variety of local circumstances.

Central Highlands Water proposed a two-part tariff structure for the majority of its tariffs, continuing its current approach:

- For residential water services, Central Highlands Water proposed a fixed water service charge and a two-tier inclining block variable usage component, where price increases in the second block. (Central Highlands Water reduced this from three tiers to two from 1 July 2013.)
- For non-residential water services, Central Highlands Water proposed a two-part tariff with a fixed service charge and a variable usage component that depends on water used.
- For non-residential sewerage services, Central Highlands Water proposed a fixed service charge and a variable usage component.

⁴⁴ We note our determinations will allow water corporations flexibility to apply to change from a price cap to a weighted average price cap or tariff basket within a regulatory period.

⁴⁵ Tariff structure refers to the way in which prices are grouped and the manner of charging, for example, water and sewerage charges, fixed and variable charges.

⁴⁶ Essential Services Commission 2016, *Guidance paper*, op. cit., p. 55.

- For residential sewerage services, Central Highlands Water proposed a fixed service charge.

Two part tariffs

We consider the two-part structure proposed by Central Highlands Water for its water service tariffs will promote efficient use of services. The two-part structure for water tariffs sends customers a signal about the costs of their water use, and is an approach that is commonly applied in other states and territories.⁴⁷ We also consider two-part tariff structures are easy to understand. Central Highlands Water's customers indicated continued support for a two-tiered inclining block tariff for the variable component.

For sewerage tariffs, we consider Central Highlands Water's proposed fixed charge only for residential customers and a two-part tariff for non-residential tariffs sends customers signals about efficient costs.⁴⁸

Unique services

We confirmed with Central Highlands Water that its proposed tariffs for recycled water, trade waste and miscellaneous services are calculated in accordance with the pricing principles referenced in our guidance.

Environmental Water

A submission by the Victorian Environmental Water Holder (VEWH) noted inconsistencies in charging arrangements for environmental water between water corporations.⁴⁹ It also noted inconsistent approaches to how water corporations charged for environmental water services (mainly differences in whether corporations' treated environmental water services as a prescribed or alternatively, a non-prescribed service).

We do not have a role in setting the maximum price for environmental water as the services provided to VEWH are not defined as prescribed services in the WIRO.⁵⁰

We note that expenditure and revenue related to the VEWH is treated as non-prescribed by Central Highlands Water.

⁴⁷ Includes the tariffs of Icon Water, Sydney Water, Hunter Water, Gosford City Council, Wyong Shire Council, Power and Water Corp, Urban Utilities, Unity Water, SA Water and TasWater.

⁴⁸ Our reasons are outlined in our 2013 draft decisions on price review 2012-13 to 2017-18.

⁴⁹ Victorian Environment Water Holder 2017, *Submission on water corporation water pricing proposals*, 9 November.

⁵⁰ The commission has never regulated Victorian environmental water charges. The charge was implemented by businesses during 2012-13 to 2017-18 as a ministerial directive.

Price and bill levels

From 2014-15, Central Highlands Water's residential customers receiving a bill with water usage charges received an annual rebate of \$50. The rebate reflects the outcomes of a government efficiency review, and ends after 2017-18. Central Highlands Water has proposed to maintain water usage prices at current levels, absorbing the removal of the rebate.

We note that Central Highlands Water proposed a small reduction to the residential and non-residential fixed sewer service charge.

Submissions by both Gerald Mallon and the Consumer Action Law Centre highlighted the impact price changes may have on some customers, particularly those with low or fixed incomes.⁵¹ On this, we consider Central Highlands Water's proposed tariffs take into account customers' interests, including low income and vulnerable customers, because:

- tariffs reflect efficient costs for delivering services
- tariffs were informed by an extensive customer engagement program
- Central Highlands Water has payment options and assistance for customers experiencing difficulty paying bills.

Draft decision

For the reasons set out above, our draft decision accepts Central Highlands Water's proposed tariff structures as set out at pages 82 of its price submission. Prior to our final decision and price determination, Central Highlands Water must submit updated prices to reflect our draft decision on the revenue requirement, and our updates to cost of debt and inflation estimates, which we will provide in late April 2018.

Adjusting prices

Central Highlands Water's proposed price adjustment mechanism is set out at page 84 of its price submission, and further detailed in response to our queries.

It proposed to continue with the existing uncertain and unforeseen events mechanism.

Our draft decision approves the continuation of Central Highlands Water's existing uncertain and unforeseen events mechanism.

⁵¹ Gerald Mallon 2017, *Submission*, 7 November; Consumer Action Law Centre 2017, *Initial Feedback: 2018 Water Price Review*, 15 November.

We note in its submission, Central Highlands Water indicated it would only seek a reopening of its determination to adjust prices for significant unforeseen events with an impact greater than \$15 million on its revenue requirement. In response to our draft decision, Central Highlands Water must further explain how it intends to apply this trigger for both upward and downward impacts on revenue.

Central Highlands Water has not included adjustments to reflect movements in the cost of debt, as set out in our guidance. We requested further information from Central Highlands Water. In response, it noted that it will accept a method set by the commission to adjust prices to reflect movements in the cost of debt.

New customer contributions

New customer contributions (or developer charges) are levied by water corporations when a new connection is made to its water, sewerage or recycled water networks. New customer contributions can be either standard or negotiated. Standard charges apply to new connections in areas where infrastructure requirements and growth rates are relatively well known, while negotiated charges allow water businesses and developers to negotiate a site-specific arrangement.

Central Highlands Water's proposed charges for new customer contributions are set out at page 82 of its price submission. Central Highlands Water proposed to maintain the standard water new customer contribution charge at the 2017-18 level until 2022-23.

Central Highlands Water outlined its intention to review standard customer contributions charges during the next regulatory period.⁵² In consultation with the commission, Central Highlands Water clarified that it will not be proposing a new charge during the period as this would have a flow through effect on approved tariffs.

For negotiated new customer contributions, Central Highlands Water proposes to continue to calculate a charge in accordance with the requirements of our NCC pricing principles.⁵³ We expect Central Highlands Water will apply a negotiated charge if there is a requirement for capacity upgrades above what is covered by a standard charge.

⁵² Central Highlands Water provided further information in response to a request for information.

⁵³ Essential Services Commission 2016, *Guidance paper*, op. cit., p. 62.

We have reviewed Central Highlands Water's proposed charge and consider it consistent with the requirements of our guidance and the NCC pricing principles.⁵⁴ For this reason, our draft decision proposes to accept Central Highlands Water's proposed new customer contribution charge.

Financial position

In approving prices, we must have regard to the financial viability of the water industry.⁵⁵ We interpret the financial viability requirements under the *Essential Services Commission Act 2001* (Vic) and the Water Industry Regulatory Order (2014) to mean that the prices we approve should provide a high level of certainty that each water corporation can generate sufficient cash flow to deliver on service commitments, including financing costs arising from investments to meet service expectations.

Central Highlands Water's price submission and the supporting financial model provided estimates for key indicators of financial performance. These estimates were based on its assumptions about revenue and expenditure. Our draft decision proposes adjustments to revenue and expenditure. We have reviewed the key indicators of financial performance based on our draft decision. Under our draft decision, we consider Central Highlands Water will generate sufficient cash flow to deliver on service commitments, including financing costs arising from investments to meet service expectations.

⁵⁴ Central Highlands Water provided the commission with supporting modelling showing its regard for incremental costs and incremental revenue.

⁵⁵ WIRO clause 8(b)(ii) and ESC Act s.8A(1)(b).

3. PREMO rating

PREMO is an incentive mechanism that links the return on equity to a water corporation's level of ambition in delivering value to its customers.

For the 2018 price review, a water corporation must rate its price submission as 'Leading', 'Advanced', 'Standard' or 'Basic'. The rating is based on an assessment against the Risk, Engagement, Management and Outcomes elements of PREMO. A 'Leading' price submission is allowed the highest return on equity, and a 'Basic' the lowest.

The assessment tool included in our guidance directs a water corporation to consider its level of ambition in relation to matters covered in its price submission, such as proposals related to operating and capital expenditure, the form of price control, and tariffs.

In Chapter 2, we noted our draft decision is to accept Central Highlands Water's proposed return on equity of 4.9 per cent, based on the justification provided for the level of ambition in its price submission. Below, we set out our preliminary assessment of Central Highlands Water's proposed PREMO rating.

Our review of Central Highlands Water's PREMO self-rating

Central Highlands Water's proposed PREMO rating, and our draft decision is summarised below.

Table 3.1 PREMO Rating

	Overall PREMO rating	Risk	Engagement	Management	Outcomes
Central Highlands Water's rating	Advanced	Advanced	Advanced	Advanced	Advanced
Commission's rating	Advanced	Advanced	Advanced	Advanced	Advanced

We agree with Central Highlands Water's proposed overall PREMO self-rating of 'Advanced'. This is reflected in the return on equity we propose to approve for Central Highlands Water at page 22.

We agree with Central Highlands Water's proposed PREMO self-ratings for each element of PREMO. In support of its self-ratings, we note:

- The quality of Central Highlands Water's engagement program. In particular, Central Highlands Water's program was inclusive, and representative of its customer base, with customers across

its 15 supply systems having opportunities to participate. This enabled the corporation to target service improvements, such as a commitment to address water quality in a number of small towns. We also consider the information provided to customers was appropriate for the purpose and nature of its engagement.

- Central Highlands Water’s proposal to deliver better service outcomes. Along with improvements to water quality, Central Highlands Water has proposed to lift service targets for a number of other outcomes. This, along with its proposal for generally stable or falling prices, indicates that Central Highlands Water customers will receive greater value.
- We considered the rate of efficiency improvement forecast by Central Highlands Water. On improvements in controllable operating costs per connection, the corporation’s proposal incorporated an expected rate of improvement around the average of other water corporations. However, we consider its self-rating is also supported by our expenditure review, which proposes no change to its capital expenditure forecast, and relatively small adjustments to operating expenditure. Its Management rating was also supported by the high quality of its written submission and financial model. We found Central Highlands Water’s proposals were supported by sound justification and data.
- Central Highlands Water has proposed to expand its guaranteed service level scheme, and accept greater revenue risk in relation to delivering on its service commitments. We note also that Central Highlands Water has a strong track record in delivering its major capital projects on time. This indicates that internal processes for budgeting and planning are sound. It has also proposed to continue with its price cap form of price control, thereby managing demand risk for its customers.

4. We invite feedback on our draft decision

We invite feedback from stakeholders on our draft decision before we make a final decision and price determination. Our final decision and price determination will be made in June 2018.

Stakeholders may comment on any aspect of our draft decision, including the information we have relied upon in our assessment (such as Central Highlands Water's price submission). Feedback may also cover:

- additional matters or issues we should consider before making our final decision
- whether our draft decision on Central Highlands Water's price submission has adequate regard to the matters in clause 11 of the WIRO and our guidance.

How to provide feedback:

Attend a public forum

We will hold a public forum in April or May 2018. Forums provide an opportunity for interested parties to discuss key features of our draft decisions. We will publish details of public forums at www.esc.vic.gov.au/waterpricereview.

Provide written comments or submissions

Written comments or submissions in response to this draft decision will be due in early May 2018.

We require submissions by this date so we have time to fully consider submissions for our final decision. Comments or submissions received after this date may not be afforded the same weight as submissions received by the due date.

We would prefer to receive comments and submissions via our website at www.esc.vic.gov.au/waterpricereview.

Alternatively, you may send comments and submissions by mail to:

2018 Water Price Review
Essential Services Commission
Level 37, 2 Lonsdale Street
Melbourne VIC 3000

We usually make all comments and submissions publicly available in the interests of transparency. If you wish part or all of your submission to be private, please discuss with commission staff.

We invite feedback

If you cannot access documents related to our price review, please contact us to make alternative arrangements (phone (03) 9032 1300).

Next steps

Indicative dates are provided below. To keep up-to-date, visit our website at www.esc.vic.gov.au/waterpricereview.

- April or May 2018 – public forum.
- 8 May 2018 – closing date for submissions on our draft decision.
- June 2018 – release date for final decision and price determination.

APPENDIX A – submissions received

Name or organisation	Date received
Environment Protection Authority Victoria	12 December 2017
Consumer Action Law Centre	15 November 2017
Victorian Environmental Water Holder	9 November 2017
Mr G Mallon	7 November 2017