



City West Water draft decision

2018 Water Price Review

28 March 2018



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Summary

In September 2017, City West 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 City West 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.

City West Water has committed to improving outcomes for customers

Our draft decision proposes to approve a revenue requirement that will allow City West 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 City West Water plans to improve outcomes for customers are by:

- reducing maximum prices for residential and non-residential customers
- providing live updates on works or service interruptions
- extending the opening hours of its customer service centre
- increasing support for customers experiencing financial hardship.

Our draft decision accepts City West Water's proposed guaranteed service levels as they were developed in consultation with its customers.

We propose a slight reduction to the revenue requirement, based on our review of efficient costs

Our draft decision proposes to approve a revenue requirement of \$3,195.4 million for City West Water over the five year period starting 1 July 2018.³ This is \$3.6 million or 0.1 per cent lower than proposed by City West Water. This reflects our proposed adjustments to City West Water's forecasts for operating and capital expenditure, and in particular:

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

² City West 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 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.

- our proposed reductions for operating costs for the new West Werribee salt reduction plant, to better reflect the expected capacity utilisation of the plant
- our adoption of lower forecasts for City West Water’s asset renewals program, with our review finding there was insufficient justification for the increase proposed by the water corporation.

More details on our assessment are available later in our draft decision paper – see from page 9 for operating expenditure, and from page 19 for capital expenditure.

Compared to City West Water’s proposal, our draft decision means City West Water’s prices over 2018-19 to 2022-23 will be around 0.1 per cent lower (on average).⁴ City West Water must respond to our draft decision and propose individual tariffs that reflect our initial views on the revenue requirement. City West Water’s response will determine the price and bill impact of our draft decision on individual tariffs and customer groups.

We have accepted City West Water’s proposals for changes to residential tariffs

We propose to accept City West 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. City West Water currently uses a price cap.

We have also accepted City West Water’s proposed tariff structures.

For residential water tariffs, City West Water proposed a fixed service charge and a variable component that depends on water use.

For the variable component, City West Water proposed to reduce the inclining block from three steps to two, to help address affordability for large families. For residential sewerage, City West Water proposed a fixed service charge and a variable sewage disposal charge. It proposed to reduce the variable sewage disposal charge as a step towards phasing this charge out. Our draft decision accepts these changes. We note they reflect a shift to more efficient tariff structures.

Our assessment of the form of price control and tariff structures is set out from page 25.

City West Water’s price submission is rated as ‘Advanced’ under PREMO

Our draft decision is to accept City West Water’s PREMO self-rating of its price submission as ‘Advanced’ (Table A). City West Water has demonstrated that its proposals will deliver better value to its customers. This is reflected in City West Water’s proposals to reduce prices, and to improve services in areas that its community engagement found are highest priority among its customers.

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.

Our review of City West Water’s PREMO rating is set out from page 33.

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
City West 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, City West 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, City West 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 City West 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 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

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.

- 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 City West Water to inform its price submission. The guidance set out how we will assess City West 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 City West 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.

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

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

⁸ Essential Services Commission 2017, *City West 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.

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

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.

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.

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.

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 City West Water's price submission

We have made our draft decision on City West Water's price submission after considering: City West Water's price submission, its responses to our queries, 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 City West 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. City West Water's price submission addressed each of these matters. Our preliminary assessment of these matters is provided in this chapter.

We found City West Water's price submission and supporting information was of a high quality. This is reflected in the relatively minor adjustments to its revenue requirement proposed in our draft decision. We also consider City West Water 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).

City West 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 City West Water in June 2018.

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

Regulatory period

City West Water proposed a five year regulatory period. Our draft decision accepts City West 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 City West Water to engage with customers to inform its price submission.

The engagement by City West Water:

- took place between November 2016 and September 2017
- included a range of engagement methods including focus groups, interviews, online discussion forums, surveys, workshops, and pop-up stalls at community festivals and shopping centres
- covered matters such as the service priorities of customers, the structure of residential tariffs, and the corporation's guaranteed service level scheme.

More detail on City West Water's engagement is available in its price submission.²⁰

Evidence that City West Water's engagement influenced its proposals includes:

- taking into account customer feedback in proposing a change from a three to two step tariff structure for its residential water usage tariff
- expanding the ways customers may contact the business, including by extending the opening hours of its customer service centre and expanding online communications
- proposing four new guaranteed service levels in response to customer feedback about service priorities.

The influence of City West 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 City West Water's price submission is available on our website at www.esc.vic.gov.au.

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).

Outcomes

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

- services to homes and businesses are safe, reliable and efficiently delivered
- customer service is accessible and enquiries are promptly resolved
- billing and payment options are efficient and convenient
- customers in hardship are supported
- the whole of the water cycle is managed in an environmentally sustainable way
- City West Water is a valued partner in servicing a growing Melbourne.

City West Water proposed measures and targets that it will use to report on performance against each outcome. These are set out at appendix B of its price submission.

City West Water has committed to reporting annually to customers on performance against the proposed targets, comparisons against the industry average, and the status of major projects. This report will be available on its website, and summarised on bills.

We will engage with City West 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.

City West Water's proposed GSLs are set out on pages 45 and 46 of its price submission. It has proposed to keep its existing GSLs, and raise the payment or rebate amount for each. In response to customer feedback, City West Water proposed to introduce four new GSLs relating to advance notice of planned water supply interruptions, the timing of unplanned water supply interruptions, the number of unplanned water supply interruptions, and sewerage spills in a house.²²

We propose to accept City West Water's proposed GSLs as they were developed in consultation with their customers. Final GSLs will be subject to our consideration of any feedback following the release of our draft decision.

²² City West Water's proposed GSLs are set out in its price submission from page 45 – its price submission is available at www.esc.vic.gov.au.

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.²³

City West Water proposed a revenue requirement of \$3,199.0 million over a five year period starting 1 July 2018. Our draft decision proposes to reject the revenue requirement in City West Water's submission, and instead approve a revenue requirement of \$3,195.4 million, 0.1 per cent lower than proposed by City West 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	475.7	474.5	466.4	467.0	467.7	2,351.3
Return on assets	79.1	80.0	80.5	80.2	80.0	399.8
Regulatory depreciation	76.8	75.6	76.2	78.6	65.1	372.5
Tax allowance	16.4	15.5	14.7	14.3	10.9	71.9
Draft decision – revenue requirement	648.1	645.6	637.8	640.2	623.7	3,195.4

Note: Numbers have been rounded

The main adjustments we've proposed in our draft decision on the revenue requirement relate to our assessment of City West Water's expenditure forecasts. Table 2.2 summarises proposed changes to the revenue requirement.

²³ 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 City West Water in the regulatory period from 1 July 2018. We had regard to their views in our draft decision.

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, City West Water 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, City West 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	648.3	646.0	638.5	641.2	625.0	3,199.0
Operating expenditure	-0.6	-0.5	-0.9	-1.0	-0.8	-3.8
Return on assets	0.3	0.2	-0.02	-0.3	-0.5	-0.3
Regulatory depreciation	-0.02	-0.1	0.2	0.2	-0.01	0.3
Tax allowance	0.01	0.004	0.1	0.1	0.03	0.2
Total adjustments	-0.3	-0.4	-0.7	-1.0	-1.3	-3.6
Draft decision revenue requirement	648.1	645.6	637.8	640.2	623.7	3,195.4

Note: Numbers have been rounded

Operating expenditure

Operating expenditure is an input to the revenue requirement. City West Water’s price submission provides detail on its forecast operating expenditure from pages 49 to 57.

We assess both:

- controllable costs – those that can be directly or indirectly influenced by a water corporation’s decisions

Our assessment

- 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 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 City West Water’s expenditure forecast is available on our website.²⁴

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 City West 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 City West 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 City West Water’s price submission.

The benchmark operating expenditure that we propose to adopt for City West Water does not represent the amount that City West 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.

²⁴ Deloitte Access Economics 2018, *City West 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	105.1	105.9	106.3	107.0	107.3	531.6
Non-controllable costs	370.6	368.6	360.1	360.1	360.3	1,819.7
Bulk services ^a	344.1	342.7	334.7	335.3	335.9	1,692.6
Environmental contribution ^b	25.9	25.3	24.7	24.2	23.6	123.6
Licence fees - ESC ^c	0.387	0.387	0.387	0.387	0.581	2.130
Licence fees - DHHS ^c	0.138	0.138	0.138	0.138	0.138	0.691
Licence fees - EPA ^c	0.122	0.122	0.122	0.122	0.122	0.611
Draft decision – operating expenditure	475.7	474.5	466.4	467.0	467.7	2,351.3

^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

City West Water proposed a total forecast controllable operating expenditure of \$535.2 million over a five-year regulatory period. For the reasons set out below, we propose to reduce this by \$3.5 million to establish a benchmark controllable operating expenditure of \$531.6 million.

Baseline controllable operating expenditure:

- City West Water has proposed a net upwards adjustment of \$0.73 million, producing a starting point for forecast annual operating expenditure. The increase was due to withheld payments for contractor performance in 2016-17, but these payments will be made in future years so should be included in the baseline. The resultant figure of \$99.80 million is 12 per cent below the benchmark of \$113.93 million allowed for 2016-17 in the previous price determination. Deloitte

Our assessment

assessed the proposed 2016-17 baseline and recommended no adjustment.²⁵ We accept Deloitte's recommendation as we consider this reflects an efficient baseline cost to forecast annual operating expenditure.

Efficiency improvement:

- Baseline operating expenditure forecasts will grow at the efficiency rate minus the growth rate of customer connections. City West Water's proposed efficiency improvement rate on controllable operating costs is 2.0 per cent per annum. This is greater than its past performance (where it met our mandated 1 per cent efficiency rate). We note City West Water's efficiency improvement rate is the lowest of the metropolitan water corporations although it is higher than all but two of the regional water corporations. This rate is lower than City West Water's forecast connection growth rate of 2.6 per cent per annum, giving an increasing annual baseline operating cost.

Proposed cost changes:

- City West Water has sought additional operating expenditure of \$20.66 million to its annual baseline cost for software, electricity and the new West Werribee salt reduction plant starting operation. It will manage any other forecast cost increases or decreases within its efficiency improvement rate and growth allowance.
- Deloitte reviewed the transfer of \$11.80 million of cloud computing costs from capital expenditure to operating expenditure. Deloitte considered City West Water's combined operating and capital IT expenditure against its 2013–18 spend and comparable Victorian water corporations. Given the combined IT expenditure is not increasing (in fact showing a slight decrease), Deloitte proposed no adjustment.²⁶ We accept Deloitte's recommendation as we are satisfied that the adjustments reflect efficient expenditure, and it is more appropriate that this is reflected as operating expenditure.
- Deloitte reviewed the \$6.86 million of proposed new operating expenditure for the production of recycled water from the new West Werribee salt reduction plant. During the Deloitte review, City West Water subsequently revised its proposed forecast to \$4.90 million, reflecting reduced facility maintenance costs compared with its price submission forecast. Deloitte recommended the adoption of City West Water's revised forecast, resulting in a reduction of \$1.96 million

²⁵ Deloitte Access Economics, op. cit., p.17.

²⁶ Deloitte Access Economics, op. cit., p. 21.

across the 2018–23 period.²⁷ We accept Deloitte’s recommendation as it reflects more efficient operating expenditure.

- City West Water advised us of a correction to its financial model due to a calculation error where increases in small market wholesale energy costs had been used for small network cost increases, thereby overstating electricity expenditure for small sites. City West Water proposed to reduce its forecast by \$0.46 million to correct this error, and we have adjusted its controllable operating expenditure accordingly.
- Deloitte reviewed forecast electricity costs above the baseline after the correction and compared these with its latest forecasts for electricity prices. Deloitte recommended an indicative reduction of \$1.09 million as it did not agree with City West Water’s forecasted higher electricity prices continuing beyond 2019-20 through to 2022-23.²⁸ 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 City West Water’s electricity contract expires 30 June 2018. We request that City West Water propose a revised electricity forecast based on its new contract prices in response to our draft decision.

We consider applying our proposed adjustment of \$3.52 million to City West Water’s total proposed controllable operating expenditure reflects the requirements of the WIRO, and the criteria for prudent and efficient expenditure outlined in our guidance.²⁹ City West Water has a forecast decline (in real terms) in controllable operating expenditure per water customer connection, slightly below the average for urban water corporations in our review (Figure 2.1).

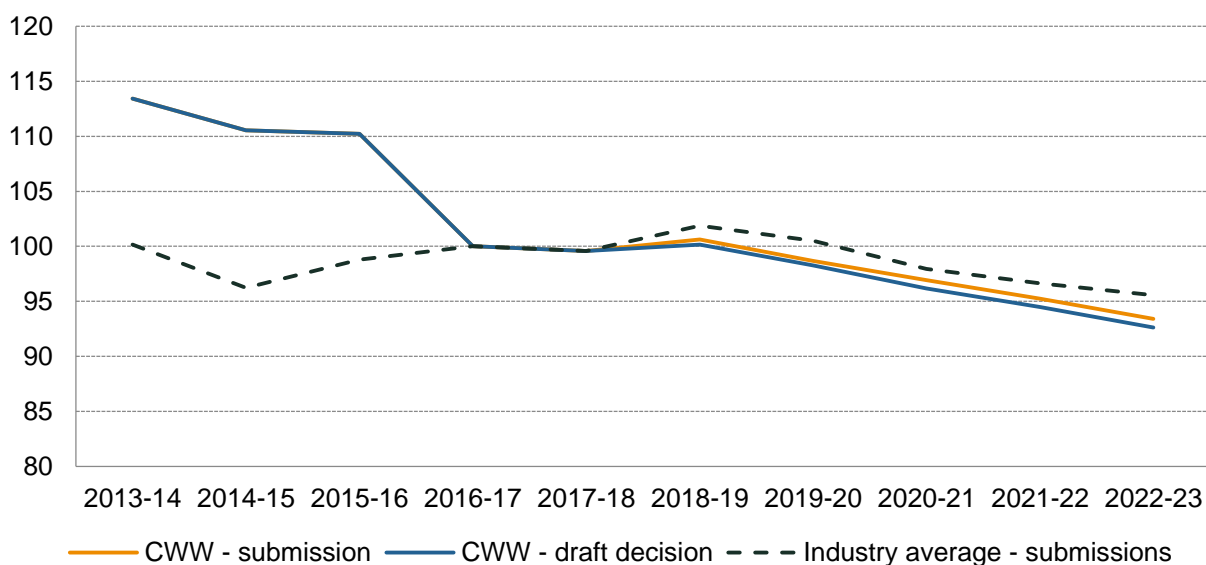
²⁷ Deloitte Access Economics, op. cit., p.22.

²⁸ Deloitte Access Economics, op. cit., pp. 22-26.

²⁹ 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 City West 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.³⁰

We have reduced City West Water’s forecast non-controllable operating expenditure by \$0.29 million across the 2018–23 period, resulting from our adjustments to:

³⁰ 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.

- increase the Department of Health and Human Services licence fee from \$0.00 million (no fee was shown in the template) to \$0.14 million per year (a total increase of \$0.69 million)
- decrease our commission licence fee by \$0.23 million per year from 2018-19 to 2021-22, and decrease the fee by \$0.04 million in 2022-23 (in total, a \$0.95 million reduction)
- decrease the Environment Protection Authority licence fee by \$0.005 million per year (a total reduction of \$0.024 million)

Overall, non-controllable operating expenditure will increase by \$8.51 million from 2017-18 to 2018-19, due primarily to the increase in the environment contribution from \$18.56 million to \$25.86 million and the increase in external bulk charges from \$342.71 million to \$344.11 million, partially offset by a decrease in licence fees.

Prior to making our final decision, we will adjust City West Water's forecast non-controllable operating expenditure for the latest inflation and external bulk charges data. We will verify City West Water's forecast bulk water charges against the current price determinations for Melbourne Water and 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	476.3	475.0	467.3	468.0	468.5	2,355.1
Electricity corrections	-0.1	-0.1	-0.1	-0.1	-0.1	-0.5
West Werribee recycled water production	-0.4	-0.3	-0.4	-0.4	-0.5	-2.0
Wholesale electricity market movements	0.0	0.0	-0.4	-0.4	-0.4	-1.1
Total adjustments to controllable costs	-0.5	-0.4	-0.8	-0.9	-0.9	-3.5
Licence fees	-0.096	-0.096	-0.096	-0.096	0.097	-0.287
Total adjustments to non-controllable costs	-0.1	-0.1	-0.1	-0.1	0.1	-0.3
Draft decision - total operating expenditure	475.7	474.5	466.4	467.0	467.7	2,351.3

Note: Numbers have been rounded

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 City West 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.³¹

We compared City West 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 'lumpy' in nature.

City West Water proposed \$446.9 million net capital expenditure over the period from 2012-13 to 2016-17. We identified some minor corrections required, which increased this to \$456.7 million. This figure is 32.1 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, City West 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 \$1,846.1 million.

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

³¹ 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	1,648.6	1,796.2	1,865.2	1,868.8	1,846.1
Plus gross capital expenditure	201.5	130.1	80.9	79.3	92.5
Less government contributions	0.6	1.2	5.0	2.5	1.3
Less customer contributions	17.6	17.0	21.5	27.9	33.1
Less proceeds from disposals	0.4	0.8	0.8	16.6	0.9
Less regulatory depreciation	35.4	42.0	50.1	55.0	57.2
Closing RAB 30 June	1,796.2	1,865.2	1,868.8	1,846.1	1,846.1

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 City West Water's forecast regulatory asset base from 1 July 2018.³² Later sections provide an overview of our assessment of the components of the forecast regulatory asset base.

³² 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	1,846.1	1,874.3	1,893.6	1,915.8	1,916.3	1,903.5
Plus gross capital expenditure	109.5	120.9	122.8	101.4	90.6	90.1
Less government contributions	-	-	-	-	-	-
Less customer contributions	21.2	24.3	24.5	24.2	24.2	23.8
Less proceeds from disposals	0.5	0.5	0.5	0.5	0.5	0.5
Less regulatory depreciation	59.6	76.8	75.6	76.2	78.6	65.1
Closing RAB 30 June	1,874.3	1,893.6	1,915.8	1,916.3	1,903.5	1,904.2

Note: Numbers have been rounded

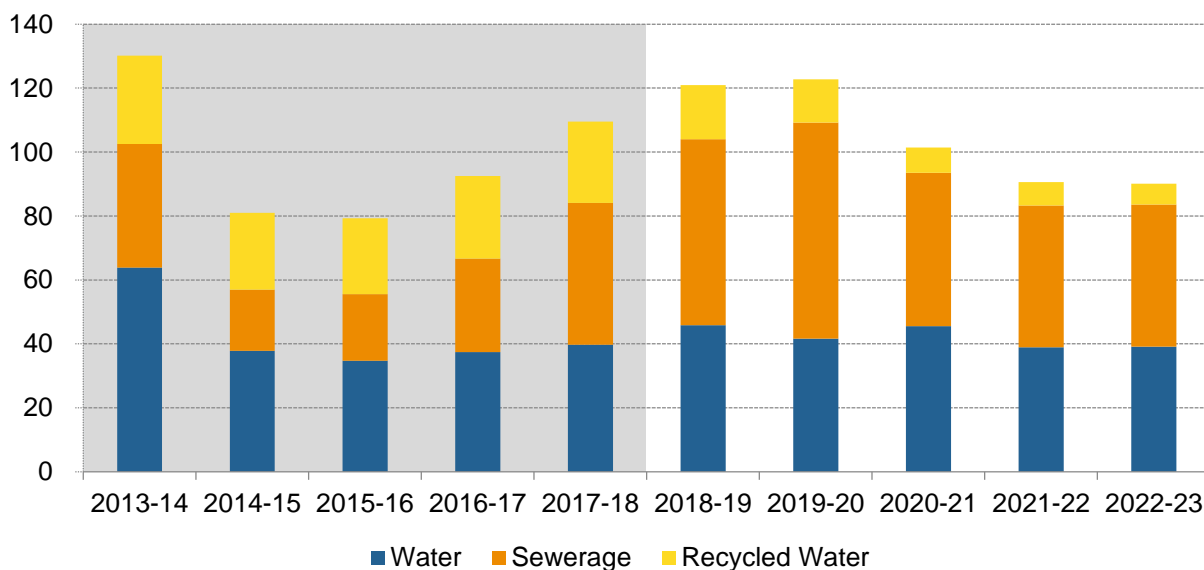
Capital expenditure

Capital expenditure is an input to estimating the regulatory asset base. City West Water's forecast capital expenditure and supporting information is provided at pages 58 to 64 and 104 to 141 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 City West Water's expenditure forecast is available on our website.³³

³³ Deloitte Access Economics 2018, 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

City West Water proposed a total gross capital expenditure of \$549.1 million over a five-year regulatory period. For the reasons set out below, we propose to reduce this by \$23.3 million (4 per cent) to establish a benchmark gross capital expenditure of \$525.8 million:

- City West Water’s price submission provided forecasts for gross capital expenditure that are 11.5 per cent or \$56.71 million higher than the current regulatory period, predominantly driven by renewals and growth.
- Deloitte requested selected documents from City West Water as a representative sample to demonstrate its asset management processes and justification for its capital expenditure program. The sample of documents reviewed demonstrate that City West Water has a reasonable approach for developing project scope, the timing of works and cost estimates.
 - Deloitte reviewed information for the water KPI renewals expenditure program, sewer growth developer works program, sewer KPI renewal program, water risk renewals water main network/reticulation program, sewer hydraulic compliance program, meter services and procurement program, and CBD sewer renewal project (stages 1 and 2). The information provided by City West Water supported the prudence and efficiency of the proposed capital expenditure for all but one of these programs.
 - For the sewer KPI renewal program, Deloitte considered there was insufficient justification for the 71 per cent increase in renewal spend compared to 2013–18 considering the relaxation of the KPI (from no more than two sewer blockages in a year to no more than three). Deloitte noted that City West Water was able to achieve this reduced KPI under its existing program.

As a result, Deloitte recommended that the program be reduced to the level of the current 2013–18 regulatory period (\$32.9 million).³⁴ We accept Deloitte’s recommendation as it is consistent with our guidance requirements for justification for increased costs, and we have removed \$23.30 million from the forecast.

- We consider the planned capital expenditure program is achievable, given City West Water’s past track record delivering its capital expenditure program. Over the current 2013–18 regulatory period, City West Water has delivered three of its planned major projects, and while two major projects are delayed, these are expected to be delivered by the end of the current period.³⁵
- City West Water has identified four major projects, including a widespread roll-out of digital metering, which have been excluded from the capital expenditure forecast due to uncertainty in timing, cost, scope or benefits. The total cost estimate for these projects ranges from about \$90 million to \$140 million, and City West Water will further investigate the prudence of these projects during the period.³⁶ This approach is consistent with our guidance for managing uncertain expenditure. For our draft decision, we accept City West Water’s proposal for addressing uncertainty, noting the following:
 - City West 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.
 - 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.
 - With regards the digital water metering, before proceeding with this program, we would expect City West Water should define the success criteria for any digital metering trials before any broader roll-out could proceed. At a minimum, we expect this would include the requirement that expenditure for a full roll-out would deliver a positive net present value for the water corporation, given there is not currently customer support for this. Any expenditure incurred by City West Water for this project may be subject to a prudence and efficiency assessment before it can be included in the regulatory asset base.

Table 2.7 below sets out our proposed adjustments to City West Water’s forecast to establish our draft decision benchmark for gross capital expenditure, consistent with our guidance and WIRO

³⁴ Deloitte Access Economics, op. cit., pp.32–34.

³⁵ Essential Services Commission 2018, *Status of major projects supplement: Water performance report 2016-17*, 1 March, pp. 8–9.

³⁶ More information can be found on pages 116 to 120 of City West Water’s price submission.

principles.³⁷ This benchmark is used to calculate the forecast regulatory asset base (Table 2.6) and the revenue requirement (Table 2.1).

Table 2.7 Draft decision – gross capital expenditure
\$ million 2017-18

	2018-19	2019-20	2020-21	2021-22	2022-23	Total
Proposed gross capital expenditure	124.5	127.1	106.1	97.3	94.1	549.1
Sewer KPI renewals	-3.5	-4.3	-4.7	-6.7	-4.0	-23.3
Draft decision – gross capital expenditure	120.9	122.8	101.4	90.6	90.1	525.8

Note: Numbers have been rounded

The benchmark that we adopt for City West 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 City West 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. City West 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.³⁸

We compared City West Water’s forecast for customer contributions with past outcomes, and its forecasts for growth in customer connections.³⁹ We consider City West Water’s forecast contributions are reasonable, having regard to past trends and its growth forecasts.

³⁷ Essential Services Commission 2016, *Guidance paper*, op.cit., p. 35.

³⁸ Revenue from new customer contributions reflects revenue raised from new connections made to a water corporation’s water, sewerage or recycled water networks.

Our draft decision proposes to accept City West Water’s forecasts for customer contributions (see Table 2.6).

Cost of debt

Our guidance required City West Water to use estimates of the cost of debt provided by the commission to estimate its revenue requirement. City West 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 City West Water, as set out in Table 2.8.

Table 2.8 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.⁴⁰ 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

City West Water rated its price submission as ‘Advanced’. Based on its PREMO self-rating, City West 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’.⁴¹

The return on equity is within the range of 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.⁴²

³⁹ Growth in customer connections can be used as an indicator of growth in customer contributions.

⁴⁰ 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.

⁴¹ Essential Services Commission 2016, *Guidance paper*, op. cit., p. 49.

Our draft decision proposes to accept City West Water's PREMO self-rating and proposed return on equity of 4.9 per cent per annum. Our assessment of City West Water's proposed PREMO rating is set out in Chapter 3.

Regulatory depreciation

Regulatory depreciation is an input to calculating the regulatory asset base. City West Water's forecast regulatory depreciation was calculated using a straight line depreciation profile.⁴³ We noted in our guidance that we prefer this approach.⁴⁴

Our draft decision on regulatory depreciation differs from City West Water's proposal due to our proposed adjustments to capital expenditure. After considering City West Water's response and any other submissions on our draft decision, 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 to the revenue requirement. City West Water's tax allowance is set out in table 23 on page 68 of its price submission, and is also included in its financial model.⁴⁵

Our draft decision on the tax allowance differs from City West Water's proposal due to our proposed adjustments to expenditure and revenue. After considering City West Water's response and any other submissions on our draft decision, our final decision will confirm the tax allowance to be reflected in the revenue requirement.

Our draft decision on tax allowance is shown in Table 2.1.

Demand

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

⁴² 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.

⁴³ For the period from 2018-19 to 2022-23, City West Water proposed regulatory depreciation of \$372.2 million.

⁴⁴ Essential Services Commission 2016, *Guidance paper*, op. cit., p. 42.

⁴⁵ For the period from 2018-19 to 2022-23, City West Water proposed a tax allowance of \$71.7 million.

City West Water's demand forecasts are set out at pages 69 to 71 of its price submission, and are also provided in its financial model.⁴⁶ Our draft decision proposes to accept City West 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

City West Water proposed a price cap form of price control. It currently uses a price cap.

Our draft decision is to accept City West Water's proposed form of price control. A price cap will allow City West 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.

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.⁴⁷

Tariff structures

City West Water's proposed maximum tariffs are set out at pages 73 to 78 and 168 to 170 of its price submission. City West Water proposed stable or falling prices for most customers from 2018-19. For water services, it proposed to reduce fixed charges and maintain its current variable charges in real terms over 2018-19 to 2022-23. For sewerage services, it proposed price reductions for all charges.

Our draft decision revenue requirement is 0.1 per cent lower than City West Water's proposed revenue requirement. We note that our draft decision is likely to have only a small impact on the prices proposed by City West Water.

City West Water must respond to our draft decision with updated prices that reflect our initial views on its revenue requirement. Because of this, our draft decision does not approve maximum prices for each tariff. We will provide final maximum prices in our final decision. However, our draft

⁴⁶ The financial model is also available on our website at www.esc.vic.gov.au.

⁴⁷ 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.

decision considers City West Water's proposals relating to changes in tariff structures, and any submissions relating to the level of prices or bills.⁴⁸

As outlined in our guidance, we have provided the water corporations with a large degree of discretion to decide on individual tariff structures.⁴⁹ 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.

City West Water found that customers generally supported its proposed tariff structures.

City West Water proposed a two-part tariff structure for the majority of its tariffs:

- For residential customers, City West Water proposed a fixed water service charge and proposed to restructure the variable usage component to reduce it from a three-tier to a two-tier inclining block, where price increases in the second block.
- For non-residential water services, City West Water proposed a two-part tariff with a fixed service charge and a variable usage component that depends on water used.
- For residential and non-residential sewerage services, City West Water proposed a fixed service charge and a variable usage component.

Two part tariffs

We consider the two-part structure proposed by City West 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.⁵⁰ We also consider two-part tariff structures are easy to understand.

For residential sewerage services, City West Water proposed a fixed service charge and a variable sewage disposal charge. Our guidance noted that we consider variable sewage disposal charges for residential customers are not cost reflective. City West Water proposed a 55 per cent reduction to the residential variable sewerage disposal charge as a step towards phasing this charge out, and replacing it with a single fixed fee. Our draft decision proposes to accept the reduction to the sewage disposal charge as a move towards our preferred tariff structure for residential sewerage.

⁴⁸ 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.

⁴⁹ Essential Services Commission 2016, *Guidance paper*, op. cit., p. 55.

⁵⁰ 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.

Inclining block tariffs

We have considered Consumer Action Law Centre’s submission, which referred to research concluding that inclining block structures are not effective on social equity grounds, as they fail to account for household size, and essential versus discretionary use.⁵¹ The submission also noted inclining blocks can confuse households.

City West Water’s price submission noted that it considered a shift to a two-part structure is a step to bring prices more into line with efficient signals, and helps to reduce inequities, such as the impact of the existing three-step variable water charge on high use, low income customers (such as some large families).⁵² We have assessed City West Water’s supporting reasons for restructuring the variable usage component, to reduce it from a three-tier to a two-tier inclining block. We note City West Water consulted with its customers on this tariff reform, and this change is consistent with the requirements of the WIRO.

Our draft decision proposes to accept City West Water’s proposal to reduce the number of steps in its inclining block tariff for residential water use from three to two.

Non-residential tariffs

For non-residential water services, City West Water proposed a reduction in the variable usage charge so non-residential water usage charges reflect the weighted average of residential step prices. This ensures that the proposed reductions in water prices are evenly distributed between residential and non-residential customers, to maintain cost reflectivity. Our draft decision proposes to accept the reduction to the variable charge for non-residential customers.

City West Water is proposing changes to its trade waste tariffs during the next regulatory period, coinciding with Melbourne Water’s 2021 price review, as outlined on page 78 and appendix K of its price submission. The proposal will replace the existing inorganic total dissolved solids load fee, and the biochemical oxygen demand load fee, with a more cost reflective price. We support the proposed tariff changes in principle, as they will lead to more efficient price signals, subject to review of City West Water’s proposal during the next regulatory period. The new tariffs should be developed in consultation with customers and stakeholders, and reflect the pricing principles associated with trade waste services.

We note that City West Water proposed to reduce the trade waste volumetric price for non-residential customers by 18 per cent. Our draft decision proposes to accept the reduction to the

⁵¹ Consumer Action Law Centre 2017, *Initial feedback: 2018 water price review*, 15 November.

⁵² See pages 75 to 77 of City West Water’s *2018 Price submission*, available at www.esc.vic.gov.au.

trade waste volumetric price as it more closely reflects the long run marginal cost of providing the service.

City West Water provides private fire services connections to its water mains in order to deliver fire-fighting water to some customer sites. City West Water proposed to introduce a private fire services connections charge from 1 July 2019. The charge of \$100 per annum recovers the costs associated with capacity provision, connections maintenance and non-revenue water loss from private fire services connections. We have reviewed the proposed charge and are satisfied that it is cost reflective. City West Water consulted customers on the charge and customers supported the proposed charge.

Yarra Valley Water and South East Water currently recover the costs associated with provision of private fire services, and City West Water's proposal to introduce the new charge will therefore align it with the other urban water businesses, which we support. For these reasons, our draft decision proposes to accept the introduction of the charge.

Unique services

We confirmed with City West 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.

Price and bill levels

From 2014-15, City West Water's residential customers receiving a bill with water usage charges received an annual rebate of \$100. The rebate reflects the outcomes of a government efficiency review, and ends after 2017-18. While City West Water has proposed reduced prices for most tariffs, the removal of the rebate means the bill impact of price changes on customer groups may vary. In particular, for some customers such as relatively low water users (including some residential tenants), bills may rise as a result of the rebate being removed.

City West Water has addressed the impact of the rebate removal on customers in its price submission by rebalancing a number of tariffs, including a reduction to the volumetric fee for sewage disposal, and reducing the number of price steps for water usage.⁵³

Consumer Action Law Centre's submission noted the impact price changes may have on some customers, particularly those with low or fixed incomes who 'already carefully manage their

⁵³ See page xiv of City West Water's *2018 Price submission*, available at www.esc.vic.gov.au.

consumption and budget'.⁵⁴ On this, we consider City West 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
- City West Water has payment options and assistance for customers experiencing difficulty paying bills.

Submissions by Frances Raymundo, Jeremy Lawrence and Gerald Mallon raised concerns about the proportion of the bill attributable to the fixed service charge.⁵⁵ City West Water's customer engagement program explored customer bills and the proportion of bills that are fixed and variable. The results of City West Water's deliberative customer forum supported the continuation of the current balance of fixed and variable charges in bills.⁵⁶

Draft decision on tariff structures

For the reasons set out above, our draft decision accepts City West Water's proposed tariff structures, as set out at pages 73 to 78 of its price submission.

Prior to our final decision and price determination, City West Water must submit updated prices to reflect our draft decision on the revenue requirement. It must also provide an update to reflect our updates to cost of debt and inflation estimates, which we will provide in late April 2018, and changes to its forecast bulk water charges, arising from changes to Melbourne Water's prices.

Adjusting prices

City West Water proposed a number of price adjustment mechanisms, as set out at pages 79 to 81 of its price submission. It proposes to continue with its existing:

- annual adjustment of prices for prescribed price movements and inflation
- approved desalination cost pass through mechanisms
- uncertain and unforeseen events mechanism.

⁵⁴ Consumer Action Law Centre 2017, op. cit.

⁵⁵ Frances Raymundo 2017, *Submission*, 10 December; Jeremy Lawrence 2017, *Submission*, 5 November; Gerald Mallon 2017, *Submission*, 7 November.

⁵⁶ See page 14 of City West Water's *2018-2023 Customer outcomes proposal*, available at www.esc.vic.gov.au.

Our draft decision accepts City West Water's proposal on its existing mechanisms. We have approved them on the basis that they are consistent with efficiency objectives, and reflect a continuation of current arrangements.⁵⁷

City West Water proposed new price adjustment mechanisms (as set out on pages 79 and 80 of its price submission) on:

- its regulatory rate of return
- environmental contributions from 2020-21 to 2021-22
- changes to revenue requirement arising from uncertain and unforeseen events.

City West Water proposed converting a nominal cost of equity to real terms in its calculation of the real regulatory rate of return. We set the cost of equity in real terms based on our PREMO assessment. Our preference is to calculate annual price adjustments in real terms for consistency with other businesses. We invite City West Water to resubmit a revised calculation of the regulatory rate of return in real terms.

Our draft decision is not to accept City West Water's proposed adjustment mechanisms for uncertain and unforeseen events and for the environmental contribution. The existing uncertain and unforeseen events mechanism allows for cost pass-throughs for tax changes (such as changes to the environmental contribution) or significant and unforeseen variations in actual costs from forecast. As such, there is no need for City West Water to propose a specific pass-through mechanism for these two items. Our draft decision is that City West Water should continue with the existing uncertain and unforeseen events mechanism in its current form.

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.

City West Water's proposed charges for new customer contributions are set out at pages 82 and 84 of its price submission. City West Water proposed to maintain the standard water and sewerage new customer contribution charge at the 2017-18 level until 2022-23. For the standard recycled water charge covering the West Werribee and Greek Hill zones, City West Water has proposed an

⁵⁷ WIRO clauses 8(b)(i)(ii) and (iii).

increase of 5.1 per cent on the 2017-18 charge for 2018-19. After this increase, City West Water have proposed no further price changes to the standard recycled water charge.

City West Water proposed to discontinue the existing standard recycled water charge in the Holden Zone. City West Water stated that land development is yet to proceed in this zone and the servicing strategy for the area has not confirmed that they should supply the zone with recycled water. City West Water proposed to negotiate recycled water charges in the Holden Zone with any future developers under the approved negotiating framework.

For negotiated new customer contributions, City West Water proposes to continue to calculate a charge in accordance with the requirements of our NCC pricing principles.⁵⁸

We have reviewed City West Water's proposed charges and consider them consistent with the requirements of our guidance and the NCC pricing principles.⁵⁹ For this reason, our draft decision proposes to accept City West Water's proposed new customer contribution charges.

Financial position

In approving prices, we must have regard to the financial viability of the water industry.⁶⁰ 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.

City West 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 City West Water will generate sufficient cash flow to deliver on service commitments, including financing costs arising from investments to meet service expectations.

City West Water received a credit opinion on its financial position reviewed by an independent credit rating agency. The credit opinion supports our current view that City West Water's financial position is sound.

⁵⁸ Essential Services Commission 2016, *Guidance paper*, op. cit., p. 62.

⁵⁹ In response to a request for information, City West Water provided supporting modelling showing its regard for incremental costs and incremental revenue.

⁶⁰ 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 proposes to accept City West 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 City West Water's proposed PREMO rating.

Our review of City West Water's PREMO self-rating

City West Water's proposed PREMO rating, and our draft decision is summarised below.

Table 3.1 PREMO Rating

	Overall PREMO rating	Risk	Engagement	Management	Outcomes
City West Water's rating	Advanced	Advanced	Advanced	Advanced	Advanced
Commission's rating	Advanced	Advanced	Advanced	Advanced	Advanced

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

In support of its self-ratings for Outcomes, Engagement and Risk, we note:

- City West Water has demonstrated that its proposals will deliver better value to its customers. This is reflected in City West Water's proposals to reduce prices, and to improve services in

areas that its community engagement found are highest priority among its customers. This supports its self-rating for the Outcomes element of PREMO.

- City West Water's engagement, which we consider provided a fair opportunity for customers to participate and to influence its proposals. City West Water used a variety of formats for customer engagement, including more deliberative approaches to test customer views on complex matters such as tariffs. The influence of City West Water's engagement is reflected in its consideration of feedback relating to residential tariff reform, and its decision to expand the ways the corporation communicates with customers. City West Water's price submission also identified the reasons for not incorporating any findings from engagement that were not reflected in its proposals.
- Increasing the revenue it has placed at risk for failing to deliver on its service targets (through increased rebates relating to guaranteed service levels). Our expenditure review proposes relatively minor adjustments to City West Water's forecast capital expenditure. Our expenditure review found City West Water generally has sound capital management programs in place, and has sound supporting justification for key projects (including through cost benefit analysis). This supports its self-rating for the Risk element of PREMO.

In assessing whether to accept City West Water's self-rating of 'Advanced' for Management, we considered our proposed adjustments to its forecast expenditure. We consider that generally, these proposed adjustments are relatively minor.

Factors supporting its self-rating include for Management the business's forecast rate of efficiency include:

- The high quality of City West Water's price submission and supporting financial model. Its price submission clearly demonstrated the links between its engagement and proposed outcomes, and provided sufficient information for us to assess its proposals.
- The rate of efficiency improvements reflected in City West Water's forecasts for controllable operating costs. City West Water's forecast rate efficiency improvement in controllable operating expenditure per connection placed it among the top performers in the sector. This contributes to the price declines proposed by City West Water from 1 July 2018.

Given these factors, we have accepted City West Water's proposed rating of 'Advanced' for Management.

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 City West 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 City West 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 of final decision and price determination.

APPENDIX A – submissions received

Name or organisation	Date received
Mr P Rogers	20 February 2018
Environment Protection Authority Victoria	12 December 2017
Ms Frances Raymundo	10 December 2017
Consumer Action Law Centre	15 November 2017
Mr G Mallon	7 November 2017
Mr J Lawrence	5 November 2017