Coliban Water final decision

2018 Water Price Review

19 June 2018

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Essential Services Commission 2018, Coliban Water final decision: 2018 Water Price Review, 19 June

Contents

Summary

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

In March 2017, we released our draft decision on Coliban Water's price submission.[1] The draft decision set out our preliminary views on Coliban Water's proposals, and invited interested parties to make further submissions. We also held a public meeting in April 2018. In addition to a submission from Coliban Water, we received 10 written submissions on our draft decision, which are available on our website.

After considering feedback, we have made a price determination for Coliban Water.[2] The price determination sets out the maximum prices Coliban Water may charge for prescribed services (or the manner in which its prices are to be calculated, determined, or otherwise regulated) for the five year period from 1 July 2018 (2018-23). This final decision paper sets out our supporting reasons and analysis for the price determination.

Where our final decision on a particular aspect is unchanged from our draft decision, we have not detailed the supporting reasons in our final decision. Rather, we have noted that our final decision confirms the reasons and position we reached in the draft decision.

Where we have reached a different decision to that proposed in our draft decision, or where new information required our consideration, we have set out our reasons in full in this final decision. This final decision should be read in conjunction with our draft decision.

Our final decision has updated the revenue to be collected by Coliban Water

Our final decision approves a revenue requirement of $605.7 million over the five year period starting 1 July 2018.[3] This is $7.9 million or 1.3 per cent higher than our draft decision, and mainly reflects our final decision on Coliban Water's return on equity and PREMO rating (see from page 22).

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[1] Clause 16 of the Water Industry Regulatory Order 2014 requires us to issue a draft decision. Coliban Water's price submission and our draft decision are available at www.esc.vic.gov.au/waterpricereview.

[2] Before the commencement of a regulatory period, clause 10 of the Water Industry Regulatory Order 2014 requires us to make a price determination which determines the maximum prices a water corporation may charge, or the manner in which its prices are to be calculated, determined or otherwise regulated during the regulatory period. See Essential Services Commission 2018, *Coliban Water Determination: 1 July 2018 – 30 June 2023*, June.

[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 the 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.

A summary of approved maximum prices for major services delivered by Coliban Water is set out from page 28. The estimated typical bill impacts for residential customers of Coliban Water's proposal and our final decision are provided in Table A. Typical bills for an owner-occupier will fall by around $26 in 2018-19, and fall by around $8 for a tenant (in constant price $2018-19 terms).

Table A Estimated typical water and sewerage bills
$ 2018-19

Customer group	Average consumption (kL p.a.)	2017-18 annual bill	2018-19 annual bill	2022-23 annual bill
Residential (Owner occupier)	188	$1,365	$1,339	$1,277
Residential (Tenant)	188	$432	$424	$404

Note: Numbers have been rounded

Coliban Water will improve services

Our final decision approves prices that will allow Coliban Water to deliver on its customer service commitments, government policy, and obligations monitored by the Environment Protection Authority Victoria and the Department of Health and Human Services.

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

- reducing prices
- increasing its support for customers experiencing bill payment difficulty
- investing in water quality improvements for a number of towns
- increasing the ways customers can communicate and receive information from the business.

We have accepted Coliban Water's proposed tariff structures

Our final decision approves Coliban Water's existing tariff structures.

For water services, we have approved Coliban Water's proposed fixed service charge and a variable component that depends on water used. For residential sewerage services, we have approved Coliban Water's proposal for a fixed service charge only. For non-residential sewerage services we have approved Coliban Water's proposal for a fixed service charge and a variable component. These reflect a continuation of its existing tariff structures.

Our final decision also approves Coliban Water's proposed price cap form of price control. This means its maximum prices are fixed subject to updates for inflation, and any other price adjustments we approve in our price determination. Coliban Water currently uses a price cap.

For more detail on tariffs and the form of price control, see from page 24.

Coliban Water's price submission is rated as 'Advanced' under PREMO

Our draft decision proposed to approve an overall PREMO rating of 'Standard' for Coliban Water's price submission. This was lower than the 'Advanced' rating proposed by Coliban Water.

Our draft decision acknowledged that Coliban Water's price submission was built on strong customer engagement and robust cost management. Coliban Water committed to improving service outcomes and expand its guaranteed service level program, thereby increasing accountability on the business to deliver on customer service targets. Coliban Water also proposed a price fall of one per cent per year from 2018-19.

Our reduced rating in the draft decision reflected our assessment of Coliban Water's initial proposals relating to the Risk element of PREMO. Whereas the PREMO framework was concerned with the transfer of risk between businesses and customers, some of the elements of Coliban Water's price submission sought to shift risk between present and future customers.

Our draft decision acknowledged these different elements of risk, and invited Coliban Water to reconsider its approach. Coliban Water's response to our draft decision addressed concerns we had with its approach. In particular, it withdrew its proposal for a financial viability adjustment.

Our final decision approves a rating of 'Standard' for Risk, up from 'Basic' in our draft decision. Our final decision confirms the 'Advanced' rating for the 'Outcomes', 'Management' and 'Engagement' elements of PREMO that we approved in our draft decision. Our overall PREMO rating for Coliban Water changes from 'Standard' in our draft decision to 'Advanced' for our final decision.

Figure A summarises our final decision on PREMO. More detail on our assessment of Coliban Water's PREMO rating is provided in Chapter 3. Coliban Water is one of nine businesses for which we have approved an 'Advanced' PREMO price submission rating (Figure B).

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

Figure A PREMO Rating

	Overall PREMO rating	Risk	Engagement	Management	Outcomes
Coliban Water's rating	**Advanced**	Advanced	Advanced	Advanced	Advanced
Commission's rating	**Advanced**	Standard	Advanced	Advanced	Advanced

Figure B Final decision on PREMO – overall rating

Leading	Advanced	Standard	Basic	Not rated
Goulburn Valley Water	Barwon Water Central Highlands Water City West Water Coliban Water GWMWater North East Water South East Water Southern Rural Water Yarra Valley Water	East Gippsland Water Gippsland Water Lower Murray Water (urban) Westernport Water	Wannon Water	South Gippsland Water Western Water *

* We have not assessed Western Water under PREMO, as prior to lodging its price submission it notified us of its intention to target a short-term pricing outcome rather than the overall value for money outcome expected under PREMO. Western Water adopted this approach to provide time for it to undertake a review to inform longer-term prices.

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.[4] The prescribed services include retail water and sewerage services, and bulk water and sewerage services delivered by the water corporations.[5]

Our task is to assess price submissions by water corporations against the legal framework that governs our role, and make a price determination that takes effect from 1 July 2018. We make a price determination after issuing a draft decision, and considering feedback from interested parties.

The price determination specifies the maximum prices a water corporation 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 making a price determination, 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
- the matters specified in our guidance[6]

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[4] 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.

[5] The prescribed services are listed at clause 7(b) of the WIRO.

- 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.

Our consideration of legal requirements 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 we have done so for our final decision for Coliban Water.[7]

In 2016, we issued guidance to Coliban Water to inform its price submission. The guidance set out how we will assess Coliban 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 Coliban Water's proposed prices.[8]

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.[9]

> The power for water corporations to impose fees is set out in the *Water Act 1989* (Vic) (Water Act). Provisions in the Water Act also govern the manner in which water corporations may impose fees, and it is for each water corporation to ensure that it complies with them.[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]

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[6] Essential Services Commission 2016, *2018 Water Price Review: Guidance paper*, November.

[7] Essential Services Commission 2018, *Coliban Water final decision, 2018 Water Price Review – commission's consideration of legal requirements*, 19 June. This is available at www.esc.vic.gov.au/waterpricereview

[8] This is a requirement of the WIRO, clause 14(b).

[9] This is provided for under the WIRO, clause 14(b)(i).

[10] See Part 13, Division 5 of the *Water Act 1989* (Vic).

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

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 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.

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[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.

The 2018 water price review is the first time we've applied our PREMO incentive mechanism. 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] The PREMO process is described in: Essential Services Commission 2016, *Guidance paper*, op. cit., pp. 44–49.

2. Our assessment of Coliban Water's price submission

We have made our price determination for Coliban Water after considering: Coliban Water's price submission, its responses to our queries and our draft decision, and written submissions from interested parties. A list of submissions responding to our draft decision is provided in Appendix A.

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

Coliban Water's price submission and financial model presented clear and comprehensive information to support its proposals. Coliban 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 customer engagement on page 6).

Our guidance included a number of matters water corporations must address in their price submissions. Coliban Water's price submission addressed each of these matters, with our preliminary assessment set out in our draft decision. Our final decision is set out below.

Regulatory period

Our draft decision accepted the five year regulatory period proposed by Coliban Water (1 July 2018 to 30 June 2023) in its price submission. Our guidance proposed to approve a five year regulatory period, subject to any alternative and justified proposal.[19]

In response to our draft decision, Consumer Action Law Centre (CALC) recommended the regulatory period should be the same for all water corporations, unless there are special circumstances.[20] In support of this, it noted factors such as greater community attention when all price reviews are undertaken at the same time.

Our final decision is to approve the five year regulatory period proposed by Coliban Water. This is the same period we have approved for all but three water corporations in our current price review.

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[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] Consumer Action Law Centre 2018, *Submission on standard draft decisions: 2018 Water Price Review*, 8 May, p. 10.

Customer engagement

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

The engagement by Coliban Water:

- took place between 2016 and August 2017, drawing on feedback gathered since 2013
- used a range of methods including surveys, face to face interviews, community forums and water taste testing events
- was informed by input from residential and rural customers, indigenous groups, vulnerable customer advocacy groups, developers, trade waste, and large business customers
- covered matters such as the length of the regulatory period, service outcomes, guaranteed service levels, price and service trade-offs, and price changes.

More detail on Coliban Water's engagement is available in its price submission.[21]

Evidence that Coliban Water's engagement influenced its proposals includes:

- improving customer access to its call centre and its website in response to feedback that customers value ease of access to advice and information
- a steady, declining price path in response to feedback that customers value affordable and stable bills
- implementing new customer rebates where the outcomes delivered by Coliban Water don't meet its commitments, in response to feedback from customers about service priorities.

The influence of Coliban Water's engagement on its proposals supports the objectives in our pricing framework relating to efficiency and the interests of consumers.[22]

Consumer Action Law Centre suggested we could play a greater role to promote best practice customer engagement and identify areas for improvement.[23] We note that following our price review, we will continue to work with water corporations to promote best practice customer engagement.

Outcomes

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

- supply high quality water customers can trust

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[21] Coliban Water's price submission is available on our website at www.esc.vic.gov.au. See pages 11 to 14.

[22] 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).

[23] Consumer Action Law Centre, op. cit., p. 4.

- provide infrastructure and services to meet customer needs now and in the future
- reduce its environmental footprint and achieve a socially responsible, sustainable business for future generations
- be open and transparent about pricing and service disruptions, and easy to do business with
- support the liveability of the region.

Coliban Water's proposed deliverables and targets for reporting against these outcomes are listed on pages 22 to 32 of its price submission. Coliban Water has committed to developing a reporting framework to report its performance to customers.

In early 2018-19, we will engage with Coliban Water to finalise measures and targets and how it will report to customers. Its performance will inform our assessment during future price reviews as part of the Performance element of PREMO assessments.

CALC commented on the need for additional funding for regional water corporations to strengthen existing hardship programs or adopt new practices to assist vulnerable customers.[24] CALC cited our 2013 price review where we provided an additional allowance for metropolitan water corporations to expend existing hardship programs or introduce new hardship programs.

We have not adopted CALC's recommendation in our final decision. We note that the additional allowance in our 2013 price review was provided in recognition of the large one-off price increases approved for the metropolitan corporations during the review.[25] Further, water corporations already allocate funds to programs aimed to deliver payment options and hardship support required by our customer service codes. Coliban Water has proposed lower prices and to increase its number of hardship grants available for low income and vulnerable customers.

Service Standards

Coliban Water has also provided a list of service standards relating to reliability and attending faults that it will include in its customer charter. These service standards and Coliban Water's targets until 2023 are set out in Appendix B. CALC has noted a range of ambitions by water corporations when it comes to proposed service standards and that water corporations should be encouraged to 'improve service standards over time'.[26] In his submission, David Beasley has commented on the time to repair water leaks. [27]

[24] ibid., p. 3.

[25] The increase in prices approved in 2013 for metropolitan Melbourne was around 20 to 25 per cent. We note for most water corporations in our 2018 price review, generally prices are remaining relatively steady, or falling.

[26] Consumer Action Law Centre, op. cit., p. 6.

[27] David Beasley 2018, *Submission*, 14 April.

We note that Coliban Water proposed standards for reliability and attending faults consistent with past years and which remain stable over the five years of the regulatory period.

We accept there are arguments for maintaining or decreasing service levels over time particularly where engagement identifies customers are satisfied with the existing level of service or do not support increasing expenditure to deliver improved service. We note that Coliban Water's proposed standards for reliability and attending faults were informed by its engagement program to reflect the priorities of customers. This approach aligns with our expectation that water corporations consider customer preferences when forming service targets.

> Approved service standards relating to reliability and attending faults are set out in Appendix B of this final decision and form part of the manner in which Coliban Water's services are regulated.

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. We expect water corporations to include GSLs in its customer charter.

Coliban Water's proposed GSLs are set out on pages 7 to 8 of Supplement B to its price submission. It proposed to revise two of its GSLs, and introduce 14 new GSLs relating to water quality, sewer spills, improved response times to queries and requests, and the timing of planned water supply outages. Our draft decision proposed to accept Coliban Water's proposed GSLs, on the basis that they were informed by its customer engagement.

CALC supported GSL payments increasing over time.[28] Coliban Water proposed to maintain payment amounts for its existing GSLs. However, it has significantly expanded the scope of its GSLs, increasing the rebates payable to customers if it does not deliver on service commitments.

For the reasons set out above, our final decision approves Coliban Water's proposed GSLs.

> Coliban Water's GSLs are set out in Appendix C.
>
> Coliban Water's commitment to GSL payments should these service levels not be met, forms part of the manner in which Coliban Water's services are regulated.

[28] Consumer Action Law Centre, op. cit., p. 1.

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.[29] Along with forecast demand, it is an input to calculating prices.

Our final decision approves a revenue requirement of $605.7 million over the five year period starting 1 July 2018.[30] This is $7.9 million or 1.3 per cent higher than our draft decision, and mainly reflects our updates to the return on equity (affecting the return on assets in the revenue requirement) since the draft decision.

Adjustments to the revenue requirement since our draft decision are set out at Table 2.2, with the reasons set out in the following sections.

Table 2.1 Final decision – Revenue requirement
$ million 2017-18

	2018-19	2019-20	2020-21	2021-22	2022-23	Total
Operating expenditure	67.3	67.0	67.2	66.7	66.8	335.0
Return on assets	20.5	20.5	20.4	20.5	20.5	102.4
Regulatory depreciation	31.5	32.6	33.6	34.7	36.0	168.3
Tax allowance	0.0	0.0	0.0	0.0	0.0	0.0
Revenue requirement	**119.3**	**120.1**	**121.2**	**121.9**	**123.2**	**605.7**

Note: Numbers have been rounded

[29] 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 Coliban Water in the regulatory period from 1 July 2018. We had regard to their views in our draft and final decisions.

[30] 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 the 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.

Table 2.2 Adjustments to draft decision revenue requirement
$ million 2017-18

	2018-19	2019-20	2020-21	2021-22	2022-23	Total
Draft decision – revenue requirement	**118.6**	**119.2**	**119.2**	**119.8**	**121.0**	**597.8**
Operating expenditure	-0.4	-0.4	0.7	0.6	0.7	1.2
Return on assets	1.1	1.1	1.2	1.2	1.2	5.8
Regulatory depreciation	0.02	0.1	0.1	0.2	0.3	0.8
Total adjustments	**0.7**	**0.9**	**2.0**	**2.1**	**2.2**	**7.9**
Final decision – revenue requirement	**119.3**	**120.1**	**121.2**	**121.9**	**123.2**	**605.7**

Note: Numbers have been rounded

Operating expenditure

Operating expenditure is an input to the revenue requirement. Our draft decision proposed to adopt a $296.7 million benchmark for Coliban Water's forecast controllable operating costs for the 2018–23 period. This was $4.6 million lower than proposed by Coliban Water, and we set out our reasoning for this adjustment in our draft decision (pages 10 to 17). In summary, we found:

- Evidence indicating its baseline controllable operating expenditure reflects an efficient benchmark.[31]
- Coliban Water proposed an efficiency improvement rate of 1.5 per cent per year, which is at the lower end of those businesses rating themselves Advanced under the PREMO framework.
- $2.57 million of additional electricity costs above the baseline were not considered prudent and efficient for our indicative draft decision.
- $1.39 million of additional trade waste monitoring, costs arising from capital expenditure, costs to fund a discount in sewerage fees, and other cost items were not considered to be prudent and efficient.
- $0.43 million to support customers in financial hardship was removed from controllable operating expenditure and transferred to revenue not collected in the financial model.

[31] Controllable costs are those that can be directly or indirectly influenced by a water corporation's decisions.

- Coliban Water did not seek additional expenditure above the growth-adjusted baseline for forecast increases in wages (above inflation), whereas some other businesses have sought additional expenditure for this.

Our draft decision also requested an updated forecast for electricity costs based on new contract prices, given the electricity contract was currently under negotiation.

We forecasted $37.0 million for Coliban Water's non-controllable operating costs for the 2018–23 period.[32] We noted in our draft decision that we would update this forecast for our final decision, and also adjust for the latest inflation and external bulk charges data.

Coliban Water's response to our draft decision provided an updated energy forecast and new information on its labour costs and its proposed Elmore sewerage access fee discount, while it accepted the commission's other adjustments:

- Coliban Water provided an updated electricity forecast which required $4.84 million above its baseline, which is $1.91 million higher than our indicative draft decision for electricity costs.[33] Coliban Water's updated forecast is based on the latest market information for 2018-19 to 2020-21 and assumes no real increase in market energy rates for 2021-22 and 2022-23.[34] We accept the updated energy forecast and the $1.91 million increase for our final decision, because it better reflects efficient expenditure.
- Coliban Water advised it is finalising a new three-year enterprise agreement which will increase labour costs above the costs assumed in its price submission forecast. It proposed to allow the reduction in payroll tax forecast for 2018-19 to offset the increased labour costs, rather than seek to increase its operating expenditure forecast.[35] We note that in its price submission, Coliban Water said it would manage forecast labour increases above inflation within its customer connection growth allowance and through efficiency gains. We consider this should still be the case under its new enterprise agreement, noting Coliban Water has a growth allowance of 1.5 per cent per year across its controllable operating expenditure, including the wages component. With no forecast increase in the number of FTE positions across the period, the growth allowance should adequately cover the wage increase above inflation. We consider the payroll tax rate reduction should be directly passed through to costs, consistent with our draft decision requirement to be provided with updated forecasts if there is a change in

[32] Non-controllable costs are those that cannot be directly or indirectly influenced by a water corporation's decisions.

[33] Coliban Water 2018, *Response to ESC draft decision*, 14 May, pp. 8 –11.

[34] We requested our expenditure consultant, Deloitte Access Economics, to review the updated electricity price forecasts and compare against the information received for our draft decision. Deloitte did not recommend any adjustments for our final decision.

[35] The 2018-19 Victorian budget cut payroll tax from 3.65 per cent to 2.425 per cent for regional corporations from 1 July 2018.

legislation or government policy. Accordingly, we have reduced Coliban Water's operating expenditure forecast by $1.00 million across the 2018–23 period.

- In its price submission, Coliban Water proposed to introduce a discounted sewer access fee for residents of Elmore, to reflect the lower level of service received by these customers. Our draft decision accepted this proposal, which reduced the revenue collected by Coliban Water by $0.24 million, and we also removed the corresponding amount from the operating expenditure forecasts on the basis that a reduction in service should have a corresponding reduction in operating costs. In its response to our draft decision, Coliban Water pointed out that its customers in Elmore have been paying the same sewerage prices as other towns, despite receiving a lower level of service. Its proposed price discount for these customers reflects the actual service level received and has no impact on the current servicing arrangement or operating costs.[36] Our final decision accepts Coliban Water's justification for the reinstatement of the $0.24 million removed in our draft decision, and we have increased the operating expenditure forecast accordingly.

CALC's submission to our draft decision supported our approach of adjusting forecast electricity costs and limiting wage increases in operating expenditure above the baseline.[37] No other new considerations were presented in submissions received following the draft decision which caused us to change our views on operating expenditure.

Accordingly, our final decision for controllable operating costs is $1.15 million higher than our draft decision.

For non-controllable operating expenditure, we have revised our draft decision forecasts where required based on the latest March 2018 inflation and external bulk charges information. We have revised our forecast environmental contribution from our draft decision, and made no changes to forecast licence fees or external bulk charges.[38]

Based on the latest inflation data, we have revised the forecast 2018-19 environmental contribution from $5.00 million to $5.02 million, which results in a total increase of $0.09 million across the 2018–23 period.

Accordingly, we have increased our draft decision forecast for Coliban Water's non-controllable operating expenditure by $0.09 million to $37.12 million across the 2018–23 period.

[36] Coliban Water 2018, op. cit., p. 12.

[37] Consumer Action Law Centre, op. cit.

[38] For the environmental 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.

Table 2.3 sets out our adjustments from our draft decision for controllable and non-controllable operating expenditure. Table 2.4 sets out the benchmark operating expenditure we have adopted for our final decision.

Table 2.3 Adjustments to operating expenditure
$ million 2017-18

	2018-19	2019-20	2020-21	2021-22	2022-23	Total
Draft decision – total operating expenditure	**67.7**	**67.4**	**66.5**	**66.1**	**66.1**	**333.7**
Elmore sewer costs	0.05	0.05	0.05	0.05	0.05	0.24
Electricity	-0.29	-0.22	0.84	0.78	0.80	1.91
Payroll tax	-0.20	-0.20	-0.20	-0.20	-0.20	-1.00
Total adjustments to controllable costs	**-0.44**	**-0.37**	**0.69**	**0.63**	**0.65**	**1.15**
Environmental contribution	0.02	0.02	0.02	0.02	0.02	0.09
Total adjustments to non-controllable costs	**0.02**	**0.02**	**0.02**	**0.02**	**0.02**	**0.09**
Final decision – total operating expenditure	**67.3**	**67.0**	**67.2**	**66.7**	**66.8**	**335.0**

Note: Numbers have been rounded

We have adopted the benchmark for operating expenditure set out in Table 2.4 for the purpose of making our final decision on Coliban Water's revenue requirement (Table 2.1). We consider our final decision for Coliban Water's forecast operating expenditure is consistent with the requirements of the Water Industry Regulatory Order 2014 (WIRO) and the criteria for prudent and efficient expenditure outlined in our guidance.[39]

[39] Essential Services Commission 2016, *Guidance paper*, op. cit., p. 31.

Table 2.4 Final decision – operating expenditure
$ million 2017-18

	2018-19	2019-20	2020-21	2021-22	2022-23	Total
Controllable costs	**59.7**	**59.5**	**59.8**	**59.4**	**59.5**	**297.9**
Non-controllable costs	**7.6**	**7.5**	**7.4**	**7.3**	**7.2**	**37.1**
Bulk services[a]	2.3	2.3	2.3	2.3	2.3	11.6
Environmental contribution[b]	5.0	4.9	4.8	4.7	4.6	24.0
Licence fees – ESC[c]	0.067	0.067	0.067	0.067	0.100	0.366
Licence fees – DHHS[c]	0.037	0.037	0.037	0.037	0.037	0.186
Licence fees – EPA[c]	0.187	0.187	0.187	0.187	0.187	0.936
Other	0.0	0.0	0.0	0.0	0.0	0.0
Final decision – total operating expenditure	**67.3**	**67.0**	**67.2**	**66.7**	**66.8**	**335.0**

[a] Bulk services covers the supply of bulk water and sewerage services

[b] The Environmental Contribution collects funds from water corporations under the *Water Industry Act 1994* (Vic)

[c] Licence 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

The benchmark operating expenditure that we have adopted for Coliban Water does not represent the amount that Coliban 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 and to provide services over the regulatory period.

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 Coliban 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 capital expenditure, government and customer contributions, and asset disposals for the period to 30 June 2017. This helps to ensure prices reflect the actual expenditure of a water corporation.

For our draft decision, we compared Coliban Water's net capital expenditure for 2012-13 to 2016-17 with the forecast used to approve maximum prices for the period from 1 July 2013.[40] We undertake a prudency 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'.

Coliban Water's net capital expenditure was 5.2 per cent higher than the forecast used to approve maximum prices for the period from 1 July 2013, below the 10 per cent threshold discussed above. After making a minor correction to past capital expenditure, Coliban Water also calculated its closing asset base in accordance with our guidance. For these reasons, our draft decision proposed to approve a closing regulatory asset base for 30 June 2017 of $481.4 million.

No new considerations were raised in submissions on our draft decision that affected our assessment of the closing regulatory asset base.

For the reasons set out above, our final decision approves a closing regulatory asset base at 30 June 2017 of $481.4 million. The calculations are provided at Table 2.5.

[40] Net capital expenditure is calculated by deducting government and customer contributions from gross capital expenditure.

Table 2.5 Final decision – Closing regulatory asset base
$ million 2017-18

	2012-13	2013-14	2014-15	2015-16	2016-17
Opening RAB 1 July	329.0	358.6	396.2	419.9	466.6
Plus gross capital expenditure	45.9	57.7	47.3	65.4	36.7
Less government contributions	0.0	0.0	0.0	0.0	0.0
Less customer contributions	4.0	3.0	4.1	3.5	3.8
Less proceeds from disposals	1.2	4.7	5.8	0.1	1.8
Less regulatory depreciation	11.2	12.4	13.7	15.1	16.2
Closing RAB 30 June	**358.6**	**396.2**	**419.9**	**466.6**	**481.4**

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 final decision on Coliban Water's forecast regulatory asset base from 1 July 2018.[41] Each component of the forecast regulatory asset base is discussed in the following sections.

[41] 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. The estimates for 2017-18 will be confirmed at the price review following the 2018 water price review.

Table 2.6 Final decision – Forecast regulatory asset base
$ million 2017-18

	2017-18	2018-19	2019-20	2020-21	2021-22	2022-23
Opening RAB 1 July	481.4	496.3	496.1	495.0	494.4	496.6
Plus gross capital expenditure	38.0	36.8	37.2	38.5	42.5	42.1
Less government contributions	0.0	0.0	0.0	0.0	0.0	0.0
Less customer contributions	4.4	3.9	4.2	4.0	4.1	4.2
Less proceeds from disposals	1.5	1.5	1.5	1.5	1.5	1.5
Less regulatory depreciation	17.2	31.5	32.6	33.6	34.7	36.0
Closing RAB 30 June	**496.3**	**496.1**	**495.0**	**494.4**	**496.6**	**497.1**

Note: Numbers have been rounded

Capital expenditure

Capital expenditure is an input to estimating the regulatory asset base. Our draft decision proposed to adopt a $193.2 million benchmark for Coliban Water's forecast gross capital expenditure for the 2018–23 period. This was $3.9 million lower than proposed by Coliban Water, and we set out our reasoning for this adjustment in our draft decision (pages 20 to 24). In summary, we found:

- Coliban Water has a reasonable approach for developing project scope, the timing of works and cost estimates.
- The digital customer metering project did not have sufficient information to demonstrate the prudency and efficiency of the proposed $5.0 million expenditure, and we reduced the allowance to $1.1 million to cover the first three phases only.
- The remaining planned capital expenditure program is achievable, given Coliban Water's past track record delivering its capital expenditure program.
- Coliban Water has an appropriate approach for managing expenditure associated with uncertain projects.
- Coliban Water's approach to forecasting its capital expenditure, other than for the digital customer metering project, is consistent with the requirements of our guidance.

Coliban Water's response to our draft decision proposed the re-inclusion of the $3.90 million we removed from the digital metering capital expenditure, and set out proposed additional customer protections.[42] While we expressed our concern as to whether all costs required to fully realise the expected savings from the project have been considered, Coliban Water has confidence in the project imposing zero additional cost to consumers. It has guaranteed that if the project cost exceeds the present forecast, it will not pass any overrun through into customer prices. It has also guaranteed to reduce prices to return unspent funds should the project not proceed.

We received a number of submissions concerned about possible health impacts from the proposed digital metering project, and other issues including:[43]

- Alana Moore raised concerns about time-of-use pricing and the ability to remotely cut off non-paying customers using digital metering.
- Janobai Smith stated that digital metering does not have zero additional costs to consumers due to the impacts on health and the environment. Ms Smith also thought Coliban Water's wording of questions for its customer engagement on digital metering may have been written to 'elicit a predetermined outcome'.

Coliban Water has sought to address these concerns by developing a policy for the conditional opt-out from digital meter installation for customers with genuine health concerns and for the voluntary take-up of time-of-use tariffs. While Coliban Water has already taken some steps to address these customer concerns, we expect Coliban Water will continue to manage any health related issues, and comply with all relevant standards and regulations. It is not our role to regulate or monitor any potential health impacts of a water corporation's projects.

CALC's submission reminded the commission and corporations that 'smart energy meters were touted as a game changer…but have so far failed to deliver on this promise'.[44] It stated that new technology must deliver tangible benefits for water customers and be backed by a comprehensive business case. In its response, Coliban Water noted its roll-out of digital metering is a key driver for an annual operating efficiency improvement gain of 1.5 per cent. It has also committed to undertake an independent peer review to confirm whether the project should proceed.

In its submission, CALC also recommended the commission sets industry-wide principles to ensure the rollout of smart meters is in the long-term interest of consumers, including support mechanisms for vulnerable customers.[45] However, our regulatory role does not extend to overseeing the design and delivery of capital projects. We agree with the Consumer Action Law

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[42] Coliban Water 2018, *Response to ESC draft decision*, op. cit., pp. 13–14, 17–22.

[43] Alana Moore 2018, *Submission,* 4 May; Carmela Leone 2018, *Submission,* 8 May; Janobai Smith 2018, *Submission: Response to ESC draft decision*, 16 May. See also pages 22 and 23 of our draft decision for our discussion on submissions received on Coliban Water's price submission.

[44] Consumer Action Law Centre, op. cit.

[45] ibid.

Centre that strong customer engagement and collaboration across the industry is important for achieving an efficient outcome for customers, including vulnerable customers. We also agree water corporations should take into account lessons learnt from the energy smart meter rollout, and from other water corporations further advanced with their digital metering programs.

Given Coliban Water's commitment to address its customers' concerns with the digital metering roll-out, and its guarantees to limit the project cost impact on customers to $5.0 million, we have reinstated the $3.90 million we removed in our draft decision on gross capital expenditure. However, we expect Coliban Water to:

- manage customer expectations and concerns with digital metering
- 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
- manage all risks associated with this roll-out, including costs and customer bill impacts.

In its submission, Urban Development Institute of Australia (Victoria) (UDIA) recommended that 'Coliban Water detail proposed investment of the full expenditure amount, embodying development servicing argumentation, timing and sequencing plans' rather than only the top ten projects. Terraco's submission also held this view and Villawood also queried the lack of development and sequencing plans.[46] To establish a capital expenditure benchmark for pricing, we assess each corporation's forecast capital expenditure based on a sample of major projects and programs proposed for the period. In part, our assessment approach seeks to ensure the cost of regulation does not outweigh the benefits and in addition, our regulatory role is not to oversee the delivery of capital projects.[47] However we expect Coliban Water to work with its customer groups (developers, households, industry, etc.) to prioritise its spend within its capital expenditure benchmark over 2018–23, for example, where population growth occurs in areas other than planned.

No other new considerations were presented in submissions received following the draft decision that caused us to change our views on gross capital expenditure.

Accordingly, we have adjusted our draft decision to re-instate the total cost for digital metering for our final decision (Table 2.7). We consider this benchmark is consistent with our guidance and

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[46] Urban Development Institute of Australia (Victoria) 2018, *Submission: Water Price Review Process, Coliban Water Draft Decision*, 9 May; Terraco 2018, *Re: Coliban Water Pricing Submission 2018 and 244 Edwards Road, Maiden Gully*, 8 May.

[47] Section 8A(1)(e) of the Essential Services Commission Act 2001 (Vic); Essential Services Commission 2016, *Guidance Paper,* op. cit., pp. 35-39.

WIRO principles, and is used to calculate our final decision on Coliban Water's forecast regulatory asset base (Table 2.6) and its revenue requirement (Table 2.1).[48]

Table 2.7 Final decision – Gross capital expenditure

$ million 2017-18

	2018-19	2019-20	2020-21	2021-22	2022-23	Total
Draft decision – gross capital expenditure	**36.4**	**36.6**	**37.5**	**41.5**	**41.1**	**193.2**
– Digital metering	0.38	0.55	0.99	0.99	0.99	3.90
Total adjustments to gross capital expenditure	**0.38**	**0.55**	**0.99**	**0.99**	**0.99**	**3.90**
Final decision – gross capital expenditure	**36.8**	**37.2**	**38.5**	**42.5**	**42.1**	**197.1**

Note: Numbers have been rounded

The benchmark that we adopt for Coliban Water does not represent the amount that the water corporation is required to spend or allocate to particular projects. 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. Coliban Water determines how to best manage the allocation of its revenue and priority of its expenditure within a regulatory period.

In our draft decision, we accepted Coliban Water's approach for addressing uncertain capital expenditure. We reiterate that Coliban Water will need to demonstrate the prudency and efficiency of additional costs incurred during the 2018–23 period if seeking to include them in the regulatory asset base.

Customer contributions

Customer contributions are deducted from gross capital expenditure so they are not included in the regulatory asset base.

Our draft decision required Coliban Water to resubmit updated forecast revenue from customer contributions to reflect its response to our draft decision on new customer contribution charges.

[48] Essential Services Commission 2016, *Guidance Paper*, op. cit., p. 35; WIRO clause 8(b)

We compared Coliban Water's updated forecast for customer contributions with past outcomes, and its forecasts for growth in customer connections.[49] We consider Coliban Water's forecast contributions are reasonable, having regard to past trends and its growth forecasts.

No other new considerations were presented in submissions received following the draft decision which caused us to change our views on revenue from customer contributions.

For the reasons set out above, our final decision accepts the benchmark revenue from customer contributions as set out at Table 2.6.

Cost of debt

In our draft decision we proposed to approve the cost of debt proposed by Coliban Water as it used the cost of debt values we specified in our guidance to calculate its revenue requirement. We also noted that we will update the value of the estimated cost of debt for 2017-18 with our calculation of the actual cost, applying the method outlined in our guidance.[50]

Consumer Action Law Centre recommends that we set the benchmark cost of debt at five per cent or around one per cent lower than the amount allowed in our draft decision (6.05 per cent per annum in nominal terms).[51] CALC submits that government owned water corporations carry less risk than private corporations and as such, the allowed cost of debt and the return on equity should be lowered compared with the rates allowed in our draft decision. These recommendations are based on a report prepared by CME for CALC. [52]

A submission by the Water Services Association of Australia (WSAA) addressed CALC's submission.[53] Among other things, WSAA's submission noted that competitive neutrality principles have been embedded in government policy, including in Victoria via the Financial Accommodation Levy. As a result, water corporations face a cost of debt that reflects the commercial cost of debt.

In keeping with government policy, the approach we take to the cost of debt is to adopt a benchmark rate that applies to all water corporations. The benchmark reflects our estimate of the

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[49] Growth in customer connections can be used as an indicator of growth in customer contributions.

[50] We received data on the actual trailing average cost of debt for 2017-18 from Treasury Corporation Victoria in April 2018 and we updated the 2017-18 estimates for our final decision.

[51] Consumer Action Law Centre, op. cit. p. 8.

[52] ibid.

[53] Water Services Association of Australia 2018, *Submission,* May.

efficient financing costs for a privately owned business facing a similar degree of economic risk to a regulated water corporation. We consider this is consistent with the requirements of the WIRO.[54]

In our view, adopting the approach recommended by CALC would mean a benchmark efficient water corporation may not have a reasonable opportunity to recover their debt costs.

A more detailed response to the issues raised by CALC is set out at Appendix D.

Our final decision adopts the benchmark cost of debt as set out in Table 2.8.

Table 2.8 Final decision – 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%	4.5%

Note: Numbers have been rounded

Return on equity – PREMO rating

Our draft decision proposed to approve a rate for the return on equity of 4.3 per cent. This reflected the return rate allowed in our guidance for a price submission self-rated by a water corporation as 'Advanced' under PREMO, which we rated as 'Standard'.[55]

CALC recommended a one per cent reduction to each return on equity value in the PREMO matrix.[56] CALC's recommendation is based on the findings of a report prepared by CME. The main reason CME proposed the reduction is due to comparisons with returns allowed for UK water entities, and that government owned water corporations carry less risk than private corporations.

The most relevant comparisons for the return on equity are other economic regulators in Australia. The rate for the return on equity (and the regulatory rate of return, comprising the cost of debt and the return on equity) approved in our draft decision are similar to rates recently estimated by other Australian-based regulators of the water sector.[57] We also consider the allowed return on equity

[54] Including, in particular, the requirements that our decision have regard to: the promotion of efficiency in regulated industries and the financial viability of the regulated water industry (cl 8(b)(ii) WIRO); efficiency in the industry and incentives for long term investment (s 8A(1)(a) ESC Act); and consistency in regulation between States and on a national basis (s 8A(1)(f) ESC Act).

[55] Essential Services Commission 2016, *Guidance paper*, op. cit., p. 45.

[56] Consumer Action Law Centre, op. cit, p. 8.

[57] Essential Services Commission of South Australia 2016, *SA Water regulatory determination 2016*, Final Determination, June; Independent Pricing and Regulatory Tribunal 2017, *WACC biannual update*, February.

should not be adjusted to reflect government ownership, as the exposure of a water corporation to market risk will not be materially affected by government ownership.

A more detailed response to the issues raised by CALC is set out at Appendix D.

We consider our approach to the return on equity is consistent with our requirements under the WIRO, and in particular, that our estimate provides water corporations with an incentive to invest efficiently, and that our approach has regard to the financial viability of the water industry.

In its submission responding to our draft decision, Coliban Water proposed a return on equity of 4.9 per cent, arguing for reinstatement of its ‘Advanced’ PREMO price submission rating.

Our final decision accepts Coliban Water’s proposed return on equity of 4.9 per cent, reflecting our views set out above, and our consideration of its PREMO rating (Chapter 3).

Regulatory depreciation

Regulatory depreciation is an input to calculating the regulatory asset base. Regulatory depreciation allows a water corporation to recover the cost of investing in assets.

In the past, most water corporations have adopted a straight line depreciation profile. For a particular asset, this means the amount for regulatory depreciation will be the same each year, over the assumed asset life. We noted in our guidance that we prefer straight line depreciation.[58]

In our draft decision, we noted Coliban Water estimated its forecast regulatory depreciation based on a straight line method. However, it proposed to shorten its assumptions for asset life (halving from around 32 to 16 years), which contributes to the doubling (approximately) of the amount reflected in its revenue requirement for regulatory depreciation, compared to the five years from 1 July 2013.[59] Its forecast depreciation included amounts it had deferred in previous periods.

As stated in our guidance, we expect the calculation of straight line depreciation will reflect a reasonable assumption about average asset life.[60] Our draft decision noted our view that Coliban Water did not provide sufficient justification for halving its asset life assumption for the purpose of calculating regulatory depreciation using a straight line approach.

We proposed to accept Coliban Water’s proposed depreciation amount, given we typically allow flexibility in the calculation of depreciation, and because the proposed allowance includes deferred

[58] Essential Services Commission 2016, *Guidance Paper*, op. cit., p. 42.

[59] This is almost half the average asset life assumed in the 2013 determination. For the period from 1 July 2018 to 30 June 2023 Coliban Water proposed a regulatory depreciation forecast of $168.3 million.

[60] Essential Services Commission 2016, *Guidance Paper*, op. cit., p. 43.

depreciation from previous periods. However we did not accept its assumptions about asset life as a basis for calculating regulatory depreciation under the straight line method.

In response to our draft decision, Coliban Water clarified that the reasons for increasing its rate of depreciation for the 2018-23 period was to achieve a smoother price path (reflecting customer preferences for stable prices and bills) and recover depreciation amounts deferred from its 2013-18 period. Also, it noted its depreciation forecast was not premised on halving asset lives.

On this basis, our final decision accepts Coliban Water's forecast regulatory depreciation.[61] The regulatory depreciation estimates we have adopted for our final decision are shown in Table 2.1.

Tax allowance

The tax allowance is an input into the revenue requirement. Our draft decision accepted Coliban Water's forecasts for zero tax in its revenue requirement, as it was calculated consistently with the method required by our guidance.[62] No new considerations were presented in submissions received following the draft decision which caused us to change our views on the tax allowance.

For the reasons set out above, our final decision adopts Coliban Water's tax forecasts, as set out in Table 2.1.

Demand

Our draft decision proposed to accept Coliban Water's demand forecasts as we considered they were estimated in a manner consistent with the requirements of our guidance. No other new considerations were presented in submissions received following the draft decision which caused us to change our views on Coliban Water's demand forecasts.

For the reasons set out above, our final decision on demand is the same as our draft decision.

Our price determination for Coliban Water includes the benchmark demand forecasts adopted for our final decision.

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[61] We note that the depreciation amount in our final decision is slightly higher than the draft decision, reflecting our final decision on capital expenditure.

[62] Essential Services Commission 2016, *Guidance paper*, op. cit., pp. 50-51.

Form of price control

Our draft decision proposed not to accept Coliban Water's proposed hybrid revenue cap because:

- Coliban Water could retain any revenue collected above the annual amount included in its hybrid revenue cap until the end of the regulatory period. This could result in prices that don't reflect our assessment of efficient costs.
- Coliban Water did not propose an annual adjustment to allow for prices to reflect changes in the cost of debt, which was inconsistent with the requirements of our guidance.
- Coliban Water did not provide sufficient information in support of its proposal that net revenue should equal 50 per cent of the over (under) recovered revenue.
- Coliban Water did not demonstrate that its proposed from of price control better satisfied the requirements of the WIRO than the existing structure.

In response to our draft decision, Coliban Water proposed a price cap form of price control. It currently uses a price cap.

Our final decision is to approve Coliban Water's proposed price cap form of price control. A price cap will allow Coliban Water to recover sufficient revenue to cover the forecast efficient costs of providing services. 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.

Tariff structures and prices

Existing tariff structures

Our draft decision accepted Coliban Water's proposal to:

- maintain a two-part tariff with a fixed service charge and a variable usage component that depends on water use for residential and non-residential water services
- maintain a fixed service charge only for residential sewerage services and a two-part tariff for non-residential services
- finalise the harmonisation of prices between the central and northern pricing zones, which began in the third regulatory period, by 2019-20.

We considered the two-part structure for water services will promote efficient use. It also provides customers a signal about their water use costs, and is an approach that is commonly applied in other states and territories.[63] We also considered two-part tariff structures are easy to understand.

For sewerage tariffs, we considered a fixed charge only for residential customers and a two-part tariff for non-residential customers sends customers signals about the efficient costs.

We considered Coliban Water's proposal to continue the harmonisation of prices for its pricing zones will promote ease of understanding and provides signals about the efficient costs of providing services to customers. It is also supported by customers.

A submission from David Beasley considered fixed water charges are too high.[64] On this, we note:

- Coliban Water's customers generally prefer to maintain the current balance of fixed and variable charges[65]
- Coliban Water's prices will decrease for most customers from 2018-19 to 2022-23
- tariffs reflect the efficient costs of providing the service
- Coliban Water has committed to expand its support for low income and vulnerable customers by proposing an additional $430,000 in expenditure over the 2018-23 regulatory period relating to financial hardship payments to customers.

For the reasons set out above, our final decision approves Coliban Water's proposed existing tariff structures.

Tariff changes

Our draft decision accepted Coliban Water's proposal to:

- abolish the residential recycled water access charge as customers are currently paying two access charges – the historical residential recycled water access charge and a standard potable water access charge, but not receiving services that are reflective of the charges
- change its irrigation outlet fees tariff from two levels (depending on number of outlets) to a single price per additional outlet
- implement a 'fast track' option for developers seeking faster processing time. The fast track tariff will initially be set at a 50 per cent premium to the standard fees
- introduce two new re-work fees charged on revisions developers make to initial plans or when they require a site re-inspection.

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[63] 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.

[64] David Beasley 2018, *Submission*, 14 April

[65] Coliban Water 2017, *Supplement C. Financing the Plan*, p. 33.

We considered that:

- removing the residential recycled water access charge will provide signals about the efficient costs of providing services to customers. Residents will continue to pay the standard potable water access charge.
- simplified outlet fees will promote ease of understanding and is supported by customers
- a fast track option fee is an optional charge for customers seeking faster assessments of applications and is supported by customers
- the two new re-work fees will provide signals to customers on the costs of plan revisions and site re-inspections.

While our draft decision accepted Coliban Water's proposed 20 per cent discount to Elmore's annual wastewater access fee, we proposed not to accept Coliban Water's cross-subsidy to fund the discount. We also considered the lower level of service should result in lower expenditure. In response to our draft decision, Coliban Water removed the cross-subsidy. We are satisfied that the proposed discount is cost reflective and provides signals about the efficient costs of providing sewerage services to customers in Elmore.

No other new considerations were presented in submissions received following the draft decision which caused us to change our views on Coliban Water's proposed tariff changes.

For the reasons set out above, our final decision approves Coliban Water's proposed tariff changes.

Mid-period tariff changes

Our draft decision proposed not to accept the additional revenue of $150,000 per annum from 2019-20 from new intermediate trade waste customers, as Coliban Water did not provide sufficient information in support of its proposed additional revenue. Coliban Water has accepted our draft decision.

We note that Coliban Water intends to explore the introduction of a new recreational water tariff, and restructure its trade waste tariffs during the 2018-23 period. It must provide us with the following information when applying to implement tariff reform:

- how the new tariffs meet our pricing principles and the WIRO requirements
- how it consulted with customers on the proposed new tariffs, and how any customer impacts have been adequately addressed.

Unique services

Our draft decision accepted Coliban Water's proposal to:

- increase its project management fees by 10 per cent as it was supported by customers

- provide a discount on the infrastructure charge for rural customers if it does not make seasonal allocations of 100 per cent. We noted that Coliban Water's proposal to discount infrastructure charges for rural customers ensures customers pay for the water received, and is therefore cost reflective.

No other new considerations were presented in submissions received following the draft decision which caused us to change our views on Coliban Water's proposed changes to price levels.

For the reasons set out above, our final decision approves Coliban Water's proposed increase in its project management fees and discount on the infrastructure charge for rural customers if it does not make seasonal allocations of 100 per cent.

Prices

Our price determination for Coliban Water sets out the maximum prices it may charge for the five year period from 1 July 2018 (or the manner in which its prices are to be calculated, determined, or otherwise regulated). Approved maximum prices for water and sewerage services applying to most residential and non-residential customers are set out at Tables 2.9 and 2.10.[66]

Table 2.9 Final decision – water prices
$ 2018-19

	2018-19	2019-20	2020-21	2021-22	2022-23
Residential					
Variable ($/kL)	2.2554	2.2283	2.2016	2.1753	2.1492
Fixed ($/year)	228.50	225.76	223.05	220.38	217.74
Non-residential					
Variable ($/kL)	2.2554	2.2283	2.2016	2.1753	2.1492
Fixed ($/year)	228.50	225.76	223.05	220.38	217.74

Note: Numbers have been rounded

[66] On 23 May 2018 (after our consultation period had closed on our draft decision for Coliban Water), we received a submission from Kingspan Environmental and Urban Water Cycle Solutions under our consultation process for Western Water's draft decision. We have considered the views raised in the submission for our final decision and price determination for Coliban Water. Our response to the submission is set out in our final decision paper for Western Water.

Table 2.10 Final decision – sewerage charges
$ 2018-19

	2018-19	2019-20	2020-21	2021-22	2022-23
Residential					
Fixed ($/year)	686.64	678.41	670.29	662.26	654.33
Non-residential					
Variable ($/kL)	0.9787	0.9669	0.9553	0.9439	0.9326
Fixed ($/year)	686.64	678.41	670.29	662.26	654.33

Note: Numbers have been rounded

Adjusting prices

In our draft decision we:

- Approved Coliban Water's proposal to continue with its existing uncertain and unforeseen events mechanism. We noted in our guidance that we propose that the mechanism continue in its current form.
- Proposed to approve Coliban Water's proposal to nominate the Castlemaine Link Interconnector Pipeline and the Goldfield Superpipe projects for specific inclusion into the uncertain and unforeseen event mechanism. We noted this approach is consistent with our guidance for managing expenditure associated with large projects.
- Invited Coliban Water to submit revised price adjustment formulas that are consistent with our draft decision and guidance.

In response to our draft decision, Coliban Water:

- proposed a pass-through of costs from changes in taxes and legislative obligations when the revenue requirement varies by more than 2.5 per cent
- proposed to pass-through any savings to customers if costs for the rollout of digital metering is lower than forecast
- worked with us to develop formulas for annual changes in the cost of debt.

Our final decision approves Coliban Water's:

- proposed pass-through of cost savings from the rollout of digital metering as it promotes cost reflectivity and provides signals about the efficient costs of providing the service to customers
- revised price adjustment formulas for changes in the cost of debt as we consider it is easy to understand and better supports customers' understanding of price changes.

Our final decision does not approve Coliban Water's proposed pass-through of costs from changes in taxes and legislative obligations when the revenue requirement varies by more than 2.5 per cent. The existing uncertain and unforeseen events mechanism provides for these cost pass-throughs if there is a material impact on costs or revenue.

We approve Coliban Water's:

- proposal to continue its existing uncertain and unforeseen events mechanism, as we consider that it worked well in the past and our guidance proposed that the mechanism continue in its current form[67]
- proposal to nominate the Castlemaine Link Interconnector Pipeline and the Goldfield Superpipe projects for specific inclusion into the uncertain and unforeseen event mechanism as it is consistent with our guidance for managing expenditure associated with large projects.

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 corporations and developers to negotiate a site-specific arrangement.

Our draft decision proposed to accept Coliban Water's proposed standard recycled water contribution charge and standard water charge, including the split of the standard water charge into 'non-growth' and 'growth' categories. However, our draft decision did not approve Coliban Water's proposed annual pass-through to the standard sewerage charge for the costs associated with the construction of sewer pump stations. Our draft decision required Coliban Water to provide updated standard sewerage new customer contribution charges.

In response to our draft decision, Coliban Water acknowledged our concern with the pass-through of pump station costs and proposed a continuation of its existing standard sewerage new customer contribution charge (plus annual adjustments for inflation). Coliban Water also proposed the standard sewerage charge be split into 'growth' and 'non-growth' categories to align with the standard water contribution charges.

For negotiated new customer contributions, our draft decision proposed to approve Coliban Water's proposed method of calculating a charge in accordance with the requirements of our new customer contribution pricing principles.[68]

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[67] Essential Services Commission 2016, *Guidance paper*, op. cit. pp. 59–61.

We received multiple submissions on our draft decision for Coliban Water's proposed new customer contribution charges.[69] Submissions received from the UDIA, Terraco and Villawood all raised similar concern about the lack of publicly available information from Coliban Water on:

- development servicing plans
- negotiation protocols
- explanations of where and when standard charges apply, and circumstances in which a negotiated charge would be applicable.

We note that our New Customer Contributions Explanatory Note expresses reasonable industry practice would see water businesses publish up to date and publicly available information covering the aforementioned concerns raised by the submissions.[70] Coliban Water's response to our draft decision expresses its intention to apply a greater focus on a negotiation approach.[71] We encourage Coliban Water to update and publish any development servicing plans and negotiation protocols to assist developers understand the underlying assumptions of its new customer contribution charges.

Additionally, the submissions received from the UDIA and Terraco noted that Coliban Water's pricing submission only detailed the top 10 capital projects. We consider that Coliban Water has complied with the requirements of guidance, which only requires businesses to provide detail on top 10 discrete capital projects.[72]

No other new considerations were presented in submissions received following the draft decision which caused us to change our views on new customer contributions charges.

Our final decision accepts Coliban Water's proposed continuation of its existing standard sewerage new customer contribution charge, including its split by 'growth' and 'non-growth' categories. Furthermore, we consider it appropriate to maintain the views expressed in our draft decision accepting Coliban Water's proposed standard water new customer contribution charges and its

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[68] ibid., p. 62.

[69] Urban Development Institute of Australia (Victoia) 2018, *Submission,* 8 May; Teraco Pty Ltd 2018, *Submission*, 8 May; Villawood Properties 2018, *Submission*, 9 May.

[70] Essential Services Commission 2013, *New Customer Contributions: Explanatory Note,* December, pp. 3-4 and pp. 9-11.

[71] Coliban Water's response to our draft decision is available on our website.

[72] Essential Services Commission 2016, *Guidance paper,* op. cit., p. 37.

method of calculating negotiated contribution charges, as they are consistent with the requirements of our guidance.[73]

Our price determination for Coliban Water sets out the approved new customer contribution charges for the five year period from 1 July 2018 (or the manner in which its prices are to be calculated, determined, or otherwise regulated).

Financial position

In approving prices, we must have regard to the financial viability of the water industry.[74] 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 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.

Our draft decision did not accept Coliban Water's proposal for a financial viability adjustment of $5 million over its five year regulatory period. Our assessment of Coliban Water's future financial position did not indicate that a financial viability adjustment was warranted. In its response to our draft decision, Coliban Water withdrew its proposal for a financial viability adjustment.

Our guidance set out key indicators of forecast financial performance. We have reviewed forecasts for these key indicators based on our final decision on Coliban Water's prices. We have assessed that, under our final decision, Coliban Water will generate sufficient cash flow to deliver on service commitments, including financing costs arising from investments to meet service expectations.

[73] ibid., pp. 62-63.

[74] WIRO clause 8(b)(ii) and ESC Act section 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, we required each water corporation to 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 final decision is to accept Coliban Water's proposed return on equity of 4.9 per cent, based on an 'Advanced' PREMO rating.

Our review of Coliban Water's PREMO rating

Coliban Water's proposed PREMO rating, and our draft and final decision are summarised below (Table 3.1).

Table 3.1 PREMO Rating

	Overall PREMO rating	Risk	Engagement	Management	Outcomes
Coliban Water's price submission	**Advanced**	Advanced	Advanced	Advanced	Advanced
Commission's draft decision rating	**Standard**	Basic	Advanced	Advanced	Advanced
Commission's final decision rating	**Advanced**	Standard	Advanced	Advanced	Advanced

Our draft decision proposed to approve an overall PREMO rating of 'Standard'. This was lower than the 'Advanced' rating proposed by Coliban Water.

Our draft decision acknowledged that Coliban Water's price submission was built on strong customer engagement and robust cost management (Figure 3.1 shows a continued improvement in controllable costs per connection, albeit at a slightly lower improvement rate than the industry average). Coliban Water committed to improving service outcomes and expand its guaranteed service level program, thereby increasing accountability on the business to deliver on customer service targets. Coliban Water also proposed a price fall of one per cent per year from 2018-19.

Our draft decision agreed with Coliban Water's proposed 'Advanced' rating for the Engagement, Management, and Outcomes elements of PREMO.[75]

In our draft decision, we assessed the Risk element of the price submission as 'Basic'. This was considerably lower than the 'Advanced' rating proposed by Coliban Water and it resulted in our overall PREMO assessment of the price submission reducing to 'Standard'.

Our lower assessment of Coliban Water's Risk rating reflected our assessment of its proposals relating to:

- The form of price control – we found Coliban Water's proposed hybrid revenue cap was unnecessarily complex and did not meet the requirements of our guidance. We considered Coliban Water could achieve the outcomes sought through a simpler form of price control.
- The inclusion of a $5 million financial viability adjustment – our assessment of Coliban Water's future financial position indicated that a viability adjustment was not warranted considering its improving financial position.
- Regulatory depreciation – we considered Coliban Water's justification for adopting a relatively aggressive approach to depreciation did not meet the requirements of our guidance.

The PREMO Risk rating was essentially developed around operational and expenditure risks, seeking to ensure those risks were managed by the water corporation wherever it was best placed to do so. That is, a water corporation should not pass on these risks in the form of higher customer prices if the corporation could better manage those risks by appropriately deploying its skills and resources.

Coliban Water's price submission highlighted an alternative element of risk management, namely, the intergenerational transfer of risk. Whereas the PREMO framework was concerned with the transfer of risk between the business and customers, some of the elements of the Coliban Water prices submission sought to shift risk between present and future customers.

[75] More detail on justification for the ratings is provided in our draft decision.

Our draft decision acknowledged these different elements of risk management and invited Coliban Water to reconsider its approach. We indicated we would reconsider Coliban Water's Risk rating if it addressed our concerns. In its response to our draft decision, Coliban Water:

- Proposed to retain a price cap form of price control, which we have approved (pages 24 to 25).
- Withdrew its proposal for a financial viability adjustment, indicating acceptance of the concerns raised in our draft decision.
- Provided further information about its approach to regulatory depreciation.

In making our final decision on the Risk element of PREMO we considered the following:

- Our pricing approach allows water corporations to propose a financial viability adjustment where necessary to do so. Coliban Water has accepted that it had adopted an overly cautious interpretation of the standards required for a financial adjustment (thereby overstating its revenue requirement) and has withdrawn its proposal.
- The proposal to use a hybrid revenue cap model did not directly affect Coliban Water's proposed price levels (unlike expenditure related matters, for example). That is, it did not alter the value received by customers. However, Coliban Water's price submission was unusual insofar as it stated that if the commission did not approve its proposed hybrid revenue cap form of price control, it would prefer to continue with its existing price cap. In effect, Coliban Water provided the commission with a decision that was better placed with its Board and management. It is not clear why Coliban Water's took this approach, nonetheless, the commission responded in its draft decision by expressing its preference for a simpler approach to the form of price control. Coliban Water has accepted our response.[76,77]
- Coliban Water provided more details about the assumptions and justifications for its approach to regulatory depreciation. This final decision approves the amounts for regulatory depreciation proposed by Coliban Water (pages 23 to 24).

Coliban Water's proposal to retain a price cap addresses the concerns we raised in our draft decision about the complexity of its proposed hybrid revenue cap. Further, by withdrawing its proposal for a financial viability adjustment and providing further justification for its approach to depreciation, we consider its revised proposals now better complies with the intent of our guidance.

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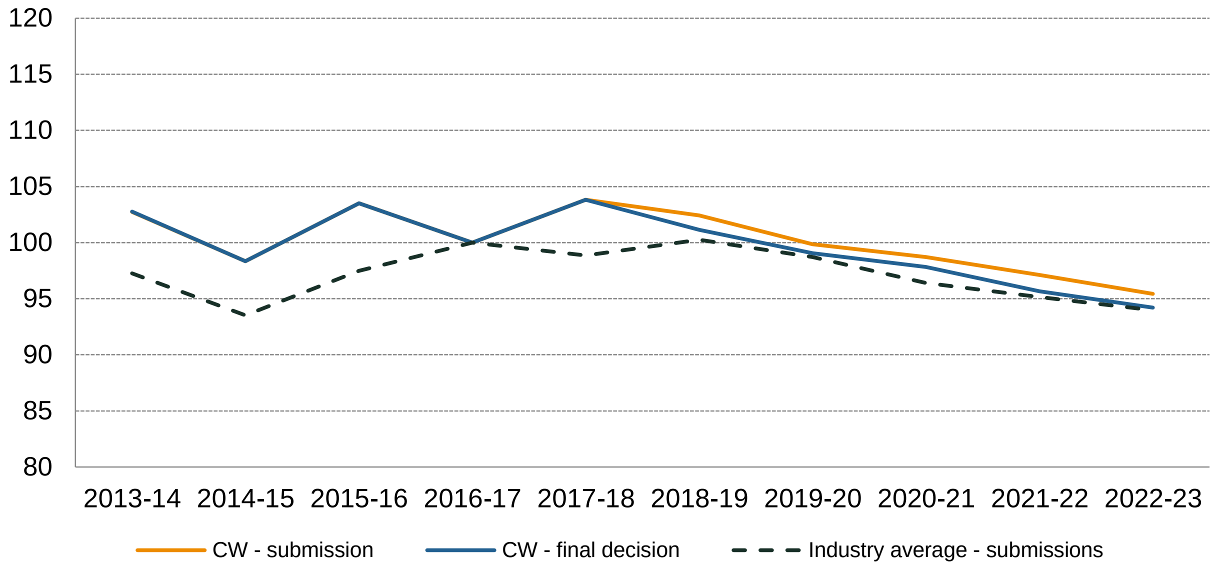
[76] We engaged Deloitte to undertake an independent review of the expenditure forecasts of the water corporations to inform our draft decision. This provided an opportunity for water corporations to provide additional information clarifying their proposals. The same approach was not adopted for matters such as the form of price control, financial viability, and regulatory depreciation.

[77] We will revise our guidance material to ensure that in future, such decisions are made exclusively by a water corporation as part of its price submission.

This final decision assigns a rating of ‘Standard’ for the Risk element in Coliban Water’s PREMO assessment. This final decision also confirms our earlier assessment of an ‘Advanced’ rating for the ‘Outcomes’, ‘Management’ and ‘Engagement’ elements of PREMO framework.

Following our reassessment of the Risk rating from ‘Basic’ to ‘Standard’, our overall PREMO rating for Coliban Water changes from ‘Standard’ in our draft decision to ‘Advanced’ in this final decision. This is reflected in the return on equity we have approved for Coliban Water at pages 22 to 23.

Figure 3.1 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. Final 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).

Appendix A – submissions received on draft decision

Name or organisation	Date received
Kingspan Environmental and Urban Water Cycle Solutions	23 May 2018
Water Services Association of Australia	16 May 2018
Janobai Smith	16 May 2018
Terraco Pty Ltd	9 May 2018
Urban Development Institute of Australia (Victoria)	9 May 2018
Villawood Properties	9 May 2018
Carmela Leone	8 May 2018
Consumer Action Law Centre	8 May 2018
Alanna Moore	4 May 2018
David Beasley	14 April 2018

Appendix B – approved service standards

We have approved the following standards and conditions of service and supply and associated targets for Coliban Water.

Coliban Water's approved service standards

Service Standard	2018-19	2019-20	2020-21	2021-22	2022-23
Water					
Number of customers experiencing more than 5 unplanned water supply interruptions in the year (number)	5	5	5	5	5
Average time taken to attend bursts and leaks (priority 1) (minutes)	32	32	32	32	32
Average time taken to attend bursts and leaks (priority 2) (minutes)	80	80	80	80	80
Average time taken to attend bursts and leaks (priority 3) (minutes)	1440	1440	1440	1440	1440
Average duration of unplanned water supply interruptions (minutes)	112	112	112	112	112
Average duration of planned water supply interruptions (minutes)	140	140	140	140	140
Sewerage					
Customers receiving more than 3 sewer blockages in the year (number)	2	2	2	2	2
Average time to attend sewer spills and blockages (minutes)	30	30	30	30	30
Average time to rectify a sewer blockage (minutes)	80	80	80	80	80
Spills contained within 5 hours (per cent)	99	99	99	99	99

Note: Numbers have been rounded

Appendix C – approved GSL schemes

We have approved the following service level obligations and corresponding amounts of payment for failure to attain the stated obligation as the guaranteed service level (GSL) scheme for Coliban Water.

In accordance with clause 13 of our Customer Service Code: Urban Water Businesses, Coliban Water must ensure that any payment is made to a customer as soon as practical after a customer becomes entitled to the GSL payment.

Coliban Water is not required to make a payment where the failure to meet the service level is due to the action or inaction of the customer or a third party. For the avoidance of doubt, third party does not include any person or firm acting on behalf of Coliban Water.

Coliban Water's approved GSL scheme

Approved service level obligation	Approved payment ($)
A blown seal sewer intrusion into your house (contained instantly)	50
Any sewer intrusion into your house contained within 1 hour	300
Sewer intrusion into your house not contained within 1 hour	1000
Special Meter Read not completed within 2 business days of the scheduled SMR date	no charge for SMR
3+ sewer blockages affecting you in a year (note target down from 4+ to 3+)	100
4+ water supply outages affecting you in a year (note target down from 6+ to 4+)	50
Water supply outage not restored within 5 hours	50
Your correspondence (letter or email) to Coliban Water not responded to within 10 business days	10
Planned water supply outage during peak periods (6AM-9AM & 6PM-9PM weekdays and on weekends)	100
Rural customers receive <100% of water allocation	rebate on fixed charge

Restricting the water supply of, or taking legal action against, a residential customer prior to taking reasonable endeavours (as defined by the commission) to contact the customer and provide information about help that is available if the customer is experiencing difficulties paying	300
There is an ongoing adverse water quality issue in your system, for example poor taste or colour	25% water access fee
High Priority inspection at practical completion not completed within 2 business days	250
High Priority mains extension approval not completed within 10 business days	no charge for service
There is a significant sewer spill to local waterways or the environment (community)	20000
There is poor water flowrate / pressure in a supply area over a prolonged period (community)	5000
Coliban Water issues a "boil water" or "do not consume" notice in your water supply system (community)	5000
There is a short-term adverse water quality issue in your system, for example poor taste or colour (community)	5000

Appendix D – rate of return

A submission from the Consumer Action Law Centre (CALC) recommended that we set the benchmark cost of debt at five per cent or around one per cent lower than the amount allowed in our draft decision (6.05 per cent per annum in nominal terms). It also recommended that we reduce each of the equity values in the PREMO matrix by one per cent. CALC submits that government owned water corporations carry less risk than private corporations, and as such, the allowed cost of debt and the return on equity should be lowered, compared with the rates allowed in our draft decision.[78] These recommendations are based on a report prepared by CME for CALC.[79]

Victoria's water corporations are subject to the competitive neutrality measures the Victorian government agreed to implement as part of the national competition policy agreement and related reforms.[80] This includes ensuring that borrowing costs reflect an estimate of a water corporation's standalone risk profile and credit rating. We note that:

- Victoria's water corporations do not access debt capital markets directly, but rather, their debt is managed by the state government treasury corporation, through the issuance of government bonds. While the treasury corporation may have access to lower debt funding costs due to government's higher credit rating, the water corporation's borrowing costs do not reflect this. Rather, the water corporations borrow from state treasuries at rates consistent with the risk inherent in the businesses as reflected in their stand-alone credit rating.
- The difference between the government's borrowing costs and the costs faced by water corporations represents consideration for state taxpayers accepting the corporations' credit risk. This is achieved via the Financial Accommodation Levy (FAL), which seeks to ensure the borrowing cost faced by each water corporation reflects the nature of their businesses, not the tax powers of government. If state-owned service providers accessed debt markets directly, then they would face debt financing interest rates that reflected their stand-alone credit ratings.

In keeping with these policy parameters, the approach we take to the cost of debt is to adopt a benchmark rate that applies to all water corporations. The benchmark rate reflects our estimate of the efficient financing costs for a privately owned business facing a similar degree of economic risk

[78] Consumer Action Law Centre, op. cit., p. 8.

[79] ibid., Appendix A.

[80] We note the Water Services Association of Australia supports application of competitive neutrality principles, see Water Services Association of Australia 2016, *Submission to the Essential Services Commission: A new model for pricing services in Victoria's water sector*, July, p. 11.

to a regulated water corporation. We consider this is consistent with the requirements of the Water Industry Regulatory Order 2014 (WIRO).[81]

Adopting the approach recommended by CALC would mean the allowed rate for the cost of debt may be lower than the rate faced by a benchmark efficient water corporation. As well as being inconsistent with government policy that water corporations pay an estimate of a commercial equivalent borrowing rate, it would also be inconsistent with the WIRO's viability and efficiency objectives. Our approach is also similar to that adopted by other Australian economic regulators.

CALC's submission also recommended a one per cent reduction to each return on equity value in the PREMO matrix.[82] CME proposed the reduction mainly based on comparisons with the return allowed for UK water entities, and its view that government-owned water corporations carry less risk than comparable privately owned businesses.

We believe the most relevant comparisons for the return on equity are other economic regulators in Australia. We note the rate for the return on equity (and the overall regulatory rate of return, comprising the cost of debt and the return on equity) approved in our draft decision are within the range of rates estimated by other Australian-based regulators.[83]

Also, our current view is that the allowed return on equity should not be adjusted to reflect government ownership. In deriving the values for the return on equity in the PREMO matrix, we had regard to the return on equity we had allowed in the past, and the incentives for water corporations to provide high quality price submissions in the interests of their customers.

CME also argues for a reduction in return on equity to reflect the prevailing revenue cap form of price control. This reflects that a revenue cap provides a water corporation with greater revenue certainty than other forms of price control, such as a price cap. We note however, that only one urban water corporation in Victoria (Yarra Valley Water) has a revenue cap form of price control. As well, a revenue cap does not necessarily change the level of systematic risk faced by a water corporation. For example, it is possible that a water corporation operating under a revenue cap is more exposed to cost risks than corporation operating under a price cap.[84]

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[81] Including, in particular, the requirements that our decision have regard to: the promotion of efficiency in regulated industries and the financial viability of the regulated water industry (cl 8(b)(ii) WIRO); efficiency in the industry and incentives for long term investment (s 8A(1)(a) ESC Act); and consistency in regulation between States and on a national basis (s 8A(1)(f) ESC Act).

[82] Consumer Action Law Centre, op. cit., p. 8.

[83] Essential Services Commission of South Australia, op. cit.; Independent Pricing and Regulatory Tribunal 2017, *WACC biannual update*, August.

[84] For example, increases in water demand can lead to increased costs for a water corporation, which would not be matched by an increase in revenue, under a revenue cap. By contrast, under a price cap increases in water demand would also lead to an increase in revenue.

While our final decision has not agreed with CALC's recommendations, we will re-consider its arguments as part of any future review of the PREMO framework.