



Lower Murray Water draft decision – urban water and sewerage services

2018 Water Price Review

28 March 2018



An appropriate citation for this paper is:

Essential Services Commission 2018, *Lower Murray Water draft decision – urban water and sewerage services: 2018 Water Price Review*, 28 March

Copyright notice

© Essential Services Commission 2018



This work, *Lower Murray Water draft decision – urban water and sewerage services*, is licensed under a Creative Commons Attribution 4.0 licence [creativecommons.org/licenses/by/4.0]. You are free to re-use the work under that licence, on the condition that you credit the Essential Services Commission as author, indicate if changes were made and comply with the other licence terms.

The licence does not apply to any brand logo, images or photographs within the publication.

Contents

Summary	iv
1. Our role and approach to water pricing	1
2. Our assessment of Lower Murray Water's price submission	5
Regulatory period	6
Customer engagement	6
Outcomes	7
Guaranteed service levels	7
Revenue requirement	8
Operating expenditure	9
Regulatory asset base	16
– Closing regulatory asset base	16
– Forecast regulatory asset base	18
– Capital expenditure	19
– Revenue from customer contributions	22
Cost of debt	22
Return on equity – PREMO rating	23
Regulatory depreciation	23
Tax allowance	23
Demand	24
Form of price control	24
Tariff structures	24
Adjusting prices	26
New customer contributions	27
Financial position	27
3. PREMO rating	29
Our review of Lower Murray Water's PREMO self-rating	29
4. We invite feedback on our draft decision	31
Attend a public forum	31
Provide written comments or submissions	31
Next steps	32
APPENDIX A – submissions received	33

Contents

Summary

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

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

Note that this draft decision covers Lower Murray Water's urban water and sewerage services. A separate paper provides our draft decision on Lower Murray Water's rural infrastructure services.³

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

Lower Murray Water has committed to deliver improved outcomes for customers

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

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

- reducing fixed and variable water, sewerage and trade waste prices
- investing in water supply infrastructure to improve water quality for Swan Hill.

Our draft decision proposes to approve a slightly lower revenue requirement than proposed by Lower Murray Water

Our draft decision proposes to approve a revenue requirement of \$187.9 million for Lower Murray Water's urban services over the five year period starting 1 July 2018, for the purpose of approving maximum prices.⁴ This is \$0.7 million or 0.4 per cent lower than proposed by Lower Murray Water.

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

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

³ Our draft decision for Lower Murray Water's rural infrastructure services is available on our website.

⁴ The revenue requirement is the forecast amount a water corporation needs to deliver on customer outcomes, government policy, and obligations monitored by technical regulators including Environment Protection Authority Victoria and the Department of Health and Human Services. Along with forecast demand, it is an input to calculating the prices to be charged by a water corporation.

Our draft decision proposes to accept Lower Murray Water's operating and capital expenditure forecasts. The change to the revenue requirement reflects minor corrections made by Lower Murray Water to its operating and capital expenditure, after lodging its original price submission.

More information on our review of operating expenditure is set out from page 9, and for capital expenditure, from page 18.

Based on our draft decision, on average Lower Murray Water's prices over 2018-19 to 2022-23 will be about 0.4 per cent lower than under its original proposal.⁵

Lower Murray Water must respond to our draft decision and propose individual tariffs that reflect our initial views on the revenue requirement. Lower Murray Water's response will determine the price and bill impact of our draft decision across individual tariffs and customer groups.

Tariff structures will remain the same

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

We propose to accept Lower Murray Water's proposed tariff basket form of price control. It currently uses a tariff basket form of control.

Our assessment of tariff structures is provided from page 23.

Lower Murray Water's price submission is rated as 'Standard' under PREMO

Our draft decision is to accept Lower Murray Water's PREMO self-rating of its price submission as 'Standard' (Table A).

In support of its proposed PREMO rating, we note Lower Murray Water's forecast for controllable operating expenditure incorporated assumptions for higher rates of improvement (on a per connection basis) than most other water corporations. As well, our review of Lower Murray Water's forecast expenditure also identified no changes to its proposals, an indication that its expenditure forecasts reflect efficient costs. Both factors indicate that the corporation is seeking to minimise

⁵ This is an indicative percentage change on prices based on the percentage change in draft decision revenue requirement compared to the proposed revenue requirement.

costs, prices and bills for its customers. Our review of Lower Murray Water’s proposed PREMO rating is provided at page 29.

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

Table A **PREMO Rating**

	Overall PREMO rating	Risk	Engagement	Management	Outcomes
Lower Murray Water’s rating	Standard	Standard	Standard	Standard	Standard
Commission’s rating	Standard	Standard	Standard	Standard	Standard

Among the 15 draft decisions we have released so far, Lower Murray Water is one of five corporations for which we propose to approve a ‘Standard’ rating (Table B).

Table B **Draft decision on PREMO – overall rating**

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

1. Our role and approach to water pricing

We are Victoria's independent economic regulator

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

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

Our review of the prices proposed by the water corporations covers the prescribed services listed in the WIRO.⁶ The prescribed services include retail water and sewerage services, and bulk water and sewerage services delivered by the water corporations.⁷

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

We assess prices against the WIRO and other legal requirements

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

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

⁶ 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.

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

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

- the matters specified in our guidance⁸
- the principle that prices should be easily understood by customers and provide signals about the efficient costs of providing services, while avoiding price shocks where possible
- the principle that prices should take into account the interests of customers of the regulated entity, including low income and vulnerable customers.

A separate document lists the specific objectives and the various matters the commission must have regard to when making a price determination and provides a guide to where the commission has done so in this draft decision.⁹

In 2016, we issued guidance to Lower Murray Water to inform its price submission. The guidance set out how we will assess Lower Murray 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 Lower Murray Water's proposed prices.¹⁰

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.¹¹

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.¹²

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.

⁸ Essential Services Commission 2016, *2018 Water Price Review, Guidance paper*, November.

⁹ Essential Services Commission 2018, *Lower Murray Water urban draft decision, 2018 Water Price Review – commission's consideration of legal requirements*, 28 March. This is located on our website at www.esc.vic.gov.au.

¹⁰ This is a requirement of the WIRO, clause 14(b).

¹¹ This is provided for under the WIRO, clause 14(b)(i).

¹² Essential Services Commission 2015, *Review of Water Pricing Approach, Consultation paper*, April.

In May 2016, we released a position paper setting out our proposed new pricing approach, and invited submissions.¹³ 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 2016.¹⁴

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.¹⁵ Our guidance explains the building blocks and how we use it to estimate the revenue requirement.¹⁶

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.¹⁷ 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.

¹³ Essential Services Commission 2016, *A new model for pricing services in Victoria's water sector, Position paper*, May.

¹⁴ For more detail on the new water pricing approach see: Essential Services Commission 2016, *Water Pricing Framework and Approach: Implementing PREMO from 2018*, October.

¹⁵ 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.

¹⁶ Essential Services Commission 2016, *Guidance Paper*, op. cit., pp. 8-9.

¹⁷ In December 2017 we issued early draft decisions for East Gippsland Water, South East Water, Westernport Water and Yarra Valley Water.

Our role and approach to water pricing

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

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

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

For the 2018 water price review, a water corporation's ambition in terms of delivering customer value is being assessed against four elements of PREMO – Risk, Engagement, Management and Outcomes.¹⁸

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.¹⁹

¹⁸ The Performance element of PREMO will be assessed at the review following the 2018 water price review.

¹⁹ Essential Services Commission 2016, *Guidance paper*, op. cit., pp. 45–49.

2. Our assessment of Lower Murray Water's price submission

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

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

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

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

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

We intend to make a price determination for Lower Murray Water in June 2018.

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

Regulatory period

Lower Murray Water proposed a five year regulatory period. Our draft decision accepts Lower Murray Water's proposal as it is consistent with our guidance. Our guidance proposed to approve a five year regulatory period, subject to any alternative and justified proposal.²⁰

Customer engagement

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

The engagement by Lower Murray Water:

- took place between September 2016 and September 2017
- used a range of methods including face-to-face and online interviews, quantitative on-line survey, pop-up kiosks, social media platforms and focus group meetings
- sought views from residential and commercial customers and major stakeholders
- was informed by a customer consultative committee who, in conjunction with an external consultant, developed the customer outcomes and measures
- covered topics such as pricing, customer financial hardship, and water security.

More detail on Lower Murray Water's engagement is available in its price submission.²¹

Evidence that Lower Murray Water's engagement influenced its proposals includes:

- its focus on maintaining services and containing costs, in response to feedback from customers indicating a low willingness to pay for improved services
- investing in water treatment and system improvements in all towns to better manage poor raw water quality events and provide greater assurance about drinking water quality.

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

²⁰ 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.

²¹ Lower Murray Water's price submission is available on our website at www.esc.vic.gov.au.

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).

Outcomes

The outcomes Lower Murray Water proposes to deliver its urban customers over the five year period starting 1 July 2018 are:

- keep my costs to a minimum
- be easy to contact and quick to respond
- provide me with consistent, safe drinking water
- provide me with reliable sewerage services
- be present and active in the community
- be mindful of our environment
- comply with other government obligations.

Lower Murray Water proposed measures and activities it will use to report on progress against achieving each outcome. These are set out at pages 65 to 71 of its price submission. Lower Murray Water proposes to report annually against its output targets. These will be available on its webpage, presented to a representative focus group twice yearly and it will undertake additional customers' surveys to check performance and relevance of outcomes.

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

Guaranteed service levels

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

Lower Murray Water's proposed GSLs are set out on pages 13 of its price submission. It has made no changes to the hardship GSL and water supply and sewerage blockage GSLs. It proposed to modify one existing GSL related to residential sewerage spills. Its justification for accepting the changes to GSLs is included on page 13 of its price submission.

Lower Murray Water consulted with customers in developing its GSLs. On this basis, our draft decision proposes to accept Lower Murray Water's proposed GSLs. Final GSLs will be subject to our consideration of any feedback following the release of our draft decision.

Revenue requirement

The revenue requirement is the forecast amount a water corporation needs to deliver on customer outcomes, government policy, and obligations monitored by technical regulators including Environment Protection Authority Victoria and the Department of Health and Human Services. Along with forecast demand, it is an input to calculating prices.²³

Lower Murray Water proposed a revenue requirement of \$188.7 million over a five year period starting 1 July 2018. Our draft decision proposes to approve a revenue requirement of \$187.9 million. Our draft decision has been informed by our assessment of each element that comprises the revenue requirement, including forecast expenditure. The slight adjustment to the revenue requirement proposed in our draft decision reflects a minor correction to estimates provided by Lower Murray Water in its original price submission.

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

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

	2018-19	2019-20	2020-21	2021-22	2022-23	Total
Operating expenditure	24.2	23.1	22.5	22.7	22.7	115.2
Return on assets	6.5	6.8	6.9	7.1	7.1	34.4
Regulatory depreciation	8.1	8.5	8.6	8.7	9.0	42.9
Non-prescribed revenue offset of revenue requirement	-0.9	-0.9	-0.9	-0.9	-1.0	-4.6
Draft decision – revenue requirement	38.0	37.4	37.1	37.6	37.9	187.9

Note: Numbers have been rounded

²³ We met with officers of the Department of Environment, Land, Water and Planning, Department of Health and Human Services, and Environment Protection Authority Victoria, to discuss their expectations of Lower Murray Water in the regulatory period from 1 July 2018. We had regard to their views in our draft decision.

Our assessment

Our final decision will be based on the latest available information. Accordingly, as well as responding to our draft decision and providing an updated price schedule, Lower Murray Water must update its revenue requirement and prices to reflect our April 2018 updates to estimates for the cost of debt and inflation.

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

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

	2018-19	2019-20	2020-21	2021-22	2022-23	Total
Proposed revenue requirement	38.1	37.5	37.2	37.8	38.1	188.7
Operating expenditure	-0.1	-0.1	-0.1	-0.2	-0.2	-0.7
Return on assets	-0.01	-0.01	-0.01	-0.01	-0.01	-0.1
Regulatory depreciation	0.004	0.004	-0.002	-0.01	-0.01	-0.01
Total adjustments	-0.1	-0.1	-0.2	-0.2	-0.2	-0.7
Draft decision – revenue requirement	38.0	37.4	37.1	37.6	37.9	187.9

Note: Numbers have been rounded

Operating expenditure

Operating expenditure is an input to the revenue requirement. Lower Murray Water’s price submission provides detail on its forecast operating expenditure from pages 39 to 44, with a cost breakdown shown in table 24 on page 39.

We assess both:

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

Our assessment

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

For controllable operating expenditure, our assessment process first confirms an efficient baseline, based on the last year of actual costs prior to our price review (that is, 2016-17). We then consider the forecast costs relative to this baseline, including the proposed efficiency improvement rate and forecast growth, and any proposed cost changes relative to the baseline. We engaged Deloitte Access Economics to provide expert advice to inform our assessment of controllable operating expenditure. Deloitte’s report on its assessment of Lower Murray Water’s expenditure forecast is available on our website.²⁴

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

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

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

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

²⁴ Deloitte Access Economics 2018, *Lower Murray Water (Urban) – expenditure review for 2018 water price review*, February.

Table 2.3 Draft decision – operating expenditure

\$ million 2017-18

	2018-19	2019-20	2020-21	2021-22	2022-23	Total
Controllable costs	21.8	20.7	20.1	20.3	20.3	103.2
Non-controllable costs	2.5	2.4	2.4	2.4	2.4	12.0
- Bulk services ^a	0.7	0.7	0.7	0.7	0.7	3.5
- Environmental contribution ^b	1.7	1.7	1.6	1.6	1.6	8.2
- Licence fees - ESC ^c	0.018	0.018	0.018	0.018	0.029	0.103
- Licence fees - DHHS ^c	0.017	0.017	0.017	0.017	0.017	0.083
- Licence fees - EPA ^c	0.039	0.039	0.039	0.039	0.039	0.195
Draft decision – operating expenditure	24.2	23.1	22.5	22.7	22.7	115.2

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

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

^c 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

For the reasons set out below, we propose to accept Lower Murray Water's forecast of \$103.2 million for total controllable operating expenditure in making our draft decision on its revenue requirement.

Correction to its price submission:

- During our initial assessment of Lower Murray Water's price submission and financial template, we identified an indexing error across a number of cost categories in its operating expenditure data, which Lower Murray Water subsequently corrected. This reduced the 2016-17 baseline year total controllable operating expenditure by \$0.07 million, resulting in a decrease from \$22.12 million to \$24.05 million. However, in its resubmitted financial template, Lower Murray Water added a \$0.36 million balancing adjustment to its proposed cost changes above the

Our assessment

baseline, effectively reversing the baseline year decrease. Lower Murray Water has applied the same correction to its separate financial model for its rural services.

Baseline controllable operating expenditure:

- Lower Murray Water has proposed downward adjustments of \$1.54 million to its actual 2016-17 baseline year controllable operating expenditure, producing a starting point for forecast annual operating expenditure. The reductions are largely to remove additional costs incurred in 2016-17 managing poor raw water due to a blue-green algae outbreak and a prolonged blackwater event affecting the Murray River. The resultant figure of \$20.52 million is 7 per cent above the benchmark of \$19.17 million allowed for 2016-17 in the previous price determination. Deloitte noted the organisational restructure in 2016-17 was a key reason for this increase above the benchmark. This restructure produced two new executive manager positions, with the aim to achieve labour force efficiencies and other efficiencies in the 2018–23 period. Deloitte considers the 2016-17 baseline figure reflects an efficient baseline cost and no adjustment is necessary.²⁵ We agree with Deloitte’s assessment and consider this is a reasonable starting point for forecasting annual operating expenditure.

Efficiency improvement:

- Lower Murray Water’s proposed efficiency improvement rate on controllable operating costs is 1.0 per cent per annum and is the equal lowest target proposed by the water businesses under review. This rate is the same as Lower Murray Water’s benchmark set by the commission for 2013–18. It is lower than Lower Murray Water’s forecast average connection growth rate of 1.1 per cent per year for 2018–23, giving a slightly increasing annual baseline operating cost.

Proposed cost changes:

- Lower Murray Water proposed additional operating expenditure of \$1.94 million, comprising electricity costs (\$1.61 million) and various other costs (\$0.33 million) above the adjusted baseline. This is largely offset by proposed net savings of \$1.68 million for labour (staff and contractors) and software costs. The net effect of this is proposed additional operating expenditure above the adjusted baseline of \$0.26 million.
- Electricity makes up a relatively large proportion of Lower Murray Water’s controllable operating expenditure. Lower Murray Water’s current contract for the purchase of electricity expires on 30 June 2018 and it is in the process of finding procurement options for 2018-19 onwards. While Deloitte does not agree with forecast higher electricity prices continuing beyond 2019-20,

²⁵ Deloitte Access Economics, op. cit., p. 13.

Our assessment

it did not recommend any adjustment as Lower Murray Water proposed to update its electricity price forecasts once it had its new contracts in place ahead of our final decision. We request that Lower Murray Water provides an updated electricity forecast based on its new contract prices in response to our draft decision.

- Deloitte did not recommend adjustments to Lower Murray Water’s additional operating expenditure.²⁶ Lower Murray Water is the only water corporation to have no recommended adjustments to controllable operating expenditure by Deloitte. We accept Deloitte’s recommendation that Lower Murray Water’s proposed cost changes reflect efficient expenditure.

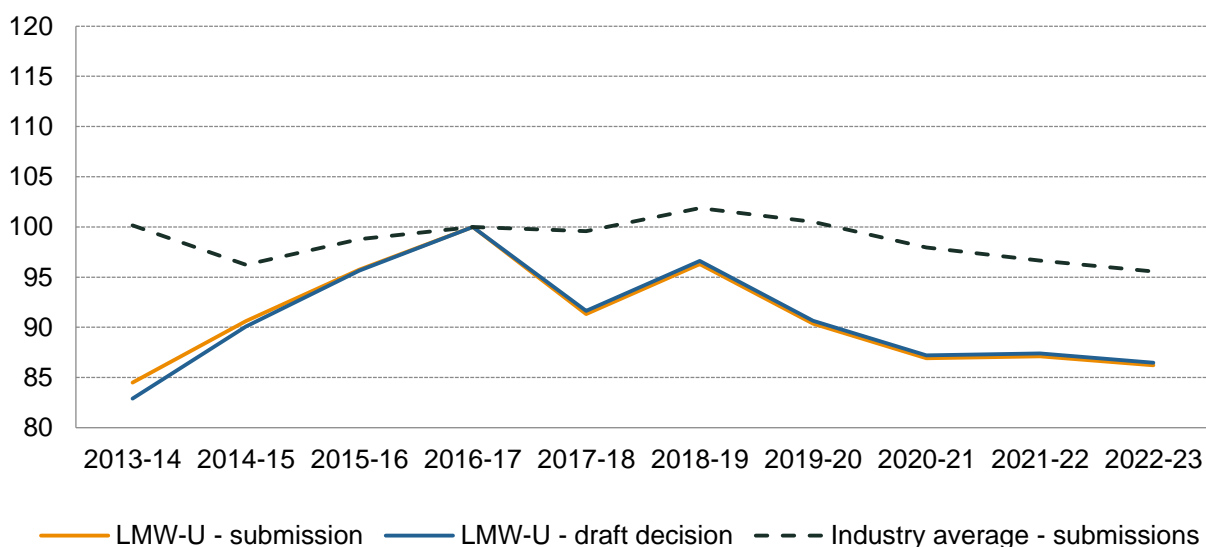
We consider Lower Murray Water’s approach to forecasting controllable operating expenditure is consistent with the requirements of the WIRO and the criteria for prudent and efficient expenditure outlined in our guidance.²⁷ Although starting with a higher baseline than the benchmark for the current 2013–18 period, there is evidence that the corporation has significantly tested its controllable expenditure requirements, resulting in a forecast decline (in real terms) in controllable operating expenditure per customer connection well ahead of the industry average (see Figure 2.1). Lower Murray Water also has the second lowest forecast controllable operating expenditure per customer connection of all the regional water businesses in the 2018–23 period.

²⁶ Deloitte Access Economics, op. cit., pp.15–20.

²⁷ Essential Services Commission 2016, *Guidance paper*, op. cit., p. 31.

Figure 2.1 Controllable operating expenditure per water connection

Index: 2016-17=100



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

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

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

We have assumed the licence fees for the Department of Health and Human Services, the Environment Protection Authority Victoria and the Essential Services Commission remain flat in real terms across the period, but with a 50 per cent increase for our commission fee in 2022-23 to align with our regulatory review cycle.²⁸

We have verified Lower Murray Water’s forecast external bulk water charges against the current price determination for Goulburn-Murray Water.

²⁸ The Department of Health and Human Services and the EPA Victoria provided their latest 2016-17 licence fees for making our draft decision. We have also based our forecast on our 2016-17 commission licence fee.

We have reduced Lower Murray Water's forecast non-controllable operating expenditure by \$0.68 million across the 2018–23 period, resulting from our adjustments to:

- increase our commission license fee by \$0.011 million in 2022-23
- decrease the Environment Protection Authority licence fees by \$0.003 million per year (a total reduction of \$0.015 million)
- decrease the environmental contribution from \$1.765 million to \$1.706 million for 2018-19 and decline this value across the period (a total reduction of \$0.671 million).

Overall, non-controllable operating expenditure will increase by \$0.45 million from 2017-18 to 2018-19, due to the increase in the environment contribution from \$1.21 million to \$1.71 million, partly offset by a decrease in external bulk charges and licence fees.

Prior to making our final decision, we will adjust Lower Murray Water's forecast non-controllable operating expenditure for the latest inflation and external bulk charges data.

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

Table 2.4 Adjustments to operating expenditure

\$ million 2017-18

	2018-19	2019-20	2020-21	2021-22	2022-23	Total
Proposed total operating expenditure	24.3	23.2	22.6	22.9	22.9	115.9
Licence fees	-0.003	-0.003	-0.003	-0.003	0.008	-0.005
Environmental contribution	-0.059	-0.098	-0.135	-0.172	-0.208	-0.671
Total adjustments to non-controllable costs	-0.1	-0.1	-0.1	-0.2	-0.2	-0.7
Draft decision - total operating expenditure	24.2	23.1	22.5	22.7	22.7	115.2

Note: Numbers have been rounded

Regulatory asset base

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

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

Closing regulatory asset base

We update the regulatory asset base to reflect actual gross capital expenditure, less government and customer contributions, and asset disposals for the period to 30 June 2017. This helps to ensure prices reflect the actual net expenditure of a water corporation.²⁹

Lower Murray Water's proposed closing asset base at 30 June 2017 and supporting calculations are set out at page 50 of its price submission.

²⁹ Net capital expenditure is calculated by deducting government and customer contributions from gross capital expenditure. Customer contributions reflects revenue earned from new connections made to the water corporation's water, sewerage or recycled water networks.

Our assessment

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

In its price submission, Lower Murray Water assumed \$40.9 million net capital expenditure over the period from 2012-13 to 2016-17. We identified some minor adjustments to the estimates adopted by Lower Murray Water, which reduced this to \$40.6 million. This figure is 27.5 per cent lower than the forecast used to approve maximum prices for the period from 1 July 2013. This is well below the 10 per cent threshold identified above, so we have not undertaken a prudence and efficiency review of its past net capital expenditure.

Other than this correction for past net capital expenditure, Lower Murray Water calculated its closing regulatory asset base in accordance with the requirements of our guidance. For these reasons, our draft decision proposes to approve a closing regulatory asset base for 30 June 2017 of \$155.0 million.

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

Table 2.5 Closing regulatory asset base

\$ million 2017-18

	2012-13	2013-14	2014-15	2015-16	2016-17
Opening RAB 1 July	147.3	148.0	152.9	153.8	157.4
Plus gross capital expenditure	6.6	13.0	9.4	11.5	6.4
Less government contributions	0.0	0.0	0.0	0.0	0.0
Less customer contributions	0.7	1.6	1.5	0.9	1.7
Less proceeds from disposals	0.3	0.7	0.6	0.2	0.1
Less regulatory depreciation	4.9	5.8	6.4	6.8	7.1
Closing RAB 30 June	148.0	152.9	153.8	157.4	155.0

Note: Numbers have been rounded

Forecast regulatory asset base

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

Table 2.6 sets out our draft decision on Lower Murray Water's proposed forecast regulatory asset base from 1 July 2018.³⁰ Our assessment of the components of the forecast regulatory asset base is set out below.

³⁰ Our guidance required water corporations to provide an estimate of the components of its regulatory asset base for 2017-18. This is so we can assess the opening asset base for 1 July 2018. Our guidance noted that where the 2017-18 forecasts for net capital expenditure (gross capital expenditure less government and customer contributions) is lower than the forecast benchmark for that year in its 2013 price determination, the lower amount must be used (otherwise the 2013 determination forecast applies). The estimates for 2017-18 will be confirmed at the price review following the 2018 water price review.

Our assessment

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

	2017-18	2018-19	2019-20	2020-21	2021-22	2022-23
Opening RAB 1 July	155.0	156.1	168.0	170.7	175.8	177.7
Plus gross capital expenditure	9.8	21.2	12.3	14.9	11.8	12.3
Less government contributions	0.0	0.0	0.0	0.0	0.0	0.0
Less customer contributions ³¹	0.8	0.8	0.8	0.8	0.8	0.8
Less proceeds from disposals	0.4	0.4	0.4	0.4	0.4	0.4
Less regulatory depreciation	7.5	8.1	8.5	8.6	8.7	9.0
Closing RAB 30 June	156.1	168.0	170.7	175.8	177.7	179.8

Note: Numbers have been rounded

Capital expenditure

Capital expenditure is an input to estimating the regulatory asset base. Lower Murray Water's forecast capital expenditure and supporting information is provided at pages 44 to 50 of its price submission. This is summarised in Figure 2.2, for the current 2013–18 period, and as proposed by the water corporation for the 2018–23 period.

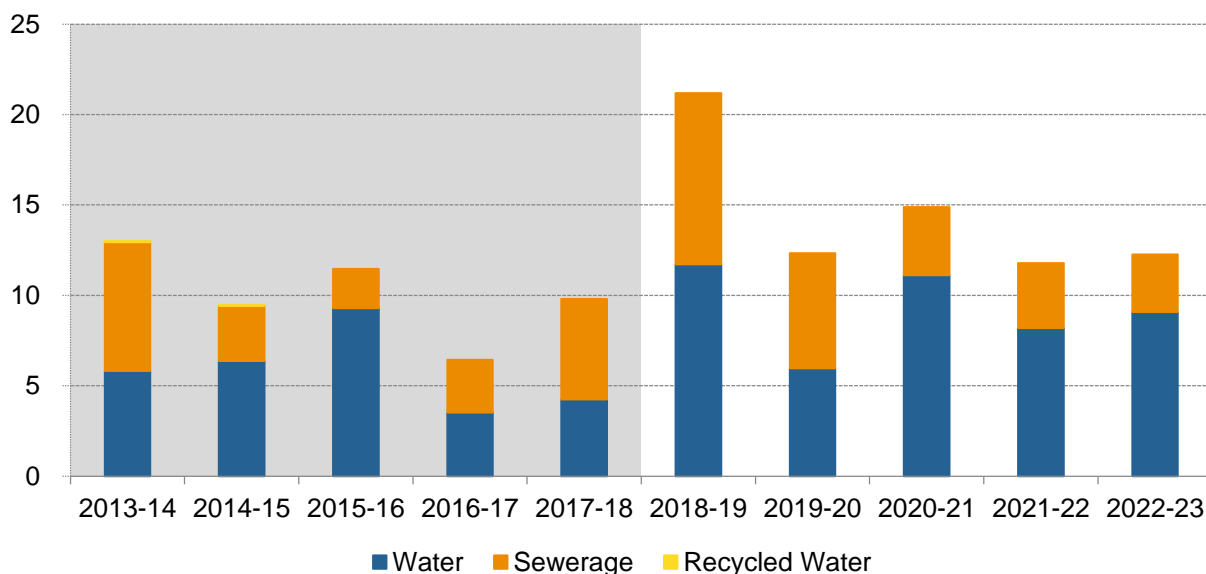
We engaged Deloitte Access Economics to provide expert advice to inform our assessment of capital expenditure. Deloitte's report on its assessment of Lower Murray Water's expenditure forecast is available on our website.³²

³¹ 2017-18 forecast for customer contribution is lower than the forecast benchmark for that year in 2013 price determination, while gross capital expenditure remained unchanged. This resulted in a \$0.4m increase in forecast net capital expenditure in 2017-18 compared to the 2013 price determination.

³² Deloitte Access Economics 2018, op. cit.

Our assessment

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



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

For the reasons set out below, we propose to accept the forecast capital expenditure of \$72.4 million proposed by Lower Murray Water for our draft decision on its revenue requirement:

- Lower Murray Water’s price submission provided evidence that its forecasts for capital expenditure are efficient. Lower Murray Water’s proposed capital expenditure for 2018–23 is \$22.3 million (44 per cent) higher than in the current regulatory period. The increase is largely driven by the proposed \$10 million for UV treatment at all water treatment plant sites to meet health-based targets for drinking water quality. In addition, renewals account for 53 per cent of capital expenditure and include a modest increase in renewals and replacement investment.
- Deloitte requested selected documents from Lower Murray Water as a representative sample to demonstrate its asset management processes and justification for its capital expenditure program. Based on the sample of documents reviewed, these demonstrate that Lower Murray Water has a robust approach for developing project scope, the timing of works and cost estimates.
 - Deloitte reviewed the business cases for installing UV treatment plants at all water treatment plants, and the purchase of water entitlements to secure an appropriate supply of water,

which are Lower Murray Water's two largest projects for the period. It also reviewed business cases for the renewals program.³³

- Deloitte recommended no adjustments to Lower Murray Water's forecast capital expenditure.
- We consider the planned capital expenditure program is achievable, given Lower Murray Water's past track record for delivering its capital expenditure program. For the current 2013–18 period, Lower Murray Water is expected to deliver most of its planned major projects, and the Merbein sewage diversion to Koorlong WWTP was able to be deferred until 2023-24 due to operational need.³⁴
- Lower Murray Water's price submission did not specifically identify any uncertain capital projects or associated costs, nor how it would manage uncertainty in timing, scope and cost from capital works. However it did note that it had identified a number of projects it could have included as uncertain, but instead moved these costs into the following 2023–28 pricing period. Lower Murray Water proposed to accept the initial financial risks if a new project arose or later projects were brought forward into the 2018–23 period. We consider this approach to managing uncertain capital expenditure is consistent with our guidance, and we note the following:
 - Lower Murray Water will need to demonstrate the prudence and efficiency of any additional costs if they are indeed incurred during the 2018–23 period if seeking to include them in the regulatory asset base.
 - Variations in capital expenditure from forecast during the 2018–23 period will form a key part of our assessment of the Performance element of PREMO at the next price review.

We agree with Deloitte's assessment and consider Lower Murray Water's approach to forecasting its capital expenditure is consistent with the requirements of our guidance and WIRO principles.³⁵

Our draft decision for total gross capital expenditure is to accept Lower Murray Water's proposed benchmark, as set out in Table 2.6.

The benchmark that we adopt for Lower Murray Water does not represent the amount that the water corporation is required to spend or allocate to particular projects. Where we have made an adjustment to exclude a project's capital expenditure from Lower Murray Water's revenue requirement, we are not requiring the corporation to remove that project. Rather, it represents assumptions about the overall level of expenditure (to be recovered through prices) that we

³³ Deloitte Access Economics, *op. cit.*, pp. 23-24.

³⁴ Essential Services Commission 2018, *Status of major projects supplement: Water performance report 2016-17*, 1 March, pp. 20–21.

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

consider sufficient to operate the business and to maintain or improve services over the regulatory period. Lower Murray Water determines how to best manage the allocation of its revenue and priority of its expenditure within a regulatory period.

Revenue from customer contributions

Revenue from customer contributions is deducted from gross capital expenditure so it is not included in the regulatory asset base.³⁶

We compared Lower Murray Water’s forecast for customer contributions with past outcomes, and its forecasts for growth in customer connections.³⁷ We consider Lower Murray Water’s forecast contributions are reasonable, having regard to past trends and its growth forecasts.

Our draft decision proposes to accept Lower Murray Water’s forecasts for customer contributions.

Cost of debt

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

Table 2.7 Trailing average cost of debt

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

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

Note: Numbers have been rounded

From 2016, we accepted a ten-year trailing average approach to estimating the benchmark cost of debt, changing from an on-the-day approach. The trailing average approach better aligns the actual cost of debt for an efficient business to the regulated benchmark, compared with an on-the-

³⁶ Revenue from new customer contributions reflects revenue earned from new connections made to a water corporation’s water, sewerage or recycled water networks.

³⁷ Growth in customer connections can be used as an indicator of growth in customer contributions.

Our assessment

day approach.³⁸ We consider the ten year trailing average approach helps to minimise risk to water corporations and provides better incentives for long-term investment.

Return on equity – PREMO rating

Lower Murray Water rated its price submission as ‘Standard’. Based on its PREMO self-rating, Lower Murray Water proposed a rate of return on equity of 4.5 per cent per annum. This reflects the maximum return rate allowed in our guidance for a price submission rated as ‘Standard’.³⁹

The return on equity is similar to rates we have approved in past reviews for the water industry. We have also had regard to the return on equity allowed or estimated by regulators in other Australian jurisdictions recently for the water industry.⁴⁰

Our draft decision accepts Lower Murray Water’s PREMO self-rating and proposed return on equity of 4.5 per cent per annum. Our assessment of Lower Murray Water’s proposed PREMO rating is set out in Chapter 3.

Regulatory depreciation

Regulatory depreciation is an input to calculating the regulatory asset base. Lower Murray Water’s forecast regulatory depreciation⁴¹ was calculated using a straight line depreciation profile. We noted in our guidance that we prefer this approach.⁴² Lower Murray Water also calculated regulatory depreciation in a manner consistent with our guidance. For these reasons, our draft decision proposes to accept Lower Murray Water’s forecast regulatory depreciation.

Tax allowance

The tax allowance is an input into the revenue requirement. Lower Murray Water has proposed no allowance for tax in its revenue requirement. Our draft decision is to accept the forecast as it was calculated consistently with the method required by our guidance.⁴³

³⁸ For more detail on the trailing average and on the day approaches to the cost of debt, see Essential Services Commission 2016, *Water pricing framework*, op. cit., p.27.

³⁹ Essential Services Commission 2016, *Guidance paper*, op. cit., p. 49.

⁴⁰ Essential Services Commission of South Australia 2016, *SA Water regulatory determination 2016, Final determination*, June; Independent Pricing and Regulatory Tribunal 2017, *WACC biannual update*, August.

⁴¹ For the period from 2018-19 to 2022-23, Lower Murray Water proposed a regulatory depreciation of \$42.9 million.

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

⁴³ Essential Services Commission 2016, *Guidance paper*, op. cit., pp. 50-51.

Our assessment

Demand

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

Lower Murray Water's demand forecasts are set out at pages 32 to 38 of its price submission, and are also included in its financial model. Our draft decision proposes to accept Lower Murray Water's demand forecasts for the purpose of approving maximum prices as we consider they were estimated in a manner that is consistent with the requirements of our guidance. This includes basing demand forecasts on the latest *Victoria In Future* population growth forecasts issued by the Victorian Government.

Form of price control

Lower Murray Water proposed to continue with a tariff basket form of price control as set out on pages 53 to 54 of its price submission. A tariff basket allows a water corporation flexibility to adjust individual tariffs, subject to the overall price change remaining within the maximum allowed in a price determination. Lower Murray Water proposed that annual individual tariff movements will continue to be subject to an upper constraint of ten per cent (not including inflation).

Our draft decision is to accept Lower Murray Water's proposed form of price control as it allows for the recovery of sufficient revenue to cover the forecast efficient costs of providing services, and for it to deliver on any health, safety, social and environmental obligations. As well, by limiting price increases under its tariff basket, its proposal helps to provide customers with price stability, while providing revenue certainty for the business.

Tariff structures

Lower Murray Water's proposed tariffs are set out at pages 54 to 56 of its price submission. Lower Murray Water proposed 0.2 per cent annual decrease across all tariffs, starting from 2018-19.

Lower Murray Water must respond to our draft decision with updated prices that reflect our initial views on its revenue requirement. Because of this, our draft decision does not approve maximum prices for each tariff. We will provide final maximum prices in our final decision. However, our draft decision considers Lower Murray Water's proposals relating to changes in tariff structures, and any submissions relating to the level of prices or bills.⁴⁴

⁴⁴ Tariff structure refers to the way in which prices are grouped and the manner of charging, for example, water and sewerage charges, fixed and variable charges.

Lower Murray Water proposed to maintain its existing tariff structures:

- For residential and non-residential water services, Lower Murray Water proposed a two-part tariff with a fixed service charge and a variable usage component that depends on water use. For residential customers, the variable component includes an inclining block structure where prices increase as higher amounts of water are used.
- For residential and non-residential sewerage services, Lower Murray Water proposed a fixed charge only.

As outlined in our guidance, we have provided the water corporations with a large degree of discretion to decide on individual tariff structures.⁴⁵ This recognises water corporations are often best placed to consider the interests of customers in designing tariffs, and that existing tariff structures have been developed over time to deal with a variety of local circumstances. We note Lower Murray Water's finding that customers generally supported its existing tariff structures.

Two-part tariffs

We consider the two-part structure proposed by Lower Murray Water for its water service tariffs will promote efficient use of services. The two-part structure for water tariffs sends customers a signal about costs of their water use, and is an approach that is commonly applied in other states and territories.⁴⁶ We also consider two-part tariff structures are easy to understand.

Price levels

Lower Murray Water proposed no significant change to its tariff levels in response to customer feedback of high levels of satisfaction. Lower Murray Water proposed to deliver a 0.2 per cent annual decrease across all components of its tariffs.

Submissions by the Consumer Action Law Centre and Gerald Mallon highlighted the impact price changes may have on some customers, particularly those with low or fixed incomes who 'already carefully manage their consumption and budget'.⁴⁷

On this, we consider Lower Murray Water's proposed tariffs take into account customers' interests, including low income and vulnerable customers, because:

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

⁴⁶ 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.

⁴⁷ Consumer Action Law Centre 2017, *Initial Feedback: 2018 Water Price Review*, 15 November.; Gerald Mallon 2017, *Submission*, 7 November.

Our assessment

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

We note that in addition to a small price decrease, Lower Murray Water proposes to continue providing households with a higher degree of control over their water bills by maintaining a high variable component. This is consistent with customer feedback.

Unique services

Lower Murray Water has confirmed its proposed tariffs for recycled water, trade waste and miscellaneous services are calculated in accordance with the pricing principles referenced in our guidance.

Draft decision on tariff structures

For the reasons set out above, our draft decision accepts Lower Murray Water's proposed tariff structures as set out at pages 54 to 56 of its price submission.

Prior to our final decision and price determination, Lower Murray Water must submit updated prices to reflect our draft decision on the revenue requirement, and our updates to cost of debt and inflation estimates, which we will provide in late April 2018

Adjusting prices

Lower Murray Water proposed price adjustment mechanisms at pages 59 to 62 of its price submission. It proposed:

- to continue with its existing uncertain and unforeseen events mechanism
- a cost of debt adjustment mechanism
- a price adjustment mechanism for electricity costs.

Our draft decision accepts Lower Murray Water's proposal to continue the existing uncertain and unforeseen events mechanism. We noted in our guidance that we propose that the mechanism continues in its current form.

Our draft decision does not accept Lower Murray Water's proposed cost of debt adjustment mechanism. The proposed mechanism is based on a price cap, and not its proposed form of price control, which is a tariff basket. Lower Murray Water must propose a revised adjustment mechanism that is consistent with the requirements of our guidance.

Our assessment

Our draft decision proposes not to accept Lower Murray Water's proposed electricity pass through mechanism. We note that Lower Murray Water proposes to share the risk of electricity cost increases with its customers in an effort to reduce the impact of forecast increases on prices. We consider that it is unclear at the time of this draft decision if Lower Murray Water requires an electricity pass-through mechanism for costs that are above its proposed forecast increase to energy costs, given the change to market conditions since its submission.⁴⁸ Also we do not consider that the proposed pass through formula is easy to understand. For this reason we propose to not accept Lower Murray Water's proposed pass through mechanism for electricity costs above its forecast.

New customer contributions

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

Lower Murray Water's proposed charges for new customer contributions are set out at pages 57 and 58 of its price submission. For standard water charges, Lower Murray Water proposed a decrease of 0.4 per cent on the 2017-18 charge. For standard sewerage charges, Lower Murray Water proposed an increase of 2.3 per cent on the 2017-18 charge.

For negotiated new customer contributions, Lower Murray Water proposes to continue to calculate a charge in accordance with the requirements of our new customer contribution pricing principles.⁴⁹

We have reviewed Lower Murray Water's proposed charges and consider they are consistent with the requirements of our guidance and the NCC pricing principles.⁵⁰ For this reason, our draft decision proposes to accept Lower Murray Water's proposed new customer contribution charges.

Financial position

In approving prices, we must have regard to the financial viability of the water industry.⁵¹ We interpret the financial viability requirements under the *Essential Services Commission Act 2001*

⁴⁸ We note Lower Murray Water has stated on page 42 of its submission that it intends to provide the commission with an update on electricity costs in response to this draft decision, that better reflect the current market.

⁴⁹ Essential Services Commission 2016, *Guidance paper*, op. cit., p. 62.

⁵⁰ In response to a request for information, Lower Murray Water provided supporting modelling showing its regard for incremental costs and incremental revenue.

(Vic) and the Water Industry Regulatory Order (2014) to mean that the prices we approve should provide a high level of certainty that each water corporation can generate sufficient cash flow to deliver on service commitments, including financing costs arising from investments to meet service expectations.

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

⁵¹ WIRO clause 8(b)(ii) and ESC Act s.8A(1)(b).

3. PREMO rating

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

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

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

In Chapter 2, we noted our draft decision is to accept Lower Murray Water's proposed return on equity of 4.5 per cent, based on the justification provided for the level of ambition in its price submission. Below, we set out our preliminary assessment of Lower Murray Water's proposed PREMO rating.

Our review of Lower Murray Water's PREMO self-rating

Lower Murray Water's proposed PREMO rating, and our draft decision is summarised below.

Table 3.1 PREMO Rating

	Overall PREMO rating	Risk	Engagement	Management	Outcomes
Lower Murray Water's rating	Standard	Standard	Standard	Standard	Standard
Commission's rating	Standard	Standard	Standard	Standard	Standard

We agree with Lower Murray Water's proposed overall PREMO self-rating of 'Standard'. This is reflected in the return on equity we propose to approve for Lower Murray Water at page 22. We also agree with Lower Murray Water's proposed self-rating for each element of PREMO.

In support of its proposed PREMO rating, we note:

PREMO rating

- Lower Murray Water’s forecast for controllable operating expenditure incorporated assumptions for higher rates of improvement (on a per connection basis) than most other water corporations.
- Our review of Lower Murray Water’s forecast expenditure identified no changes to its proposals, an indication that its expenditure forecasts reflect efficient costs.

These factors indicate that the corporation is seeking to minimise costs, prices and bills for its customers, consistent with a ‘Standard’ rating for Management.

In support of its Engagement self-rating of ‘Standard’, our review found Lower Murray Water engaged early and widely. It used a mix of online and face-to-face engagement methods such as focus groups, and used social media to update and inform the community about its proposals.

The range of engagement methods used by Lower Murray Water was in response to low levels of engagement in the past by its urban customers, demonstrating the corporation has used past experience to better target its community engagement.

While (on average) customer prices and bills will remain the same or fall, Lower Murray Water proposed to improve services in key areas, including water quality and customer service standards. It has also committed to improve overall customer satisfaction (measured through customer surveys). These factors support its self-rating of ‘Standard’ for Outcomes.

Lower Murray Water has also increased its acceptance of risk, proposing a higher customer rebate amount for its guaranteed service level related to sewer spills within houses, in response to customer feedback about the inconvenience cause by sewer spills.

4. We invite feedback on our draft decision

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

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

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

How to provide feedback:

Attend a public forum

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

Provide written comments or submissions

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

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

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

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

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

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

We invite feedback

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

Next steps

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

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

We invite feedback

APPENDIX A – submissions received

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