

Western Water final decision

2018 Water Price Review

19 June 2018

An appropriate citation for this paper is:

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

Copyright notice

© Essential Services Commission, 2018



This work, Western Water final decision, 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 Western Water’s price submission	5
Regulatory period	5
Customer engagement	5
Outcomes	6
Service Standards	7
Guaranteed service levels	7
Revenue requirement	8
Operating expenditure	10
Regulatory asset base	12
Closing regulatory asset base	13
Forecast regulatory asset base	14
Capital expenditure	15
Customer contributions	17
Cost of debt	17
Return on equity	18
Regulatory depreciation	19
Tax allowance	19
Demand	20
Form of price control	20
Tariff structures and prices	21
Adjusting prices	24
New customer contributions	24
Financial position	27
Appendix A – submissions received on draft decision	28
Appendix B – approved service standards	29
Appendix C – approved GSL schemes	30
Appendix D – rate of return	31

Summary

In March 2018, Western Water provided a submission to us proposing prices for a two year period starting 1 July 2018

In April 2018, we released our draft decision on Western Water's price submission.¹ The draft decision set out our initial views on Western Water's proposals, and invited interested parties to make further submissions. In addition to a response from Western Water, we received seven written submissions on our draft decision, which are available on our website. A list of these submissions is included in Appendix A to this final decision.

After considering feedback, we have made a price determination for Western Water.² The price determination sets out the maximum prices Western Water may charge for prescribed services (or the manner in which its prices are to be calculated, determined, or otherwise regulated) for the two year period from 1 July 2018 (2018–20). 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 accepts 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 approves a revenue requirement of \$160.5 million over the two year period starting 1 July 2018.³ This is the same as our draft decision.

A summary of approved maximum prices for major services delivered by Western Water is set out from page 23. The estimated bill impacts of Western Water's proposal and our final decision for

¹ Clause 16 of the Water Industry Regulatory Order 2014 requires us to issue a draft decision. Western 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, *Western Water Determination: 1 July 2018 – 30 June 2020*, 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.

residential customers are provided in Table A. Typical residential bills will remain steady over the two years from 1 July 2018 (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	2019-20 annual bill
Residential (Owner occupier) ^a	180	\$1,019	\$1,019	\$1,019
Residential (Tenant) ^a	180	\$244	\$244	\$244

^a Following a \$100 efficiency rebate paid to customers.

Note: Numbers have been rounded

Western Water has committed to improve outcomes for customers

Our final decision approves prices that will allow Western 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 Western Water plans to improve outcomes for customers are by:

- supporting service reliability and growth by upgrading water and sewerage assets
- progressively rolling out new SMS alerts for customer service interruptions, and making greater use of e-billing
- providing ongoing support for customers experiencing financial difficulty
- limiting price increases to inflation.

Tariff structures and the form of price control will remain the same

Our final decision approves Western Water’s proposed tariff structures, which reflect a continuation of its current approach. For water services, we have approved Western Water’s proposal for a fixed service charge and a variable component that depends on water use. For sewerage services, we have approved Western Water’s proposal for a fixed charge only.

Our final decision also approves Western 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. Western Water currently uses a price cap.

More detail on tariffs and the form of price control are available from page 20 to 24.

We have not assigned Western Water a PREMO rating

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 (that is, prices increasing by inflation only) 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. The guidance we issued Western Water noted we would not assess its price submission under PREMO.

Figure A PREMO Rating

	Overall PREMO rating	Risk	Engagement	Management	Outcomes
Western Water's rating	Not rated	Not rated	Not rated	Not rated	Not rated
Commission's rating	Not rated	Not rated	Not rated	Not rated	Not rated

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

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 for Western Water, 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 guidance⁶

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 Western Water.⁷

In 2018, we issued guidance to Western Water to inform its price submission. The guidance set out how we will assess Western 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 Western 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

⁶ Essential Services Commission 2018, *Guidance – Western Water's 2018 water price review*, January.

⁷ Essential Services Commission 2018, *Western 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

In November 2016, we issued guidance for the 2018 water price review, which set out how price submissions should be prepared in accordance with our new approach, including our new PREMO self-assessment incentive mechanism.¹⁴

Given Western Water's unique circumstances in seeking a two year period with prices increasing by inflation only, our separate guidance prepared for Western Water states that it is not required to self-assess and give itself a PREMO rating.¹⁵ Rather we have set Western Water's return on equity at 4.5 per cent, which reflects the rate of return a 'Standard' corporation would receive under the PREMO incentive mechanism.¹⁶

Our consultation on the pricing approach informed the guidance we issued Western Water in January 2018, which informs Western Water's price submission for the 2018 water price review.

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

¹⁵ Essential Services Commission 2018, *Guidance paper*, op. cit., p. 26.

¹⁶ Under the PREMO incentive mechanism, return on equity is linked to a water corporation's level of ambition – 'Leading', 'Advanced', 'Standard' or 'Basic'. However, this mechanism does not apply to Western Water in this instance. More information on the PREMO mechanism is available in Essential Services Commission 2016, *Guidance paper*, op. cit.

2. Our assessment of Western Water's price submission

We have made our price determination for Western Water after considering: Western 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 Western 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. Western Water's price submission addressed each of these matters, with our initial assessment set out in our draft decision. Our final decision is set out below.

Regulatory period

Our draft decision accepted the two year regulatory period proposed by Western Water (1 July 2018 to 30 June 2020) in its price submission.

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.¹⁷ In support of this, it noted factors such as greater community attention when all price reviews are undertaken at the same time. We note that Western Water's two year proposal is a better outcome for customers as it provides the business with time to develop a strategy to respond to its high growth.

Our final decision is to approve the two year regulatory period proposed by Western Water.

Customer engagement

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

The engagement by Western Water:

- took place between December 2014 and August 2017
- used a range of methods including online and face-to-face surveys, workshops, focus groups, deliberative forums and developer forums

¹⁷ Consumer Action Law Centre 2018, *Submission on standard draft decisions: 2018 Water Price Review*, 8 May, p. 10.

- sought views from community representatives, business groups, traditional owners, and a community engagement reference group established by the corporation
- covered matters such as water quality, customer service and satisfaction, guaranteed service levels and focus areas for future service improvement.

More detail on Western Water's engagement is available in its price submission.¹⁸

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

- adjusting service targets to reflect feedback from customers about their service priorities
- limiting price increases in response to customer feedback that affordability is a key issue
- increasing on-line functionality in response to feedback from customers about self-serve tools.

The influence of Western Water's engagement on its proposals supports the objectives in our pricing framework relating to efficiency and the interests of consumers.¹⁹

In a submission responding to our draft decision, CALC suggested we could play a greater role to promote best practice customer engagement and identify areas for improvement.²⁰ We note that following our price review, we will continue to work with water corporations to promote best practice customer engagement.

Outcomes

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

- fair and affordable charges for all customers
- reliable, safe services to existing and new customers
- innovative approaches to addressing customer needs
- care of the environment, and
- sustainable contribution to the community and regional liveability.

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

- supporting service reliability and growth by upgrading water and sewerage assets
- progressively rolling out new SMS alerts for customer service interruptions, and making greater use of e-billing
- providing ongoing support for customers experiencing financial difficulty
- limiting price increases to inflation.

¹⁸ Western Water's price submission is available on our website at www.esc.vic.gov.au. See pages 8 to 10.

¹⁹ 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).

²⁰ Consumer Action Law Centre, op. cit., p. 4.

Western Water proposed measures and targets for reporting on these outcomes are set out at page 11 of its price submission. Western Water has committed to report on its performance annually to its customers via its website and bill inserts.

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

Service Standards

Western 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 Western Water's targets until 2020 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'.²¹ We note that Western Water has proposed standards for reliability and attending faults that remain at the same level as its past targets.

We accept there are arguments for maintaining or decreasing service levels over time particular where engagement identifies customers are satisfied with the existing level of service or do not support increasing expenditure to deliver improved service. We expect water corporations to consider customer preferences when forming these service targets.

We note that many of Western Water's proposed standards for reliability and attending faults reflect the preferences of customers, which 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 Western 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.

Western Water's proposed GSLs are set out on page 15 of its price submission. It has made no changes to the GSL relating to payment difficulty, and increased payment on three GSLs relating

²¹ Consumer Action Law Centre, op. cit., p. 6.

to service interruptions. In our draft decision we provided an overview of Western Water's proposed GSLs.

CALC supported increasing payments for GSLs so they are 'not losing their value over time'.²² We note Western Water has increased the payment amounts for some of its GSLs.

Western Water's proposed GSLs were informed by the results of customer surveys and discussions in customer workshops to reflect the aspects of service delivery most important to customers.²³ For these reasons, our final decision approves Western Water's proposed GSLs.

Western Water's GSLs are set out in Appendix C to this final decision.

Western Water's commitment to GSL payments should these service levels not be met, forms part of the manner in which Western Water's services are regulated.

Revenue requirement

Our draft decision proposed to approve a revenue requirement of \$160.5 million over a two year period starting 1 July 2018, based on Western Water's proposal to increase its prices by inflation only.²⁴ We note our building block method produced a maximum allowed or 'notional' revenue requirement of \$165.2 million, which was higher than that sought by Western Water.

Our final decision also approves a revenue requirement of \$160.5 million. The new revenue requirement is still below the final decision notional revenue requirement of \$165.2 million (Table 2.1). Adjustments to the notional revenue requirement from our draft decision are set out in Table 2.2, and described later in this Chapter.

We also consider our final decision approves prices and a revenue requirement that enables Western Water 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.²⁵

Our final decision approves Western Water's proposal to increase prices by inflation only over the two years from 1 July 2018. Under our final decision, Western Water will forego approximately

²² Consumer Action Law Centre, op. cit., p. 1.

²³ Justification for Western Water's proposed GSLs is set out in its price submission available at www.esc.vic.gov.au.

²⁴ 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.

²⁵ 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 Western Water in the regulatory period from 1 July 2018. We had regard to their views in our draft decision and final decisions.

\$4.6 million in revenue, due to our different approach to regulatory depreciation compared to its proposal (page 19). It will not be able to recover these amounts in future regulatory periods.

Table 2.2 itemises the updates to the notional revenue requirement since our draft decision. The following sections outline our assessment of the notional revenue requirement.

Table 2.1 Final decision – Revenue requirement

\$ million 2017-18

	2018-19	2019-20	Total
Operating expenditure	55.4	55.8	111.1
Return on assets	18.8	20.8	39.6
Regulatory depreciation	6.5	8.0	14.5
Tax allowance	-0.1	-0.1	-0.1
Notional revenue requirement	80.7	84.5	165.2
Forgone revenue	-0.9	-3.8	-4.6
Final decision revenue requirement	79.8	80.7	160.5

Note: Numbers have been rounded

Table 2.2 Adjustments to draft decision notional revenue requirement

\$ million 2017-18

	2018-19	2019-20	Total
Draft decision – notional revenue requirement	80.7	84.4	165.2
Operating expenditure	-0.03	0.01	-0.02
Return on assets	0.002	0.02	0.03
Regulatory depreciation	0.001	0.01	0.01
Total adjustments	-0.03	0.05	0.02
Final decision – notional revenue requirement	80.7	84.5	165.2

Note: Numbers have been rounded

Operating expenditure

Operating expenditure is an input to the revenue requirement. Our draft decision proposed to increase Western Water's total controllable operating expenditure forecast of \$82.0 million over a two year period by \$0.2 million to \$82.2 million. The small increase was the result of a correction we made to figures provided by Western Water.

Aside from this correction, we considered Western Water's proposed controllable operating expenditure was prudent and efficient, and we set out our reasoning for this in our draft decision (pages 10 to 15). In summary, we found:

- Evidence indicating that after the correction had been made its baseline controllable operating expenditure reflected an efficient benchmark.²⁶
- Western Water's efficiency improvement rate of 4.0 per cent per year is the highest rate proposed by any water corporation, although we note Western Water's efficiency rate only applies for two years, where other water corporations' efficiency rates apply for five or eight years.
- Western Water has proposed to absorb within its growth and efficiency adjusted baseline: increases in electricity prices and consumption, labour costs above inflation, and increases in water treatment and chemical costs.
- Western Water's proposed forecast will result in a decline (in real terms) in controllable operating expenditure per connection relative to the baseline year, falling well below the average for urban water corporations in our review.

We forecasted \$29.0 million for Western Water's non-controllable operating costs for the two year period.²⁷ 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.

Western Water's response to our draft decision accepted our adjustments. No other new considerations were presented in submissions received following the draft decision that caused us to change our views on controllable operating expenditure.

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.²⁸

²⁶ Controllable costs are those that can be directly or indirectly influenced by a water corporation's decisions.

²⁷ Non-controllable costs are those that cannot be directly or indirectly influenced by a water corporation's decisions.

²⁸ 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 2018–20 regulatory period.

We have reduced our draft decision forecast for Western Water’s non-controllable operating expenditure by \$0.02 million across the 2018–20 period, resulting from the following adjustments:

- reducing 2018-19 external bulk charges by \$0.05 million, based on the recently approved tariffs for Melbourne Water for that year
- increasing the forecast 2018-19 environmental contribution from \$3.01 million to \$3.03 million based on the latest inflation data. We have then declined this value in real terms across the period (a total increase of \$0.02 million).

Table 2.3 sets out our adjustments from our draft decision for 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	Total
Draft decision – total operating expenditure	55.4	55.8	111.2
Environment contribution	0.01	0.01	0.02
Bulk water charges correction	-0.05	0.00	-0.05
Total adjustments to non-controllable costs	-0.03	0.01	-0.02
Final decision – total operating expenditure	55.4	55.8	111.1

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 Western Water’s revenue requirement (Table 2.1). We consider our final decision for Western 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.²⁹

²⁹ Essential Services Commission 2018, *Guidance paper*, op. cit., p. 16.

Table 2.4 Final decision – operating expenditure

\$ million 2017-18

	2018-19	2019-20	Total
Controllable costs	41.0	41.2	82.2
Non-controllable costs	14.4	14.5	28.9
Bulk services ^a	11.2	11.5	22.7
Environmental contribution ^b	3.0	3.0	6.0
Licence fees – ESC ^c	0.048	0.048	0.095
Licence fees – DHHS ^c	0.026	0.026	0.053
Licence fees – EPA ^c	0.051	0.051	0.102
Other	0.0	0.0	0.0
Final decision – total operating expenditure	55.4	55.8	111.1

^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 Western Water does not represent the amount that Western 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 Western 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.

Our draft decision accepted Western Water's proposed closing regulatory asset base for 30 June 2017 of \$403.6 million because:

- Western Water's actual net capital expenditure for the period from 2012-13 to 2016-17 was 17.9 per cent lower than the forecast used to approve prices for the period from 1 July 2013.^{30 31}
- Western Water also calculated its closing regulatory asset base in accordance with the requirements of our guidance.

No other new considerations were raised in other submissions on our draft decision that affected our assessment of the closing regulatory asset base. Our final decision approves a closing regulatory asset base at 30 June 2017 of \$403.6 million. The calculations are provided at Table 2.5.

³⁰ Net capital expenditure is calculated by deducting government and customer contributions from gross capital expenditure.

³¹ We take a risk-based approach to including past capital expenditure in the regulatory asset base. We undertake a prudency and efficiency review where a water corporation has exceeded its net capital expenditure forecasts by more than 10 per cent. We believe this approach is reasonable given capital expenditure can be relatively 'lumpy' in nature.

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	299.7	312.5	323.3	330.2	353.2
Plus gross capital expenditure	26.2	21.0	18.4	36.8	71.0
Less government contributions	0.0	2.1	0.0	0.1	0.1
Less customer contributions	6.2	3.0	6.1	7.9	14.0
Less proceeds from disposals	0.5	0.5	0.5	0.5	0.3
Less regulatory depreciation	6.8	4.7	5.0	5.4	6.2
Closing RAB 30 June	312.5	323.3	330.2	353.2	403.6

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 Western Water's forecast regulatory asset base from 1 July 2018.³² The following sections provide an overview of our assessment of each component of the forecast regulatory asset base.

³² Our guidance required Western Water 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
Opening RAB 1 July	403.6	452.6	496.4
Plus gross capital expenditure	70.4	58.8	72.3
Less government contributions	0.0	0.0	0.0
Less customer contributions	13.9	8.1	10.1
Less proceeds from disposals	0.4	0.4	0.4
Less regulatory depreciation	7.2	6.5	8.0
Closing RAB 30 June	452.6	496.4	550.2

Note: Numbers have been rounded

Capital expenditure

Capital expenditure is an input to estimating the regulatory asset base. In our draft decision (pages 18 to 21), we proposed to accept Western Water’s gross capital expenditure forecast of \$131.1 million over the two year period. In summary, we found:

- Western Water has a reasonable approach for developing and managing its capital program.
- Western Water’s top five major projects for 2018–20 are deliverable within their proposed timeframes, as some projects are already underway and the two year period provides greater certainty on timing, scope and costs of projects.
- Western Water has an appropriate approach for managing expenditure associated with uncertain projects.
- Western Water’s approach to forecasting its capital expenditure is consistent with the requirements of our guidance.

In response to our draft decision, Woodlea provided us with a copy of its earlier submission dated 23 April 2018 addressing Western Water’s price submission. It asked us to consider the points raised in this earlier submission, including in relation to forecast capital works for specific infrastructure in the Woodlea precinct. Western Water’s response to our draft decision provided

more information relating to its approach to these specific projects.³³ We note that our role does not extend to planning or developing cost estimates for specific assets or infrastructure projects – these are matters for each water corporation. We establish an overall capital expenditure benchmark, noting each corporation decides how to best manage the allocation of its revenue and priority of its expenditure within a regulatory period. A water corporation may spend more or less than the benchmark. The new customer contributions framework sets out processes whereby individual developers can negotiate with water corporations. Woodlea should engage with Western Water about capital expenditure needs in the Woodlea precinct.³⁴

Woodlea recommended the provision of a plan or breakdown of infrastructure timing in the growth corridor to ensure timely delivery in line with forecast development rates. It also suggested working with industry bodies to review the capital works program and budget.³⁵ In its response to the draft decision, Western Water noted it is preparing new development servicing plans, which will be publicly available before the new price submission comes into effect on 1 July 2018.

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

Accordingly, we have adopted the gross capital expenditure benchmark proposed in our draft decision for the purpose of making our final decision on Western Water’s forecast regulatory asset base (Table 2.6) and its revenue requirement (Table 2.1). We consider this benchmark is consistent with our guidance and WIRO principles.³⁶

The benchmark that we adopt for Western 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. Western 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 Western Water’s approach for addressing uncertain capital expenditure. We reiterate that Western Water will need to demonstrate the prudence and efficiency of additional costs incurred during the 2018–20 period if seeking to include them in the regulatory asset base.

³³ Western Water 2018, *Response to draft decision for Western Water’s 2018/19 to 2019/20 price submission*, 28 May, pp. 5–6.

³⁴ We note that water corporations employ negotiation protocols and dispute resolution frameworks should a developer have any concerns with their particular connection to a water corporation’s infrastructure.

³⁵ Woodlea 2018, *Western Water – water price review*, 25 May.

³⁶ Essential Services Commission 2018, *Guidance paper*, op. cit., pp. 19-20; WIRO clause 8(b).

Customer contributions

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

Our draft decision considered Western Water's forecast revenue from customer contributions were reasonable, having regard to past trends and its growth forecasts.

No new considerations were raised in submissions responding to our draft decision that caused us to change our views on customer contributions.

However, given that we have smoothed the transition of Western Water's increases to new customer contribution charges (explained from page 24), we have reduced the benchmark revenue from customer contributions compared to our draft decision. Our final decision on Western Water's benchmark revenue from customer contributions is set out at Table 2.6.

Cost of debt

In our draft decision we proposed to approve the cost of debt proposed by Western Water as it used the cost of debt values we specified in our guidance to calculate its revenue requirement. Our draft decision included updated values for the estimated cost of debt for 2017-18.³⁷

CALC 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).³⁸ 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.³⁹

A submission by the Water Services Association Australia (WSAA) addressed CALC's submission.⁴⁰ 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

³⁷ 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.

³⁸ Consumer Action Law Centre, *op. cit.*, p. 8

³⁹ *Ibid.*

⁴⁰ Water Services Association 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.⁴¹

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 2.7.

Table 2.7 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

Our draft decision proposed a return on equity for Western Water of 4.5 per cent per annum (in real terms, after tax). We noted this was consistent with our guidance for Western Water which did not require Western Water to self-assess and give itself a PREMO rating.⁴² This return on equity is similar to the rate allowed for Western Water at its most recent price review (2013), and reflects the rate of return a ‘Standard’ business would receive under the PREMO incentive mechanism.⁴³

CALC recommended a one per cent reduction to each return on equity value in the PREMO matrix.⁴⁴ 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. We note 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

⁴¹ 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).

⁴² Essential Services Commission 2018, *Guidance paper*, op. cit., p. 26.

⁴³ Under the PREMO incentive mechanism, return on equity is linked to a water corporation’s level of ambition – ‘Leading’, ‘Advanced’, ‘Standard’ or ‘Basic’. However, this mechanism does not apply to Western Water in this instance. More information on the PREMO mechanism is available in Essential Services Commission 2016, *Guidance paper*, op. cit.

⁴⁴ Consumer Action Law Centre, op. cit.

by other Australian regulators of the water sector.⁴⁵ We also consider the allowed return on equity 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.

For the reasons set out above, our final decision approves a return on equity of 4.5 per cent per annum (in real terms, after tax).

Regulatory depreciation

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

Our draft decision did not accept Western Water's proposed deferral of regulatory depreciation on the grounds that Western Water did not provide reasonable justification for its forecasts. We were concerned that its proposal would unreasonably transfer costs to future customers. Our draft decision approved an amount for regulatory depreciation that was \$4 million higher over its 2018-20 period than its proposal. We based our forecast on Western Water's current approach.

In its response to our draft decision Western Water requested we reconsider our position. It argued that the price impacts of its original proposal would be mitigated by future customer growth. It proposed to recover the \$4 million not provided for in our draft decision from 2025-26.

We analysed Western Water's forecast for regulatory depreciation against customer connections. On a per connection basis, Western Water's depreciation declines markedly in the 2018-20 period, and increases significantly in later years. This suggests future customer growth will not fully absorb the future cost impacts of deferring depreciation from the 2018-20.

On this basis, our final decision confirms our draft decision. Table 2.1 sets out the benchmark for regulatory depreciation we have adopted for our final decision.

Tax allowance

The tax allowance is an input into the revenue requirement. Our draft decision accepted Western Water's forecasts for zero tax in its revenue requirement, as it was calculated consistently with the

⁴⁵ 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.

method required by our guidance.⁴⁶ No other 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 Western Water's tax forecasts, as set out in Table 2.1.

Demand

Our draft decision proposed to approve Western Water's demand forecasts, noting the forecasts were optimistic, and that we would monitor actual demand during the period to inform Western Water's next price review.⁴⁷ In its response to our draft decision, Western Water confirmed its commitment to achieving its proposed reduction in demand.

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

For these reasons, our final decision adopts Western Water's demand forecasts.

The benchmark amounts adopted in our final decision on demand are set out in Western Water's price determination.

Form of price control

Our draft decision accepted Western Water's proposal to retain a price cap form of price control. We considered that a price cap provides customers with price certainty, and means a water corporation is managing demand risk on behalf of its customers. We also noted that we consider demand risk is more efficiently managed by a water corporation, rather than its customers.

No other new considerations were presented in submissions received following the draft decision which caused us to change our views on the form of price control.

For the reasons set out above, our final decision approves Western Water's proposed price cap form of price control.⁴⁸

⁴⁶ Essential Services Commission 2018, *Guidance paper*, op. cit., pp. 27-28.

⁴⁷ Our draft decision noted that in its 2020 price submission Western Water will need to demonstrate that its demand forecasts: represent the best available estimates derived from an appropriate forecasting methodology; and reflect assumptions on the key drivers of demand that are well explained and reasonable.

⁴⁸ We note our determinations allow water corporations flexibility to apply to change from a price cap to a weighted average price cap or tariff basket within a regulatory period.

Tariff structures and prices

Our draft decision accepted Western Water proposal to maintain its existing tariff structures. We expected Western Water to propose to continue with its current tariff structures – given its plan to undertake a business review.

Western Water proposed:

- For residential water customers, a two part tariff with a fixed service charge and a variable usage component with a three-tier inclining block, where price increases in the second and third block.
- For non-residential water customers, a two part tariff with a fixed service charge and a variable usage component that depends on water used.
- For residential and non-residential sewerage services, a fixed service charge only.

Our draft decision also acknowledged the continuation of Western Water’s annual rebate to residential customers receiving a bill with water usage charges.

In response to our draft decision on Western Water we received a submission from a residential customer of Western Water who raised concerns about the level of Western Water’s fixed water and sewerage charges, and its impact on her bill.⁴⁹ As noted in our guidance, we expected Western Water would propose to continue with its current tariff structures for the next two years, given its plan to undertake a business review. We understand that in the development of its next price submission (for the period commencing 1 July 2020) Western Water will work closely with customers to develop tariffs that are easy to understand, and provide signals about the efficient costs of providing services.

A submission from Kingspan Environmental and Urban Water Cycle Solutions raised a number of issues relating to tariffs and efficiency, including that:⁵⁰

- the proposed two part tariff based on a calculated long-run marginal cost has been incorrectly applied as all costs are variable in the long run, therefore two part tariffs do not promote the efficient use of prescribed services to customers. The submission contends that all costs faced by water corporations are variable and should be recovered via usage charges.
- the operating costs of Melbourne’s water corporations have increased by around 85 per cent in real terms over the period from 2004 to 2016, with little or no increase in the volume of water supplied or treated (resulting in loss of efficiency).

⁴⁹ Angela 2018, *Submission*, 11 May.

⁵⁰ Kingspan Environmental and Urban Water Cycle Solutions 2018, Western Water Price Proposal Submission to the Essential Services Commission, 23 May.

- we have not had sufficient regard for the importance of water efficiency programs in the efficient operation of water corporations, and that the implementation of water efficiency programs may directly impact the annual revenue of a water corporation.

On these matters, we note:

- Western Water is currently reviewing its longer-term tariffs (a reason for its shorter, two-year pricing period), and matters covered in the submission may be considered by Western Water as part of this review.
- Our function is to assess if a water corporation's proposed prices comply with the mandatory factors we must have regard to under the WIRO.⁵¹ If we assess the proposals submitted by a water corporation comply with the WIRO, we must approve them, even where we consider there are alternatives that may better meet the WIRO.
- A shift to a substantially higher (or fully) variable charge would need to consider any price shock impacts on customers (required under the WIRO)⁵². A fully variable charge would impact specific customer groups, particularly tenants who under Victorian legislation are charged for usage only (the variable component of a two-part tariff), and these matters would need to be taken into account. Further, water corporations have undertaken robust customer engagement including consultation on tariff structures including the mix of fixed and variable charges prior to making a price submission.
- No water corporation has proposed a fully variable charge in our current water price review, however we have approved a trial for a fully variable water tariff in the past.⁵³
- With regards to the operating costs for Melbourne's water corporations, we note that much of the increase in costs cited in the submission can be attributed to payments for the Victorian desalination plant. Melbourne Water makes these payments and passes the costs through to metropolitan water corporations linked to the Melbourne network.
- The decision on whether to implement particular water efficiency initiatives is a matter for each water corporation. If proposed by a water corporation, we would assess the merits of a proposed water efficiency initiative against the requirements of WIRO. In the past we have approved water efficiency initiatives proposed by Victorian water corporations, including recycled water projects.
- Research presented in the submission focusses on Brisbane, and does not take into account the inclining block tariff structure used by Western Water, and some other Victorian water corporations.

⁵¹ For more information on this see Essential Services Commission 2018, *Western Water final decision: 2018 Water Price Review – Commission's consideration of legal requirements*, 19 June.

⁵² WIRO Clause 11(d)(ii) requires us to have regard to whether Western Water's prices 'provide signals about the efficient costs of providing prescribed services to customers while avoiding price shocks where possible'.

⁵³ In 2013, we approved Yarra Valley Water's proposal to implement a trial tariff comprising a fully volumetric water tariff.

- While there is merit in the suggestion that all costs are variable in the long run, capital asset lives in the water sector are typically 70 to 100 years which requires consideration of the intergenerational impact of cost recovery.

We received a submission from Carmel Jacobs, a residential customer of Western Water who requested our review of Western Water’s proposed prices consider the impact on low income and vulnerable customers.⁵⁴ We consider that approving Western Water’s proposal to hold prices at current levels (with an allowance for inflation) for the two-year price period is in the interests of customers. Western Water also provides a range of assistance programs for customers experiencing financial hardship.

For the reasons set out above, our final decision approves Western Water’s proposed tariffs.

Our price determination for Western Water sets out the maximum prices it may charge for the two year period from 1 July 2018 (or the manner in which its prices are to be calculated, determined, or otherwise regulated for each tariff). Approved maximum prices for water and sewerage services applying to most residential and non-residential customers are set out in Tables 2.8 and 2.9 (in \$2018-19). The approved tariffs take into account Western Water’s commitment to a \$100 rebate.

Table 2.8 Final decision – water prices
\$ 2018-19

	2018-19	2019-20
Residential		
Variable (\$/kL)		
1st tier	1.8336	1.8336
2nd tier	2.4328	2.4328
3rd tier	3.7291	3.7291
Fixed (\$/year)	234.26	234.26
Non-residential		
Variable (\$/kL)	2.4328	2.4328
Fixed (\$/year)	234.26	234.26

Note: Numbers have been rounded down

⁵⁴ Carmel Jacobs 2018, *submission*, 6 April.

Table 2.9 Final decision – sewerage charges
\$ 2018-19

	2018-19	2019-20
Residential		
Fixed (\$/year)	540.72	540.72
Non-residential		
Fixed (\$/year)	540.72	540.72

Note: Numbers have been rounded down

Adjusting prices

In our draft decision we approved Western Water’s proposal to continue its existing uncertain and unforeseen events mechanism. We approved them on the basis that they are consistent with efficiency objectives, and reflect a continuation of current arrangements.

We have also developed price adjustment formulas that allow Western Water’s prices to adjust for changes in the cost of debt.

No other new considerations were presented in submissions received following the draft decision which caused us to change our views on Western Water’s adjustment mechanisms.

Our final decision approves Western Water’s proposed uncertain and unforeseen events mechanism and updated price adjustment mechanism that adjust prices for changes in the cost of debt.

New customer contributions

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

Western Water’s price submission proposed to continue applying separate standard charges for infill and greenfield connections, with infill being charged at 50 per cent of the standard greenfield charge.⁵⁵ Western Water proposed to transition its existing standard connection charges, over the next two regulatory periods, to a level that reflects the costs the corporation is facing for

⁵⁵ Western Water’s submission classifies a new connection as infill if the connection occurs within an existing area already serviced by Western Water.

construction of major new infrastructure to service the high growth occurring in the region. For negotiated new customer contributions, Western Water proposed to continue to calculate a charge in accordance with the requirements of our new customer contribution pricing principles.⁵⁶

Our draft decision acknowledged the significant forecast growth and associated costs. We agreed with the need for a shift to a more cost-reflective new customer contribution charge. However, we considered material provided to the commission by Western Water showed little evidence of consultation with developers about its proposed changes, including developers' views on the timing of the transition to a higher charge.

Our draft decision sought further submissions from developers on Western Water's proposed transition and proposed increase to charges in 2018-19 and 2019-20. Western Water's proposed charges can be seen at page 46 of its price submission.

In response to our draft decision, Woodlea lodged its original submission responding to Western Water's price submission.⁵⁷ A submission from the Urban Development Institute of Australia (UDIA) raised similar points to the submission from Woodlea, related to Western Water's proposed increase to NCC charges, and lot forecasts and capital works program.⁵⁸

The submission from the UDIA also recommended that the level of Western Water's customer contribution charges should be brought into line with other water corporations.

Our new customer contribution principles require water corporations to develop charges that have regard to the estimated incremental costs of a new connection. This estimate varies across water corporations, depending on factors such as the number of customer connections, forecast investment in infrastructure, and offsetting revenue received from new connections. Accordingly, new customer contribution charges will be different for each water corporation, as each corporation is required to calculate its new customer contribution charges in line with the principles.

Our final decision recognises the significant forecast growth and associated costs faced by Western Water, and acknowledge its strategy to shift to a more cost-reflective charge. However, the submissions received from Woodlea and the UDIA both raised concern with the proposed rate of increase to Western Water's standard charges over the next two years. Acknowledging these concerns, we consider Western Water's proposed increases to standard connection charges in 2018-19 and 2019-20 should be smoothed, given its price submission stated that it plans to transition the standard charges to a more cost reflective level over the next two regulatory periods.

⁵⁶ Essential Services Commission 2018, *Guidance paper*, op cit., p. 33. In response to a request for information, Western Water confirmed the use of NCC pricing principles.

⁵⁷ Woodlea, op. cit.

⁵⁸ Urban Development Institute of Australia (Victoria) 2018, *UDIA Victoria Submission: ESC 2018 Price Review – Western Water Draft Decision*, 28 May.

We also consider a smoothed price increase is appropriate given that Western Water is undertaking a review to inform how it responds to growth in future years. This may impact on future new customer contribution charges.

Our final decision smooths the transition of the standard charges by reducing the proposed increases to 10 per cent (per annum) in real terms for 2018-19 and 2019-20 as shown in Table 2.10. We expect Western Water to consult with developers on the continued transition of the charge in the lead up to its 2020 price submission.

In relation to lot forecasts, we consider that Western Water has complied with the requirements of our guidance by using the latest Victoria in Future forecasts for population growth. We consider the VIF forecasts provide an arms-length and reputable data source for demand forecasting.

In response to our draft decision, Western Water stated that it has since sent out a letter to developers and consultants outlining its methodology of the charge calculation (utilising the NCC pricing principles) and the issues it faces in servicing growth. Western Water also sought feedback on its proposed new customer contribution charges and provided the opportunity for recipients to register for involvement in Western Water's 2020 price submission.

Western Water also stated that it is preparing new developing servicing plans to provide transparency to the development industry on timing of investment in the expansion of its networks. Western Water noted the plans will be publicly available on 1 July 2018. Our new customer contributions explanatory note explains reasonable industry practice would see water corporations publish up to date and publicly available service plans.⁵⁹

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.

We consider it appropriate to maintain the views expressed in our draft decision accepting Western Water's method of calculating negotiated contribution charges, as they are consistent with the requirements of our guidance.⁶⁰

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

⁵⁹ Essential Services Commission 2013, *New Customer Contributions: Explanatory Note, December*, pp. 3-4 and pp. 9-11.

⁶⁰ Essential Services Commission 2016, *Guidance paper, op. cit.*, p. 33.

Table 2.10 Final Decision NCC's per lot
\$2018-19

	2018-19	2019-20
Greenfield charge	4,838	5,322
Infill charge	2,419	2,661

Note: Numbers have been rounded

Financial position

In approving prices, we must have regard to the financial viability of the water industry.⁶¹ We interpret the financial viability requirements under the *Essential Services Commission Act 2001* (Vic) and the WIRO 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 guidance set out key indicators of forecast financial performance. We have reviewed forecasts for these key indicators based on our final decision on Western Water's prices. We have assessed that, under our final decision, Western Water will generate sufficient cash flow to deliver on service commitments, including financing costs arising from investments to meet service expectations.

⁶¹ WIRO clause 8(b)(ii) and ESC Act section 8A(1)(b).

Appendix A – submissions received on draft decision

Name or organisation	Date received
Urban Development Institute of Australia (UDIA)	28 May 2018
Woodlea	25 May 2018
Kingspan Environmental and Urban Water Cycle Solutions	23 May 2018
Water Services Association of Australia	16 May 2018
Angela (surname withheld)	11 May 2018
Consumer Action Law Centre	8 May 2018
Carmel Jacobs	6 April 2018

Appendix B – approved service standards

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

Western Water’s approved service standards

Service Standard	2018-19	2019-20
Water		
Number of customers experiencing more than 5 unplanned water supply interruptions in the year (number)	0	0
Average time taken to attend bursts and leaks (priority 1) (minutes)	30	30
Average time taken to attend bursts and leaks (priority 2) (minutes)	60	60
Average time taken to attend bursts and leaks (priority 3) (minutes)	1440	1440
Average duration of unplanned water supply interruptions (minutes)	126	126
Average duration of planned water supply interruptions (minutes)	240	240
Sewerage		
Customers receiving more than 3 sewer blockages in the year (number)	0	0
Average time to attend sewer spills (minutes)	30	30
Average time to attend blockages (minutes)	60	60
Average time to rectify a sewer blockage (minutes)	47	47
Spills contained within 5 hours (per cent)	100%	100%

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 Western Water.

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

Western 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 Western Water.

Western Water’s approved GSL scheme

Approved service level obligation	Approved payment (\$)
No more than five unplanned water supply interruptions in any 12 months (applicable for years 1–3)	75
No more than four unplanned water supply interruptions in any 12 months (application for years 4–5)	75
All water quality complaints will receive a response within three business days after notification (noting resolution may take longer)	100
Not restricting the water supply of a residential customer, or taking legal action, prior to taking reasonable endeavours to contact the customer and provide information about help that is available if the customer is experiencing difficulties paying	Annual water access charge fee or \$350 for tenants
We will contain sewage spills within a house resulting from the failure of our pipes within one hour of notification (GSL is in addition to clean-up costs)	Annual wastewater access fee or \$550 for tenants
We will contain sewage spills onto property within five hours of notification	350

Appendix D – rate of return

A submission from the Consumer Action Law Centre (CALC) recommended 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.⁶² These recommendations are based on a report prepared by CME for CALC.⁶³

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.⁶⁴ 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 the state treasury corporation 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 reflects our estimate of the efficient financing costs for a privately owned business facing a similar degree of economic risk to

⁶² Consumer Action Law Centre, op. cit.

⁶³ *ibid.*, Appendix A.

⁶⁴ 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.

a regulated water corporation. We consider this is consistent with the requirements of the Water Industry Regulatory Order 2014 (WIRO).⁶⁵

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.⁶⁶ 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.⁶⁷

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.⁶⁸

⁶⁵ 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).

⁶⁶ Consumer Action Law Centre, *op. cit.*

⁶⁷ Essential Services Commission of South Australia, *op. cit.*; Independent Pricing and Regulatory Tribunal, *op.cit.*

⁶⁸ 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.