Central Highlands Water final decision

2018 Water Price Review

19 June 2018

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

Contents

Summary

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

In March 2018, we released our draft decision on Central Highlands Water's price submission.[1] The draft decision set out our preliminary views on Central Highlands Water's proposals, and invited interested parties to make further submissions. We also held a public meeting in April 2018. In addition to a response from Central Highlands Water, we received three 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 Central Highlands Water.[2] The price determination sets out the maximum prices Central Highlands Water may charge for prescribed services (or the manner in which its prices are to be calculated, determined, or otherwise regulated) for the five year period from 1 July 2018 (2018–23). This final decision paper sets out our supporting reasons and analysis for the price determination.

Where our final decision on a particular aspect is unchanged from our draft decision, we have not detailed the supporting reasons in our final decision. Rather, we have noted that our final decision 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 has updated the revenue to be collected by Central Highlands Water

Our final decision approves a revenue requirement of $442.6 million over the five year period starting 1 July 2018.[3] This is $3.0 million or 0.7 per cent lower than our draft decision, and mainly reflects our updates to forecast operating expenditure.

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[1] Clause 16 of the Water Industry Regulatory Order 2014 requires us to issue a draft decision. Central Highlands 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, *Central Highlands Water Determination: 1 July 2018 – 30 June 2023*, June.

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

A summary of approved maximum prices for major services delivered by Central Highlands Water is set out from page 24. The estimated typical bill impacts of Central Highlands Water's proposal and our final decision on residential customers is provided in Table A. The typical bill for an owner-occupier will fall by around $20 in 2018-19, and remain steady for a tenant (in constant price $2018-19 terms).

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

Customer group	Average consumption (kL p.a.)	2017-18 annual bill	2018-19 annual bill	2022-23 annual bill
Residential (Owner occupier)	150	$1,257	$1,237	$1,168
Residential (Tenant)	150	$288	$288	$288

Note: Numbers have been rounded

Central Highlands Water will improve services

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

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

Tariff structures remain the same

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

Our final decision also approves Central Highlands Water's proposed price cap form of price control. This means its maximum prices are fixed subject to updates for inflation, and any other

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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.

price adjustments we approve in our price determination. Central Highlands Water currently uses a price cap.

More detail on tariffs and the form of price control is available from page 22.

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

Our final decision accepts Central Highlands Water's PREMO self-rating of its price submission of 'Advanced'. Central Highlands Water has committed to deliver better value to its customers through improvements in service outcomes, such as through improvements to water quality, and setting improved targets for a number of service indicators. It has also proposed prices that are generally stable or falling, implying many customers will get more for less. This is consistent with an 'Advanced' rating for PREMO.

Figures A and B summarise our final decision on PREMO. More detail on our assessment of Central Highlands Water's PREMO rating is provided in Chapter 3. Central Highlands Water is one of nine corporations for which we have approved an 'Advanced' PREMO price submission rating.

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

Figure A PREMO Rating

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

Figure B Final decision on PREMO – overall rating

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

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

1. Our role and approach to water pricing

We are Victoria's independent economic regulator

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

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

Our review of the prices proposed by the water corporations covers the prescribed services listed in the WIRO.[4] The prescribed services include retail water and sewerage services, and bulk water and sewerage services delivered by the water corporations.[5]

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

The price determination specifies the maximum prices a water corporation may charge for prescribed services, or the manner in which prices are to be calculated, determined or otherwise regulated. We also issue a final decision that sets out the supporting reasons for our price determination.

We assess prices against the WIRO and other legal requirements

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

- the objectives and matters specified in clause 8 of the WIRO, which include economic efficiency and viability matters, industry specific matters, customer matters, health, safety, environmental and social matters, and other matters which are specified in sections 8 and 8A of the ESC Act and section 4C of the WI Act

[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 matters specified in our guidance[6]
- 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 Central Highlands Water.[7]

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

If we consider the price submission has adequate regard for the matters in clause 11 of the WIRO and complies with our guidance, we must approve Central Highlands Water's proposed prices.[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 2016, *2018 Water Price Review: Guidance paper*, November.

[7] Essential Services Commission 2018, *Central Highlands 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.

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

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

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

We finalised our new approach to water pricing in October 2016.[13]

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

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

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

PREMO

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

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

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

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

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

[15] Essential Services Commission 2016, *Guidance Paper*, op. cit., pp. 8–9.

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

The 2018 water price review is the first time we've applied our PREMO incentive mechanism. A water corporation's ambition in terms of delivering customer value is being assessed against four elements of PREMO – Risk, Engagement, Management and Outcomes.[17]

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

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

[18] The PREMO process is described in: Essential Services Commission 2016, *Guidance paper*, op. cit., pp. 44–49.

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

We have made our price determination for Central Highlands Water after considering: Central Highlands 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. We also held a public meeting in April on our draft decision to receive feedback.

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

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

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

Regulatory period

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

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

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

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

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

Customer engagement

Our guidance required Central Highlands Water to engage with customers to inform its price submission. The engagement by Central Highlands Water:

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

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

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

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

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

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

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

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

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

Outcomes

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

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

Central Highlands Water's proposed measures and targets for reporting against these outcomes are set out on pages 33 to 38 of its price submission. Central Highlands Water has committed to reporting to customers annually against each of these measures. Performance information will be available on its website, and promoted using social media, bill inserts and email.

In early 2018-19, we will engage with Central Highlands Water to finalise the set of measures, targets, and how it will report on its achievement against outcomes. Its performance will inform our assessment during future price reviews as part of the Performance element of PREMO assessments.

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

We have not adopted CALC's recommendation in our final decision. We note that the additional allowance in our 2013 price review was provided in recognition of the large one-off price increases approved for the metropolitan corporations during the review.[25] Further, water corporations already allocate funds to programs aimed to deliver payment options and hardship support required by our customer service codes. Central Highlands Water has proposed lower prices and will continue to provide payment options and assistance for customers experiencing difficulty paying bills.

Service Standards

Central Highlands 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 Central

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[24] Consumer Action Law Centre, op. cit., p. 3.

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

Highlands Water's targets until 2023 are set out in Appendix B. CALC has noted a range of ambitions by water corporations when it comes to proposed service standards and that water corporations should be encouraged to improve service standards over time.[26] We note that Central Highlands Water proposed standards for reliability and attending faults that improve on targets from previous years, and improve over the five years of the regulatory period.

Service standards relating to reliability and attending faults are set out in Appendix B and form part of the manner in which Central Highlands 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 their customer charter.

Central Highlands Water's proposed GSLs are set out on pages 41 and 42 of its price submission. It has proposed to revise existing GSLs, and introduced two new GSLs relating to water quality and sewer spills. In our draft decision we provided an overview of Central Highlands Water's proposed GSLs.

CALC supported GSL payments increasing over time.[27] We note Central Highlands Water has increased the payment amounts for all but one of its GSLs. Central Highlands Water's proposed GSLs were informed by customer feedback, including input from a customer forum and its customer reference group, which we consider provides assurance that its GSLs reflect the most important aspects of service from a customer perspective. For these reasons our final decision approves Central Highlands Water's proposed GSLs.

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

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

[26] Consumer Action Law Centre 2018, op. cit., p. 6.

[27] ibid., p. 1.

Environment Protection Authority Victoria and the Department of Health and Human Services.[28] Along with forecast demand, it is an input to calculating prices.

Our draft decision proposed to approve a revenue requirement of $445.6 million over a five year period starting 1 July 2018. Our final decision approves a slightly lower revenue requirement of $442.6 million. This reflects our final decision on each element of the revenue requirement, as set out in Table 2.1.

The reduction for our final decision is mainly due to updates we made to Central Highlands Water's forecast operating expenditure. The reduced return on assets reflects our updates to the cost of debt (see pages 19 to 20) following our draft decision. Adjustments to the revenue requirement since our draft decision are set out at Table 2.2, with the reasons set out in the following sections.

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

	2018-19	2019-20	2020-21	2021-22	2022-23	Total
Operating expenditure	57.1	56.6	55.8	55.6	55.6	280.7
Return on assets	14.3	14.7	15.1	15.4	15.5	75.1
Regulatory depreciation	16.2	17.0	17.4	18.0	18.3	86.9
Tax allowance	0.0	0.0	0.0	0.0	0.0	0.0
Revenue requirement	**87.6**	**88.3**	**88.3**	**89.0**	**89.4**	**442.6**

Note: Numbers have been rounded

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

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

	2018-19	2019-20	2020-21	2021-22	2022-23	Total
Draft decision – revenue requirement	**88.6**	**89.5**	**88.7**	**89.3**	**89.6**	**445.6**
Operating expenditure	-0.7	-1.0	-0.1	-0.0	0.1	-1.7
Return on assets	-0.2	-0.2	-0.3	-0.3	-0.3	-1.3
Total adjustments	**-1.0**	**-1.2**	**-0.3**	**-0.3**	**-0.2**	**-3.0**
Final decision – revenue requirement	**87.6**	**88.3**	**88.3**	**89.0**	**89.4**	**442.6**

Note: Numbers have been rounded

Operating expenditure

Operating expenditure is an input to the revenue requirement. Our draft decision proposed to adopt a $258.6 million benchmark for Central Highlands Water's forecast controllable operating costs for the 2018–23 period. This was $7.4 million lower than proposed by Central Highlands Water, and we set out our reasoning for this adjustment in our draft decision (pages 9 to 15). In summary, we found:

- Evidence indicating its baseline controllable operating expenditure reflects an efficient benchmark.[29]
- Central Highlands Water proposed an efficiency improvement rate of 1.6 per cent per year, which is the same as its forecast growth of 1.6 per cent per year.
- $3.80 million of proposed additional labour costs, for wage increases above inflation resulting from its enterprise agreement, were not considered to be prudent.
- An additional $3.59 million to cover costs associated with electricity and new initiatives was not considered to meet the requirements of our guidance.

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

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

We forecasted $23.8 million for Central Highlands Water's non-controllable operating costs for the 2018–23 period.[30] 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.

Central Highlands Water's response to our draft decision provided updated forecasts for payroll and electricity prices. In its response, Central Highlands Water also maintained that its labour and water efficiency initiatives expenditure above the baseline were justified.

- The 2018-19 Victorian budget cut the payroll tax from 3.65 per cent to 2.425 per cent for regional corporations from 1 July 2018. As a result, Central Highlands Water has advised a reduction of $1.20 million across the 2018–23 period. This is consistent with our draft decision requirement to be provided with updated forecasts if there is a change in legislation or government policy, and we have reduced the forecast accordingly.
- Central Highlands Water initially accepted our draft decision on its electricity costs, but subsequently provided an updated forecast based on the updated VicWater electricity price forecast, as it doesn't have updated contract prices available.[31] We were unable to reconcile Central Highlands Water's prices to any of the scenarios in the VicWater report, but we note that Central Highlands Water used a weighted average of 60 per cent high price scenario and 40 per cent medium price scenario from the previous VicWater report for its original price submission.[32] Given the updated VicWater report states that the NEG (medium) scenario is now looking much more likely than the other scenarios, we have used the NEG scenario prices (converted from nominal to 2017-18 real terms) to estimate a revised electricity forecast for Central Highlands Water. Accordingly we have reduced our draft decision on Central Highlands Water's electricity costs by $1.68 million across the 2018–23 period.
- In its response, Central Highlands Water maintained that its proposed additional labour costs for wage increases above inflation were justified, since it is holding its number of full-time equivalent (FTE) staff flat.[33] However, Central Highlands Water's controllable operating

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

[31] The VicWater Supply Chain Excellence Program 5 Year Electricity Price Forecast May 2018 sets out three scenarios; 'Status Quo', 'National Energy Guarantee' (NEG) and 'Luddite' (broadly corresponding to high, medium and low). The prices in the report are expressed in nominal terms, and must be converted to 2017-18 real terms for use in our financial models.

[32] We requested our expenditure consultant, Deloitte Access Economics, to review the updated electricity price forecasts and compare against the information received for our draft decision. Deloitte recommended a $1.68 million reduction for our final decision.

[33] Our pricing approach does not necessarily allow for the direct pass through of costs incurred (or forecast to be incurred) by a water corporation. This approach is commonly adopted by economic regulators, and is consistent with efficiency objectives in the WIRO. For example, in the Australian Energy Regulator's 2015 decision for the SA Power Networks (SAPN) 2015-20 regulatory period, it rejected SAPN's proposed annual wage increase because it considered them above the efficient market rate. SAPN's proposal had reflected its future actual wage costs, arising from an

expenditure, including the wages component, increases by 1.6 per cent per year through the customer connection growth allowance. We consider this growth allowance will more than cover the difference between inflation and the 3.0 per cent wage increase provided by the current enterprise agreement, especially in light of Central Highlands Water's assertion that there will be no actual growth in number of FTEs. Therefore, our final decision on labour costs remains unchanged from our draft decision.

- Central Highlands Water's response outlined its water efficiency initiatives are associated with expanded government obligations and are supported by customers. It highlighted the government has revived the Target Your Water Use efficiency program and is expanding the Schools Water Efficiency program. Given Central Highlands Water notes it requires additional expenditure above its baseline to implement the government obligations and to address outcomes supported by customers, we have reinstated the $1.10 million removed in our draft decision. We note these government programs are required for all urban water corporations, and most corporations (particularly those seeking an 'Advanced' rating) have not sought additional expenditure above that already in their baseline to fund any changes in these obligations.

CALC's submission to our draft decision supported our approach of adjusting forecast electricity costs and limiting wage increases in operating expenditure above the baseline.[34] 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 or external bulk charges.[35]

Based on the latest inflation data, we have revised the forecast 2018-19 environmental contribution from $3.88 million to $3.89 million, which results in a total increase of $0.07 million across the 2018–23 period.

Accordingly, we have increased our draft decision forecast for Central Highlands Water's non-controllable operating expenditure by $0.07 million to $23.87 million across the 2018–23 period.

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enterprise agreement it had entered into with its employees. The AER's approach in relation to labour costs was affirmed as reasonable by both the Tribunal and the Full Federal Court.

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

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

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

Table 2.3 Adjustments to operating expenditure
$ million 2017-18

	2018-19	2019-20	2020-21	2021-22	2022-23	Total
Draft decision – total operating expenditure	**57.8**	**57.5**	**55.9**	**55.6**	**55.5**	**282.4**
Water efficiency programs	0.22	0.22	0.22	0.22	0.22	1.10
Electricity	-0.74	-0.95	-0.08	-0.01	0.10	-1.68
Payroll tax	-0.24	-0.24	-0.24	-0.24	-0.24	-1.20
Total adjustments to controllable costs	**-0.76**	**-0.97**	**-0.10**	**-0.03**	**0.08**	**-1.78**
Environmental contribution	0.01	0.01	0.01	0.01	0.01	0.07
Total adjustments to non-controllable costs	**0.01**	**0.01**	**0.01**	**0.01**	**0.01**	**0.07**
Final decision – total operating expenditure	**57.1**	**56.6**	**55.8**	**55.6**	**55.6**	**280.7**

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 Central Highlands Water's revenue requirement (Table 2.1). We consider our final decision for Central Highlands 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.[36]

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

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

	2018-19	2019-20	2020-21	2021-22	2022-23	Total
Controllable costs	**52.2**	**51.7**	**51.1**	**50.9**	**51.0**	**256.8**
Non-controllable costs	**4.9**	**4.9**	**4.8**	**4.7**	**4.6**	**23.9**
Bulk services[a]	0.8	0.8	0.8	0.8	0.8	3.9
Environmental contribution[b]	3.9	3.8	3.7	3.6	3.6	18.6
Licence fees – ESC[c]	0.050	0.050	0.050	0.050	0.077	0.277
Licence fees – DHHS[c]	0.030	0.030	0.030	0.030	0.030	0.150
Licence fees – EPA[c]	0.187	0.187	0.187	0.187	0.187	0.937
Other	0.0	0.0	0.0	0.0	0.0	0.0
Final decision – total operating expenditure	**57.1**	**56.6**	**55.8**	**55.6**	**55.6**	**280.7**

[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 Central Highlands Water does not represent the amount that Central Highlands Water is required to spend or allocate to particular operational, maintenance and administrative activities. Rather, it represents assumptions about the overall level of operating expenditure (to be recovered through prices) that we consider sufficient to operate the business 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 Central Highlands Water to propose its:

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

Closing regulatory asset base

We update the regulatory asset base to reflect actual 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 proposed to approve a closing regulatory asset base for 30 June 2017 of $335.0 million. We proposed to approve this amount as Central Highlands Water's actual net capital expenditure was 20.5 per cent lower than the forecast used to approve maximum prices for the period from 1 July 2013.[37] [38] Central Highlands Water also calculated its closing regulatory asset base in accordance with the requirements of our guidance.

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

For the reasons set out above, our final decision approves a closing regulatory asset base at 30 June 2017 of $335.0 million. The calculations are provided at Table 2.5.

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

[38] 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	319.2	321.6	322.0	324.7	328.7
Plus gross capital expenditure	17.0	16.8	20.8	22.0	23.1
Less government contributions	2.2	0.8	0.8	2.2	0.5
Less customer contributions	2.3	1.9	1.9	1.4	1.4
Less proceeds from disposals	0.2	0.2	1.5	0.2	0.5
Less regulatory depreciation	10.0	13.5	13.9	14.2	14.6
Closing RAB 30 June	**321.6**	**322.0**	**324.7**	**328.7**	**335.0**

Note: Numbers have been rounded

Forecast regulatory asset base

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

Table 2.6 sets out our final decision on Central Highlands Water's forecast regulatory asset base from 1 July 2018.[39] Our assessment of each component of the forecast regulatory asset base is set out in following sections.

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

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

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

Note: Numbers have been rounded

Capital expenditure

Capital expenditure is an input to estimating the regulatory asset base. In our draft decision (pages 18 to 21), we proposed to accept Central Highlands Water's gross capital expenditure forecast of $130.0 million for the 2018–23 period. The reasons for this were:

- Central Highlands Water's price submission and business cases provided evidence that its forecasts for capital expenditure are efficient.
- We considered the planned capital expenditure program is achievable, given Central Highlands Water's past track record delivering its capital expenditure program.
- Central Highlands Water has an appropriate approach for managing expenditure associated with uncertain projects.
- We considered Central Highlands Water's approach to forecasting its capital expenditure is consistent with the requirements of our guidance.

Central Highlands Water's response to our draft decision did not provide any new information on our draft decision for gross capital expenditure.

CALC's submission reminded the commission and corporations that 'smart energy meters were touted as a game changer…but have so far failed to deliver on this promise'.[40] It stated that new technology must deliver tangible benefits for water customers and be backed by a comprehensive business case. Central Highlands Water has proposed a full roll-out of digital meters across its entire water supply network, to be completed within the 2018–23 period. It has completed a proof-of-concept trial, and has demonstrated strong customer support for digital metering. In our draft decision, we noted that we expect Central Highlands Water to develop measures to assess the success of each phase of the rollout, to inform its decision to proceed to the next phase, and to manage customer concerns and all risks associated with this roll-out.

CALC also recommended the commission sets industry-wide principles to ensure the rollout of smart meters is in the long-term interest of consumers, including support mechanisms for vulnerable customers.[41] However, our regulatory role does not extend to overseeing the design and delivery of capital projects. We agree with the CALC that strong customer engagement and collaboration across the industry is important for achieving an efficient outcome for customers, including vulnerable customers. We also agree water corporations should take into account lessons learnt from the energy smart meter rollout, and from other water corporations further advanced with their digital metering programs.

No other new considerations were presented in submissions received following the draft decision which 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 Central Highlands 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.[42]

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

In our draft decision, we accepted Central Highlands Water's approach for addressing uncertain capital expenditure. We reiterate that Central Highlands Water will need to demonstrate the

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

[41] ibid.

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

prudency and efficiency of additional costs incurred during the 2018–23 period if seeking to include them in the regulatory asset base.

Customer contributions

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

Our draft decision considered Central Highlands Water's forecast revenue from customer contributions was reasonable, having regard to past trends and its growth forecasts. We proposed to accept Central Highlands Water's forecast. No other new considerations were presented in submissions received following the draft decision which caused us to change our views on revenue from customer contributions.

For the reasons set out above, our final decision on revenue from customer contributions is the same as our draft decision. Our final decision adopts the benchmarks set out at Table 2.6.

Cost of debt

In our draft decision we proposed to approve the cost of debt proposed by Central Highlands Water as it used the cost of debt values we specified in our guidance to calculate its revenue requirement. We also noted that we will update the value of the estimated cost of debt for 2017-18 with our calculation of the actual cost, applying the method outlined in our guidance.[43]

In its submission 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).[44] 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.[45]

A submission by the Water Services Association Australia (WSAA) addressed CALC's submission.[46] 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.

[43] 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.

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

[45] ibid., Appendix A.

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

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 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.[47]

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 – PREMO rating

Central Highlands Water rated its price submission as ‘Advanced’. Based on its PREMO self-rating, Central Highlands Water proposed a return on equity of 4.9 per cent per annum. This reflects the maximum return rate allowed in our guidance for a price submission rated as ‘Advanced’.[48]

Our draft decision accepted Central Highlands Water’s proposed return on equity. This reflected our preliminary review of its PREMO self-rating.

CALC recommended a one per cent reduction to each return on equity value in the PREMO matrix.[49] 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

[47] 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).

[48] Essential Services Commission 2016, *Guidance paper*, op. cit., p. 49.

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

debt and the return on equity) approved in our draft decision are similar to rates recently estimated by other Australian regulators of the water sector.[50] 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. We have also had regard to the return on equity allowed or estimated by regulators in other Australian jurisdictions recently for the water industry.[51]

Consistent with our draft decision, our final decision accepts Central Highlands Water's proposed return on equity of 4.9 per cent per annum, reflecting our views above, and our final decision on its PREMO rating (see Chapter 3).

Regulatory depreciation

Regulatory depreciation is an input to calculating the regulatory asset base. Our draft decision proposed to accept Central Highlands Water's forecast regulatory depreciation, as it was calculated in a manner consistent with the requirements of our guidance.[52] No new considerations were presented in submissions received following the draft decision which caused us to change our views on depreciation.

For the reasons set out above, our final decision adopts Central Highlands Water's forecast for regulatory depreciation, as set out in Table 2.1.

Tax allowance

The tax allowance is an input into the revenue requirement. Our draft decision accepted Central Highlands Water's forecasts for zero tax in its revenue requirement, as it was calculated consistently with the method required by our guidance.[53] No new considerations were presented in

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[50] 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.

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

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

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

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 Central Highlands Water's tax forecasts, as set out in Table 2.1.

Demand

In our draft decision, we proposed to approve Central Highlands Water's demand forecasts as we considered they were estimated in a manner consistent with the requirements of our guidance. Our final decision accepts the position in our draft decision for the same reasons, and accepts Central Highlands Water's demand forecasts.

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

Form of price control

Our draft decision accepted Central Highlands 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 on the form of price control were raised in response to our draft decision.

For the reasons set out above, our final decision approves Central Highlands Water's proposed price cap form of price control.[54]

Tariff structures and prices

Our draft decision accepted Central Highlands Water's proposal to maintain its existing tariff structures, comprising:

- For residential water services, a fixed water service charge and a two-tier inclining block variable usage component, where price increases in the second block.
- For residential sewerage services, a fixed service charge.

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[54] 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.

- For non-residential water services, a two-part tariff with a fixed service charge and a variable usage component that depends on water use.
- For non-residential sewerage services, a fixed service charge and a variable usage component.

We considered the two-part structure for water services will promote efficient use. It also provides customers a signal about their water use costs, and is an approach that is commonly applied in other states and territories.[55] We also considered two-part tariff structures are easy to understand.

For sewerage tariffs, we considered Central Highlands Water's proposed fixed charge only for residential customers and a two-part tariff for non-residential customers sends customers signals about efficient costs.[56]

No other new considerations were presented in submissions received following the draft decision which caused us to change our views on Central Highlands Water's tariffs structures.[57]

For the reasons set out above, our final decision approves Central Highlands Water's proposed tariffs.

Our price determination for Central Highlands Water sets out the maximum prices it may charge for the five year period from 1 July 2018 (or the manner in which its prices are to be calculated, determined, or otherwise regulated 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).

[55] 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.

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

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

Table 2.8 Final decision – water prices
$ 2018-19

	2018-19	2019-20	2020-21	2021-22	2022-23
Residential					
Variable ($/kL)					
1st tier	1.8958	1.8958	1.8958	1.8958	1.8958
2nd tier	2.2750	2.2750	2.2750	2.2750	2.2750
Fixed ($/year)	198.83	198.83	198.83	198.83	198.83
Non-residential					
Variable ($/kL)	1.8958	1.8958	1.8958	1.8958	1.8958
Fixed ($/year)	198.83	198.83	198.83	198.83	198.83

Note: Numbers have been rounded down

Table 2.9 Final decision – sewerage charges
$ 2018-19

	2018-19	2019-20	2020-21	2021-22	2022-23
Residential					
Fixed ($/year)	756.40	737.11	718.31	699.99	681.79
Non-residential					
Variable ($/kL)	1.1090	1.1090	1.1090	1.1090	1.1090
Fixed ($/year)	756.40	737.11	718.31	699.99	681.79

Note: Numbers have been rounded down

Adjusting prices

Our draft decision approved the continuation of Central Highlands Water's existing uncertain and unforeseen events mechanism. We approved the mechanism on the basis that they are consistent with efficiency objectives, and reflect a continuation of current arrangements.[58]

[58] WIRO clauses 8(b)(i)(ii) and (iii).

Our draft decision noted Central Highlands Water's proposal to reopen its price determination only for unforeseen events of significant consequence (i.e. value impact greater than $15 million). Our draft decision requested further information on the proposal. In response, Central Highlands Water suggested it intended to apply the threshold where the materiality of a cost increase (or revenue decrease) exceeds $15 million (nominal) during the regulatory period. We note Central Highlands Water's commitment to reducing customer risk. However, there may be instances that necessitate a cost pass through to Central Highlands Water's customers.

Our draft decision noted Central Highlands Water would accept a method set by the commission to adjust prices to reflect movements in the cost of debt.

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

Our final decision approves Central Highlands Water's existing uncertain and unforeseen events mechanism. Its price determination also includes the mechanism developed by the commission to allow its prices to change in response to movements in the cost of debt.

New customer contributions

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

Our draft decision proposed to accept Central Highlands Water's proposal to maintain the standard water new customer contribution charge at the 2017-18 level until 2022-23 (plus annual adjustments for inflation).[59] For negotiated new customer contributions, we proposed to approve Central Highlands Water's proposed method of calculating a charge in accordance with the requirements of our new customer contribution pricing principles.[60]

In its response to our draft decision, Central Highlands Water noted it will update its new customer contribution negotiating framework to reflect the circumstances where negotiated charges will be used. Central Highlands Water should make its negotiating framework publicly available, in

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

[60] Essential Services Commission 2016, *Guidance paper,* op. cit., p. 62.

addition to any development servicing plans, to assist developers understanding of whether a standard or negotiated charge will apply to a new customer connection.[61]

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.

For the reasons set out above, we consider it appropriate to maintain the views expressed in our draft decision. Our final decision approves Central Highlands Water's proposed new customer contribution charges, including its method of calculating negotiated contribution charges, as they are consistent with the requirements of our guidance.[62]

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

Financial position

In approving prices, we must have regard to the financial viability of the water industry.[63] 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 Central Highlands Water's prices. We have assessed that, under our final decision, Central Highlands Water will generate sufficient cash flow to deliver on service commitments, including financing costs arising from investments to meet service expectations.

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

[62] Essential Services Commission 2016, *Guidance paper, op. cit.*, pp. 62-63.

[63] WIRO clause 8(b)(ii) and ESC Act section 8A(1)(b).

3. PREMO rating

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

For the 2018 price review, 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 final decision is to accept Central Highlands Water's proposed return on equity of 4.9 per cent, based on our PREMO review.

Our review of Central Highlands Water's PREMO rating

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

Table 3.1 PREMO Rating

	Overall PREMO rating	Risk	Engagement	Management	Outcomes
Central Highlands Water's rating	**Advanced**	Advanced	Advanced	Advanced	Advanced
Commission's draft decision rating	**Advanced**	Advanced	Advanced	Advanced	Advanced
Commission's final decision rating	**Advanced**	Advanced	Advanced	Advanced	Advanced

Consistent with our draft decision, our final decision rates Central Highlands Water's price submission as 'Advanced' under PREMO. In support of its PREMO rating, we note:

- The quality of Central Highlands Water's engagement. In particular, we consider Central Highlands Water's program was inclusive and representative of its customer base. This enabled the corporation to target service improvements, such as a commitment to address water quality in a number of small towns. We also consider the information provided to customers was appropriate for the purpose and nature of its engagement. These factors support Central Highlands Water's Engagement rating.

- Central Highlands Water's proposal to deliver better service outcomes. Along with improvements to water quality, Central Highlands Water has proposed to improve service targets for a number of other outcomes. This, along with its proposal for generally stable or falling prices, indicates that Central Highlands Water customers will receive greater value. These factors support Central Highlands Water's Outcomes rating.
- Central Highlands Water has proposed to expand its guaranteed service level scheme, and accept greater revenue risk in relation to delivering on its service commitments. We note Central Highlands Water has a strong track record in delivering its major capital projects on time. This indicates that internal processes for budgeting and planning are sound. It has proposed to continue with its price cap form of price control, thereby managing demand risk for its customers. These factors support Central Highlands Water's Risk rating.

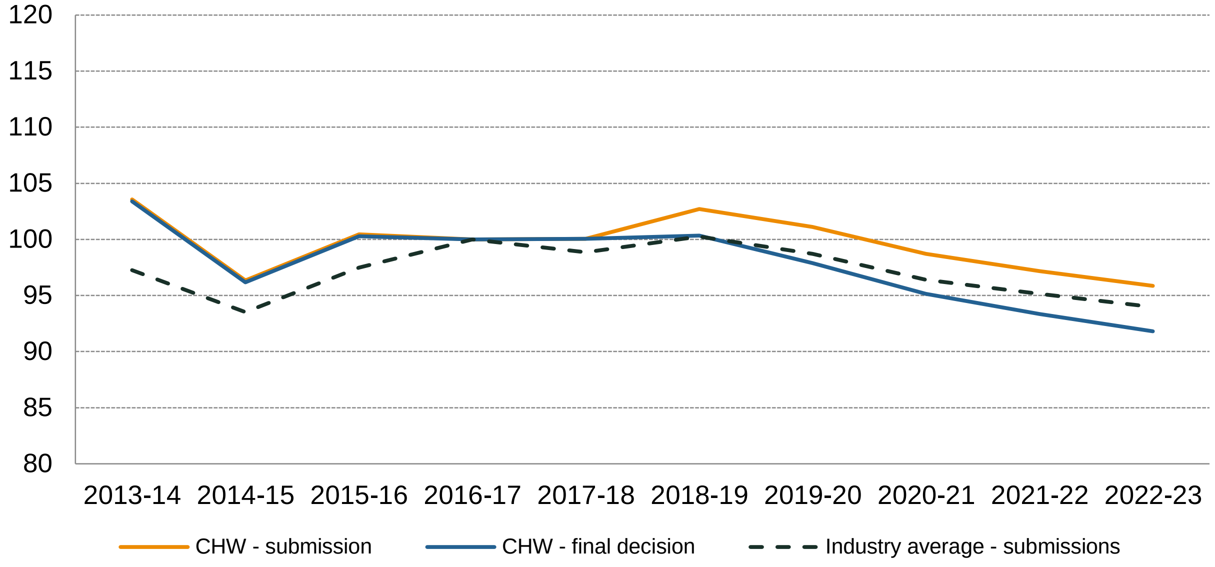
Our draft decision approved a rating of 'Advanced' for Management for Central Highlands Water. We considered its self-rating was supported by our expenditure review, which proposed no change to its capital expenditure forecast. Its Management rating was also supported by the high quality of its written submission and financial model. On controllable operating cost efficiency (measured in relation to customer connections), its price submission forecasts incorporated an expected rate of improvement slightly higher than the industry average (Figure 3.1).

For all corporations, our draft decision noted that wage increases above inflation should be funded through efficiency improvements or via higher revenue generated from the customer growth forecast by the corporation. Central Highlands Water's response to our draft decision again sought recovery of these costs. However it provided no new information supporting this additional expenditure. We expect an 'Advanced' proposal would set ambitious targets to absorb these costs.

These factors prompted us to consider whether an 'Advanced' rating for Management was still warranted. However, on balance we have retained our draft decision rating, taking a more conservative approach given this is the first review under the PREMO framework.

Our final decision to rate Central Highlands Water's price submission as 'Advanced' is reflected in the return on equity we have approved at pages 20 to 21.

Figure 3.1 Controllable operating expenditure per water connection
Index: 2016-17=100



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

Appendix A – submissions received on draft decision

Name or organisation	Date received
Kingspan Environmental and Urban Water Cycle Solutions	23 May 2018
Water Services Association of Australia	15 May 2018
Consumer Action Law Centre	8 May 2018

Appendix B – approved service standards

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

Central Highlands Water's approved service standards

Service Standard	2018-19	2019-20	2020-21	2021-22	2022-23
Water	0	0	0	0	0
Number of customers experiencing more than 5 unplanned water supply interruptions in the year (number)	45	45	45	40	40
Average time taken to attend bursts and leaks (priority 1) (minutes)	70	70	70	65	65
Average time taken to attend bursts and leaks (priority 2) (minutes)	450	450	450	450	450
Average time taken to attend bursts and leaks (priority 3) (minutes)	120	120	120	120	120
Average duration of unplanned water supply interruptions (minutes)	200	200	200	175	175
Average duration of planned water supply interruptions (minutes)					
Sewerage					
Customers receiving more than 3 sewer blockages in the year (number)	0	0	0	0	0
Average time to attend sewer spills and blockages (minutes)	45	45	45	40	40
Average time to rectify a sewer blockage (minutes)	120	120	120	120	120
Spills contained within 5 hours (per cent)	100	100	100	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 Central Highlands Water.

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

Central Highlands 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 Central Highlands Water.

Central Highlands Water's approved GSL scheme

Approved service level obligation	Approved payment ($)
Failure to provide clean drinking water with the presence of dirty water (more than 5 turbidity units) as the result of a Central Highlands Water fault	100
Failure to rectify an unplanned interruption to a customer's water supply upon becoming aware of the interruption	100
Water supply interruptions for each customer in any 12 month period	100
Failure to repair leaking service upon becoming aware of the leak	100
In the event of a sewer spill within a customer's house, which is caused by Central Highlands Water, the annual wastewater service fee will be refunded as a rebate	750
Failure to rectify a sewer interruption upon becoming aware of the interruption	100
Sewer sewerage service interruptions for each customer in any 12 month period	100
Restricting the water supply of, or taking legal action against, a residential customer prior to taking reasonable endeavours to contact the customer and provide information about help that is available if the customer is experiencing difficulties paying.	300

Appendix D – rate of return

A submission from the Consumer Action Law Centre (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). It also recommends 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. These recommendations are based on a report prepared by CME for CALC.[64]

A number of the arguments raised in the CALC submission have previously been considered by the Australian Energy Market Commission (AEMC), in the context of a proposal to change the National Electricity Rules to provide for return on debt allowances for government-owned network businesses.[65] The AEMC did not accept that proposal for a number of reasons, including:

- Government-owned service providers do not access debt capital markets directly, but rather, their debt is managed by the respective state government's treasury corporations through the issuance of government bonds. While treasury corporations may have access to lower debt funding costs due to the government's higher credit rating, the state-owned service providers borrowing costs do not reflect this. Rather, the state-owned service providers borrow from state treasuries at rates consistent with the risk inherent in the businesses as reflected in their stand-alone credit rating.
- The difference between the government's borrowing costs and the costs faced by the state-owned service providers, commonly referred to as debt guarantee fees represents consideration for state taxpayers accepting the corporations' credit risk. This mechanism ensures that the borrowing costs faced by each state-owned business reflect the nature of their businesses, not the taxation powers of their government lenders. If state-owned service providers were to access debt capital markets directly, then they would face debt financing interest rates that reflected their stand-alone credit ratings.

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[64] Consumer Action Law Centre, op. cit., Appendix A.

[65] Australian Energy Market Commission, Rule Determination: National Electricity Amendment (Economic Regulation of Network Service Providers) Rule 2012; National Gas Amendment (Price and Revenue Regulation of Gas Services) Rule 2012, 29 November 2012; Australian Energy Market Commission, Draft Rule Determinations: Draft National Electricity Amendment (Economic Regulation of Network Service Providers) Rule 2012; Draft National Gas Amendment (Price and Revenue Regulation of Gas Services) Rule 2012, 23 August 2012, pp 78-89.

The Australian Energy Regulator has similarly rejected arguments for separate rate of return benchmarks to be established for state-owned and privately owned businesses.[66]

We agree with this analysis, and for similar reasons, we consider that the cost of debt allowed for water corporations should not be adjusted to account for government ownership.

We note that the financing costs faced by each water corporation are comparable to those faced by a privately owned business facing similar risks. This is because a water corporation's borrowing costs include a financial accommodation levy (FAL), applied by the Victorian government. While government accesses lower debt costs due to its taxation powers, the FAL means a water corporation's financing costs are likely to be comparable to a private sector business.

Victoria's water corporations are subject to the competitive neutrality measures the government agreed to implement as part of the national competition policy agreement and related reforms.[67] This includes ensuring that borrowing costs reflect a water corporation's standalone risk profile and credit rating, which is achieved via the FAL.

The approach that we take to the rate of return (comprising the cost of debt and return on equity) is to estimate the efficient financing costs for an entity facing a similar degree of risk to a regulated water corporation, which is consistent with the requirements of the Water Industry Regulatory Order 2014 (WIRO).[68]

In our view, the risk faced by each water corporation is not materially affected by the fact that it is government owned. Therefore, the key issue is the degree of risk faced by each business in the provision of services. Our decision to allow a cost of debt based on a BBB credit rating reflects our assessment of the degree of risk faced by each water corporation in the provision of services.

Adopting the approach recommended by CALC, in our view, would mean an efficient water corporation would not have a reasonable opportunity to recover their actual debt costs – using CME's estimates, the allowable rate for the cost of debt would be lower than the rates an efficient water corporation actually pay. As well as being inconsistent with government policy, we consider this would also be inconsistent with the financial viability and efficiency objectives in the WIRO.

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[66] Australian Energy Regulator, *Explanatory Statement: Rate of Return Guideline,* December 2013, pp. 44–45.

[67] 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.

[68] 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).

CALC's submission also recommended a one per cent reduction to each return on equity value in the PREMO matrix.[69] 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.

We consider 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 allowed by other Australian-based regulators.[70]

We also consider 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 also had regard to equity market conditions and the exposure of a water corporation to non-diversifiable market risk. Market conditions and the exposure of a water corporation to market risk will not be materially affected by government ownership.

The paper by CME also argues for a reduction in the allowable rates for the return on equity to reflecting the prevailing revenue cap form of price control which provides for revenue certainty. Only one urban water corporation (Yarra Valley Water) has a revenue cap form of price control. As well, water corporations operating under a revenue cap are exposed to risks associated with costs.

[69] Consumer Action Law Centre 2018, op. cit., p. 8

[70] Essential Services Commission of South Australia, op. cit.; Independent Pricing and Regulatory Tribunal 2017, August, op. cit.