

Southern Rural Water final decision

2018 Water Price Review

19 June 2018

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Summary

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

In March 2017, we released our draft decision on Southern Rural Water's price submission.¹ The draft decision set out our preliminary views on Southern Rural 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 Southern Rural 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 Southern Rural Water.² The price determination sets out the maximum prices Southern Rural 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 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.

Southern Rural Water will improve services

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

- improving processing times for customer orders

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

- facilitating trade of unused water and improving water availability
- improving consistency of irrigation flow rates
- improving access to real-time usage information, and making it easier to transact online.

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

Our final decision approves a revenue requirement of \$152.1 million over the five year period starting 1 July 2018.³ This is \$2.7 million or 1.8 per cent lower than our draft decision, and mainly reflects updates to remove non-prescribed costs from the operating expenditure forecasts (see pages 9 to 12).

We approve Southern Rural Water’s proposals to simplify tariffs

Our final decision approves Southern Rural Water’s proposed tariff structures, some of which are being simplified. We approve Southern Rural Water’s proposals to combine some existing tariffs, and to remove periodic licence renewal fees for surface and groundwater customers.

Our final decision also approves Southern Rural Water’s proposed hybrid revenue cap form of price control. The majority of Southern Rural Water’s annual charges will continue to be subject to a revenue cap with a ten per cent annual rebalancing constraint on individual tariffs. This means the revenue Southern Rural Water can earn is fixed at the start of its regulatory period, but customer prices may vary annually – within pre-defined limits – so the corporation can meet its revenue requirement.

Southern Rural Water’s miscellaneous charges (application fees) will continue to be subject to a tariff basket form of price control.

For more detail on tariffs and the form of price control, see pages 20 to 22.

Southern Rural Water’s price submission is rated as ‘Advanced’ under PREMO

Consistent with our draft decision, our final decision accepts Southern Rural Water’s PREMO self-rating of its price submission as ‘Advanced’. Southern Rural Water’s PREMO rating is supported by the increased value the corporation will deliver its customers. Southern Rural Water’s irrigation bills will generally remain steady from 1 July 2018 (Macalister and Werribee flat, Bacchus March up around 1.7 per cent), with groundwater and surface water bills reducing by a bit over two per cent (in constant price \$2018-19 terms).

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.

We found Southern Rural Water’s Engagement to be ‘Leading’, justified by the opportunity its customer committees had to influence the corporation’s proposals. Feedback to us from each of the chairs of Southern Rural Water’s committees was very positive about Southern Rural Water’s engagement approach.

Figures A and B summarise our final decision on PREMO. More detail on our assessment of Southern Rural Water’s PREMO rating is provided in Chapter 3. Southern Rural Water is one of nine businesses 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
Southern Rural Water’s rating	Advanced	Standard	Leading	Advanced	Advanced
Commission’s rating	Advanced	Standard	Leading	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		
	GMMWater			
	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 our 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 guidance⁶
- the principle that prices should be easily understood by customers and provide signals about the efficient costs of providing services, while avoiding price shocks where possible
- the principle that prices should take into account the interests of customers of the regulated entity, including low income and vulnerable customers.

A separate document lists the specific objectives and the various matters the commission must have regard to when making a price determination and provides a guide to where we have done so for our final decision for Southern Rural Water.⁷

In 2016, we issued guidance to Southern Rural Water to inform its price submission. The guidance set out how we will assess Southern Rural 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 Southern Rural 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, *Southern Rural Water final decision, 2018 Water Price Review – commission's consideration of legal requirements*, 19 June. This is available at www.esc.vic.gov.au/waterpricereview.

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

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

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

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

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

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

We finalised our new approach to water pricing in October 2016.¹³

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

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

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

PREMO

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

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

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 Southern Rural Water's price submission

We have made our price determination for Southern Rural Water after considering: Southern Rural 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 Southern Rural Water's price submission are available on our website (to the extent the content is not confidential).

Southern Rural Water's price submission and financial model presented clear and comprehensive information to support its proposals. Southern Rural 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. Southern Rural 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 Southern Rural Water (1 July 2018 to 30 June 2023) in its price submission. Our guidance proposed to approve a five year regulatory period, subject to any alternative and justified proposal.¹⁹

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

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

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

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

Customer engagement

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

The engagement by Southern Rural Water:

- used a range of methods including on-line and phone surveys, regional focus groups, one on one interviews, social media, attendance at industry field days
- was informed by findings from its ongoing engagement program and its four customer consultative committees, which represent each of the four major irrigation areas
- covered topics such as service improvements related to water trading, maintenance of irrigation assets, water security and its strategy for the Macalister Irrigation District.

More details about Southern Rural Water's engagement are available in its price submission.²¹

Evidence that Southern Rural Water's engagement influenced its proposals includes:

- taking a more proactive role in facilitating water trading in line with strong customer support that Southern Rural Water do more to promote water trading
- simplifying and removing some tariffs in response to customer feedback
- implementing a customer portal to allow access to online services in response to feedback that customers value easier ways to manage their interactions with Southern Rural Water.

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

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

Outcomes

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

- Southern Rural Water provides great customer service

²¹ Southern Rural Water's price submission is available on our website at www.esc.vic.gov.au. See pages 12 to 18.

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.

- Southern Rural Water’s water supply system enables good practice irrigation
- Southern Rural Water manages water resources well, maintaining a good balance between customer needs as a water user and the sustainability of the resource
- Southern Rural Water works to manage customer water needs and entitlements
- Southern Rural Water keeps prices as low as possible.

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

- improving processing times for customer orders
- facilitating trade of unused water and improving water availability
- improving consistency of irrigation flow rates
- improving access to real-time usage information, and making it easier to transact online.

Southern Rural Water’s proposed measures and targets for reporting against these outcomes are set out at pages 5 to 10 of its price submission. Southern Rural Water has committed to reporting to customers annually against each of these measures. Performance information will be available on its website and via newsletters targeted to each customer group and region. Performance will also be discussed with Customer Consultative Committees.

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

Service standards

Southern Rural Water has also provided a list of service standards that it will include in its customer charter. These service standards and Southern Rural Water’s targets until 2023 are set out in Appendix B.

Consumer Action Law Centre 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’.²⁴ We note that Southern Rural Water proposed targets for standards relating to reliability and attending faults that improve on past targets, and continue to improve over the 2018-23 period.

²⁴ Consumer Action Law Centre, op. cit., p. 4.

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 Southern Rural 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 Environment Protection Authority Victoria and the Department of Health and Human Services.²⁵ Along with forecast demand, it is an input to calculating prices.

Our draft decision approved a revenue requirement of \$154.8 million over a five year period starting 1 July 2018. Our final decision approves a lower revenue requirement of \$152.1 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 Southern Rural Water's forecast operating expenditure (see pages 9 to 12). The reduced return on assets reflects our updates to the cost of debt following our draft decision (see pages 17 to 18). 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	21.9	21.6	21.6	21.7	22.0	108.8
Return on assets	2.7	3.2	3.6	3.8	3.8	17.2
Regulatory depreciation	3.8	4.7	5.4	5.9	6.3	26.1
Tax allowance	0.0	0.0	0.0	0.0	0.0	0.0
Revenue requirement	28.4	29.5	30.6	31.4	32.1	152.1

Note: Numbers have been rounded

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 Southern Rural Water in the regulatory period from 1 July 2018. We had regard to their views in our draft decision.

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	29.1	30.0	31.1	31.9	32.7	154.8
Operating expenditure	-0.6	-0.5	-0.5	-0.6	-0.6	-2.9
Return on assets	-0.03	-0.01	-0.002	-0.01	-0.01	-0.06
Regulatory depreciation	0.01	0.04	0.05	0.05	0.05	0.2
Total adjustments	-0.6	-0.5	-0.5	-0.5	-0.6	-2.7
Final decision – revenue requirement	28.4	29.5	30.6	31.4	32.1	152.1

Note: Numbers have been rounded

Operating expenditure

Operating expenditure is an input to the revenue requirement. Our draft decision proposed to reduce Southern Rural Water’s total controllable operating expenditure forecast of \$103.0 million for the 2018–23 period by \$2.1 million to \$100.9 million. The reduction comprised \$0.4 million to correct inflation and cost of debt errors in Southern Rural Water’s submission, and \$1.8 million to remove costs for providing state environmental water from its baseline expenditure because this is not a prescribed service.

Aside from these corrections, we considered Southern Rural Water’s proposed operating expenditure was prudent and efficient, and we set out our reasoning for this in our draft decision (pages 9 to 14). In summary, we found:

- Evidence indicating its baseline controllable operating expenditure reflects an efficient benchmark.²⁶
- Southern Rural Water has proposed the largest percentage reduction to controllable operating expenditure of all the water corporations.
- Southern Rural Water has not sought any additional expenditure above the growth-adjusted baseline. Any forecast increases in wages (above inflation) and electricity prices are managed

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

within its proposed efficiency improvement targets, whereas some other businesses have sought additional expenditure for these items.

- \$1.75 million for providing environmental water to the Victorian Environmental Water Holder (VEWH) is not a prescribed service, as defined under the Water Industry Regulatory Order 2014 (WIRO).²⁷

We noted in our draft decision that we would update the forecast non-controllable operating expenditure for our final decision, and adjust for the latest inflation and external bulk charges data.²⁸

Southern Rural Water's response to our draft decision sought further information on the transfer of VEWH costs from prescribed (regulated) to non-prescribed services because it considered there might be implications for other charges.²⁹ We discussed with Southern Rural Water the definitions of prescribed services under the WIRO. Where Southern Rural Water provides a non-prescribed service, the commission has no power to determine a price and as a result, the cost of providing the service must be excluded from the revenue requirement. Following our draft decision, Southern Rural Water identified other non-prescribed services and advised us to remove:

- \$2.57 million from its forecast controllable operating expenditure³⁰
- \$0.33 million from its non-controllable operating expenditure.

No other new considerations were presented in submissions received following the draft decision which caused us to change our views on 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.³¹

We have reduced our draft decision forecast for Southern Rural Water's non-controllable operating expenditure by \$0.32 million across the 2018–23 period, resulting from the following adjustments:

²⁷ Clause 7 of the WIRO outlines declared and prescribed services that are regulated by the commission.

²⁸ Non-controllable costs are those that cannot be directly or indirectly influenced by a water corporation's decisions.

²⁹ Southern Rural Water 2018, *Southern Rural Water draft decision: 2018 Water Price Review: Responses to specific issues*, 5 May, p. 2.

³⁰ Southern Rural Water operates storages on behalf of various entitlement owners. Under the WIRO, some of these entitlements are considered prescribed, and some non-prescribed. As the service provision, and therefore the cost base, is not separable for individual entitlement holders, a proportional share of the total cost base has been deducted as a single adjustment against the revenue requirement via operating expenditure.

³¹ 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.

- reducing other non-controllable costs by \$0.33 million over the 2018–23 period, as advised by Southern Rural Water
- increasing the forecast 2018-19 environmental contribution from \$0.529 million to \$0.531 million based on the latest inflation data. We have then declined this value in real terms across the period (a total increase of \$0.01 million).

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	22.5	22.1	22.1	22.3	22.7	111.7
Non-prescribed storage operator charges (additional to VEWH)	-0.54	-0.52	-0.50	-0.50	-0.51	-2.57
Total adjustments to controllable costs	-0.54	-0.52	-0.50	-0.50	-0.51	-2.57
Environmental contribution	0.002	0.002	0.002	0.002	0.002	0.01
Not-prescribed portion of recoverable works	-0.09	-0.02	-0.02	-0.05	-0.14	-0.33
Total adjustments to non-controllable costs	-0.09	-0.02	-0.02	-0.05	-0.14	-0.32
Final decision – total operating expenditure	21.9	21.6	21.6	21.7	22.0	108.8

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 Southern Rural Water’s revenue requirement (Table 2.1). We consider our final decision on Southern Rural Water’s forecast operating expenditure is consistent with the

Our assessment

requirements of the WIRO and the criteria for prudent and efficient expenditure outlined in our guidance.³²

Table 2.4 Final decision – Operating expenditure
\$ million 2017-18

	2018-19	2019-20	2020-21	2021-22	2022-23	Total
Controllable costs	19.6	19.7	19.7	19.7	19.7	98.3
Non-controllable costs	2.2	2.0	1.9	2.0	2.4	10.5
Bulk services ^a	1.3	1.3	1.3	1.3	1.3	6.6
Environmental contribution ^b	0.5	0.5	0.5	0.5	0.5	2.5
Licence fees – ESC ^c	0.019	0.019	0.019	0.019	0.028	0.102
Licence fees – DHHS ^c	0.002	0.002	0.002	0.002	0.002	0.010
Licence fees – EPA ^c	0.000	0.000	0.000	0.000	0.000	0.000
Other	0.3	0.1	0.1	0.2	0.5	1.2
Final decision – total operating expenditure	21.9	21.6	21.6	21.7	22.0	108.8

^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 Southern Rural Water does not represent the amount that Southern Rural 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.

³² Essential Services Commission 2016, *Guidance paper*, op. cit., p. 31.

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 Southern Rural 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 \$44.1 million. We proposed to approve this amount as Southern Rural Water's actual net capital expenditure was 39.7 per cent lower than the forecast used to approve maximum prices for the period from 1 July 2013.^{33 34} Southern Rural Water also calculated its closing regulatory asset base in accordance with the requirements of our guidance.

No other new considerations were raised in 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 \$44.1 million. The calculations are provided at Table 2.5.

³³ Net capital expenditure is calculated by deducting government and customer contributions from gross capital expenditure.

³⁴ We take a risk-based approach to including past capital expenditure in the regulatory asset base. We undertake a prudence 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	39.6	45.9	47.3	44.5	48.2
Plus gross capital expenditure	11.5	19.8	14.8	17.8	21.3
Less government contributions	0.0	3.2	7.9	5.7	7.7
Less customer contributions	0.8	10.8	4.7	3.0	12.4
Less proceeds from disposals	0.0	0.8	0.9	0.8	0.6
Less regulatory depreciation	4.4	3.6	4.1	4.5	4.7
Closing RAB 30 June	45.9	47.3	44.5	48.2	44.1

Note: Numbers have been rounded

Forecast regulatory asset base

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

Table 2.6 sets out our final decision on Southern Rural Water's forecast regulatory asset base from 1 July 2018.³⁵ The forecast regulatory asset base has been updated to reflect adjustments between our draft and final decisions to forecast expenditure.

³⁵ 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	44.1	61.3	71.6	84.8	91.1	91.6
Plus gross capital expenditure	40.1	44.5	27.4	15.4	8.3	7.8
Less government contributions	16.1	21.7	6.5	1.9	0.0	0.0
Less customer contributions	1.5	7.9	2.4	1.1	1.2	0.9
Less proceeds from disposals	0.8	0.7	0.7	0.7	0.7	0.7
Less regulatory depreciation	4.5	3.8	4.7	5.4	5.9	6.3
Closing RAB 30 June	61.3	71.6	84.8	91.1	91.6	91.5

Note: Numbers have been rounded

Capital expenditure

Capital expenditure is an input to estimating the regulatory asset base. In our draft decision, we proposed to reduce Southern Rural Water’s gross capital expenditure forecast of \$103.4 million for the 2018–23 period by \$1.6 million to correct an error in its submission, to establish a benchmark gross capital expenditure of \$101.8 million. We considered this represented prudent and efficient capital expenditure, and we set out our reasoning for this in our draft decision (pages 17 to 20). In summary, we found:

- Southern Rural Water’s price submission and business cases provided evidence that its forecasts for capital expenditure are efficient.
- Southern Rural Water has an appropriate approach for managing expenditure associated with uncertain projects.
- We considered Southern Rural Water’s approach to forecasting its capital expenditure is consistent with the requirements of our guidance.

In response to our draft decision, Southern Rural Water identified that various minor adjustments within the financial model (in particular, the reduced rate of return and the timing of government contributions) had created some headroom within prices for the Macalister Irrigation District. Consistent with its customers’ preference to invest in modernisation rather than reduce prices,

Southern Rural Water has included a further \$1.5 million against its Macalister Irrigation District 2030 Phase 2 project, which we accept.

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

Accordingly, we have adopted Southern Rural Water’s proposed increase and the gross capital expenditure benchmark proposed in our draft decision for our final decision (Table 2.7). We consider this benchmark is consistent with our guidance and WIRO principles, and is used to calculate our final decision on Southern Rural Water’s forecast regulatory asset base (Table 2.6) and its revenue requirement (Table 2.1).³⁶

Table 2.7 Final decision – Gross capital expenditure
\$ million 2017-18

	2018-19	2019-20	2020-21	2021-22	2022-23	Total
Draft decision – gross capital expenditure	43.7	26.6	15.4	8.3	7.8	101.8
MID2030 2	0.75	0.75	0.00	0.00	0.00	1.50
Total adjustments to gross capital expenditure	0.75	0.75	0.00	0.00	0.00	1.50
Final decision – gross capital expenditure	44.5	27.4	15.4	8.3	7.8	103.3

Note: Numbers have been rounded

The benchmark that we adopt for Southern Rural 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. Southern Rural 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 Southern Rural Water’s approach for addressing uncertain capital expenditure. We reiterate that Southern Rural Water will need to demonstrate the efficiency of additional costs incurred during the 2018–23 period if seeking to include them in the regulatory asset base.

³⁶ Essential Services Commission 2016, *Guidance Paper*, op. cit., p. 35; WIRO clause 8(b).

Customer contributions

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

Our draft decision proposed to accept Southern Rural Water's proposed forecast for customer contributions. Southern Rural Water proposed to utilise savings captured in a modernisation fund to offset the costs of proposed modernisation capital projects, in agreement with customer committees.

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

For the reasons set out above, our final decision confirms 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 Southern Rural 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.³⁷

Consumer Action Law Centre recommends that we set the benchmark cost of debt at five per cent or around one per cent lower than the amount allowed in our draft decision (6.05 per cent per annum in nominal terms).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.

³⁷ We received data on the actual trailing average cost of debt for 2017-18 from Treasury Corporation Victoria in April 2018.

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

³⁹ *Ibid.*, Appendix A.

⁴⁰ WSAA 2018, *WSAA Submission to ESC Cost of debt*, 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.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 C.

Our final decision adopts the benchmark cost of debt as set out in Table 2.8.⁴²

Table 2.8 Final decision – Trailing average cost of debt

	2008-09	2009-10	2010-11	2011-12	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18
Cost of debt (nominal)	6.9%	7.4%	7.0%	6.3%	5.3%	7.1%	5.4%	5.3%	4.9%	4.5%

Note: Numbers have been rounded

Return on equity – PREMO rating

Southern Rural Water rated its price submission as ‘Advanced’. Based on its PREMO self-rating, Southern Rural Water proposed a rate of return on equity of 4.9 per cent per annum. This reflects the maximum return rate allowed in our guidance for a price submission rated as ‘Advanced’.⁴³

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

Consumer Action Law Centre (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.

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 We received data on the actual trailing average cost of debt for 2017-18 from Treasury Corporation Victoria in April 2018.

⁴³ Essential Services Commission 2016, *Guidance paper*, op. cit., p. 49.

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

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

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.⁴⁶

Consistent with our draft decision, our final decision accepts Southern Rural 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 Southern Rural Water's forecast regulatory depreciation, as it was calculated in a manner consistent with the requirements of our guidance.⁴⁷

Our final decision on regulatory depreciation is slightly higher than our draft decision due to final decision adjustments to the forecast capital expenditure, as set out in Table 2.7.

No new considerations for depreciation were raised in submissions on our draft decision.

For the reasons set out above, our final decision adopts Southern Rural Water's revised 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 Southern Rural Water's forecasts for zero tax in its revenue requirement, as it was calculated consistently

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.

⁴⁶ Essential Services Commission of South Australia 2016, *SA Water regulatory determination 2016*, Final determination, June; Independent Pricing and Regulatory Tribunal 2017, *WACC biannual update*, August.

⁴⁷ Essential Services Commission 2016, *Guidance paper*, op. cit., p. 42.

with the method required by our guidance.⁴⁸ No new considerations were presented in submissions received following the draft decision which caused us to change our views on the tax allowance.

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

Demand

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

For these reasons, our final decision confirms our draft decision.

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

Form of price control

Our draft decision accepted Southern Rural Water's proposal to continue with its current form of price control, a hybrid revenue cap. However, we did not accept its proposal to apply an annual rebalancing constraint based on customer bill movements, rather than individual prices for tariffs under its revenue cap. We considered its proposal was not consistent with the requirements of the WIRO.

In response to our draft decision, Southern Rural Water proposed to continue with its existing rebalancing constraint of ten per cent on individual prices captured under its revenue cap. Our final decision approves Southern Rural Water's proposed constraint, as our guidance noted that we would generally approve a continuation of existing arrangements and its proposal is compliant with our guidance and the WIRO. Southern Rural Water may choose to apply its own constraint on bill movements that may arise from any tariff rebalancing during the regulatory period.

Our draft decision did not accept the proposed shift of simple transfer fees to the hybrid revenue cap as Southern Rural Water had not provided the commission with sufficient information on the strategy underlying the proposal. In response to our draft decision, Southern Rural Water provided the commission with additional information on its proposed tariff reform during the regulatory period and stated that implementation of any reform would be in consultation with customers and in accordance with regulatory requirements. Southern Rural Water also noted that shifting licence

⁴⁸ Essential Services Commission 2016, *Guidance paper*, op. cit., pp. 50-51.

transfer fees to the revenue cap would provide greater flexibility to bundle transfer fees with annual licence fees and allow customers to trade against entitlements without incurring additional fees.⁴⁹ In light of this additional information our final decision approves Southern Rural Water's proposed shift of licence transfer fees into its revenue cap.

Our draft decision proposed to accept Southern Rural Water's proposed annual rebalancing constraint of five per cent on its application fees under a tariff basket. We note that this is tighter than the existing rebalancing constraint of ten per cent, which will improve price stability.

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, we accept Southern Rural Water's revised proposal to continue its existing rebalancing constraint on tariffs under its revenue cap, and to include licence transfer fees within its revenue cap. Our final decision also maintains the views we expressed in our draft decision accepting Southern Rural Water's proposed continuation of a tariff basket for application fees, although with a tighter annual constraint on price movements of five per cent.

Tariff structures and prices

Our draft decision proposed to accept Southern Rural Water's proposal to:

- simplify tariff structures in the Macalister, Werribee and Bacchus Marsh Irrigation areas and the Macalister and Thompson and Werribee Regulated systems for easier understanding
- simplify tariff structures for unregulated surface and ground water for easier understanding
- remove the intensive management charge for Koo Wee Rup groundwater as additional monitoring costs are no longer incurred
- simplify the naming of its tariffs and remove charges that are no longer applicable to any customers
- remove licence renewal fees for surface and groundwater licences, in response to customer feedback, and fund the renewal process via the existing annual licence charges
- simplify its miscellaneous fees (application charges), reduce the cost of repeat transfers and revise the tiered structure for surface and groundwater applications. Southern Rural Water confirmed that these changes are consistent with the miscellaneous pricing principles.⁵⁰

Our draft decision noted that we provided the water corporations with a large degree of discretion to decide on individual tariff structures.⁵¹ This recognises water corporations are often best placed

⁴⁹ Southern Rural Water's response to our draft decision can be found on our website.

⁵⁰ Southern Rural Water confirmed this via a response to a RFI.

to consider the interests of customers in designing tariffs, and that existing tariff structures have been developed over time to deal with a variety of local circumstances.

We also proposed to accept Southern Rural Water's proposal to calculate tariffs for recycled water and miscellaneous services in accordance with the pricing principles referenced in our guidance. These pricing principles promote cost reflectivity of tariffs.

Our draft decision also noted that we do not have a role in setting the maximum price for environmental water as the services provided to VEWH are not defined as a prescribed service in the WIRO.⁵² In response to our draft decision, and subsequent discussions with the commission, Southern Rural Water has identified some further non-prescribed entitlements and removed the associated costs from its prescribed revenue requirement. We discuss the adjustments in more detail in our operating expenditure section on pages 9 to 12.

No new considerations were presented in submissions received following the draft decision which caused us to change our views on Southern Rural Water's proposed tariff structures.⁵³

In its response to our draft decision, Southern Rural Water proposed tariffs reflecting our draft decision on its revenue requirement. The proposed tariffs:

- reflect the forecast efficient costs of delivering services
- were informed by an extensive customer engagement program
- would allow the corporation to recover revenue sufficient to cover forecast efficient costs

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

Our price determination for Southern Rural 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). Southern Rural Water's irrigation bills will generally remain steady from 1 July 2018 (Macalister and Werribee flat, Bacchus March up around 1.5 per cent), with groundwater and surface water bills reducing by a bit over two per cent (in constant price \$2018-19 terms).

⁵¹ Essential Services Commission 2016, *Guidance paper*, op. cit., p. 55.

⁵² The commission has never regulated Victorian environmental water charges. The charge was implemented by corporations during 2012-13 to 2017-18 as a ministerial directive.

⁵³ On 23 May 2018 (after our consultation period had closed on our draft decision for Southern Rural 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 Southern Rural Water. Our response to the submission is set out in our final decision paper for Western Water.

Adjusting prices

In our draft decision we:

- proposed to approve Southern Rural Water’s proposal to continue the existing uncertain and unforeseen events mechanism
- proposed to work with Southern Rural Water on price adjustment formulas that allowed prices to adjust to changes in the cost of debt.

Southern Rural Water worked with the commission to establish a cost of debt adjustment formula that was consistent across the industry. Our approved cost of debt adjustment formula is set out in our determination for Southern Rural Water.

Our final decision approves Southern Rural Water’s uncertain and unforeseen events mechanism and updated price adjustment mechanisms as they satisfy the requirements of our guidance.

Financial position

In approving prices, we must have regard to the financial viability of the water industry.⁵⁴ We interpret the financial viability requirements under the *Essential Services Commission Act 2001* (Vic) and the Water Industry Regulatory Order (2014) to mean that the prices we approve should provide a level of certainty that each water corporation can generate sufficient cash flow to deliver on service commitments, including financing costs arising from investments to meet service expectations.

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

⁵⁴ 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 Southern Rural Water's proposed return on equity of 4.9 per cent, based on our PREMO review.

Our review of Southern Rural Water's PREMO self-rating

Southern Rural 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
Southern Rural Water's rating	Advanced	Standard	Leading	Advanced	Advanced
Commission's draft decision rating	Advanced	Standard	Leading	Advanced	Advanced
Commission's final decision rating	Advanced	Standard	Leading	Advanced	Advanced

We agree with Southern Rural Water's proposed PREMO self-ratings for each element of PREMO. In support of its self-ratings we note:

- Southern Rural Water's forecasts for improvements in efficiency. Under its proposal, Southern Rural Water's forecast for controllable operating costs in 2022-23 (the final year of its next

regulatory period) was more than three per cent lower than its 2016-17 result. This is the largest percentage reduction to controllable operating costs proposed by any corporation in the current price review.

- Informed by its engagement program, Southern Rural Water is proposing improvements in service outcomes. This includes in areas such as the consistency of irrigation flow rates, additional water availability, providing for real-time water usage information, and expanding online information and payment options for customers. This, along with generally flat or falling prices demonstrate Southern Rural Water's commitment to delivering better value to customers, consistent with an 'Advanced' PREMO rating for Outcomes.
- Southern Rural Water has proposed no changes to its approach to managing Risk on behalf of its customers. Its price submission addressed key risks being managed by the water corporation, including its approach to revenue and water supply risk. On this basis we agree with Southern Rural Water's proposed 'Standard' rating for Risk.

Southern Rural Water's engagement for its price submission relied heavily on the structures it has in place to inform its long-term business strategy. This includes drawing on its existing customer committees, results from its detailed biennial customer surveys, and customer field days. To inform its price submission it also undertook additional targeted engagement through surveys, focus groups, and one-on-one interviews, in order to design and test its proposals.

Southern Rural Water justified its 'Leading' rating for Engagement mainly on the basis of the quality of its engagement with existing customer committees. In order to assess this we contacted the chair of each customer committee to get their feedback on how Southern Rural Water engaged with the committee and the level of influence committees had on the proposals in the price submission.

All chairs provided positive feedback about Southern Rural Water's approach to engagement. This included the representativeness of committee members of the customer base, the appropriateness of the information committees received in order to provide a basis for feedback, the accountability of Southern Rural Water on issues committee members raise, and the opportunity each committee had to influence Southern Rural Water's proposals. On this basis, our final decision accepts a 'Leading' rating for Southern Rural Water's Engagement.

Consistent with our draft decision, we agree with Southern Rural Water's proposed overall PREMO self-rating of 'Advanced'. This is reflected in the return on equity we have approved at pages 18 and 19.

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 Southern Rural Water.

Southern Rural Water’s approved service standards

Service Standard	2018-19	2019-20	2020-21	2021-22	2022-23
Applications completed within set timeframes (% applications)	90	90	90	90	90
Delivery volume accuracy (Werribee Irrigation District) (% deliveries)	98	98	98	98	98
Delivery efficiency (Werribee Irrigation District) (% water)	70	75	80	80	80
Delivery reliability (Werribee Irrigation District) (% orders)	99	99	99	99	99
Delivery volume accuracy (Bacchus Marsh Irrigation District) (% deliveries)	98	98	98	98	98
Delivery efficiency (Bacchus Marsh Irrigation District) (% water)	70	75	80	80	80
Delivery reliability (Bacchus Marsh Irrigation District) (% orders)	99	99	99	99	99
Channel pool performance (Macalister Irrigation District) (% time)	78	79	81	82	85
Delivery efficiency (Macalister Irrigation District) (% water)	80	82	85	85	85
Delivery reliability (Macalister Irrigation District) (% orders)	99	99	99	99	99
Customers with access to Demand Management System (% customers)	40	50	60	70	75
Water is harvested at the maximum possible rate (Pykes Creek and Merrimu) (% time)	95	95	95	95	95

Service Standard	2018-19	2019-20	2020-21	2021-22	2022-23
Recycled water salinity (EC)	<1800	<1800	<1800	<1800	<1800
Headworks release within 10% or 5ML of ordered flow (Werribee system) (% time)	95	95	95	95	95
Headworks release within 10% or 1ML of ordered flow (Maribyrnong system) (% time)	95	95	95	95	95
Headworks release within 10% of ordered flow (Latrobe system) (% time)	95	95	95	95	95

Note: Numbers have been rounded

Appendix C – 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.⁵⁵ These recommendations are based on a report prepared by CME for CALC.⁵⁶

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.⁵⁷ 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

⁵⁵ Consumer Action Law Centre, op. cit.

⁵⁶ *ibid.*, Appendix A.

⁵⁷ 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.

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.⁵⁸

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.⁵⁹ 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.⁶⁰

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.⁶¹

⁵⁸ 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).

⁵⁹ Consumer Action Law Centre, *op. cit.*

⁶⁰ Essential Services Commission of South Australia 2016, *op. cit.*; Independent Pricing and Regulatory Tribunal 2017, August, *op. cit.*

⁶¹ 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.