

Wannon Water final decision

2018 Water Price Review

19 June 2018

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Contents

Summary	iv
1. Our role and approach to water pricing	1
2. Our assessment of Wannon Water's price submission	5
Regulatory period	5
Customer engagement	5
Outcomes	6
Service Standards	8
Guaranteed service levels	8
Revenue requirement	9
Operating expenditure	10
Regulatory asset base	18
Closing regulatory asset base	18
Forecast regulatory asset base	19
Capital expenditure	20
Customer contributions	22
Cost of debt	23
Return on equity – PREMO rating	24
Regulatory depreciation	25
Tax allowance	25
Demand	25
Form of price control	26
Tariff structures and prices	26
Adjusting prices	28
New customer contributions	29
Financial position	30
3. PREMO rating	31
Our review of Wannon Water's PREMO rating	31
Wannon Water's response to our draft decision on PREMO and our final decision	32
Appendix A – submissions received on draft decision	36
Appendix B – approved service standards	37
Appendix C – approved GSL schemes	38
Appendix D – rate of return	39

Summary

In September 2017, Wannon 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 Wannon Water's price submission.¹ The draft decision set out our preliminary views on Wannon 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 Wannon Water, we received two 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 Wannon Water.² The price determination sets out the maximum prices Wannon 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 Wannon Water

Our final decision approves a revenue requirement of \$331.4 million over the five year period starting 1 July 2018.³ This is \$0.01 million lower than our draft decision. A reduction in the forecast cost of debt was offset by increase in operating and capital expenditure approved in our final decision.

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

³ The revenue requirement is the forecast amount a water corporation needs to deliver on customer outcomes, government policy, and obligations monitored by technical regulators including the Environment Protection Authority Victoria and the Department of Health and Human Services. Along with forecast demand, it is an input to calculating the prices to be charged by a water corporation.

A summary of approved maximum prices for major services delivered by Wannon Water is set out from page 27. The estimated typical bill impacts of Wannon Water’s proposal and our final decision on residential customers are provided in Table A. The typical annual bill for owner occupiers and tenants will remain steady in 2018-19 (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)	146	\$1,121 ^a	\$1,121 ^b	\$1,121
Residential (Tenant)	146	\$205 ^a	\$205 ^b	\$205

^a Following a \$70 rebate paid to customers from a government efficiency review.

^b Includes a rebate.

Note: Numbers have been rounded

Wannon Water will improve services

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

- expanding the ways customers can contact the corporation
- improving the taste and smell of drinking water
- upgrading Warrnambool’s sewerage infrastructure to support growth.

Tariff structures are the same

Our final decision approves Wannon Water’s proposed tariff structures, which reflect a continuation of its current approach. For water services, we have approved Wannon Water’s proposal for a fixed service charge and a variable component that depends on water use. For residential customers, the variable component includes an inclining block structure where prices increase as higher amounts of water are used. For residential sewerage services, we have approved Wannon Water’s proposal for a fixed charge only. For non-residential sewerage services, we have approved Wannon Water’s proposal for a fixed service charge and a variable component.

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

For more detail on tariffs and the form of price control, see pages 25 to 27.

Summary

Wannon Water’s price submission is rated as ‘Basic’ under PREMO

Consistent with our draft decision, our final decision is to approve a rating of ‘Basic’ for Wannon Water’s price submission, compared to the ‘Standard’ proposed by Wannon Water. This mainly reflects our review of Wannon Water’s ratings for the Management and Risk elements of PREMO; both of which we have rated as ‘Basic’, compared to the ‘Standard’ proposed by Wannon Water.

In its response to our draft decision, Wannon Water requested that we ‘reassess and agree’ that its original ‘Standard’ PREMO rating was appropriate. Wannon Water’s reasons for seeking a reassessment are set out at pages 12 to 13 of its response to our draft decision.

While we have not agreed that a ‘Standard’ PREMO rating is justified at this time, we would accept an application from Wannon Water for us to consider a further review of its PREMO rating during the 2018-23 regulatory period.

Figures A and B summarise our final decision on PREMO. More detail on our assessment of Wannon Water’s PREMO rating is provided in Chapter 3.

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
Wannon Water’s rating	Standard	Standard	Advanced	Standard	Standard
Commission’s rating	Basic	Basic	Advanced	Basic	Standard

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 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 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 Wannon Water.⁷

In 2016, we issued guidance to Wannon Water to inform its price submission. The guidance set out how we will assess Wannon 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 Wannon 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, *Wannon 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 Wannon Water’s price submission

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

Our guidance included a number of matters water corporations must address in their price submissions. Wannon 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 Wannon Water (1 July 2023 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 Wannon 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 Wannon Water to engage with customers to inform its price submission.

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.

The engagement by Wannon Water:

- took place between December 2015 and September 2017
- used a range of methods including face to face and phone interviews, surveys, focus groups, community events and a deliberative forum
- sought views from a range of customer groups including residential, small business and major business, environmental, community and its stakeholder reference group
- covered topics such as prices, tariffs, service levels, the taste of water and the environment.

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

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

- its approach to service levels, with customers indicating they are satisfied with current outcomes
- introducing customer SMS and email alerts in response to feedback that customers like timely notification of service outages
- partnering with the community to develop investment plans to improve water quality, in response to feedback from customers about water quality issues.

The influence of Wannon 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.

Outcomes

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

- provide safe and reliable water supplies
- provide sewerage services that protect public health and the environment
- ensure the long-term resilience of services
- be responsive and willing to adapt as customer needs change
- protect and enhance the environment in line with community expectations
- partner with communities and help its region flourish

²¹ Wannon Water's price submission is available on our website at www.esc.vic.gov.au. See pages 13 to 20.

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.

- ensure it provides great value.²⁴

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

- expanding the ways customers can contact the corporation
- improving the taste and smell of drinking water
- upgrading Warrnambool's sewerage infrastructure to support growth.

Wannon Water's proposed measures and targets for reporting against these outcomes are set out at pages 21 to 52 of its price submission. Wannon Water has committed to reporting to customers annually against each of these measures. Performance information will be available on its website, via email and social media.

In early 2018–19, we will engage with Wannon Water to finalise measures and targets and how it will report to customers on its performance 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.²⁵ 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.²⁶ Further, water corporations already allocate funds to programs aimed to deliver payment options and hardship support required by our customer service codes. Wannon Water has responded to its customers' views on affordability by maintaining its current level of support to customers in financial hardship and by developing a Financial Inclusion Action Plan to guide its support of low income and vulnerable customers. Its response to our draft decision also proposed prices consistent with flat bills for residential customers.

²⁴ Wannon Water's price submission is available on our website at www.esc.vic.gov.au. See page 5.

²⁵ Consumer Action Law Centre, *op. cit.*, p. 3.

²⁶ 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.

Service Standards

Wannon 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 Wannon 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'.²⁷ We note that Wannon Water proposed standards for reliability and attending faults that remain largely the same as the past and will remain stable over the next five years.

We accept there are arguments for maintaining or decreasing service levels over time, particular where engagement identifies customers are satisfied with the existing level of service or do not support increasing expenditure to deliver improved service.

We note that Wannon Water's proposed standards for reliability and attending faults were informed by its engagement program to reflect the priorities of customers. This approach aligns with our expectation that water corporations consider customer preferences when forming service targets.

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

Guaranteed service levels

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

Wannon Water's proposed GSLs are set out on page 52 of its price submission. It proposed to revise some existing GSLs, and introduce a GSL relating to a sewage spill on a customer's property. We note Wannon Water has increased the payment amounts of some of its GSLs and extended the eligibility criteria of others.

Our draft decision provided an overview of Wannon Water's proposed GSLs.

²⁷ Consumer Action Law Centre, *op. cit.*, p. 6.

In its submission CALC supported GSL payments increasing over time.²⁸ We note Wannon Water has proposed to expand its GSL scheme, and increase some payments. For this reason, our final decision approves Wannon Water's proposed GSLs.

Wannon Water's GSLs are set out in Appendix C.

Wannon Water's commitment to GSL payments should these service levels not be met, forms part of the manner in which Wannon 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.²⁹ Along with forecast demand, it is an input to calculating prices.

Our draft decision proposed to approve a revenue requirement of \$331.5 million over a five year period starting 1 July 2018. Our final decision approves a slightly lower revenue requirement of \$331.4 million. This reflects our final decision on each element of the revenue requirement, as set out in Table 2.1. 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.

²⁸ Consumer Action Law Centre, *op. cit.*, p. 1.

²⁹ We met with officers of the Department of Environment, Land, Water and Planning, Department of Health and Human Services, and Environment Protection Authority Victoria, to discuss their expectations of Wannon Water in the regulatory period from 1 July 2018. We had regard to their views in our draft decision.

Table 2.1 Final decision – Revenue requirement

\$ million 2017-18

	2018-19	2019-20	2020-21	2021-22	2022-23	Total
Operating expenditure	41.7	42.2	40.5	40.0	39.8	204.2
Return on assets	12.5	13.1	14.2	15.1	15.2	70.1
Regulatory depreciation	9.9	10.4	11.1	12.4	12.7	56.5
Tax allowance	0.1	0.1	0.1	0.1	0.1	0.7
Revenue requirement	64.2	65.8	66.0	67.5	67.9	331.4

Note: Numbers have been rounded

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	64.8	66.4	65.9	67.1	67.2	331.5
Operating expenditure	-0.3	-0.3	0.3	0.4	0.5	0.7
Return on assets	-0.2	-0.2	-0.2	-0.2	-0.1	-1.0
Regulatory depreciation	-0.03	-0.1	0.02	0.2	0.2	0.3
Total adjustments	-0.6	-0.6	0.1	0.4	0.6	-0.01
Final decision – revenue requirement	64.2	65.8	66.0	67.5	67.9	331.4

Note: Numbers have been rounded

Operating expenditure

Operating expenditure is an input to the revenue requirement. Our draft decision proposed to adopt a \$185.3 million benchmark for Wannon Water's forecast controllable operating costs for the

Our assessment

2018–23 period.³⁰ This was \$16.5 million lower than proposed by Wannon Water, and we set out our reasoning for this adjustment in our draft decision (pages 9 to 16). In summary:

- We found evidence indicating its baseline controllable operating expenditure reflects an efficient benchmark.
- We removed \$9.18 million of Wannon Water’s additional forecast labour costs which were for increases in wages above inflation. We found \$2.67 million of additional forecast labour costs for increases in staff positions were reasonable.
- We removed:
 - \$0.09 million of additional forecast costs for electricity associated with smaller projects because it was considered not efficient.
 - \$3.21 million of additional forecast costs for electricity because we did not agree with Wannon Water’s forecasted higher electricity prices continuing beyond 2019-20.
- We reduced cost savings from the Carbon Neutrality Plan due to our revised electricity price forecast, resulting in an increase of \$0.36 million to controllable operating expenditure.
- \$1.91 million of funds for Wannon Water’s tenant rebate and Water for the Community program were not considered operating costs, and we instead classified these as revenue not collected.
- \$2.50 million of other additional operating costs were removed because they were not considered new obligations for the corporation.

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

We forecasted \$18.2 million for Wannon Water’s non-controllable operating costs for the 2018–23 period.³¹ 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.

Wannon Water’s response to our draft decision appears to refine its price submission’s proposed controllable operating expenditure to meet our draft decision. Wannon Water has:

- proposed the addition of \$0.58 million to its 2016-17 baseline year for vacant positions over 2016–18 and has increased its proposed efficiency improvement rate from 1.0 per cent to 2.0 per cent, resulting in a \$2.42 million reduction to its adjusted baseline over the 2018–23 period
- proposed \$2.19 million above the baseline for positions filled in 2017-18, instead of the \$2.67 million allowed in our draft decision

³⁰ Controllable costs are those that can be directly or indirectly influenced by a water corporation’s decisions.

³¹ Non-controllable costs are those that cannot be directly or indirectly influenced by a water corporation’s decisions.

- proposed the allowance of \$6.41 million above the baseline for wages above inflation, taking into account the additional savings from its increased efficiency improvement rate
- proposed a \$0.87 million reduction for the lower payroll tax rate announced in the 2018-19 Victorian budget, superannuation changes and capitalised labour amounts
- provided updated forecast electricity costs based on its latest contract information, which includes \$1.38 million above the baseline
- accepted our adjustments for the Water for the Community program and tenant rebate, which transferred the costs from operating expenditure to revenue not collected
- accepted the removal of \$2.49 million for some new operating costs above the baseline, but proposed the re-inclusion of \$0.43 million for increased bio-solids management.

We consider Wannon Water's response to our draft decision represents a different proposal to its original price submission, in order to demonstrate a stronger case for its PREMO rating to be reinstated to 'Standard'. Its new proposal presupposes a higher return on equity consistent with this, and the revised operating expenditure forecast appears to be contingent on this assumption. Our framework and guidance does not provide for a water corporation to improve its 'best offer' to match its claimed PREMO rating. As set out in Chapter 3, we have retained our overall PREMO rating of 'Basic' for our final decision. This means Wannon Water will not receive the additional return on equity it has assumed. As such, the re-cut operating expenditure forecast in the proposed new model would leave Wannon Water with less revenue than our draft decision, because:

- its proposed higher efficiency improvement rate reduces the benchmark by \$5.2 million
- we do not accept all of its proposed increases above the revised baseline
- the net change arising from our assessment would reduce the overall operating expenditure benchmark allowance.

Given we have not accepted Wannon Water's assumptions for a higher return on equity, we do not consider it appropriate to accept its proposed larger efficiency reduction. Accordingly, we have retained the efficiency assumptions in our draft decision, and evaluated Wannon Water's response on each cost item on its own merits, as set out below.

Wannon Water's new model set out the labour forecasts differently to its price submission and our draft decision. Consistent with our views above, we do not accept this new approach, and hold to our draft decision with the following considerations:

- Wannon Water proposed an additional \$0.31 million in the 2016-17 baseline expenditure to reflect wages for some positions that were filled for only part of the year. This represents a

vacancy rate of about 1.5 per cent.³² Consistent with our decisions for other water corporations, we consider a 2 per cent vacancy rate is reasonable for all water corporations, and we therefore do not accept that Wannon Water's proposed amendment warrants an increase in operating expenditure.

- Wannon Water also proposed to include \$0.28 million in the baseline year for vacancies that were filled during 2017-18. Given our decision above which makes allowance for a reasonable vacancy rate, we will allow the additional expenditure associated with filling these ongoing positions in 2017-18. Accordingly, we will increase the labour forecast by \$1.38 million across the period.
- Wannon Water pointed out that its low customer connections growth rate (compared to other regional urban water corporations) limits its ability to absorb cost increases via growth in revenue, particularly wage increases above inflation.³³ It also noted that while it has used the state government's Victoria in Future population growth forecast figure of 0.8 per cent, it is not confident it will exceed the current growth rate of 0.6 per cent. We accept this means the wage increases above inflation may not be fully covered by Wannon Water's customer growth allowance, and we have therefore provided an additional allowance of 0.55 per cent of its total wage costs for each year (\$0.46 million across the period) to address this shortfall.³⁴ We note that in its price submission, Wannon Water requested a total of \$9.18 million for wage increases above inflation (which we did not allow in our draft decision). However, this figure represents about 9 per cent of its total wages bill across the period – much greater than the increment above inflation it pertains to represent. Wannon Water has made a similar error in its response to our draft decision, where its request for an additional, albeit reduced, \$6.41 million represents about 6 per cent of its total wages bill. These errors in Wannon Water's submissions exacerbate the difference between what we have allowed for our final decision and what Wannon Water has requested.

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, Wannon Water has advised a reduction of \$1.18 million across the 2018–23 period. This is consistent with our draft decision requirement to be provided

³² We have adopted a 2 per cent vacancy assumption as water corporations are likely to have unfilled positions in any given year, and we do not consider it efficient to recover 100 per cent of expected labour costs from customers.

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 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 Wannon Water's current enterprise agreement provides for 3.25 per cent per year wage rises. Using the 2017-18 inflation figure of 1.9 per cent, a growth allowance of 0.8 per cent leaves a shortfall of 0.55 per cent.

with updated forecasts if there is a change in legislation or government policy, and we have reduced the forecast accordingly.

Wannon Water also requested additional costs totalling \$0.28 million to cover the increase in superannuation rate for the last two years of the 2018–23 period. We recognise this is a genuine cost increase to Wannon Water, and we have increased the controllable operating expenditure forecast by this amount.

Wannon Water submitted an updated forecast for electricity prices and carbon neutrality savings based on its contract prices for 2018–20 and then estimates until June 2023. This update proposed \$1.38 million above its baseline across 2018–23, a decrease of \$0.76 million from our indicative draft decision of \$2.14 million. The proposal also includes \$0.05 million for electricity consumption increases from new infrastructure (a reduction from the \$0.09 million in its price submission). Wannon Water considers this inclusion is appropriate in the context of its low customer connection growth and its increased efficiency improvement rate.³⁵ We accept Wannon Water’s proposed electricity costs of \$1.38 million above the baseline, because it better reflects efficient expenditure.

Wannon Water proposed the re-inclusion of \$0.43 million for increased bio-solids management costs due to expected increases in load from its major customers, in particular from the Warrnambool water reclamation plant. It argued the increase would be about 4 per cent per year, considerably greater than the growth allowance of 0.8 per cent. We accept that the increase in biosolids production will result in additional transportation costs beyond the growth allowance, and accordingly we have adjusted the expenditure allowance to include the \$0.43 million that we removed for our draft decision.

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.³⁶ No other new considerations were presented in submissions received following the draft decision that caused us to change our views on controllable operating expenditure.

Accordingly, our final decision for controllable operating expenditure adopts a net \$0.59 million increase from our draft decision.

For non-controllable operating expenditure, we have revised our draft decision forecasts where required based on the latest March 2018 inflation and external bulk charges information. We have

³⁵ We requested our expenditure consultant, Deloitte Access Economics, review the updated electricity price forecasts and compare against the information received for our draft decision. Deloitte did not recommend any adjustments for our final decision.

³⁶ Consumer Action Law Centre, op cit.

revised our forecast environmental contribution from our draft decision, and made no changes to forecast licence fees or external bulk charges.³⁷

Based on the latest inflation data, we have revised the forecast 2018-19 environmental contribution from \$3.23 million to \$3.24 million, which results in a total increase of \$0.06 million across the 2018–23 period.

Accordingly, we have increased our draft decision forecast for Wannon Water’s non-controllable operating expenditure by \$0.06 million to \$18.29 million across the 2018–23 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.

³⁷ 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 Adjustments to operating expenditure

\$ million 2017-18

	2018-19	2019-20	2020-21	2021-22	2022-23	Total
Draft decision – total operating expenditure	42.1	42.5	40.2	39.6	39.2	203.5
Labour – back-filled positions	0.27	0.27	0.27	0.27	0.27	1.37
Labour – wage increase	0.09	0.09	0.09	0.09	0.09	0.46
Electricity	-0.48	-0.49	0.08	0.06	0.07	-0.76
Payroll tax and superannuation	-0.26	-0.24	-0.24	-0.13	-0.03	-0.90
Operating costs - biosolids	0.04	0.06	0.09	0.11	0.13	0.43
Total adjustments to controllable costs	-0.33	-0.30	0.29	0.40	0.53	0.59
Environmental contribution	0.01	0.01	0.01	0.01	0.01	0.06
Total adjustments to non-controllable costs	0.01	0.01	0.01	0.01	0.01	0.06
Final decision – total operating expenditure	41.7	42.2	40.5	40.0	39.8	204.2

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 Wannon Water’s revenue requirement (Table 2.1). We consider our final decision for Wannon 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.³⁸

Table 2.4 Final decision – operating expenditure

\$ million 2017-18

	2018-19	2019-20	2020-21	2021-22	2022-23	Total
Controllable costs	38.0	38.4	36.8	36.4	36.3	185.9
Non-controllable costs	3.8	3.7	3.7	3.6	3.5	18.3
Bulk services ^a	0.3	0.3	0.3	0.3	0.3	1.7
Environmental contribution ^b	3.2	3.2	3.1	3.0	3.0	15.5
Licence fees – ESC ^c	0.040	0.040	0.040	0.040	0.061	0.221
Licence fees – DHHS ^c	0.020	0.020	0.020	0.020	0.020	0.100
Licence fees – EPA ^c	0.158	0.158	0.158	0.158	0.158	0.789
Other	0.0	0.0	0.0	0.0	0.0	0.0
Final decision – total operating expenditure	41.7	42.2	40.5	40.0	39.8	204.2

^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 Wannon Water does not represent the amount that Wannon 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.

³⁸ 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 Wannon 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 \$320.2 million. We proposed to approve this amount as Wannon Water's actual net capital expenditure was 17.6 per cent lower than the forecast used to approve maximum prices for the period from 1 July 2013.^{39 40} Wannon 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 \$320.2 million. The calculations are provided at Table 2.5.

³⁹ Net capital expenditure is calculated by deducting government and customer contributions from gross capital expenditure.

⁴⁰ 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	264.3	285.8	296.8	303.0	310.0
Plus gross capital expenditure	30.2	20.5	17.4	17.6	21.5
Less government contributions	0.0	0.1	0.1	0.1	0.2
Less customer contributions	1.0	0.7	2.0	0.6	1.0
Less proceeds from disposals	1.1	0.5	0.4	0.5	0.5
Less regulatory depreciation	6.6	8.2	8.8	9.3	9.6
Closing RAB 30 June	285.8	296.8	303.0	310.0	320.2

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 Wannon Water's forecast regulatory asset base from 1 July 2018.⁴¹ An overview of our assessment for each component of the forecast regulatory asset base is set out in the following sections.

⁴¹ Our guidance required water corporations to provide an estimate of the components of its regulatory asset base for 2017-18. This is so we can assess the opening asset base for 1 July 2018. Our guidance noted that where the 2017-18 forecasts for net capital expenditure (gross capital expenditure less government and customer contributions) is lower than the forecast benchmark for that year in its 2013 price determination, the lower amount must be used. The estimates for 2017-18 will be confirmed at the price review following the 2018 water price review.

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

	2017-18	2018-19	2019-20	2020-21	2021-22	2022-23
Opening RAB 1 July	320.2	329.6	339.1	365.0	398.6	408.7
Plus gross capital expenditure	20.4	20.9	37.9	46.3	24.0	13.3
Less government contributions	0.1	0.0	0.2	0.2	0.1	0.0
Less customer contributions	1.0	1.0	0.9	0.9	0.9	0.9
Less proceeds from disposals	0.5	0.5	0.5	0.5	0.5	0.5
Less regulatory depreciation	9.4	9.9	10.4	11.1	12.4	12.7
Closing RAB 30 June	329.6	339.1	365.0	398.6	408.7	407.9

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 Wannon Water's gross capital expenditure forecast of \$156.5 million for the 2018–23 period by \$18.2 million, to establish a benchmark gross capital expenditure of \$138.3 million. We considered this represented prudent and efficient capital expenditure, and we set out our reasoning for this in our draft decision (pages 19 to 23). In summary, we found:

- Wannon Water's price submission and business cases provided evidence that its forecasts for capital expenditure are based on a reasonable capital planning approach.
- We removed \$11.69 million from Wannon Water's proposed renewals program, so that costs align with a smaller 25 per cent increase in spend above historical levels.
- We allowed 5 per cent for business case development costs for Wannon Water's two water tower supply projects, and removed \$6.53 million of the proposed \$6.88 million because there was uncertainty around the timing of both projects.
- Wannon Water has an appropriate approach for managing expenditure associated with uncertain projects.

Wannon Water's response to our draft decision:

- accepted our adjustments for its asset renewals program and for the Wollaston Road water tower project
- confirmed the forecast costs for the Warrnambool water reclamation plant upgrade remained unchanged from its price submission, based on its current business case progress
- proposed to reinstate the full cost (an increase of \$4.12 million) for the Wangoom Road water tower project in Warrnambool.

Wannon Water noted it will need to construct three water tower projects to provide a reliable water supply to Warrnambool growth corridors in the near future, but the precise timing for each will depend on the rate of residential development in each area. It therefore only included two of the three tower projects in its price submission, with the Hopkins Road water tower excluded because that project had the greatest level of timing uncertainty, compared to the Wangoom Road and Wollaston Road towers. In our draft decision, we considered that each of the two included towers had sufficient timing uncertainty to warrant our removal of the full project cost from the forecast gross capital expenditure, particularly since both had been included in the 2013–18 capital forecast, but we retained 5 per cent of the proposed costs for development of robust business cases. However following Wannon Water's response to our draft decision, we accept that it is very likely that at least one of the three towers will be constructed during the 2018–23 period, and that it is therefore unreasonable to exclude the expenditure for all three projects. Wannon Water identified the Wangoom Road water tower as the most likely to be constructed first, with the need firming over the summer of 2017-18. In light of this new information, we accept Wannon Water's proposal to reinstate the \$4.12 million for the Wangoom Road water tower project that we removed for our draft decision, and we have increased the capital expenditure forecast accordingly. Should the other two towers also be required to commence during the period, Wannon Water may seek to recover the associated costs at the end of the period, consistent with our guidance for managing costs of uncertain capital projects.

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 the gross capital expenditure benchmark proposed in our draft decision, amended to include the full cost of the Wangoom Road water tower project, 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 Wannon Water's forecast regulatory asset base (Table 2.6) and its revenue requirement (Table 2.1).⁴²

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

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	20.9	37.3	44.6	22.1	13.3	138.3
Wangoom Road Water Tower	0.01	0.54	1.66	1.91	0.00	4.12
Total adjustments to gross capital expenditure	0.01	0.54	1.66	1.91	0.00	4.12
Final decision – gross capital expenditure	20.9	37.9	46.3	24.0	13.3	142.4

Note: Numbers have been rounded

The benchmark that we adopt for Wannon 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. Wannon 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 Wannon Water’s approach for addressing uncertain capital expenditure. We reiterate that Wannon Water will need to demonstrate the prudence and efficiency of additional costs incurred during the 2018–23 period, including its identified water tower projects, 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 Wannon Water’s forecast revenue from customer contributions was reasonable, having regard to past trends and its growth forecasts. We proposed to accept Wannon 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 confirms our draft decision. The final decision adopts the benchmark amounts for revenue from customer contributions set out in Table 2.6.

Cost of debt

In our draft decision we proposed to approve the cost of debt proposed by Wannon 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.

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 2.8.

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.*

⁴⁶ Water Services Association of Australia 2018, *Submission*, May.

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).

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

Wannon Water rated its price submission as ‘Standard’. Based on its PREMO self-rating, Wannon Water proposed a rate of return on equity of 4.5 per cent per annum. This reflects the maximum return rate allowed in our guidance for a price submission rated as ‘Standard’.⁴⁸

Our draft decision proposed not to accept Wannon Water’s proposed return on equity. This reflected our draft decision to rate Wannon Water’s price submission as ‘Basic’ under PREMO. This lowered the rate for the return on equity adopted for our draft decision from the 4.5 per cent proposed by Wannon Water, to 3.9 per cent.

CALC recommended in its submission that 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 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.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.

Wannon Water’s response to our draft decision incorporated an assumption for a 4.5 per cent rate for the return on equity, consistent with its original proposal for a ‘Standard’ PREMO rating.

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

⁴⁹ Consumer Action Law Centre, op. cit., 8

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.

As outlined in Chapter 3, our final decision on Wannon Water’s PREMO rating is consistent with our draft decision; that is, we have rated Wannon Water’s price submission as ‘Basic’ under PREMO. Reflecting our views above, and our view on Wannon Water’s PREMO rating, our final decision approves a rate for the return on equity of 3.9 per cent.

Regulatory depreciation

Regulatory depreciation is an input to calculating the regulatory asset base. Our draft decision on regulatory depreciation differed from Wannon Water’s proposal due to our proposed adjustments to capital expenditure (noting that otherwise, Wannon Water’s proposed regulatory depreciation complied with the requirements of our guidance).

Our final decision has accepted some of the adjustments to capital expenditure proposed by Wannon Water in response to our draft decision (see page 18). This has an impact on forecast regulatory depreciation. No other new considerations were presented in submissions received following the draft decision which caused us to change our views on the regulatory depreciation.

For the reasons set out above, our final decision adopts the forecasts for regulatory depreciation set out in Table 2.1.

Tax allowance

The tax allowance is an input into the revenue requirement. Our draft decision accepted Wannon Water’s forecasts for zero tax in its revenue requirement, as it was calculated consistently with the method required by our guidance.⁵¹ No other new considerations were presented in submissions received following the draft decision which caused us to change our views on the tax allowance.

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

Demand

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

For the reasons set out above, our final decision confirms our draft decision.

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

Wannon Water's price determination includes the benchmark demand forecasts adopted for our final decision.

Form of price control

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

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

For the reasons set out above, our final decision confirms our draft decision, and approves Wannon Water's proposed price cap form of control.⁵²

Tariff structures and prices

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

- For water services – a two-part tariff structure with a fixed service charge and a variable component that depends on water use. For residential customers, the variable component includes a three-tier inclining block, where the price increases with each higher tier.
- For residential sewerage services – a fixed service charge only.
- For non-residential sewerage services – a fixed service charge and a variable 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.⁵³ We also considered two-part tariff structures are easy to understand.

For sewerage tariffs, we considered a fixed charge only for residential customers and a two-part tariff for non-residential tariffs sends customers signals about the efficient costs.⁵⁴

⁵² 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.

⁵³ 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.

⁵⁴ Our reasons are outlined in our 2013 draft decisions for our price review 2012-13 to 2017-18.

Our draft decision accepted Wannon Water's proposal to calculate tariffs for recycled water, trade waste 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 accepted Wannon Water's proposal to reduce its water tariffs from four to two groups and its sewerage tariff from three groups to a single consistent tariff across the region. We considered these reforms promote ease of understanding and provide signals about the efficient costs of providing services.

In response to our draft decision, a submission by CALC highlighted the impact price changes may have on some customers, particularly those with low or fixed incomes.⁵⁵

In response to our draft decision Wannon Water is proposing to:

- reduce residential tier 1 and non-residential non-potable water volumetric charges by an average of 5.8 per cent per annum
- reduce residential tier 2 and 3 and non-residential potable water volumetric charges by an average of 1.1 per cent per annum
- include a rebate for residential owner and tenant customers phased out over a four year period from \$56 in 2018-19 to \$14 in 2021-22.

The outcomes of Wannon Water's proposals result in generally flat bills for residential customers from 1 July 2018. We also note that Wannon Water has proposed to use its current framework to assist customers experiencing payment difficulty, and is developing a Financial Inclusion Action Plan as part of its response to the needs of low income and vulnerable customers.

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

Our price determination for Wannon Water sets out the maximum prices it may charge for the five year period from 1 July 2018 (or the manner in which its prices are to be calculated, determined, or otherwise regulated). Approved maximum prices for water and sewerage services applying to most residential and non-residential customers are set out at Tables 2.9 and 2.10. Approved maximum prices take into account Wannon Water's commitment to the rebate noted above.

⁵⁵ Consumer Action Law Centre, *op. cit.*, pp. 2-3.

Table 2.9 Final decision – water prices
\$ 2018-19

	2018-19	2019-20	2020-21	2021-22	2022-23
Residential					
Variable (\$/kL)					
1st tier	1.7930	1.6962	1.5977	1.5003	1.4028
2nd tier	2.2457	2.2210	2.1965	2.1724	2.1485
3rd tier	3.3687	3.3317	3.2950	3.2587	3.2230
Fixed (\$/year)	168.18	168.18	168.18	168.18	168.18
Non-residential					
Variable (\$/kL)					
	2.2457	2.2210	2.1965	2.1724	2.1485
Fixed (\$/year)	168.18	168.18	168.18	168.18	168.18

Note: Numbers have been rounded down

Table 2.10 Final decision – sewerage charges
\$ 2018-19

	2018-19	2019-20	2020-21	2021-22	2022-23
Residential					
Fixed (\$/year)					
	737.08	726.03	715.13	704.41	693.85
Non-residential					
Variable (\$/kL)					
	1.2012	1.2468	1.2942	1.3434	1.3945
Fixed (\$/year)					
	737.08	726.03	715.13	704.41	693.85

Note: Numbers have been rounded down

Adjusting prices

In our draft decision we proposed to approve Wannon Water’s proposal to continue the existing uncertain and unforeseen events mechanism. We noted in our guidance that we propose that the mechanism continue its current form. Submissions responding to our draft decision did not raise any matters that caused us to change our view expressed in the draft decision. Our final decision approves the uncertain and unforeseen events mechanism.

Our assessment

Our draft decision also required Wannon Water to submit price adjustment formulas that allowed prices to adjust to changes in the cost of debt. Wannon Water worked with us to develop a mechanism. The price determination for Wannon Water includes the price adjustment mechanism approved in our final decision. We consider the mechanism satisfies WIRO objectives relating to efficiency, including that prices reflect efficient costs.

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 accepted Wannon Water's proposed continuation of its standard water and sewer new customer contribution charges at current levels (plus annual adjustments for inflation). Our draft decision also accepted the continuation of unique water new customer contribution charges (plus annual adjustments for inflation) for Warrnambool growth areas and Warrnambool roof harvesting areas.

Furthermore, our draft decision accepted Wannon Water's proposal to include Hamilton and Portland, two areas previously charged a unique sewerage connection charge, in the standard sewerage charge. This proposal represents a 50 per cent decrease on 2017-18 area specific charge for Hamilton and Portland.

For negotiated new customer contributions, we proposed to accept Wannon Water proposal to continue to calculate charges in accordance with the requirements of our new customer contribution pricing principles.

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 accepts the position in our draft decision for the same reasons, and accepts Wannon 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.⁵⁶

⁵⁶ Essential Services Commission 2016, *Guidance paper, op. cit.*, pp. 62-63.

Our price determination for Wannon 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).

Wannon Water should update and publish any development servicing plans and negotiation protocols to assist developers understand the underlying assumptions of its new customer contribution charges.⁵⁷

Financial position

In approving prices, we must have regard to the financial viability of the water industry.⁵⁸ 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 Wannon Water's prices. We have assessed that, under our final decision, Wannon Water will generate sufficient cash flow to deliver on service commitments, including financing costs arising from investments to meet service expectations.

⁵⁷ Essential Services Commission 2013, *New Customer Contributions: Explanatory Note, December*, pp. 9-11.

⁵⁸ WIRO clause 8(b)(ii) and ESC Act section 8A(1)(b).

3. PREMO rating

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

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

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

In Chapter 2, we noted our final decision is to adopt a return on equity of 3.9 per cent, based on our PREMO review.

Our review of Wannon Water’s PREMO rating

Wannon 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
Wannon Water’s proposed rating (price submission)	Standard	Standard	Advanced	Standard	Standard
Commission’s draft decision rating	Basic	Basic	Advanced	Basic	Standard
Commission’s final decision rating	Basic	Basic	Advanced	Basic	Standard

Our draft decision agreed with Wannon Water’s proposed PREMO ratings for the Engagement (‘Advanced’) and Outcomes (‘Standard’) elements of PREMO. However, our rating for the Management and Risk elements of PREMO was ‘Basic’, lower than the ‘Standard’ rating proposed by Wannon Water. This resulted in Wannon Water’s overall price submission PREMO rating falling to ‘Basic’ in our draft decision.

In its response to our draft decision, Wannon Water requested that we ‘reassess and agree’ that its original ‘Standard’ PREMO rating was appropriate. Wannon Water’s reasons for seeking a reassessment are set out at pages 12 to 13 of its response to our draft decision.

Having considered Wannon Water’s reasons and for the reasons provided below, **this final decision confirms our earlier draft decision to give Wannon Water’s price submission an overall rating of ‘Basic’.**

While we have not agreed with Wannon Water’s reasons at this time, we would accept an application from Wannon Water for us to consider a reassessment of its PREMO rating during the 2018–23 regulatory period.⁵⁹

Wannon Water’s response to our draft decision on PREMO and our final decision

Wannon Water offered two main reasons for seeking to reinstate its proposed ‘Standard’ PREMO rating, namely:

- our draft decision did not comply with our guidance, and
- it has revised its expenditure forecasts following our draft decision.

On the first matter, Wannon Water contends its price submission did not reflect any of the examples for a ‘Basic’ submission in the PREMO assessment tool included in our guidance, and therefore, our draft decision did not comply with our guidance.

We do not agree with Wannon Water’s contention that we did not comply with our guidance.

In relation to our assessment of Wannon Water’s Management rating, we note the PREMO assessment tool in our guidance included the following questions:

- To what extent has the business demonstrated its commitment to cost efficiency or productivity improvements?
- To what extent has the business demonstrated how its proposed prices reflect only prudent and efficient expenditure?

In our draft decision, we provided the following reasons for rating Wannon Water’s price submission as ‘Basic’ for the Management element of PREMO:

- Our draft decision identified large reductions to the corporation’s operating and capital expenditure forecasts. In percentage terms, our proposed reductions in the draft decision for Wannon Water were the largest of any water corporation in our price review.

⁵⁹ See Essential Services Commission 2016, *Framework*, op. cit., p. 43.

- Wannon Water’s operating cost forecasts included expectations for efficiency improvement that were the lowest of any water corporation in our price review.⁶⁰ Figure 3.1 shows that Wannon Water’s price submission included expectations for improvement in controllable costs per connection (a measure of efficiency) well below other water corporations.
- Wannon Water’s price submission had the highest proportion of upward cost variations relative to the 2016-17 baseline year.

These findings are not consistent with the guidance’s expectation that price submissions would demonstrate a commitment to productivity improvements, and prudent and efficient expenditure.

Moreover, the commission Chairperson wrote to water corporations in May 2017 to reinforce its expectation that in undertaking its PREMO assessment, each water corporation would outline the assumptions and justification for its expenditure forecasts.

“As part of our assessment ... we will test the justification provided by a business for its forecast costs. This will include assessing the ambition of a business to control costs through efficiency targets for example, and whether a business has prioritised expenditure so it aligns with the outcomes most valued by customers. PREMO will not reward businesses that take a “cost plus” approach to estimating their expenditure needs.”

There are also multiple references to efficient costs in the examples listed in the PREMO assessment tool published by the commission.⁶¹

The emphasis the PREMO framework places on efficient costs is beyond doubt — as evidenced by other water corporations’ compliance with the requirements of the framework.

This final decision finds that our earlier rating of ‘Basic’ for Management is consistent with our PREMO framework and guidance, given the magnitude of expenditure adjustments we found necessary to meet the requirement for prudent and efficient expenditure forecasts.

In relation to our draft decision assessment of Wannon Water’s Risk rating, we note that the PREMO assessment tool included the following guiding question:

⁶⁰ Wannon Water’s response to our draft decision considered that the commission has not given due consideration to the \$1.3 million of “identified efficiencies” within its price submission. Our understanding is that these “identified efficiencies” are a result of investments in energy efficiency savings. These savings are relatively small in the context of the reductions to operating expenditure proposed in our draft and final decisions.

⁶¹ We note Wannon Water appears to have incorrectly interpreted the role of the examples included in the PREMO assessment tool. Our guidance noted the guiding questions would be used as the basis to assess price submissions for PREMO. We also noted that the examples in the assessment tool do not provide an exhaustive list of matters that may be considered in arriving at a price submission PREMO rating. That is, it is open to the commission (and businesses) to consider examples beyond those included in the assessment tool.

- To what extent has the business demonstrated a robust process for identifying risk, and how it has decided who should bear these risks?

In our draft decision, we noted that Wannon Water’s asset renewals program incorporated relatively high amounts for unspecified works, indicating a high level of uncertainty in renewals planning. This represents a transfer of risk from the business to customers who are being asked to pay for unknown works with unknown benefits, and it increases the likelihood that customers will pay for works that are not delivered by the end of the regulatory period. We assessed this risk transfer to customers as material given Wannon Water’s price submission also proposed prices that would lead to bill increases from 1 July 2018.

This final decision reaffirms our draft decision rating for Risk as ‘Basic’, having regard to our guidance and our finding that Wannon Water had not done all it could in its price submission to mitigate price impacts.

Wannon Water’s second reason for seeking our reconsideration of its PREMO rating was to reflect the revised proposals it made in its response to our draft decision. These changes mainly include a greater commitment to operating expenditure efficiencies, and revisions to its capital expenditure.

We acknowledge that Wannon Water’s revised proposal forecast delivers better value to its customers, but this does not provide grounds for a reassessment of the PREMO rating.

The PREMO framework seeks to ensure a water corporation puts its best offer forward in its price submission. Our pricing framework states that businesses cannot seek to improve their rating with an alternative proposal.⁶²

While our assessment of Wannon Water’s price submission remains unchanged in this final decision, we would accept an application from Wannon Water for us to consider a reassessment of its PREMO rating during the 2018–23 period.

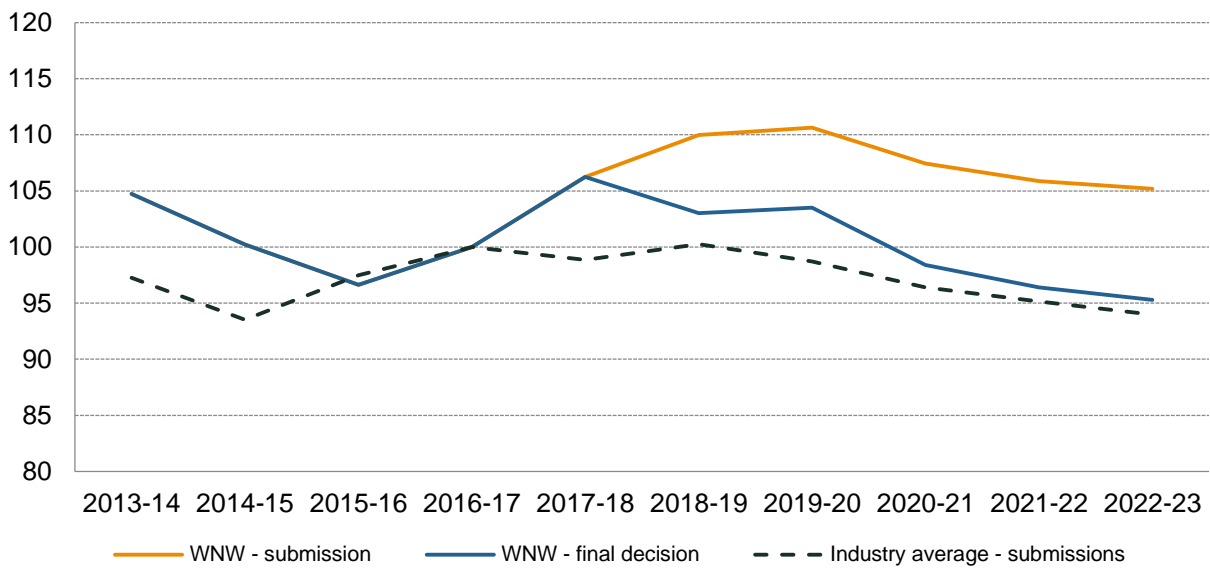
Wannon Water must notify us of any intention to submit an application for a reassessment of its PREMO rating at least one year before it lodges an application. This will enable us to provide it with guidance on our information requirements for such a reassessment. Wannon Water will need to provide at least two years of performance data under the PREMO framework when it applies for a reassessment.

The scope of the review would be limited to whether Wannon Water’s overall PREMO rating and return on equity might be reinstated to match the original ‘Standard’ rating it proposed in its price submission.

⁶² See Essential Services Commission 2016, *Framework*, op. cit., p. 49.

Figure 3.1 Controllable operating expenditure per water connection

Index: 2016-17=100



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

Appendix A – submissions received on draft decision

Name or organisation	Date received
Kingspan Environmental and Urban Water Cycle Solutions	23 May 2018
Water Services Association of Australia	16 May 2018
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 Wannon Water.

Wannon Water's approved service standards

Service Standard	2018-19	2019-20	2020-21	2021-22	2022-23
Water					
Number of customers experiencing more than 5 unplanned water supply interruptions in the year (number)	0	0	0	0	0
Average time taken to attend bursts and leaks (priority 1) (minutes)	21	21	21	21	21
Average time taken to attend bursts and leaks (priority 2) (minutes)	30	30	30	30	30
Average time taken to attend bursts and leaks (priority 3) (minutes)	85	85	85	85	85
Average duration of unplanned water supply interruptions (minutes)	80	80	80	80	80
Average duration of planned water supply interruptions (minutes)	135	135	135	135	135
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)	35	35	35	35	35
Average time to rectify a sewer blockage (minutes)	117	117	117	117	117
Spills contained within 5 hours (per cent)	99	99	99	99	99

Note: Numbers have been rounded

Appendix C – approved GSL schemes

We have approved the following service level obligations and corresponding amounts of payment for failure to attain the stated obligation as the guaranteed service level (GSL) scheme for Wannon Water. Refer to section 7.7 of Wannon Water’s price submission for further detail.

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

Wannon 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 Wannon Water.

Wannon Water’s approved GSL scheme

Approved service level obligation	Approved payment (\$)
Subject to exclusions, If there are more than two unplanned interruptions to the service supplying water to the customer’s property in any 12-month period.	100
Subject to exclusions, If there is a sewerage spill in a customer’s house.	500
Subject to exclusions, If there is a sewerage spill on a customer’s property.	100
If Wannon Water restricts the water supply of, or takes 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) recommended that we set the benchmark cost of debt at five per cent or around one per cent lower than the amount allowed in our draft decision (6.05 per cent per annum in nominal terms). It also recommended that we reduce each of the equity values in the PREMO matrix by one per cent. CALC submits that government owned water corporations carry less risk than private corporations, and as such, the allowed cost of debt and the return on equity should be lowered, compared with the rates allowed in our draft decision.⁶³ These recommendations are based on a report prepared by CME for CALC.⁶⁴

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.⁶⁵ This includes ensuring that borrowing costs reflect an estimate of a water corporation's standalone risk profile and credit rating. We note that:

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

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

⁶³ Consumer Action Law Centre, op. cit., p. 8.

⁶⁴ *ibid.*, Appendix A.

⁶⁵ We note the Water Services Association of Australia supports application of competitive neutrality principles, see Water Services Association of Australia 2016, *Submission to the Essential Services Commission: A new model for pricing services in Victoria's water sector*, July, p. 11.

to a regulated water corporation. We consider this is consistent with the requirements of the Water Industry Regulatory Order 2014 (WIRO).⁶⁶

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.⁶⁷ 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.⁶⁸

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.⁶⁹

⁶⁶ 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).

⁶⁷ Consumer Action Law Centre, *op. cit.*

⁶⁸ Essential Services Commission of South Australia, *op. cit.*; Independent Pricing and Regulatory Tribunal, *op. cit.*

⁶⁹ 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.