

Westernport Water final decision

2018 Water Price Review

29 May 2018

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Summary

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

In December 2017, we released our draft decision on Westernport Water's price submission.¹ The draft decision set out our preliminary views on Westernport Water's proposals, and invited interested parties to make further submissions. We also held a public meeting in February 2018. In addition to a response by Westernport Water, we received four written submissions on our draft decision, which are available on our website. A list of these submissions is included in Attachment A to this final decision.

After considering feedback, we have made a price determination for Westernport Water.² The price determination sets out the maximum prices Westernport 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 confirms 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 requirement for Westernport Water

Our final decision approves a revenue requirement of \$112.4 million over the five year period starting 1 July 2018 (see pages 9 and 10).³ This is \$1.0 million or 0.9 per cent lower than our draft

¹ Clause 16 of the Water Industry Regulatory Order (WIRO) 2014 requires us to issue a draft decision. Westernport 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 WIRO 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, *Westernport Water Determination: 1 July 2018 – 30 June 2023*, 29 May.

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.

decision, and mainly reflects updated forecasts for operating expenditure, including payroll tax and non-controllable costs (as anticipated in our draft decision).

A summary of approved maximum prices for major services provided by Westernport Water is set out on page 23. The estimated typical bills for residential customer groups under our final decision are provided in Table A. Not including inflation, compared with 2017–18, the estimated annual bill for a residential owner occupier rise by around \$12 in 2018–19, and rise by around \$27 for a residential tenant. The bill paid by a customer will vary depending on water use, prices for fixed and variable tariffs, and other charges.

Table A **Estimated typical residential water and sewerage bills**
\$ million 2018-19

Customer group	Annual water consumption (kL)	2017–18 annual bill	2018-19 annual bill	2022-23 annual bill
Residential (Owner occupier)	150	\$1,280 ^a	\$1,292	\$1,292
Residential (Tenant)	150	\$274 ^a	\$301	\$301
Residential (Owner occupier)	80	\$1,139 ^a	\$1,152	\$1,152
Residential (Tenant)	80	\$132 ^a	\$160	\$160

^a Following a \$30.45 rebate paid to customers from a government efficiency review.

Note: Average residential customer consumption is around 80 kilolitres per year, but this includes the high proportion of non-permanent residents that make up Westernport Water’s customer base. For permanent residents, we have also provided bill estimates for 150 kilolitres per year, which is similar to average consumption in Melbourne.

Note: Numbers have been rounded

Westernport Water will improve services

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

- improving the security of water availability for Phillip Island
- investing in asset renewals to maintain service reliability
- improving support for customers experiencing payment difficulty.

In addition to its guaranteed service level scheme, if it does not meet certain service targets, Westernport Water will provide a rebate to its customers. The rebate is payable in 2023-24, with the amount varying depending on the number of service targets missed during the 2018–23 period.

Summary

Tariff structures are the same

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

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

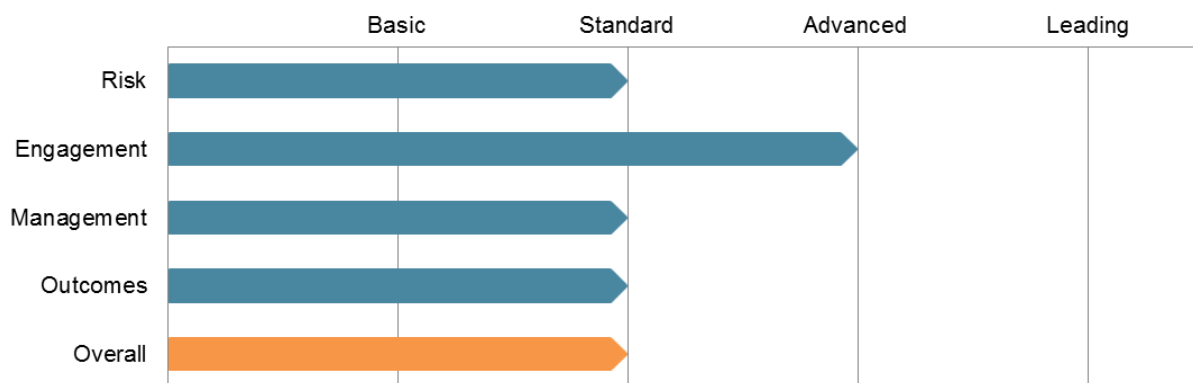
For more detail on the form of price control and tariffs, see pages 21 to 23.

Westernport Water’s price submission is rated as ‘Standard’ under PREMO

Consistent with our draft decision, our final decision is to accept Westernport Water’s PREMO self-rating of ‘Standard’. In support of Westernport Water’s self-rating, we note the efficiency improvement target for controllable operating expenditure in its price submission, which was high relative to other water corporations and helped to offset the price and customer bill impacts of increases in its non-controllable costs.

Figure A summarises our final decision on PREMO. More detail on our assessment of Westernport Water’s PREMO rating is provided in Chapter 3.

Figure A PREMO – Westernport Water final decision summary



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

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 for Westernport Water, we have had regard to each of the matters required by clause 11 of the WIRO, including:

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

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.

Our consideration of legal requirements document lists the specific objectives and the various matters the commission must have regard to when making a price determination and provides a guide to where we have done so for our price determination for Westernport Water.⁷

In 2016, we issued guidance to Westernport Water to inform its price submission. The guidance set out how we will assess Westernport 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 Westernport 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, *Westernport Water final decision, 2018 Water Price Review – commission's consideration of legal requirements*, 29 May. This is available at www.esc.vic.gov.au/waterpricereview.

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

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

¹⁰ See Part 13, Division 5 of the Water Act.

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

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

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

We finalised our new approach to water pricing in October 2016.¹³

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

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

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

PREMO

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

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

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 the 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 Westernport Water's price submission

We have made our price determination for Westernport Water after considering: Westernport 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 February on our draft decision to receive feedback.

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

Westernport Water's price submission and financial model presented clear and comprehensive information to support its proposals. Westernport 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 pages 6 and 7).

Our guidance included a number of matters water corporations must address in their price submissions. Westernport 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 on the following pages.

All financial values referred to in this chapter are in \$2017-18, unless otherwise specified.

Regulatory period

Our draft decision accepted the five year regulatory period (1 July 2018 to 30 June 2023) proposed by Westernport Water 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 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 Westernport Water. This is the same period we have approved for the other three final decisions released at this time.

Customer engagement

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

The engagement by Westernport Water:

- took place between September 2016 and May 2017
- used a range of methods including online and face-to-face surveys, an online question and answer forum, and workshops
- was tailored to the demographics of its customer base, noting its customer base includes a relatively high proportion of non-permanent residents
- covered matters such as service levels, the size of customer rebates for poor customer service, investments in recycled water and asset renewals, and tariff structures.

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

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

- customer feedback in workshops informing the nature of its asset renewals program
- increasing the number of grants available to customers experiencing financial hardship, reflecting feedback about the importance of accessible and affordable services

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: Comment on Early Draft Decisions*, 13 March, pp. 5-6.

²¹ Westernport Water's price submission is available on our website at www.esc.vic.gov.au. See pages 4 to 11.

- maintaining the current mix of fixed and variable charges in residential customer bills, reflecting mixed feedback from customers about whether variable charges should increase.

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

In a submission responding to our draft decision, Consumer Action Law Centre (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.

The submission by CALC also noted its view that Westernport Water did not adequately consult its customers on its proposed price increases and price path. We have taken this into account in our assessment of Westernport Water's PREMO rating (Chapter 3).

Outcomes

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

- reliable water and wastewater services
- better tasting water
- affordable and responsive services
- a more sustainable community.

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

- improving the security of water availability for Phillip Island
- investing in asset renewals to maintain service levels
- improving support for customers experiencing payment difficulty.

Westernport Water proposed measures and targets that it will use to report on performance against each outcome. These are set out at pages 13 to 16 of its price submission. Westernport Water has committed to reporting on its performance against each outcome and associated output measures annually to customers. Information will be available via annual updates on its website.

In support of its commitment to deliver its proposed service targets, Westernport Water will provide customers with a new rebate, payable in 2023-24, with the amount varying depending on the

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 2018, *Early Draft Decisions*, op. cit., p. 4.

number of service targets missed during the 2018–23 period. The rebate will range from \$5 to \$20 for each customer (see page 17 of Westernport Water’s price submission for more information).

During 2018-19, we will engage with Westernport Water to finalise the set of measures, 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 future PREMO assessments.

Service Standards

Westernport Water 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 Westernport Water’s targets over the five year period to June 2023 are set out in Appendix B.

In a submission on our draft decision Consumer Action Law Centre 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 Westernport Water proposed standards for reliability and attending faults that largely improve on targets from the past.

Service standards relating to reliability and attending faults are set out in Appendix B and form part of the manner in which Westernport 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.

Westernport Water’s proposed GSLs are set out on pages 19 and 20 of its price submission. It has proposed a new GSL for water quality and increasing payments associated with its existing GSLs.

In our draft decision we provided an overview of Westernport Water’s proposed GSLs.

In a submission responding to our draft decisions, Consumer Action Law Action Centre supported increasing payments for GSLs so they are ‘not losing their value over time’.²⁵ We note Westernport Water has increased the payment amounts for its proposed GSLs.

²⁴ Consumer Action Law Centre 2018, *Early Draft Decisions*, op. cit., p. 7.

²⁵ Consumer Action Law Centre 2018, *Early Draft Decisions*, ibid.

Westernport Water's proposed GSLs were informed by the results of customer surveys and discussions in customer workshops. We are therefore satisfied that Westernport Water's proposed GSLs reflect the most important aspects of service delivery identified by customers.

For these reasons, our final decision approves Westernport Water's proposed GSLs.

Westernport Water's GSLs are set out in Appendix C. Westernport Water's commitment to GSL payments should these service levels not be met, forms part of the manner in which Westernport 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.²⁶ Along with forecast demand, it is an input to calculating prices.

Our draft decision accepted Westernport Water's proposed revenue requirement of \$113.4 million over a five year period starting 1 July 2018. Our final decision approves a slightly lower revenue requirement of \$112.4 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 mainly reflects updated forecasts for operating expenditure, including payroll tax and non-controllable costs (see pages 10 to 14). The reduced return on assets reflects our updates to the cost of debt following our draft decision (see pages 17 and 18). Adjustments to the revenue requirement since our draft decision are set out at Table 2.2, with the reasons set out in following sections.

²⁶ 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 Westernport Water in the regulatory period from 1 July 2018. We had regard to their views in our draft and final decisions.

Table 2.1 Final decision – Revenue requirement

\$ million 2017-18

	2018-19	2019-20	2020-21	2021-22	2022-23	Total
Operating expenditure	14.8	14.8	14.8	14.5	14.5	73.5
Return on assets	4.8	4.9	5.0	5.1	5.1	25.0
Regulatory depreciation	2.3	2.5	2.8	3.0	3.3	14.0
Tax allowance	0.0	0.0	0.0	0.0	0.0	0.0
Final decision – revenue requirement	22.0	22.3	22.6	22.6	22.9	112.4

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	22.2	22.5	22.8	22.9	23.1	113.4
Operating expenditure	-0.2	-0.2	-0.2	-0.2	-0.2	-0.9
Return on assets	-0.03	-0.03	-0.03	-0.03	-0.03	-0.2
Total adjustments	-0.2	-0.2	-0.2	-0.2	-0.2	-1.0
Final decision – revenue requirement	22.0	22.3	22.6	22.6	22.9	112.4

Note: Numbers have been rounded

Operating expenditure

Operating expenditure is an input to the revenue requirement. In our draft decision (pages 9 to 13), we proposed to accept Westernport Water’s operating expenditure forecast of \$74.3 million for the 2018–23 period. The reasons for this were:

Our assessment

- Evidence indicating its baseline controllable operating expenditure reflects an efficient benchmark.²⁷
- The second highest efficiency improvement rate of 2.7 per cent per year, which is greater than its forecast growth of 1.9 per cent per year.
- Westernport Water has not sought any additional expenditure above the growth-adjusted baseline. Any forecast increases in wages (above inflation) and electricity prices are managed within its proposed efficiency improvement targets, whereas some other corporations have sought additional expenditure for these items.

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

Westernport Water's response to our draft decision did not provide any new information on our draft decision for 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.

The Victorian budget 2018-19 was released after Westernport Water submitted its response to our draft decision. This budget reduced the payroll tax rate from 3.65 per cent to 2.425 per cent for regional corporations from 1 July 2018. As a result, Westernport Water advised us of a \$0.31 million reduction over the 2018–23 period. This is consistent with our draft decision requirement to be provided with updated forecasts if there is a change in laws or government policy.

For non-controllable operating expenditure, we have adjusted Westernport Water's forecasts where required based on the latest information received from the relevant regulatory authorities on their licence fees and the environmental contribution. We have also taken into account the latest data on inflation and external bulk charges.

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

We have assumed the licence fees for the Department of Health and Human Services, the Environment Protection Authority Victoria and the Essential Services Commission remain flat in

²⁷ Controllable costs are those that can be directly or indirectly influenced by a water corporation's decisions.

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

real terms across the period, but with a 50 per cent increase for our commission fee in 2022-23 to align with our regulatory review cycle.²⁹

We have reduced Westernport Water's forecast non-controllable operating expenditure by \$0.54 million across the 2018–23 period, resulting from the following adjustments:

- increasing the Environment Protection Authority Victoria licence fee by \$0.008 million per year (a total increase of \$0.04 million)
- increasing the forecast for our commission licence fee by \$0.002 million per year from 2018-19 to 2021-22, and by \$0.008 million in 2022-23 (a total increase of \$0.02 million)
- adopting a forecast for the environmental contribution of \$0.90 million for 2018-19 and assuming that it declines in real terms across the rest of the period (a total reduction of \$0.61 million)
- increasing external bulk water charges by \$0.01 million in total for the period 2018-19 to 2022-23.

Overall, non-controllable operating expenditure will increase by \$0.67 million from 2017-18 to 2018-19, due to the introduction of external bulk charges (\$0.58 million) and the increase in the environmental contribution from \$0.79 million to \$0.90 million.

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

²⁹ The Department of Health and Human Services and the Environment Protection Authority Victoria provided their latest 2016-17 licence fees. We have also based our forecast on our 2016-17 commission licence fee.

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	15.0	15.0	14.9	14.7	14.6	74.3
Payroll tax rate change	-0.06	-0.06	-0.06	-0.06	-0.06	-0.31
Total adjustments to controllable costs	-0.06	-0.06	-0.06	-0.06	-0.06	-0.31
Licence fees	0.01	0.01	0.01	0.01	0.02	0.06
Environment contribution	-0.13	-0.12	-0.12	-0.12	-0.12	-0.61
External bulk charges	0.00	0.002	0.004	0.001	0.001	0.01
Total adjustments to non-controllable costs	-0.12	-0.11	-0.11	-0.11	-0.10	-0.54
Final decision – total operating expenditure	14.8	14.8	14.8	14.5	14.5	73.5

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 Westernport Water’s revenue requirement (Table 2.1). We consider Westernport Water’s approach to forecasting controllable operating expenditure, alongside the \$0.85 million reduction for payroll costs and non-controllable costs, 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.³⁰

³⁰ Essential Services Commission 2016, *Guidance paper*, op. cit., p. 31.

Table 2.4 Final decision – Operating expenditure

\$ million 2017-18

	2018-19	2019-20	2020-21	2021-22	2022-23	Total
Controllable costs	13.3	13.3	13.2	13.2	13.2	66.1
Non-controllable costs	1.6	1.6	1.6	1.3	1.3	7.3
Bulk services ^a	0.6	0.6	0.6	0.4	0.4	2.4
Environmental contribution ^b	0.9	0.9	0.9	0.8	0.8	4.3
Licence fees – ESC ^c	0.013	0.013	0.013	0.013	0.019	0.069
Licence fees – DHHS ^c	0.007	0.007	0.007	0.007	0.007	0.037
Licence fees – EPA ^c	0.033	0.033	0.033	0.033	0.033	0.165
Other	0.1	0.1	0.1	0.1	0.1	0.3
Final decision – total operating expenditure	14.8	14.8	14.8	14.5	14.5	73.5

^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

^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 Westernport Water does not represent the amount that Westernport Water is required to spend or allocate to particular operational, maintenance and administrative activities. Rather, it represents assumptions about the overall level of operating expenditure (to be recovered through prices) that we consider sufficient to operate the business and to provide services over the regulatory period.

Regulatory asset base

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

- closing regulatory asset base at 30 June 2017

Our assessment

- forecast regulatory asset base for each year of the regulatory period from 1 July 2018.

Closing regulatory asset base

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

Our draft decision accepted Westernport Water's proposed closing regulatory asset base for 30 June 2017 of \$116.9 million because:

- Westernport Water's actual net capital expenditure for the period from 2012-13 to 2016-17 was about the same as the forecast used to approve prices for the period from 1 July 2013.^{31 32}
- Westernport Water calculated its closing regulatory asset base in accordance with the requirements of our guidance.

Following our draft decision, Westernport Water advised us there was a data entry error in its price submission forecasts for proceeds from disposals in 2015-16 and 2016-17, and in capital expenditure for 2016-17. We have verified these corrections against Westernport Water's regulatory accounts. The corrections result in a closing regulatory asset base for 30 June 2017 of \$117.1 million, compared to the \$116.9 million in our draft decision.

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

Our final decision approves a closing regulatory asset base at 30 June 2017 of \$117.1 million. The calculations are provided at Table 2.5.

³¹ Net capital expenditure is calculated by deducting government and customer contributions from gross capital expenditure.

³² 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	98.6	109.5	110.9	113.8	115.3
Plus gross capital expenditure	14.5	4.4	5.4	4.3	5.3
Less government contributions	0.0	0.0	0.0	0.0	0.0
Less customer contributions	0.9	0.5	0.4	0.4	0.8
Less proceeds from disposals	0.1	0.6	0.04	0.1	0.1
Less regulatory depreciation	2.6	1.9	2.1	2.3	2.5
Closing RAB 30 June	109.5	110.9	113.8	115.3	117.1

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 Westernport Water's forecast regulatory asset base from 1 July 2018.³³ Since our draft decision we have updated the closing asset base (noted previously). We have not adjusted any other element of the forecast regulatory asset base for our final decision.

³³ 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	117.1	120.4	122.8	125.2	127.2	128.3
Plus gross capital expenditure	6.6	5.3	5.5	5.4	4.8	5.5
Less government contributions	0.0	0.0	0.0	0.0	0.0	0.0
Less customer contributions	0.6	0.6	0.6	0.6	0.6	0.5
Less proceeds from disposals	0.07	0.05	0.05	0.05	0.05	0.04
Less regulatory depreciation	2.6	2.3	2.5	2.8	3.0	3.3
Closing RAB 30 June	120.4	122.8	125.2	127.2	128.3	129.8

Note: Numbers have been rounded

Capital expenditure

Capital expenditure is an input to estimating the regulatory asset base. In our draft decision (pages 15 to 17), we proposed to accept Westernport Water’s gross capital expenditure forecast of \$26.5 million for the 2018–23 period. The reasons for this were:

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

Westernport Water’s response to our draft decision did not provide any new information on our draft decision for gross capital expenditure. No new considerations were presented in submissions received following the draft decision which caused us to change our views on capital expenditure.

Accordingly, we consider it appropriate to maintain the views we expressed in our draft decision in relation to the gross capital expenditure benchmark for the same reasons proposed in our draft

Our assessment

decision. We consider this benchmark is consistent with our guidance and WIRO principles,³⁴ and is reflected in our final decision on Westernport Water's forecast regulatory asset base (Table 2.6) and its revenue requirement (Table 2.1).

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

Customer contributions

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

Our draft decision considered Westernport Water's forecast revenue from customer contributions were reasonable, having regard to past trends and its growth forecasts. No 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, we consider it appropriate to maintain the views we expressed in our draft decision. Our final decision accepts the position in our draft decision for the same reasons, and accepts the benchmark revenue from customer contributions proposed by Westernport Water and set out at Table 2.6.

Cost of debt

In our draft decision we proposed to approve the cost of debt proposed by Westernport 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.³⁵

³⁴ Essential Services Commission 2016, *Guidance Paper*, op. cit., p. 35; WIRO clause 8(b)

³⁵ We received data on the actual trailing average cost of debt for 2017-18 from Treasury Corporation Victoria in April 2018.

A submission from the 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).³⁶ 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.³⁷

A submission by the Water Services Association Australia (WSAA) addressed CALC’s submission.³⁸ 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.³⁹

In our view, adopting the approach recommended by CALC would mean a benchmark efficient water corporation may not have a reasonable opportunity to recover their debt costs.

A more detailed response to the issues raised by CALC is set out at Appendix D.

Our final decision adopts the benchmark cost of debt as set out in Table 2.7.⁴⁰

Table 2.7 Final decision – Trailing average cost of debt

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

Note: Numbers have been rounded

³⁶ Consumer Action Law Centre 2018, *Submission: Cost of debt and allowed return on equity in the 2018 Water Price Review*, 26 March.

³⁷ Consumer Action Law Centre 2018, *Cost of debt*, op cit., Appendix A.

³⁸ WSAA 2018, *WSAA Submission to ESC Cost of debt*, May.

³⁹ 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).

⁴⁰ We received data on the actual trailing average cost of debt for 2017-18 from the Treasury Corporation Victoria in April 2018, and we updated the 2017-18 estimates for our final decision.

Return on equity – PREMO rating

Westernport Water rated its price submission as ‘Standard’. Based on its PREMO self-rating, Westernport 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’.⁴¹

The return on equity is similar to rates we have approved in past reviews for the water industry. We have also had regard to the return on equity allowed or estimated by regulators in other Australian jurisdictions recently for the water industry.⁴²

Our draft decision proposed to accept Westernport Water’s proposed return on equity. This reflected our preliminary review of its PREMO self-rating.

A submission from the Consumer Action Law Centre (CALC) recommended a one per cent reduction to each return on equity value in the PREMO matrix.⁴³ 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.⁴⁴ 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.

Our final decision accepts Westernport Water’s proposed return on equity of 4.5 per cent per annum, reflecting our views above, and our final decision on its PREMO rating (Chapter 3).

Regulatory depreciation

Regulatory depreciation is an input to calculating the regulatory asset base. Our draft decision proposed to accept Westernport Water’s forecast regulatory depreciation, as it was calculated in a

⁴¹ Essential Services Commission 2016, *Guidance paper*, op. cit., p. 49.

⁴² 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.

⁴³ Consumer Action Law Centre 2018, *Cost of debt*, op. cit.

⁴⁴ 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.

manner consistent with the requirements of our guidance.⁴⁵ No new considerations were presented in submissions received following the draft decision which caused us to change our views on depreciation.

For the reasons set out above, we consider it appropriate to maintain the views we expressed in our draft decision. Our final decision accepts the position in our draft decision for the same reasons, and accepts Westernport Water's forecast for regulatory depreciation, as set out in Table 2.1.

Tax allowance

The tax allowance is an input into the revenue requirement. Our draft decision accepted Westernport Water's forecasts for zero tax in its revenue requirement, as it was calculated in a manner consistent with the requirements of our guidance.⁴⁶ 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, we consider it appropriate to maintain the views we expressed in our draft decision. Our final decision accepts the position in our draft decision for the same reasons, and accepts Westernport Water's tax forecasts, as set out in Table 2.1.

Demand

In our draft decision, we proposed to approve Westernport Water's demand forecasts as we considered they were estimated in a manner consistent 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 these reasons, we consider it appropriate to maintain the views we expressed in our draft decision. Our final decision accepts the position in our draft decision for the same reasons, and accepts Westernport Water's demand forecasts.

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

⁴⁵ Essential Services Commission 2016, *Guidance paper*, op. cit., p. 42.

⁴⁶ Essential Services Commission 2016, *Guidance paper*, op. cit., pp. 50-51.

Form of price control

Our draft decision accepted Westernport 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 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 consider it appropriate to maintain the views we expressed in our draft decision. Our final decision accepts the position in our draft decision for the same reasons, and approves Westernport Water's proposed price cap form of price control.⁴⁷

Tariff structures and prices

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

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

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.⁴⁸ We also considered two-part tariff structures are easy to understand.

Our draft decision accepted Westernport 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 Westernport Water's proposed new standpipe tariff for water carting, where the price would match the lowest rate offered among neighbouring water corporations. We proposed to accept this tariff as we agreed with Westernport Water's justification on page 74 of its price submission. We also noted the proposed tariff is easy to understand and it provides price signals to customers about the efficient costs of accessing water.

⁴⁷ 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.

⁴⁸ 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.

In its response to our draft decision, Consumer Action Law Centre noted that some water corporations, but not Westernport Water, proposed to adjust variable and fixed charges to help ensure the end of a rebate after 2017-18 had a minimal impact on customer bills.⁴⁹ It also noted Westernport Water had not responded to feedback at a workshop indicating a majority of customers preferred an increase in variable charges relative to fixed charges.⁵⁰

Our draft decision noted that we provide water corporations with a large degree of discretion to decide on individual tariff structures.⁵¹ This recognises water corporations are often best placed to consider the interests of customers in designing tariffs.

Westernport Water concluded there was insufficient majority support for changing the mix of fixed and variable tariffs. Also, Westernport Water's submission considered the importance of fixed charges in allowing the corporation to meet its revenue requirement, given the relatively high proportion of customers who are non-permanent residents. We are satisfied Westernport Water's price submission adequately considered customer views on tariff structures. We note that an increase in the variable charge relative to the fixed would further increase tenants' bills, exacerbating the impact of the government rebate ending.

The submission from the Consumer Action Law Centre also commented on the estimated bill increase in 2018–19 for residential customers arising from Westernport Water's proposed prices. It supports an approach that smooths any increases over time.⁵² Our role is to approve maximum prices. Our final decision approves prices that decline in real terms from 1 July 2018, based on our review of efficient costs and other matters we are required to consider. The estimated bill increase in 2018–19 is mainly due to the ending of a rebate after 2017-18, and an increase in Westernport Water's non-controllable costs. We also note Westernport Water has committed to expand support for customers experiencing payment difficulty.

No new considerations were presented in submissions received following the draft decision which caused us to change our views on Westernport Water's proposed recycled water, trade waste and miscellaneous services tariffs and the new standpipe tariff.

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 approves Westernport Water's proposed tariff structures.

⁴⁹ From 2014-15, Westernport Water's residential customers receiving a bill including water usage charges received an annual rebate. The rebate reflects the outcomes of a government efficiency review, and ends after 2017-18.

⁵⁰ Consumer Action Law Centre 2018, *Early Draft Decisions*, op. cit., p. 2 and p. 5.

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

⁵² Consumer Action Law Centre 2018, *Early Draft Decisions*, op. cit., p. 3.

Our price determination for Westernport 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 2.8 and 2.9.

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

	2018-19	2019-20	2020-21	2021-22	2022-23
Residential					
Variable (\$/kL)	2.0040	2.0040	2.0040	2.0040	2.0040
Fixed (20mm) (\$/year)	389.98	389.98	389.98	389.98	389.98
Non-residential					
Variable (\$/kL)	2.0040	2.0040	2.0040	2.0040	2.0040
Fixed (20mm) (\$/year)	389.98	389.98	389.98	389.98	389.98

Note: Numbers have been rounded down

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

	2018-19	2019-20	2020-21	2021-22	2022-23
Residential					
Fixed (\$/year)	601.22	601.22	601.22	601.22	601.22
Non-residential					
Fixed (1 cistern) (\$/year)	601.22	601.22	601.22	601.22	601.22

Note: Numbers have been rounded down

Adjusting prices

In our draft decision we:

- proposed to approve Westernport Water's proposal to continue the existing uncertain and unforeseen events mechanism

Our assessment

- agreed with Westernport Water’s justification for its proposed pass-through for any usage of its entitlement in the Greater Yarra–Thomson system, but invited Westernport Water to submit revised price adjustment formulas that were easier to understand
- invited Westernport Water to submit price adjustment formulas that allowed prices to adjust to changes in the cost of debt.

In response to our review of Westernport Water’s proposed price adjustment mechanism, Westernport Water worked with us to develop formulas for usage of its entitlement in the Greater Yarra–Thomson system and changes in the cost of debt. We assessed Westernport Water’s revised price adjustment formulas and consider it is easy to understand and better supports customers’ understanding of price changes.

Our final decision approves Westernport Water’s uncertain and unforeseen events mechanism and updated price adjustment mechanisms.

New customer contributions

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

Our draft decision proposed to accept Westernport Water’s proposed charges for new customer contributions, which included a decrease to the standard water contribution charge and an increase to the standard sewerage contribution charge in 2018-19. Our draft decision considered that Westernport Water’s proposed new customer contributions charges are consistent with the requirements of our guidance.⁵³

Our draft decision also proposed to accept Westernport Water’s proposal to continue to calculate negotiated charges in accordance with the requirements of our new customer contribution 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.

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,

⁵³ Essential Services Commission 2016, *Guidance paper*, op. cit., pp. 62–63

and accepts Westernport Water’s proposed new customer contribution charges for water and sewerage, including its method of calculating negotiated contribution charges.

Our price determination for Westernport 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).

Westernport 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.⁵⁴

Financial position

In approving prices, we must have regard to the financial viability of the water industry.⁵⁵ 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 Westernport Water’s prices. We have assessed that, under our final decision, Westernport Water will generate sufficient cash flow to deliver on service commitments, including financing costs arising from investments to meet service expectations.

⁵⁴ Essential Services Commission 2013, *New Customer Contributions: Explanatory Note, December*, pp. 9-11.

⁵⁵ 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 Westernport Water's proposed return on equity of 4.9 per cent, based on the justification provided for the level of ambition in its price submission. In this chapter we set out our assessment of Westernport Water's proposed PREMO rating.

Our review of Westernport Water's PREMO self-rating

Westernport Water's proposed PREMO rating, and our draft and final decisions are summarised in Table 3.1. After considering submissions in response to our draft decision, our final decision agrees with Westernport Water's proposed PREMO rating.

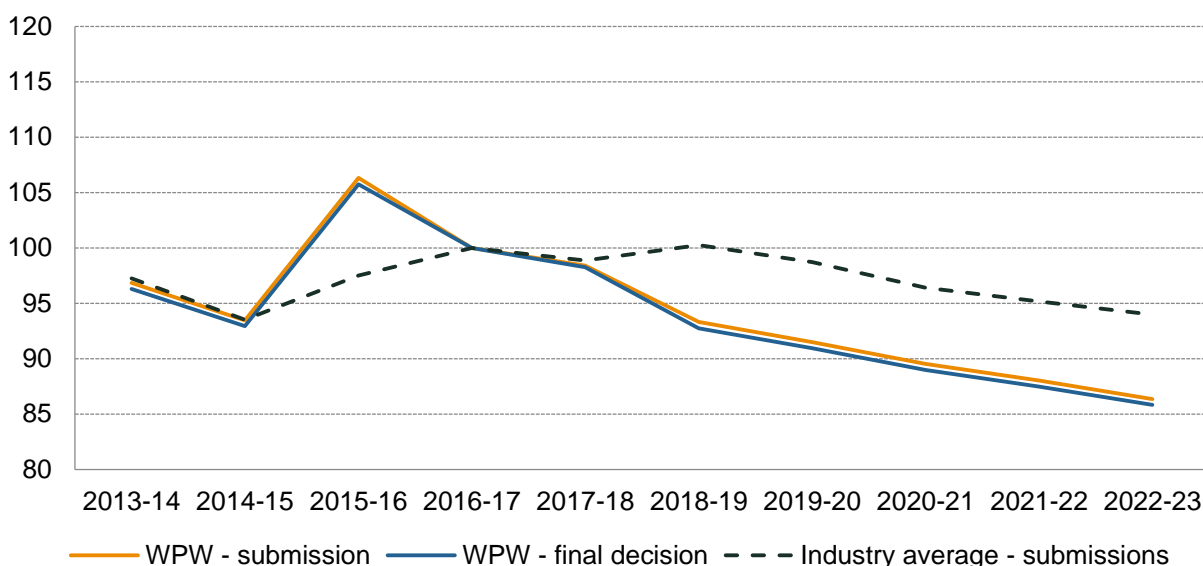
Table 3.1 PREMO Rating

	Overall PREMO rating	Risk	Engagement	Management	Outcomes
Westernport Water's rating	Standard	Standard	Advanced	Standard	Standard
Commission's draft decision rating	Standard	Standard	Advanced	Standard	Standard
Commission's final decision rating	Standard	Standard	Advanced	Standard	Standard

In support of its proposed PREMO rating, we note Westernport Water’s efficiency improvement rate for operating expenditure in its price submission, which was high relative to the proposals of other water corporations, and will deliver a significant reduction in operating cost per customer compared with the industry average (Figure 3.1).

Figure 3.1 Controllable operating expenditure per water connection

Index: 2016-17=100



Our final decision affirms our draft decision rating of ‘Advanced’ for Engagement. As noted in our draft decision, based on the information provided to us, we consider Westernport Water could have done more to explain to customers how their bills would be affected when the annual government rebate ends after 2017-18. We consider this is important information for customers. This was also raised in a submission by the Consumer Action Law Centre responding to our draft decision.⁵⁶

This was offset however, by other features of Westernport Water’s engagement including:

- its tailored approach to reaching its main customer segments, including non-permanent residents which account for a relatively high share of its residential customers
- the involvement of customers in setting service levels, and the rebate that will apply if Westernport Water fails to meet its service targets
- evidence that customers influenced its proposals, such as its approach to the share of variable tariffs in customer bills.

⁵⁶ Consumer Action Law Centre 2018, *Submission: Comment on Early Draft Decisions*, 13 March, p. 2.

Consistent with our draft decision, we agree with Westernport Water’s proposed overall PREMO self-rating of ‘Standard’. This is reflected in the return on equity we have approved for Westernport Water at page 19.

Appendix A – submissions received on draft decision

Name or organisation	Date received
Water Services Association Australia	16 May 2018
Consumer Action Law Centre	26 March 2018
Consumer Action Law Centre	13 March 2018
Environment Protection Authority Victoria	12 December 2017

Appendix B – approved service standards

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

Westernport 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)	30	30	30	30	30
Average time taken to attend bursts and leaks (priority 2) (minutes)	35	35	35	35	35
Average time taken to attend bursts and leaks (priority 3) (minutes)	300	300	300	300	300
Average duration of unplanned water supply interruptions (minutes)	96	96	96	96	96
Average duration of planned water supply interruptions (minutes)	157	157	157	157	157
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)	60	60	60	60	60
Average time to rectify a sewer blockage (minutes)	200	200	200	200	200
Spills contained within 5 hours (per cent)	100	100	100	100	100

Note: Numbers have been rounded

Appendix C – approved GSL schemes

We have approved the following service level obligations and corresponding amounts of payment for failure to attain the stated obligation as the guaranteed service level (GSL) scheme for Westernport Water.

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

Westernport 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 Westernport Water.

Westernport Water's approved GSL scheme

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

Appendix D – rate of return

A submission from the Consumer Action Law Centre (CALC) recommended 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.⁵⁷ These recommendations are based on a report prepared by CME for CALC.⁵⁸

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.⁵⁹ 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 due to state taxpayers for accepting the business' 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

⁵⁷ Consumer Action Law Centre 2018, *Cost of debt*, op. cit.

⁵⁸ Consumer Action Law Centre 2018, *Cost of debt*, op cit., Appendix A.

⁵⁹ 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 WIRO.⁶⁰

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.⁶¹ 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.⁶²

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.⁶³

⁶⁰ 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).

⁶¹ Consumer Action Law Centre 2018, *Cost of debt*, op. cit.

⁶² 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

⁶³ 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.