

Barwon Water final decision

2018 Water Price Review

19 June 2018

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Summary

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

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

Our final decision has updated Barwon Water’s revenue requirement

Our final decision approves a revenue requirement of \$973.4 million over the five year period starting 1 July 2018.³ This is \$2.1 million or 0.2 per cent lower than our draft decision, and mainly reflects updates to Barwon Water’s non-controllable operating costs (see page 12).

A summary of approved maximum prices for major services delivered by Barwon Water is set out on page 25. The estimated typical bills for residential customer groups under Barwon Water’s proposals and our final decision are provided in Table A. In 2018-19 the estimated typical annual bill for a residential customer will remain steady (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)	160	\$1,025 ^a	\$1,025	\$1,038
Residential (Tenant)	160	\$287 ^a	\$287 ^b	\$300 ^b

^a Following an \$80 rebate paid to customers from a government efficiency review

^b Includes a rebate of \$20 in 2018-19 and \$43 in 2022-23

Note: Numbers have been rounded

Barwon Water will improve services

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

- increasing the share of water usage charges in residential bills, in response to feedback that customers wanted greater control over their bills
- increasing support for financially vulnerable customers
- providing more timely notice of water supply interruptions by SMS

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.

Summary

- introducing programs to help customers use water more efficiently.

The share of variable charges will rise, providing for greater customer control over bills

Our final decision approves Barwon Water's proposed tariff structures. For water services, we have approved a fixed service charge and a variable component that depends on water used. In response to customer feedback that they wanted more control over bills, Barwon Water proposed to increase the share of water variable charges in bills. Consistent with our draft decision, our final decision accepts this change, noting it was the subject of extensive consultation with customers.

For residential sewerage services, we have approved Barwon Water's proposal for a fixed charge only. For non-residential sewerage services, we have approved a two-part tariff with a fixed service charge and a variable usage component. We have approved these tariff structures on the basis that they meet the criteria in our guidance and are a continuation of Barwon Water's current approach (see pages 23 to 25).

Our draft decision did not accept Barwon Water's proposed net revenue cap form of price control, as outlined in its price submission. We considered Barwon Water did not demonstrate that its proposal better satisfies the requirements of the Water Industry Regulatory Order, compared to its current approach. In response to our draft decision, Barwon Water proposed instead to continue with its price cap form of price control. We have approved Barwon Water's proposal for a price cap form of price control, as it reflects a continuation of current arrangements, and otherwise meets the requirements of our guidance (see page 23).

Barwon Water's price submission is rated as 'Advanced' under PREMO

Our final decision accepts Barwon Water's PREMO self-rating of its price submission as 'Advanced'. Barwon Water has demonstrated its proposals will deliver better value to its customers, consistent with an 'Advanced' price submission. In particular, we found Barwon Water's engagement was 'Leading', relying heavily on deliberative approaches to provide customers with the opportunity to influence its proposals. We also found Barwon Water demonstrated a strong commitment to controlling costs. Its price submission was also of a high quality.

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

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

Figure A Barwon Water PREMO Rating

	Overall PREMO rating	Risk	Engagement	Management	Outcomes
Barwon Water's rating	Advanced	Advanced	Leading	Advanced	Advanced
Commission's rating	Advanced	Standard	Leading	Advanced	Advanced

Figure B Final decision on PREMO – overall rating

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

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

1. Our role and approach to water pricing

We are Victoria's independent economic regulator

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

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

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

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

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

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

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

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.

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

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.

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.

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

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 Barwon Water's price submission

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

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

Our guidance included a number of matters water corporations must address in their price submissions. Barwon 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 Barwon Water (1 July 2018 to 30 June 2023) in its price submission. Our guidance proposed to approve a five year regulatory period, subject to any alternative and justified proposal.¹⁹

In response to our draft decision, the 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 Barwon Water. This is the same period we have approved for all but three water corporations in our current price review.

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

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

Customer engagement

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

The engagement by Barwon Water:

- took place between June 2016 and September 2017
- included a range of methods such as workshops, focus groups, surveys, and a community panel (running as a form of citizens' jury) with members representative of its customer base
- was informed by input from community and indigenous groups, vulnerable customer advocacy groups, large business customers and an environmental consultative committee
- covered matters such as supply reliability, prices and tariff structures, and the level of assistance provided to vulnerable customers.

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

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

- accepting 10 recommendations made by the community panel in full, and another five with some amendment
- increasing the share of water variable charges in residential bills, in response to customer feedback that they wanted more control over their bills
- encouraging greater use of recycled water in response to feedback that customers see this as a way to improve water security.

The influence of Barwon 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 engagement.

Outcomes

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

- a reliable, secure water future for its region
- timely, innovative services for customers

²¹ Barwon Water's price submission is available on our website at www.esc.vic.gov.au. See pages 6 to 29.

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.

- a healthier environment for all
- deeper knowledge and partnerships within its community
- affordability for all customers.

Barwon Water's proposed measures and targets for reporting on these outcomes are set out on page 6 of the executive summary in its price submission.

Barwon Water has committed to report to customers annually on its performance against each of these measures. Performance information will be available on its website, engagement portal, social media and email. Barwon Water has committed to returning funds to customers if it does not meet key performance indicators – more detail is available on pages 132 to 133 of its price submission.

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

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

We have not adopted CALC's recommendation in our final decision. We note that the additional allowance in our 2013 price review was provided in recognition of the large one-off price increases approved for the metropolitan corporations during the 2013 review.²⁵ Further, water corporations already allocate funds to programs aimed to deliver payment options and hardship support required by our customer service codes. Barwon Water has responded to customer views on affordability by increasing customer hardship grants.

Service Standards

Barwon 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 Barwon Water's targets until 2023 are set out in Appendix B of our final decision.

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

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

CALC noted a range of ambitions by water corporations in relation to proposed service standards, and that water corporations should be encouraged to improve service standards over time.²⁶

We note that Barwon Water proposed targets for service standards relating to reliability and attending faults that are consistent with its past performance. We accept there are arguments for maintaining or decreasing service levels; for example, where engagement identifies customers are satisfied with the existing level of service, or where customers prefer a reduction in service performance as it delivers a reduction in prices and bills. Barwon Water's proposed standards for reliability and attending faults were informed by its engagement. This approach aligns with our expectation that water corporations consider customer preferences when forming these service targets.

Barwon Water has also committed to improving outcomes for customers in areas such as providing more timely notice of water supply interruptions (by SMS), and introducing programs to help customers use water more efficiently.

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

Barwon Water's proposed GSLs are set out on pages 136 and 137 of its price submission.

In our draft decision we provided an overview of Barwon Water's proposed GSLs.

CALC supported GSL payments increasing over time.²⁷ We note that Barwon Water proposes to increase the rebate for its existing GSLs to reflect movements in inflation. Barwon Water's proposed GSLs were based on recommendations of its community panel, which we consider provides assurance that its GSLs reflect the most important aspects of service delivery from a

²⁶ Consumer Action Law Centre, *op. cit.*, p. 6.

²⁷ *ibid.*, p. 1.

customer perspective.²⁸ For these reasons, our final decision approves Barwon Water's proposed GSLs.

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

Barwon Water's commitment to GSL payments should these service levels not be met, forms part of the manner in which Barwon 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 \$975.5 million over a five year period starting 1 July 2018. Our final decision approves a slightly lower revenue requirement of \$973.4 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 is mainly due to updates we made to Barwon Water's forecast non-controllable operating expenditure (see pages 12 to 13). The reduced return on assets reflects our update to the cost of debt (see pages 20 to 21), which was foreshadowed in our draft decision.

Adjustments to the revenue requirement since our draft decision are set out at Table 2.2, with the reasons explained in more detail in the following sections.

²⁸ Justification for Barwon Water's proposed GSLs is set out in its price submission at appendix 2 – its price submission is available at www.esc.vic.gov.au.

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 Barwon 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	98.4	97.1	95.9	96.1	95.4	482.8
Return on assets	55.3	55.9	56.6	57.0	57.3	282.1
Regulatory depreciation	37.7	40.3	42.5	44.2	43.8	208.5
Tax allowance	0.0	0.0	0.0	0.0	0.0	0.0
Revenue requirement	191.3	193.3	195.0	197.3	196.5	973.4

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	191.7	193.7	195.4	197.7	196.9	975.5
Operating expenditure	-0.4	-0.4	-0.4	-0.4	-0.4	-1.8
Return on assets	-0.03	-0.04	-0.1	-0.1	-0.1	-0.2
Total adjustments	-0.4	-0.4	-0.4	-0.4	-0.4	-2.1
Final decision – revenue requirement	191.3	193.3	195.0	197.3	196.5	973.4

Note: Numbers have been rounded

Operating expenditure

Operating expenditure is an input to the revenue requirement. Our draft decision proposed to adopt a \$443.4 million benchmark for Barwon Water's forecast controllable operating costs for the 2018-23 period. This was \$12.2 million lower than proposed by Barwon Water, and we set out our reasoning for this adjustment in our draft decision (pages 9 to 16). In summary, we found:

Our assessment

- Evidence indicating its baseline controllable operating expenditure reflects an efficient benchmark.³⁰
- Barwon Water proposed the fourth highest efficiency improvement rate of 2.3 per cent per year (at the time), which exceeds its forecast customer connection growth of 1.6 per cent per year, giving a declining annual baseline operating cost.
- \$7.90 million of additional labour costs to cover wage increases above inflation resulting from its enterprise agreement should be removed.
- \$1.97 million of additional electricity costs should be removed, and we requested an updated forecast for electricity costs based on new contract prices, given the electricity contract was currently under negotiation.
- A correction was required to Barwon Water's financial model where it treated finance lease costs for a biosolids drying plant as non-controllable operating expenditure. This correction increased total controllable operating expenditure by \$22.10 million, and reduced the non-controllable operating expenditure by the corresponding amount.

We forecasted \$41.2 million for Barwon 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.

Barwon Water's response to our draft decision accepted our correction to its financial model, and provided new information for labour, payroll tax and an updated forecast for electricity.

Barwon Water accepted our draft decision that wage increases above inflation resulting from its enterprise agreement should be managed through productivity improvements and through the 1.6 per cent customer connection growth allowance. However it pointed out that half of the requested \$7.9 million labour cost increase above the baseline costs were due to filling six positions that were vacant in 2016-17. Barwon Water's full-time equivalent (FTE) staff target is 315 positions, so this represents a vacancy rate of 1.9 per cent. We consider a vacancy rate of two per cent to be reasonable for a water corporation, so Barwon Water's situation does not warrant an increase in operating costs to fill these positions to meet its FTE target.³² For this reason, our final decision for forecast labour remains unchanged from our draft decision.

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, Barwon Water has advised a reduction of \$2.00 million across the 2018–23 period. This is consistent with our draft decision requirement to be provided

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.

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.

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

Barwon Water accepted our draft decision's indicative removal of \$1.97 million to its proposed electricity cost increase above the baseline. It also provided an updated electricity cost forecast for 2018-19 of \$6.1 million compared to its original forecast of \$5.41 million, based on new contract prices.³³ Although the new cost estimate is marginally higher than the price submission, Barwon Water does not propose to adjust its revenue requirement. We accept Barwon Water's final proposal, and our final decision for electricity costs remains unchanged from 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.³⁴ No other new considerations were presented in submissions received following the draft decision which caused us to change our views on operating expenditure.

For non-controllable operating expenditure, we have revised our draft decision forecasts where required based on the latest March 2018 inflation and external bulk charges information. We have revised our forecast environmental contribution from our draft decision, and made no changes to forecast licence fees or external bulk charges.³⁵

Based on the latest inflation data, we have revised the forecast 2018-19 environmental contribution from \$8.22 million to \$8.25 million, which results in a total increase of \$0.15 million across the 2018–23 period.

Accordingly, we have increased our draft decision forecast for Barwon Water's non-controllable operating expenditure by \$0.15 million to \$41.36 million across the 2018–23 period.

Table 2.3 sets out our final decision adjustments for operating expenditure. Table 2.4 sets out the benchmark values for environmental contribution, bulk charges and licence fees we have adopted for our final decision.

³³ We requested our expenditure consultant, Deloitte Access Economics, to review the updated electricity price forecasts and compare against the information received for our draft decision. Deloitte did not recommend any adjustments for our final decision.

³⁴ Consumer Action Law Centre, *op. cit.*

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

Table 2.3 Adjustments to operating expenditure

\$ million 2017-18

	2018-19	2019-20	2020-21	2021-22	2022-23	Total
Draft decision – total operating expenditure	98.7	97.5	96.2	96.4	95.7	484.6
Payroll tax	-0.40	-0.40	-0.40	-0.40	-0.40	-2.00
Total adjustments to controllable costs	-0.40	-0.40	-0.40	-0.40	-0.40	-2.00
Environmental contribution	0.03	0.03	0.03	0.03	0.03	0.15
Total adjustments to non-controllable costs	0.03	0.03	0.03	0.03	0.03	0.15
Final decision – total operating expenditure	98.4	97.1	95.9	96.1	95.4	482.8

Note: Numbers have been rounded

We have adopted the benchmark for operating expenditure set out in Table 2.4 for the purpose of making our final decision on Barwon Water's revenue requirement (Table 2.1). We consider our final decision for Barwon Water's forecast operating expenditure is consistent with the requirements of the Water Industry Regulatory Order 2014 (WIRO) and the criteria for prudent and efficient expenditure outlined in our guidance.³⁶

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

Table 2.4 Final decision – operating expenditure

\$ million 2017-18

	2018-19	2019-20	2020-21	2021-22	2022-23	Total
Controllable costs	89.7	88.7	87.6	88.0	87.4	441.4
Non-controllable costs	8.6	8.4	8.3	8.1	8.0	41.4
Bulk services ^a	0.0	0.0	0.0	0.0	0.0	0.0
Environmental contribution ^b	8.3	8.1	7.9	7.7	7.5	39.5
Licence fees – ESC ^c	0.112	0.112	0.112	0.112	0.169	0.619
Licence fees – DHHS ^c	0.073	0.073	0.073	0.073	0.073	0.363
Licence fees – EPA ^c	0.185	0.185	0.185	0.185	0.185	0.926
Other	0.0	0.0	0.0	0.0	0.0	0.0
Final decision – total operating expenditure	98.4	97.1	95.9	96.1	95.4	482.8

^a Bulk services covers the supply of bulk water and sewerage services

^b The Environmental Contribution collects funds from water corporations under the *Water Industry Act 1994* (Vic)

^c Licence fees are paid to cover costs incurred by Department of Health and Human Services, Environment Protection Authority Victoria, and the Essential Services Commission in their regulatory activities related to the water corporation

Note: Numbers have been rounded

The benchmark operating expenditure that we have adopted for Barwon Water does not represent the amount that Barwon 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 Barwon 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 Barwon Water's proposed closing regulatory asset base for 30 June 2017 of \$1,338.2 million, as it was calculated in accordance with the requirements of our guidance.

In its response to our draft decision, Barwon Water proposed to recover \$21.65 million in payments it made to Melbourne Water in 2016–17 for bulk water services. Its response proposed that the amounts be included in its closing regulatory asset base for 30 June 2017.³⁷ Barwon Water did not seek recovery of the payments in its price submission, so it was not assessed for our draft decision.

Our final decision approves Barwon Water's proposal to add \$21.65 million to our draft decision amount for the closing regulatory asset base, as we have assessed that the bulk water expenditure is prudent and efficient. Compared to our draft decision, including the expenditure increases the revenue requirement by \$4.5 million over the 2018-23 regulatory period (by increasing the return on assets in the revenue requirement).

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

For the reasons set out above, our final decision approves a closing regulatory asset base at 30 June 2017 of \$1,359.9 million. The calculations are provided at Table 2.5.

³⁷ This approach means the payments made to Melbourne Water are treated as capital expenditure in our pricing model, not operating expenditure, and so the costs are recovered over a number of years (compared with operating expenditure, which is recovered in the same year it is incurred).

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	1,081.5	1,198.5	1,256.5	1,274.2	1,305.8
Plus gross capital expenditure ^a	170.4	103.4	66.6	82.7	106.7
Less government contributions	8.1	6.0	1.6	0.2	0.3
Less customer contributions	12.6	6.7	13.1	15.7	11.8
Less proceeds from disposals ^b	1.7	1.3	2.2	2.1	6.4
Less regulatory depreciation	31.0	31.4	32.0	33.0	34.2
Closing RAB 30 June	1,198.5	1,256.5	1,274.2	1,305.8	1,359.9

^a gross capital expenditure for the period: 2013-14 includes \$8.2 million NVIRP contribution capitalisation, and 2016-17 includes \$21.65 million prepayment to Melbourne Water for bulk water services

^b proceeds from disposals for the period 2014-15 to 2016-17 includes \$8.32 million for property realisation program

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 Barwon Water's forecast regulatory asset base from 1 July 2018.³⁸ Each element of the forecast regulatory asset base is discussed below.

³⁸ 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	1,359.9	1,334.6	1,342.9	1,364.0	1,377.9	1,382.5
Plus gross capital expenditure ^a	50.6	86.0	79.1	63.5	55.9	61.0
Less government contributions	0.0	0.0	0.0	0.0	0.0	0.0
Less customer contributions	12.3	6.3	6.6	6.7	6.6	6.8
Less proceeds from disposals ^b	28.6	33.8	11.2	0.4	0.4	0.4
Less regulatory depreciation	35.1	37.7	40.3	42.5	44.2	43.8
Closing RAB 30 June	1,334.6	1,342.9	1,364.0	1,377.9	1,382.5	1,392.6

^a gross capital expenditure for the period: 2020-21 to 2022-23 include \$16.94 million capitalised payments to Melbourne Water for bulk water services

^b proceeds from disposals for the period 2017-18 to 2019-20 include \$72.55 million for property realisation program.

Note: Numbers have been rounded

Capital expenditure

Capital expenditure is an input to estimating the regulatory asset base. In our draft decision (pages 19 to 22), we proposed to accept Barwon Water's gross capital expenditure forecast of \$328.6 million for the 2018–23 period. The reasons for this were:

- Barwon 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 Barwon Water's past track record delivering its capital expenditure program.
- Barwon Water has an appropriate approach for managing expenditure associated with uncertain projects.
- We considered Barwon Water's approach to forecasting its capital expenditure is consistent with the requirements of our guidance.

In its response to our draft decision, Barwon Water did not propose any changes to its capital expenditure forecasts.

Our assessment

However, we have made a change in our treatment in the financial model of Barwon Water's capitalisation of headworks charges payable to Melbourne Water. This change increases the gross capital expenditure forecast by \$16.94 million, but does not change the net capital expenditure or the revenue requirement, and therefore has no impact on customer prices.

CALC's submission reminded the commission and corporations that 'smart energy meters were touted as a game changer...but have so far failed to deliver on this promise'.³⁹ It stated that new technology must deliver tangible benefits for water customers and be backed by a comprehensive business case. Barwon Water is commencing a transition to digital water meters, by starting with a trial project at Colac. However it has excluded the expected \$20 million cost from its forecast gross capital expenditure due to uncertainty around scope and costs. In our draft decision, we highlighted Barwon Water needs to define success criteria for its digital metering trial before any broader roll-out could proceed. At a minimum, we expect this would include the requirement that expenditure for a full roll-out would deliver a positive net present value for the water corporation, or meet customer willingness-to-pay criteria.

CALC also recommended the commission sets industry-wide principles to ensure the rollout of smart meters is in the best interest of consumers, including support mechanisms for vulnerable customers.⁴⁰ However, our regulatory role does not extend to overseeing the design and delivery of capital projects. We agree with CALC that strong customer engagement and collaboration across the industry is important for achieving an efficient outcome for customers, including vulnerable customers. We also agree water corporations should take into account lessons learnt from the energy smart meter rollout, and from other water corporations further advanced with their digital metering programs.

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

Accordingly, we have adopted the gross capital expenditure benchmark proposed in our draft decision, amended to include the capitalised headworks charges, 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 Barwon Water's forecast regulatory asset base (Table 2.6) and its revenue requirement (Table 2.1).⁴¹

³⁹ Consumer Action Law Centre, op. cit.

⁴⁰ *ibid.*

⁴¹ 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	86.0	79.1	57.6	50.4	55.5	328.6
Bulk water prepayment	0.00	0.00	5.91	5.52	5.52	16.94
Total adjustments to gross capital expenditure	0.00	0.00	5.91	5.52	5.52	16.94
Final decision – gross capital expenditure	86.0	79.1	63.5	55.9	61.0	345.6

Note: Numbers have been rounded

The benchmark that we adopt for Barwon 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. Barwon 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 Barwon Water’s approach for addressing uncertain capital expenditure. We reiterate that Barwon 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 Barwon Water’s forecast revenue from customer contributions was reasonable, having regard to past trends and its growth forecasts. We proposed to accept Barwon Water’s forecast. No other new considerations were presented in submissions received following the draft decision which caused us to change our views on revenue from customer contributions.

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

Cost of debt

In our draft decision we proposed to approve the cost of debt proposed by Barwon 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.⁴²

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).⁴³ 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.⁴⁴

A submission by the Water Services Association of Australia (WSAA) addressed CALC's submission.⁴⁵ 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.⁴⁶

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.

⁴² 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.

⁴³ Consumer Action Law Centre, *op. cit.*, p. 8

⁴⁴ *ibid.*

⁴⁵ Water Services Association of Australia 2018, *Submission*, May.

⁴⁶ 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

Barwon Water rated its price submission as ‘Advanced’. Based on its PREMO self-rating, Barwon Water proposed a rate of return on equity of 4.9 per cent per annum. This reflects the maximum allowed in our guidance – as specified in a PREMO matrix – for an ‘Advanced’ price submission.⁴⁷

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

CALC recommended a one per cent reduction to each return on equity value in the PREMO matrix.⁴⁸ 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. 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.⁴⁹ We also consider the allowed return on equity should not be adjusted to reflect government ownership, as the exposure of a water corporation to market risk will not be materially affected by government ownership.

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

We consider our approach to the return on equity is consistent with our requirements under the WIRO. In particular, we consider our estimate provides water corporations with an incentive to

⁴⁷ Essential Services Commission 2016, *Guidance paper*, op. cit., p. 49.

⁴⁸ Consumer Action Law Centre, op. cit., Appendix A.

⁴⁹ 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.

invest efficiently, and has regard to financial viability matters. We have also had regard to the returns estimated recently by regulators in other Australian jurisdictions for the water industry.⁵⁰

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

Regulatory depreciation

Regulatory depreciation is an input to calculating the regulatory asset base. Our draft decision proposed to accept Barwon Water's forecast regulatory depreciation, as it was calculated in a manner consistent with the requirements of our guidance.⁵¹ No other new considerations were presented in submissions received following the draft decision which caused us to change our views on regulatory depreciation.

For the reasons set out above, our final decision adopts Barwon 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 Barwon Water's forecasts for zero tax in its revenue requirement, as it was calculated consistently with the method required by our guidance.⁵² No other new considerations were presented in submissions received following the draft decision which caused us to change views on the tax allowance.

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

Demand

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

For the reasons set out above, our final decision confirms our draft decision and approves Barwon Water's demand forecasts.

⁵⁰ Essential Services Commission of South Australia, *op. cit.*; Independent Pricing and Regulatory Tribunal 2017, *WACC biannual update*, August.

⁵¹ Essential Services Commission 2016, *Guidance paper*, *op. cit.*, p. 42.

⁵² *Ibid.*, pp. 50-51.

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

Form of price control

Our draft decision did not accept Barwon Water's proposed net revenue cap form of price control. We considered Barwon Water did not demonstrate that its proposal better satisfied the requirements of the WIRO, compared to its current price cap approach.⁵³

In response to our draft decision, Barwon Water instead proposed to continue with its current price cap approach. We consider a price cap provides customers with price certainty, and means a water corporation is managing demand risk on behalf of customers. We also note a price cap reflects a continuation of the current approach, and otherwise meets our guidance.

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

Tariff structures and prices

Our draft decision accepted Barwon Water's proposals to:

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

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

Our draft decision accepted Barwon Water's proposal to increase the share of variable water charges, relative to fixed service charges, in customer bills. We were satisfied that Barwon Water's proposed changes were in line with customer preferences identified by its engagement.

⁵³ In considering whether to approve a proposed form of price control, our guidance outlined at p. 53 that we would have particular regard to whether the proposal involves a continuation of an existing structure or the introduction of a new price control. When a change is proposed, businesses will need to provide evidence to demonstrate that the new price control better satisfies the requirements in clause 11 of the WIRO than the existing structure.

⁵⁴ We note our determinations allow water corporations flexibility to apply to change from a price cap to a weighted average price cap or tariff basket within a regulatory period.

⁵⁵ Includes the tariffs of Icon Water, Sydney Water, Hunter Water, Gosford City Council, Wyong Shire Council, Power and Water Corp, Urban Utilities, Unity Water, SA Water and TasWater.

A submission responding to our draft decision contended Barwon Water’s sewerage service charge is “overpriced”.⁵⁶ As noted in our draft decision, we provide water corporations with a large degree of discretion to decide on individual tariff structures.⁵⁷ This recognises water corporations are often best placed to consider the interests of customers in designing tariffs.

We note that Barwon Water’s proposed tariff structures were informed by an extensive customer engagement program, particularly through its community panel. The panel considered the mix of residential tariffs a number of times and ultimately supported Barwon Water’s proposed tariff structures for residential customers.⁵⁸

In its response to our draft decision, Barwon Water proposed tariffs reflecting our draft decision on its revenue requirement. We consider these proposed tariffs take into account customers’ interests, including low income and vulnerable customers, because:

- the proposed tariffs reflect the forecast efficient costs of delivering services
- the proposed two-part structure for water services tariffs will promote efficient water use, and provide customers a signal about the costs of their water use
- the proposed tariffs were informed by an extensive customer engagement program
- the proposed tariffs allow the corporation to recover revenue to cover forecast efficient costs
- Barwon Water has payment options and assistance for customers experiencing difficulty paying bills.

No other new considerations were presented in submissions received following the draft decision which caused us to change views on Barwon Water’s proposed tariff structures.⁵⁹

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

Our price determination for Barwon Water sets out the maximum prices it may charge for the five year period from 1 July 2018 (or the manner in which its prices are to be calculated, determined, or otherwise regulated for each tariff). Approved maximum prices for water and sewerage services applying to most residential and non-residential customers are set out in Tables 2.9 and 2.10 (in \$2018-19).

⁵⁶ Anonymous 2018, *Submission*, 11 April.

⁵⁷ Essential Services Commission 2016, *Guidance paper*, op. cit., p. 55.

⁵⁸ Community Panel Report, *Barwon Water price submission*, p. 22.

⁵⁹ On 23 May 2018 (after our consultation period had closed on our draft decision for Barwon Water), we received a submission from Kingspan Environmental and Urban Water Cycle Solutions under our consultation process for Western Water’s draft decision. We have considered the views raised in the submission for our final decision and price determination for Barwon Water. Our response to the submission is set out in our final decision paper for Western Water.

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

	2018-19	2019-20	2020-21	2021-22	2022-23
Residential					
Variable (\$/kL)	1.9198	1.9768	2.0341	2.0921	2.1507
Fixed (\$/year)	154.58	149.38	143.88	137.68	130.49
Non-residential					
Variable (\$/kL)	2.3020	2.2632	2.2251	2.1876	2.1507
Fixed (\$/year)	174.96	162.59	151.09	140.41	130.49

Note: Numbers have been rounded

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

	2018-19	2019-20	2020-21	2021-22	2022-23
Residential					
Fixed (\$/year)	563.58	563.58	563.58	563.58	563.58
Non-residential					
Variable (\$/kL)	1.9131	1.9131	1.9131	1.9131	1.9131
Fixed (\$/year)	341.00	341.00	341.00	341.00	341.00

Note: Numbers have been rounded

Adjusting prices

In our draft decision we approved Barwon Water’s proposal to continue the existing uncertain and unforeseen events mechanism. We approved the mechanism on the basis that it reflects a continuation of current arrangements, and otherwise meets the requirements of our guidance.

We also invited Barwon Water to resubmit a price adjustment mechanism for the cost of debt based on a benchmark cost of debt (its price submission specified the mechanism based on actual costs). Barwon Water’s response to our draft decision proposed an adjustment mechanism based on our benchmark cost of debt. We have assessed its revised proposal and consider it meets the requirements of our guidance.

Our assessment

For the reasons set out above, our final decision approves Barwon Water's proposed uncertain and unforeseen events mechanism and cost of debt adjustment mechanism.

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 Barwon Water's proposed restructuring of its new customer contribution charges. The changes involve offering different standard new customer contributions for infill and greenfield developments, in response to feedback Barwon Water received from developers. Barwon Water proposed that a development would be considered infill if it could be serviced by existing infrastructure and did not trigger the need for a capacity upgrade. We also proposed to accept Barwon Water's proposed removal of standard new customer contributions for sewerage connections due to reduced capital expenditure forecasts in sewerage assets catering for growth.⁶⁰

Our draft decision also proposed to accept Barwon Water's proposed continuation of location specific water and sewerage new customer contribution charges for the Fyansford growth area (plus annual adjustments for inflation).

For negotiated new customer contributions, we proposed to accept Barwon 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 approves Barwon 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.⁶¹

⁶⁰ In response to a request for information, Barwon Water provided supporting modelling showing its regard for incremental costs and incremental revenue.

⁶¹ Essential Services Commission 2016, *Guidance paper*, op. cit., pp. 62-63.

Our price determination for Barwon 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).

Barwon 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.⁶²

Financial position

In approving prices, we must have regard to the financial viability of the water industry.⁶³ We interpret the financial viability requirements under the *Essential Services Commission Act 2001* (Vic) and the 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 Barwon Water's prices. We have assessed that, under our final decision, Barwon Water will generate sufficient cash flow to deliver on service commitments, including financing costs arising from investments to meet service expectations.

⁶² Essential Services Commission 2013, *New Customer Contributions: Explanatory Note*, December, pp. 9-11.

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

3. PREMO rating

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

For the 2018 price review, 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 accept Barwon Water's proposed return on equity of 4.9 per cent, based on our PREMO assessment.

Our review of Barwon Water's PREMO rating

Barwon 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
Barwon Water's rating	Advanced	Advanced	Leading	Advanced	Advanced
Commission's draft decision rating	Advanced	Standard	Leading	Advanced	Advanced
Commission's final decision rating	Advanced	Standard	Leading	Advanced	Advanced

Our final decision accepts Barwon Water's PREMO self-rating of its price submission as 'Advanced'. In our view Barwon Water has demonstrated its proposals will deliver better value to its customers, consistent with an 'Advanced' price submission.

Factors supporting Barwon Water's PREMO rating include:

- Barwon Water's forecast operating expenditure incorporated an expectation for ongoing efficiency improvements, slightly ahead of the industry average (Figure 3.1) contributing to its objective to minimise prices. We also found its price submission was of a high quality, with very few errors and sound supporting justification for its proposals. These support the Management rating.
- Barwon Water's commitments to improve services in areas customers identified as high priority, with feedback from surveys indicating that a large majority of customers (around 80 per cent) are comfortable with the outcomes it will deliver. These support its Outcomes rating.
- Barwon Water's engagement, which we assess to be 'Leading'. Barwon Water provided its customers with multiple ways to influence its proposals. It ran a customer challenge group, which provided a forum for customers to provide feedback on proposals and test early findings. Barwon Water also established a community panel, which ran as a citizens' jury – it was one of the few corporations to run a citizens' jury, a form of deliberative engagement. The panel made recommendations to Barwon Water's board. We consider these types of deliberative processes are well suited to the complexity of the issues Barwon Water engaged on.

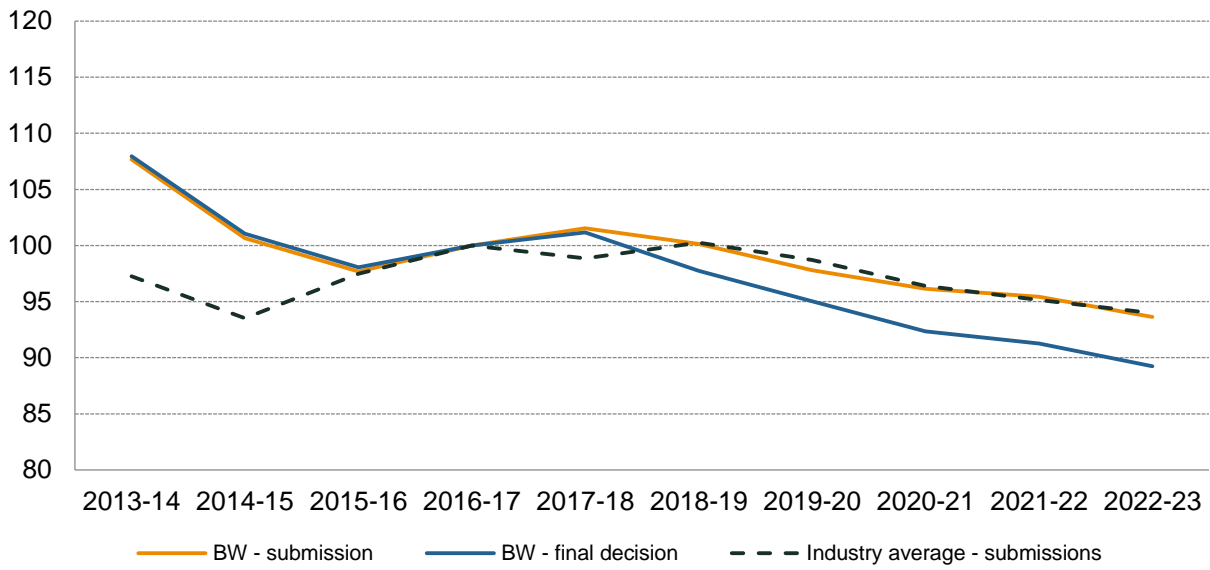
Consistent with our draft decision, our final decision rates Barwon Water's Risk element as 'Standard', compared to the 'Advanced' proposed by Barwon Water. As noted in our draft decision, Barwon Water's price submission proposed a form of price control (a form of revenue cap) that would have increased the risk that prices are higher than they need to be.

We acknowledge, however, the performance incentive scheme that will be introduced by Barwon Water, which supports its Risk rating. Under the scheme, Barwon Water will compensate customers if it fails to deliver on the outcomes it has promised. Barwon Water will return up to \$11.5 million to customers over its 2018-23 period if it fails to deliver on the outcomes it has promised.

Our final decision to rate Barwon Water's price submission as 'Advanced' is reflected in the return on equity we have approved on pages 21 to 22.

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
Anonymous	11 April 2018

Appendix B – approved service standards

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

Barwon 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)	100	100	100	100	100
Average time taken to attend bursts and leaks (priority 1) (minutes)	27	27	27	27	27
Average time taken to attend bursts and leaks (priority 2) (minutes)	43	43	43	43	43
Average time taken to attend bursts and leaks (priority 3) (minutes)	226	226	226	226	226
Average duration of unplanned water supply interruptions (minutes)	125	125	125	125	125
Average duration of planned water supply interruptions (minutes)	210	210	210	210	210
Sewerage					
Customers receiving more than 3 sewer blockages in the year (number)	1	1	1	1	1
Average time to attend sewer spills and blockages (minutes)	53	53	53	53	53
Average time to rectify a sewer blockage (minutes)	178	178	178	178	178
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 Barwon Water.

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

Barwon 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 Barwon Water.

Barwon Water’s approved GSL scheme

Approved service level obligation	Approved payment (\$)
No more than five unplanned water supply interruptions per customer per year	\$80
No more than three unplanned sewerage service interruptions to a customer’s property per year	\$80
No more than two sewer spills on a customer property per year	\$613
We will not restrict water supply or take legal action against a customer prior to making reasonable efforts to contact the customer and provide information about help that is available if the customer is experiencing difficulties paying a bill.	\$367

Appendix D – rate of return

A submission from the Consumer Action Law Centre (CALC) recommended we set the benchmark cost of debt at five per cent or around one per cent lower than the amount allowed in our draft decision (6.05 per cent per annum in nominal terms). It also recommended that we reduce each of the equity values in the PREMO matrix by one per cent. CALC submits that government owned water corporations carry less risk than private corporations, and as such, the allowed cost of debt and the return on equity should be lowered, compared with the rates allowed in our draft decision.⁶⁴ These recommendations are based on a report prepared by CME for CALC.⁶⁵

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.⁶⁶ This includes ensuring that borrowing costs reflect an estimate of a water corporation's standalone risk profile and credit rating. We note that:

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

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

⁶⁴ Consumer Action Law Centre, op. cit.

⁶⁵ *ibid.*, Appendix A.

⁶⁶ We note the Water Services Association of Australia supports application of competitive neutrality principles, see Water Services Association of Australia 2016, *Submission to the Essential Services Commission: A new model for pricing services in Victoria's water sector*, July, p. 11.

a regulated water corporation. We consider this is consistent with the requirements of the Water Industry Regulatory Order 2014 (WIRO).⁶⁷

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.⁶⁸ 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.⁶⁹

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.⁷⁰

⁶⁷ 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).

⁶⁸ Consumer Action Law Centre, op. cit.

⁶⁹ Essential Services Commission of South Australia, op. cit.; Independent Pricing and Regulatory Tribunal 2017, August, op. cit.

⁷⁰ 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.