

# South East Water draft decision

2018 Water Price Review

7 December 2017



**An appropriate citation for this paper is:**

Essential Services Commission 2018, *South East Water draft decision: 2018 Water Price Review*, 7 December

**Copyright notice**

© Essential Services Commission 2018



This work, *South East Water draft decision*, is licensed under a Creative Commons Attribution 4.0 licence [[creativecommons.org/licenses/by/4.0/](https://creativecommons.org/licenses/by/4.0/)]. You are free to re-use the work under that licence, on the condition that you credit the Essential Services Commission as author, indicate if changes were made and comply with the other licence terms.

The licence does not apply to any brand logo, images or photographs within the publication.

# Contents

Summary	iv
1. Our role and approach to water pricing	1
2. Our assessment of South East Water's price submission	5
Regulatory period	6
Customer engagement	6
Outcomes	7
Guaranteed service levels	7
Revenue requirement	8
Operating expenditure	9
Regulatory asset base	13
– Closing regulatory asset base	13
– Forecast regulatory asset base	14
– Capital expenditure	15
– Customer contributions	18
Cost of debt	18
Return on equity – PREMO rating	19
Regulatory depreciation	19
Tax allowance	19
Demand	20
Form of price control	20
Prices and tariff structures	20
Adjusting prices	24
New customer contributions	25
Financial position	26
3. PREMO rating	27
Our review of South East Water's PREMO self-rating	27
4. We invite feedback on our draft decision	29
Attend a public meeting	29
Provide written comments or submissions	29
Next steps	30
APPENDIX A – submissions received	31



# Summary

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

This draft decision sets out our preliminary views on South East Water's price submission.<sup>1</sup> Our draft decision for South East Water approves a revenue requirement of \$4,497.7 million over the five year period starting 1 July 2018, for the purpose of approving maximum prices.<sup>2</sup>

The typical bill impacts of South East Water's proposal and our draft decision are provided below.

**Table 1.1** Typical water and sewerage bills  
\$ 2017-18

Customer group	Average consumption (kL p.a.)	2017-18 annual bill	2018-19 annual bill	2022-23 annual bill
Residential (Owner occupier)	150	\$1,017*	\$943	\$943
Residential (Tenant)	112	\$356*	\$348	\$348
Non-residential (Small)	150	\$1,317	\$1,243	\$1,243
Non-residential (Medium)	460	\$2,845	\$2,685	\$2,685
Non-residential (Large)	3,500	\$17,829	\$16,827	\$16,827

\* Following a \$100 rebate paid to customers from a government efficiency review.

Note: Numbers have been rounded

We invite interested parties to comment on our preliminary views in this draft decision before we make a final decision and issue a price determination. Details on how to make a submission on our draft decision are provided in Chapter 4.

Our draft decision should be read together with South East Water's price submission.<sup>3</sup>

---

<sup>1</sup> Clause 16 of the Water Industry Regulatory Order 2014 requires us to issue a draft decision.

<sup>2</sup> 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. Along with forecast demand, it is an input to calculating the prices to be charged by a water corporation.

## **We have released an early draft decision for South East Water**

South East Water's price submission provided clear and comprehensive information supporting its proposals. South East Water also provided evidence that its engagement captured the main priorities and concerns of customers and taken this feedback into account. This enabled us to quickly assess South East Water's price submission against the legal framework that governs our role.

We also accept South East Water's proposals. While we are seeking further information to inform our final decision, we consider our requests do not involve matters that materially impact on customer prices or outcomes.

For these reasons, we are releasing this draft decision now, rather than March 2018 as currently planned for most other water corporations. We are releasing a fast-tracked draft decision for four of the sixteen water corporations that have provided a submission to us.<sup>4</sup>

Our draft decision provides an opportunity for us to test our preliminary views with stakeholders before we make a final decision and determination on South East Water's prices in May to June 2018.

## **Our draft decision should allow South East Water to deliver the outcomes outlined in its price submission**

Our draft decision should allow South East Water to deliver on its customer service commitments, government policy, and obligations monitored by Environment Protection Authority Victoria and Department of Health and Human Services.

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

- reducing water and sewerage prices
- providing real-time notification to customers of service disruptions and
- reducing the number of steps in the residential water variable tariff from three to two, to help its customers avoid unexpected high bills.

---

<sup>3</sup> South East Water's price submission is available on our website [www.esc.vic.gov.au](http://www.esc.vic.gov.au)

<sup>4</sup> At the time of preparing this draft decision, Western Water has not yet lodged its price submission with the commission. We will provide separate guidance specific to Western Water, requiring its price submission to be lodged early in 2018.

## **Some tariff structures will change**

Our draft decision approves South East Water's proposed tariff structures, which include some changes to residential water, sewerage and recycled water tariffs.

For residential water tariffs, South East Water proposed a fixed service charge and a variable component that depends on water use. For the variable component, South East Water proposed to reduce the inclining block from three steps to two, to balance affordability for large households, make the charges simpler, and to continue to provide customers some reward for saving water.

For residential sewerage services, South East Water proposed a fixed and variable component. For the variable component, South East Water proposed to reduce the sewerage disposal charge by 50 per cent in line with customer preferences. It also proposed a lower fixed service charge.

We propose to approve South East Water's proposed tariff basket form of price control that will cover the majority of its tariffs. South East Water currently uses a tariff basket.

## **South East Water's price submission is rated as 'Advanced' under PREMO**

Our draft decision is to accept South East Water's PREMO self-rating of its price submission as 'Advanced'.





# 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.<sup>5</sup> The prescribed services include retail water and sewerage services, and bulk water and sewerage services delivered by the water corporations.<sup>6</sup>

In September 2017, South East Water provided a submission to us proposing prices for a five year period starting 1 July 2018. Our task is to assess the price submission against the legal framework that governs our role, and make a price determination that takes effect from 1 July 2018. The price determination will specify the maximum prices South East Water 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 explains the 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 reaching this draft decision 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,

---

<sup>5</sup> 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.

<sup>6</sup> The prescribed services are listed at clause 7(b) of the WIRO.

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

- the matters specified in our guidance<sup>7</sup>
- the principle that prices should be easily understood by customers and provide signals about the efficient costs of providing services, while avoiding price shocks where possible
- the principle that prices should take into account the interests of customers of the regulated entity, including low income and vulnerable customers.

A separate document lists the specific objectives and the various matters the commission must have regard to when making a price determination and provides a guide to where the commission has done so in this draft decision.<sup>8</sup>

In 2016, we issued guidance to South East Water to inform its price submission. The guidance set out how we will assess South East 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 South East Water's proposed prices.<sup>9</sup>

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.<sup>10</sup>

### **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.<sup>11</sup>

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.

---

<sup>7</sup> Essential Services Commission 2016, *2018 Water Price Review – Guidance paper*, November.

<sup>8</sup> Essential Services Commission 2017, *South East Water draft decision: 2018 Water Price Review – commission's consideration of legal requirements*, 7 December. This is located on our website at [www.esc.vic.gov.au](http://www.esc.vic.gov.au)

<sup>9</sup> This is a requirement of the WIRO, clause 14(b).

<sup>10</sup> This is provided for under the WIRO, clause 14(b)(i).

<sup>11</sup> Essential Services Commission 2015, *Review of Water Pricing Approach, Consultation paper*, April.

In May 2016, we released a position paper setting out our proposed new pricing approach, and invited submissions.<sup>12</sup> 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.<sup>13</sup>

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.<sup>14</sup> Our guidance explains the building blocks and how we use it to estimate the revenue requirement.<sup>15</sup>

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 a fast-track provision is now available for price submissions we can readily assess in a short timeframe. These incentives are described next.

Our consultation on the pricing approach informed the guidance we issued water corporations in November 2017 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 with 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.

---

<sup>12</sup> Essential Services Commission 2016, *A new model for pricing services in Victoria's water sector, Position paper*, May.

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

<sup>14</sup> 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.

<sup>15</sup> Essential Services Commission 2016, *Guidance paper*, op. cit., pp. 8-9.

For the 2018 water price review, a water corporation's ambition in terms of delivering customer value is being assessed against four elements of PREMO: risk, engagement, management and outcomes.<sup>16</sup>

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.<sup>17</sup>

### **Early draft decisions**

We may fast track a water corporation's price submission to an early draft and final decision if it provides comprehensive and clear information in support of its proposals. Final decisions for fast-tracked price submissions will be made in May rather than June 2018.

We may release a fast-tracked draft decision in response to a price submission if we consider that:

- the price submission is sufficiently clear and comprehensive to facilitate our timely assessment against the legal framework that guides our role
- the price submission demonstrates that customer priorities and concerns have been identified and taken into account
- any changes required to allow us to accept prices are relatively minor
- the overall PREMO rating proposed is appropriate.

---

<sup>16</sup> The Performance element of PREMO will be assessed at the review following the 2018 water price review.

<sup>17</sup> For more information, see Essential Services Commission 2016, *Guidance paper*, op. cit., pp. 45–49.

## 2. Our assessment of South East Water's price submission

We have made our draft decision on South East Water's price submission after considering: South East Water's price submission, its responses to our queries, and written submissions from interested parties (a list of submissions is provided in Appendix A).

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

South East Water's price submission presented clear and comprehensive information to support its proposals. South East 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 the customer engagement section on page 6).

For these reasons, we were able to form an early view to accept South East Water's proposals for our draft decision.

If consultation on our draft decision does not result in significant further review being required, we intend to make a price determination for South East Water in May 2018. If consultation, or our ongoing assessment, causes us to form a view that significant further review is required, we may defer our price determination for South East Water until June 2018.

Our guidance included a number of matters water corporations must address in their price submissions. South East Water's price submission addressed each of these matters. Our preliminary assessment of these matters is provided in this chapter.

In some cases, we have asked South East Water to provide more information to inform our final decision and price determination. We consider our requests do not involve matters that materially impact on customer prices or outcomes.

South East Water must submit a response to our draft decision and provide an updated financial model by 9 March 2018 (via email to [water@esc.vic.gov.au](mailto:water@esc.vic.gov.au)). The response will be published on our website.

All financial values referred to in this chapter are in \$2017-18.

## Regulatory period

South East Water proposed a five year regulatory period. Our draft decision approves South East Water's proposal as it is consistent with our guidance. Our guidance proposed to approve a five year regulatory period, subject to any alternative and justified proposal.<sup>18</sup>

## Customer engagement

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

The engagement by South East Water:

- took place between August 2016 and September 2017
- included a range of methods including an online survey, deliberative online discussions, an online bill simulator, focus groups, workshops and a consultation panel
- was informed by a customer consultation committee which was used by South East Water to challenge, advise and influence its engagement program<sup>19</sup>, and
- covered matters such as customer willingness to pay for certain services, tariffs and Guaranteed Service Levels.

More information about South East Water's engagement is available in its price submission.<sup>20</sup>

Evidence that South East Water's engagement influenced its proposals includes South East Water:

- proposing to reduce the number of steps in its residential water variable tariff from three to two, in response to customer feedback on the impact of the existing structure on large households, and
- investing in digital notifications such as website and SMS alerts in response to feedback that customers valued early notification of service issues.

The influence of South East Water's engagement on its proposals supports the objectives in our pricing framework relating to efficiency and the interests of consumers.<sup>21</sup>

---

<sup>18</sup> 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.

<sup>19</sup> South East water's price submission included a letter from the committee that supported the business's engagement approach.

<sup>20</sup> See Appendix 3 of South East Water's price submission available at [www.esc.vic.gov.au](http://www.esc.vic.gov.au)

<sup>21</sup> 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).

## Outcomes

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

- get the basics right, always
- warn me, inform me
- fair and affordable for all
- make my experience better, and
- support my community, protect our environment

South East Water's proposed measures and activities it will use to report on progress against achieving each outcome are set out at pages 18 to 44 of its price submission. Specific targets are listed on page 6 of its price submission.

South East Water proposed to report on its progress performance against the measures via its website and in billing information. An example of its proposed performance report is provided at Appendix 4 (page 107) of its price submission.

The WIRO provides us with the power to specify standards and conditions of service in a code we make under the WI Act.

In early 2018-19, we will update our urban customer service code to reflect the outcomes proposed by South East Water and the measures it will use to report on performance.<sup>22</sup> We will engage with South East Water to finalise the measures, and how it will publicly report on outcomes.

## 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.

South East Water's proposed GSLs are set out at pages 47 and 48 of its price submission. It proposed to increase the rebate amount for its payment difficulty GSL from \$300 to \$500, revise seven existing GSLs, and introduce a new one related to the impact on the local community of a spill caused by it that results in the closure of a beach. Revisions include increasing rebates for existing GSLs where it does not deliver on the specified service level.

---

<sup>22</sup> Essential Services Commission 2017, *Customer Service Code Urban Water Businesses*, April.

We note that South East Water's proposed GSLs were informed by its customer engagement, specifically through its workshops. Its justification for accepting the changes to GSLs is found on page 47 of its price submission.

In early 2018-19, we will update our urban customer service code to reflect the proposed GSLs, subject to our consideration of any feedback following the release of our draft decision.<sup>23</sup>

## 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. Along with forecast demand, it is an input to calculating prices.<sup>24</sup>

Our draft decision for South East Water approves a revenue requirement of \$4,497.7 million over a five year period starting 1 July 2018. This reflects our assessment of each element that comprises the revenue requirement, as set out in Table 2.1.

Our final decision will be based on the latest available information. Accordingly, as well as responding to our draft decision and providing a price schedule, South East Water must also update its revenue requirement and prices to reflect:

- our updates to cost of debt and inflation estimates, which we will provide in late April 2018
- changes to its forecast bulk water charges, arising from changes to Melbourne Water's prices.

There may be changes in laws or government policy before we make a price determination. If any such changes occur between the draft decision and the price determination, and impact on the revenue requirement, South East Water should update its price submission and also provide us with an updated financial model. Any updates will be publicly available on our website.

---

<sup>23</sup> Essential Services Commission 2017, *ibid*.

<sup>24</sup> 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 South East Water in the regulatory period from 1 July 2018. We had regard to their views in our draft decision.



**Table 2.1 Revenue requirement**  
\$ million 2017-18

	2018-19	2019-20	2020-21	2021-22	2022-23	Total
Operating expenditure <sup>a</sup>	664.1	662.2	651.6	652.1	652.4	3,282.5
Return on assets	143.7	149.0	153.0	156.6	160.1	762.4
Regulatory depreciation	59.2	67.3	75.7	83.8	91.1	377.0
Tax allowance	13.5	14.6	15.8	15.5	16.4	75.8
<b>Revenue requirement <sup>a</sup></b>	<b>880.6</b>	<b>893.1</b>	<b>896.1</b>	<b>907.9</b>	<b>920.0</b>	<b>4,497.7</b>

<sup>a</sup> The annual figures for the revenue requirement differs from South East Water's price submission due to a correction in operating expenditure (bulk water charges). Minor corrections were also made to regulatory depreciation and tax.

Note: Numbers have been rounded

## Operating expenditure

Operating expenditure is an input to the revenue requirement. South East Water's forecast operating expenditure is provided at Table 2.2 broken down into controllable and non-controllable components. South East Water's price submission provides detail on its forecast operating expenditure from pages 57 to 64.

For controllable operating expenditure, our assessment process first confirms an efficient baseline, based on the last year of actual costs prior to our price review (that is, 2016-17). We then consider the forecast costs relative to this baseline, including the proposed efficiency improvement rate and forecast growth, and any proposed cost changes relative to the baseline.

For non-controllable expenditure (including bulk water and sewerage services, government charges and licence fees) we confirm the proposed forecasts with reference to the relevant regulatory body, where appropriate.

**Table 2.2 Operating expenditure**  
\$ million 2017-18

	2018-19	2019-20	2020-21	2021-22	2022-23
Controllable costs <sup>a</sup>	123.5	123.8	124.9	125.2	125.2
Non-controllable costs <sup>b</sup>	540.6	538.4	526.7	526.9	527.2
- Bulk services <sup>c</sup> *	499.4	498.1	487.5	488.2	488.9
- Environmental contribution <sup>d</sup>	39.8	38.9	38.0	37.2	36.3
- Licence fees <sup>e</sup>	1.0	1.0	0.8	1.1	1.5
- Other	0.4	0.4	0.5	0.5	0.5
<b>Operating expenditure*</b>	<b>664.1</b>	<b>662.2</b>	<b>651.6</b>	<b>652.1</b>	<b>652.4</b>

<sup>a</sup> Controllable costs are those that can be directly or indirectly influenced by a water corporation's decisions.

<sup>b</sup> Non-controllable costs are those that cannot be directly or indirectly influenced by a water corporation's decisions.

<sup>c</sup> Bulk services costs are paid to Melbourne Water for the supply of bulk water and sewerage services.

<sup>d</sup> The Environmental Contribution collects funds from water corporations under the WI Act.

<sup>e</sup> License 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.

\* Annual figures for bulk services differ from South East Water's price submission due to corrections identified during our review. The correction results in an increase in each forecast year of around \$9 to 10 million.

Note: Numbers have been rounded

For the reasons set out below, we have accepted the forecast controllable operating expenditure proposed by South East Water in making our draft decision on its revenue requirement.

Baseline controllable operating expenditure:

- South East Water has proposed an upwards adjustment of \$0.96 million to capture ongoing costs that were not reflected in its actual 2016-17 baseline year controllable operating expenditure, to produce its starting point for forecast annual operating expenditure. The resultant figure of \$120.9 million is 5 per cent below the 2016-17 benchmark allowance of \$127.3 million established in the previous price determination. We consider this reflects an efficient baseline cost to forecast annual operating expenditure.

Our assessment

- We also note other evidence indicating its baseline controllable operating expenditure reflects a reasonable benchmark:
  - South East Water’s price submission (page 58) cited the Bureau of Meteorology’s annual comparison report as showing it had the lowest operating costs per property of the comparable Melbourne water corporations.<sup>25</sup> It also referred to an independent study that showed South East Water was ranked in the first or second quartiles for 94 of the 130 cost categories benchmarked in the study.<sup>26</sup>
  - In a benchmarking study undertaken for the commission, South East Water ranked second among Victorian urban water corporations on technical efficiency.<sup>27</sup>

#### Efficiency improvement:

- South East Water’s proposed average efficiency improvement rate on controllable operating costs is 2.3 per cent per annum. This is relatively high compared to its past performance (where it met our mandated 1 per cent efficiency rate) and the rate proposed by other water corporations in their price submissions. It matches South East Water’s forecast average connection growth rate of 2.3 per cent per annum, effectively absorbing growth costs and giving a flat annual baseline operating cost.

#### Proposed cost changes:

- South East Water has sought additional operating expenditure above the annual baseline, including:
  - \$1.53 million to improve its information technology security
  - \$3.36 million for maintenance and testing for Aquarevo
  - \$4.70 million for increased operating costs following upgrades to the Lang Lang Water Recycling Plant and the Boneo Water Recycling Plant upgrade.
- This increase results in a 2.1 per cent increase above the baseline by the final year of the period, however we note that forecast increases in wages (above inflation) and electricity prices will be absorbed within the proposed efficiency improvement target.

We consider South East Water’s approach to forecasting its operating expenditure is consistent with the requirements of our guidance, and we are satisfied that its proposed forecast represents efficient controllable operating expenditure. There is evidence that the corporation has significantly

---

<sup>25</sup> Bureau of Meteorology 2017, *National performance report 2015-16: urban water utilities*, March.

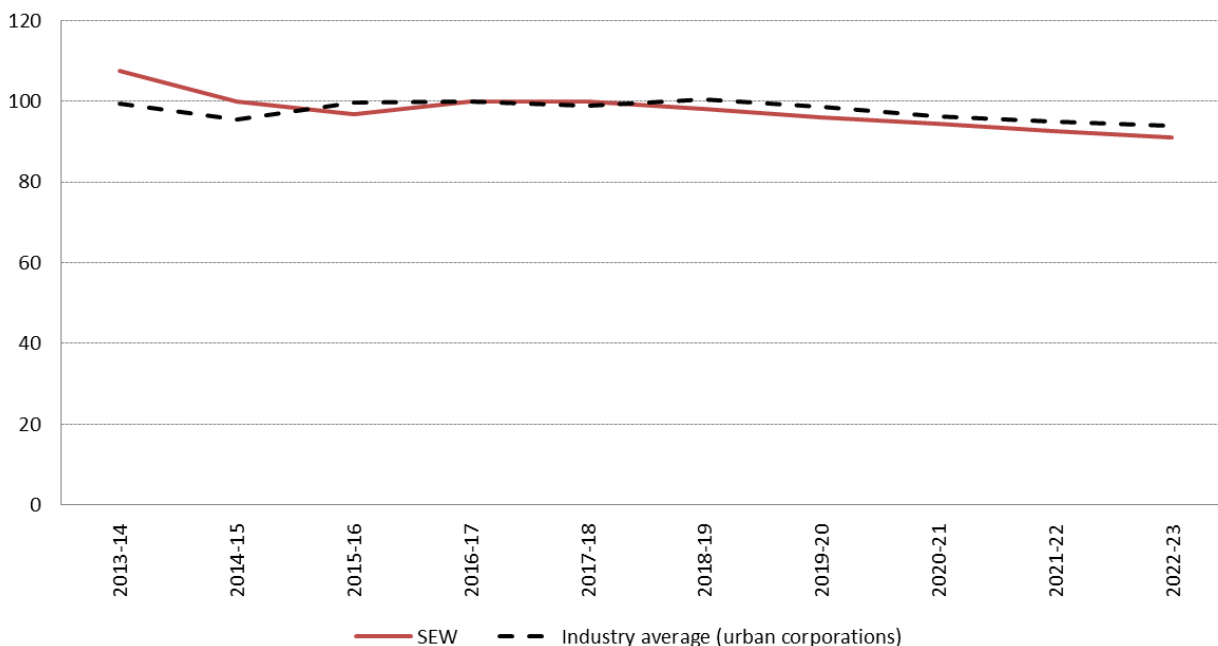
<sup>26</sup> A financial benchmarking exercise undertaken by the Water Services Association of Australia (WSAA).

<sup>27</sup> Economic Insights 2014, *Victorian Urban Water Utility Benchmarking*, July. Available at [www.esc.vic.gov.au](http://www.esc.vic.gov.au)

tested its controllable expenditure requirements, resulting in a forecast decline (in real terms) in controllable operating expenditure per customer connection across 2018–23 and beyond. The rate of the forecast decline in controllable operating expenditure per customer connection from 2016-17 is greater than the average for urban water corporations in our review (Figure 2.1).

**Figure 2.1 Controllable operating expenditure per water connection**

Index: 2016-17=100



Non-controllable operating expenditure increases by \$13.7 million in 2018-19, due mainly to an increase in the environmental contribution as advised by the Department of Environment, Land, Water and Planning. This is largely offset from 2020-21 by a reduction in the external bulk charges, which we have verified are consistent with Melbourne Water’s current price determination.

Melbourne Water’s current price determination ends in 2020-21. In the two years to 2022-23, South East Water has assumed bulk charges payable to Melbourne Water will increase with inflation. South East Water has proposed price adjustment mechanisms to account for differences between its forecast and actual bulk charges (discussed later).

We will accept South East Water’s proposed non-controllable operating expenditure for our draft decision, noting that the environmental contribution values in the model have not been appropriately adjusted for inflation. Prior to making our final decision, we will update the forecast license fee values with the relevant regulatory bodies and also adjust for the latest inflation and external bulk charges data.

Our draft decision is to accept South East Water's proposed operating expenditure, as set out in Table 2.2.

## 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 South East Water to propose its:

- closing regulatory asset base at 30 June 2017, and
- 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.

Table 2.3 sets out South East Water's proposed regulatory asset base at 30 June 2017.

We compared South East Water's actual net capital expenditure for the period from 2012-13 to 2016-17 with the forecast used to approve maximum prices for the period from 1 July 2013.<sup>28</sup>

South East Water's net capital expenditure was \$292.5 million lower than forecast.<sup>29</sup> It also calculated its closing regulatory asset base in accordance with the requirements of our guidance. For these reasons, our draft decision accepts South East Water's proposed closing regulatory asset base for 30 June 2017 of \$3,289.9 million.

---

<sup>28</sup> Net capital expenditure is calculated by deducting government and customer contributions from gross capital expenditure.

<sup>29</sup> We take a risk-based approach to including past capital expenditure in the regulatory asset base. We undertake a prudency and efficiency review where a water corporation has exceeded its net capital expenditure forecasts by more than 10 per cent. We believe this approach is reasonable given capital expenditure can be relatively 'lumpy' in nature.

**Table 2.3 Closing regulatory asset base**  
\$ million 2017-18

	2012-13	2013-14	2014-15	2015-16	2016-17
Opening RAB 1 July	2,794.8	2,904.0	3,061.7	3,204.4	3,239.8
Plus gross capital expenditure	187.4	229.4	232.7	149.6	169.5
Less government contributions	0.0	0.0	0.0	0.0	0.0
Less customer contributions	18.7	22.6	31.9	47.8	45.3
Less proceeds from disposals	1.5	1.9	1.8	1.8	3.0
Less regulatory depreciation	58.0	47.2	56.2	64.6	71.1
<b>Closing RAB 30 June</b>	<b>2,904.0</b>	<b>3,061.7</b>	<b>3,204.4</b>	<b>3,239.8</b>	<b>3,289.9</b>

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 2.4 sets out South East Water's proposed opening regulatory asset base from 1 July 2018.<sup>30</sup> Our draft decision is to accept South East Water's forecast regulatory asset base for the period from 1 July 2018, as we are satisfied it meets the requirements of our guidance.

<sup>30</sup> 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 2.4 Forecast regulatory asset base**  
\$ million 2017-18

	2017-18	2018-19	2019-20	2020-21	2021-22	2022-23
Opening RAB 1 July	3,289.9	3,358.9	3,484.8	3,608.5	3,677.3	3,777.7
Plus gross capital expenditure	184.6	249.9	253.0	193.7	219.5	195.9
Less government contributions	0.0	0.0	0.0	0.0	0.0	0.0
Less customer contributions	38.4	38.3	38.1	38.0	33.5	33.4
Less proceeds from disposals	1.8	26.6	23.9	11.2	1.8	1.8
Less regulatory depreciation	75.3	59.2	67.3	75.7	83.8	91.1
<b>Closing RAB 30 June</b>	<b>3,358.9</b>	<b>3,484.8</b>	<b>3,608.5</b>	<b>3,677.3</b>	<b>3,777.7</b>	<b>3,847.3</b>

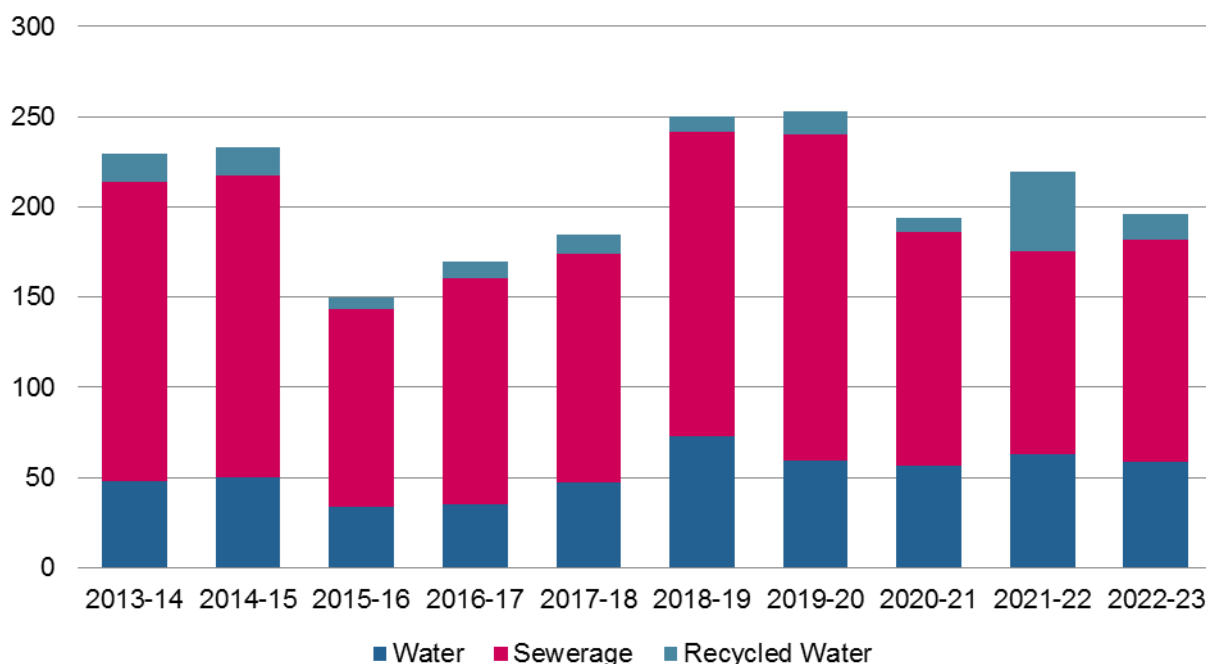
Note: Numbers have been rounded

### Capital expenditure

Capital expenditure is an input to estimating the regulatory asset base. South East Water's forecast capital expenditure and supporting information is provided at pages 65 to 77 of its price submission. A summary of capital expenditure for the 2013–18 and 2018–23 periods is provided in Figure 2.2. Values in the period to 2016-17 reflect actual outcomes, with following years reflecting South East Water's forecasts.

**Figure 2.2 Gross capital expenditure by service category**

\$ million 2017-18



Note: actuals 2013-14 to 2016-17 and forecasts for 2017-18 to 2022-23

For the reasons set out below, we have accepted the forecast capital expenditure proposed by South East Water for our draft decision on its revenue requirement.

- South East Water’s price submission provided evidence that its forecasts for capital expenditure are efficient. Total capital expenditure forecast for the 2018–23 period of \$1,112 million is over 15 per cent higher than the \$966 million actual expenditure in the current 2013–18 period. However, the current figure is well below the benchmark of \$1,256 million approved in the 2013 price determination, due to the deferral of \$50 million of works for the Boneo Water Recycling Plant upgrade, along with innovative design changes to reduce costs for the peninsula sewer backlog program by \$100 million.
- We requested selected documents from South East Water as a representative sample to demonstrate its asset management processes and justification for its capital expenditure program. Based on the sample of documents reviewed, these demonstrate that South East Water has a robust approach for developing project scope, the timing of works and cost estimates.
- We requested and reviewed the business cases and supporting reports for:
  - Boneo Water Recycling Plant upgrade
  - digital capability pilot

Our assessment



- integrated water initiatives for new developments at Fishermans Bend and Aquarevo.
- The Boneo Water Recycling Plant upgrade is South East Water’s largest single project, with a current cost estimate of \$101.5 million. We understand this project is currently out to tender, and request South East Water to provide the revised cost forecast prior to our final decision.
- We consider the planned capital expenditure program is achievable, given South East Water’s past track record delivering its capital expenditure program. We note that over the 2013–18 period, South East Water will deliver all of its planned major projects and programs, except the deferral of the Boneo treatment plant capacity upgrade until 2018-19 following interim works and operational changes.<sup>31</sup>
- South East Water has assumed \$50 million of capital expenditure risk by only including projects that are certain and estimates that align with project delivery cost. Specifically, it has excluded costs for Elster Creek sewer catchment capacity improvement works and Clayton East and West sewer catchment capacity improvement works, as it investigates alternative approaches that may reduce the level of investment required. For our draft decision, we accept South East Water’s proposal for addressing uncertain expenditure, noting the following:
  - South East Water will need to demonstrate the efficiency of these costs if they are indeed incurred during the 2018–23 period if seeking to include them in the regulatory asset base.
  - Variations in capital expenditure from forecast during the 2018–23 period will form a key part of our assessment of the Performance element of PREMO at the next price review.
- South East Water has also noted it will absorb any escalation in construction costs beyond inflation, which could total up to \$60 million based on its latest escalation advice.
- South East Water has proposed \$10.1 million for a digital capability pilot including digital water meters, associated IT and communications capabilities.<sup>32</sup> We accept this proposal for our draft decision, but we do not make any allowance for further expenditure associated with a digital metering roll-out following the pilot. In response to this draft decision, we expect South East Water to define the success criteria for the pilot 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. Any expenditure incurred by South East Water beyond the pilot may be subject to a prudence and efficiency assessment before it can be included in the regulatory asset base.

---

<sup>31</sup> Essential Service Commission 2016, *Performance of Victorian urban water and sewerage businesses 2015-16*, December, p. 107.

<sup>32</sup> See South East Water’s price submission, pages 34 and 73.

- We consider South East Water’s approach to forecasting its capital expenditure is consistent with the requirements of our guidance.

Our draft decision for total gross capital expenditure is to accept South East Water’s proposed benchmark as set out in Table 2.4. Our final decision will reflect the revised cost forecast for the Boneo Water Recycling Plant upgrade project.

### Customer contributions

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

We compared South East Water’s forecast for customer contributions with past outcomes, and its forecasts for growth in customer connections.<sup>33</sup> We consider South East Water’s forecast contributions are reasonable, having regard to past trends and its growth forecasts.<sup>34</sup>

Our draft decision proposes to accept South East Water’s forecasts for customer contributions.

### Cost of debt

Our guidance required South East Water to use estimates of the cost of debt provided by the commission to estimate its revenue requirement.<sup>35</sup> South East Water confirmed that they will use the cost of debt values we specify to calculate its revenue requirement. For this reason, our draft decision approves the cost of debt proposed by South East Water, as set out in Table 2.5 below.

**Table 2.5** 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%	4.9%*

\* Estimated cost of debt – we will update the 2017-18 figure before the final decision and price determination.

From 2016, we accepted a ten-year trailing average approach to estimating the benchmark cost of debt, changing from an on-the-day approach. The trailing average approach better aligns the actual cost of debt for an efficient business to the regulated benchmark, compared with an on-the-

<sup>33</sup> Growth in customer connections can be used as an indicator of growth in customer contributions.

<sup>34</sup> In response to a request for information, South East Water provided further information regarding the method of forecasting customer contributions.

<sup>35</sup> Essential Services Commission 2016, *Guidance paper*, op. cit., pp. 43-44.

day approach.<sup>36</sup> We consider the ten year trailing average approach helps to minimise risk to water corporations and provides incentives for long-term investment.

## **Return on equity – PREMO rating**

South East Water rated its price submission as ‘Advanced’. Based on its PREMO self-rating, South East Water proposed a return on equity of 4.9 per cent per annum. This reflects the maximum return rate allowed in our guidance for a price submission rated as ‘Advanced’.<sup>37</sup>

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.<sup>38</sup>

Our draft decision approves South East Water’s PREMO self-rating and proposed return on equity of 4.9 per cent per annum. Our assessment of South East Water’s proposed PREMO rating is set out in Chapter 3.

## **Regulatory depreciation**

Regulatory depreciation is an input to calculating the regulatory asset base.

South East Water’s forecast regulatory depreciation was calculated using a straight line depreciation profile. We noted in our guidance that we prefer this approach.<sup>39</sup> South East Water also calculated regulatory depreciation in a manner consistent with our guidance.

For these reasons, our draft decision proposes to accept South East Water’s forecast for regulatory depreciation.

## **Tax allowance**

The tax allowance is an input to the revenue requirement.

Our draft decision is to approve South East Water’s forecast tax allowance, as set out in table 41 on page 80 of its price submission. Our draft decision approves the forecast as it was calculated consistently with the method required by our guidance.<sup>40</sup>

---

<sup>36</sup> For more detail on the trailing average and on the day approaches to the cost of debt, see Essential Services Commission 2016, *Water pricing framework*, op. cit., p. 27.

<sup>37</sup> Essential Services Commission 2016, *Guidance paper*, op. cit., p. 49.

<sup>38</sup> 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.

<sup>39</sup> Essential Services Commission 2016, *Guidance paper*, op. cit., p. 42.

## **Demand**

Along with the revenue requirement, demand forecasts are an input to calculating prices.

South East Water's demand forecasts are set out at pages 49 to 56 of its price submission, and are also provided in its financial model. Our draft decision proposes to accept South East Water's demand forecasts as we consider they were estimated in a manner that is consistent with the requirements of our guidance. South East Water provided adequate justification in accepting connection growth assumptions that differ from the latest Victoria in Future's population growth forecasts.<sup>41</sup> The connection forecasts are generally higher than implied by the Victoria in Future forecasts; this has the effect of reducing estimated prices.

## **Form of price control**

South East Water proposed to continue its current form of price control. The majority of tariffs are proposed to be subject to a tariff basket with a three per cent annual limit on price increases (not including inflation). Remaining tariffs are proposed to be subject to a price cap.<sup>42 43</sup>

Our draft decision is to approve South East Water's proposed form of price control as it allows for the recovery of sufficient revenue to cover the forecast efficient costs of providing services, and for it to deliver on any health, safety, social and environmental obligations. As well, by limiting price increases under its tariff basket, and using a price cap, its proposal helps to provide customers with price stability, while providing revenue certainty for the business.

## **Prices and tariff structures**

South East Water's proposed tariffs are set out on pages 81 to 88 of its price submission. Proposed prices for water and sewerage services applying to most residential and non-residential customers are set out at Tables 2.6 and 2.7.

From 2014-15, South East Water's residential customers receiving a bill including water usage charges received an annual rebate of \$100. The rebate ends after 2017-18. While South East

---

<sup>40</sup> Essential Services Commission 2016, *Guidance paper*, op. cit., pp. 50-51.

<sup>41</sup> Provided in response to a request for further information. Email received 30 October 2017.

<sup>42</sup> South East Water responded to a request for information confirming that tariffs listed under schedule 2 part B of our 2013 determination are proposed to continue to be subject to a price cap.

<sup>43</sup> We note our determinations will 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.

Water proposes reduced prices for most tariffs, the removal of the rebate means the bill impacts of the price changes on customer groups will vary.<sup>44</sup> In particular, for some customers such as relatively low water users (including some residential tenants), bills may rise as a result of the rebate being removed. This issue was raised in a submission by the Consumer Action Law Centre.<sup>45</sup>

We note the price changes proposed by South East Water seek to address the impact of the rebate removal on customers. It has also proposed additional assistance for customers experiencing a bill increase, particularly tenants.

We consider South East Water's proposed tariffs will allow it to recover sufficient revenue to cover efficient costs. As outlined in our guidance, we have provided the water corporations with a large degree of discretion to decide on individual tariff structures.<sup>46</sup> This recognises water corporations are often best placed to consider the interests of customers in designing tariffs, and that existing tariff structures have been developed over time to deal with a variety of local circumstances.

South East Water proposed to maintain a two-part structure for the majority of its tariffs. For residential water services, South East Water proposed a fixed service charge and a variable component that depends on water used. It has proposed to reduce the number of steps in the inclining block tariff that applies to the variable component from three to two.

We consider 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.<sup>47</sup> We also consider two-part tariff structures are easy to understand.

The submission from the Consumer Action Law Centre referred to research that inclining block structures are not effective on social equity grounds, as they fail to account for household size, and essential versus discretionary use.<sup>48</sup> The submission also noted inclining blocks can confuse households.

We note a number of Victorian water corporations and interstate water businesses have removed inclining block structures in recent years. We have previously noted our preference for a single

---

<sup>44</sup> Noting the rebate applied to residential water users only.

<sup>45</sup> Consumer Action Law Centre 2017, *Initial Feedback: 2018 Price Review*, November.

<sup>46</sup> Essential Services Commission 2016, *Guidance paper*, op. cit., p. 55.

<sup>47</sup> 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.

<sup>48</sup> Consumer Action Law Centre 2017, op. cit.

volumetric charge for water services on efficiency grounds.<sup>49</sup> We agree that reducing the number of steps in the inclining block reduces complexity, and reflects a shift towards our preferred tariff structure. For these reasons, we have approved South East Water's proposal to reduce the number of steps in its inclining block tariff for residential water use from three to two.

For residential sewerage services, South East Water proposed a fixed service charge and a variable sewage disposal charge. It proposed a 50 per cent reduction to the variable sewage disposal charge. Our draft decision proposes to accept the reduction to the sewage disposal charge. Our guidance noted that we consider the variable sewage disposal charge is difficult to understand and not cost reflective.

For residential recycled water services, South East Water proposed to remove the fixed annual service charge and reduce the usage charge. It is currently set at 87 per cent of the first tier residential variable water charge, and will be reduced to 80 per cent from 2018-19. Our draft decision proposes to accept South East Water's reduction to its recycled water usage charge and removal of the annual service charge, as it is in line with customer preferences to provide a greater incentive for recycled water use.

South East Water confirmed its proposed tariffs for trade waste, recycled water and miscellaneous services are calculated in accordance with the pricing principles referenced in our guidance.

---

<sup>49</sup> Essential Services Commission 2011, *2013 Water Price Review – Tariff Issues Paper*, July, p.26.

**Table 2.6 Proposed water prices**  
\$ 2017-18

	2017-18	2018-19	2019-20	2020-21	2021-22	2022-23
<b>Residential</b>						
Variable (\$/kL)						
1st tier	2.67	2.40	2.40	2.40	2.40	2.40
2nd tier	3.24	3.05	3.05	3.05	3.05	3.05
3rd tier	3.86					
Fixed (\$/year)	121.08	114.27	114.27	114.27	114.27	114.27
<b>Non-residential</b>						
Variable (\$/kL)	3.24	3.05	3.05	3.05	3.05	3.05
Fixed (\$/year)	121.08	114.27	114.27	114.27	114.27	114.27

**Table 2.7 Proposed sewerage charges**  
\$ 2017-18

	2017-18	2018-19	2019-20	2020-21	2021-22	2022-23
<b>Residential</b>						
Variable (\$/kL)	1.88	0.94	0.94	0.94	0.94	0.94
Fixed (\$/year)	384.48	362.87	362.87	362.87	362.87	362.87
<b>Non-residential</b>						
Variable (\$/kL)	1.88	1.77	1.77	1.77	1.77	1.77
Fixed (\$/year)	456.60	430.93	430.93	430.93	430.93	430.93

Consumer Action Law Centre’s submission also highlighted the impact price changes may have on some customers, particularly those with low or fixed incomes who ‘already carefully manage their consumption and budget’. We consider South East Water’s proposed tariffs take into account customers’ interests, including low income and vulnerable customers, because:

- tariffs reflect efficient costs for delivering services

Our assessment

- tariffs were informed by an extensive customer engagement program
- South East Water has payment options and assistance for customers experiencing difficulty paying bills.

South East Water proposed to increase awareness of its existing support for customers experiencing financial difficulty, likely increasing the number of customers who receive support via its hardship program.

A submission by Mike Vallis outlined that ‘the system used for calculating charges is flawed, unfair and promotes wastage of scarce resources’.<sup>50</sup> On this, we note South East Water’s finding that its customers generally prefer to maintain the current balance of fixed and variable charges.<sup>51</sup> We note that South East Water’s tariffs for volumetric water use have increased since 2012-13, which we consider sends a signal to customers about the costs of their water consumption.

Our draft decision proposes to accept South East Water’s proposed tariff structures as set out at pages 81 to 88 of its price submission.

Prior to our final decision and price determination, South East Water must propose updated prices to reflect our draft decision on the revenue requirement and:

- our updates to cost of debt and inflation estimates, to be made in late April 2018
- changes to its forecast bulk water charges, arising from changes to Melbourne Water’s prices.

## **Adjusting prices**

South East Water proposed a number of price adjustment mechanisms, as set out at page 89 of its price submission. It proposes to continue with its existing:

- uncertain and unforeseen events mechanism.
- adjustment mechanisms for desalination water orders and changes to the security charge, and
- adjustment mechanism for pass through of other annual changes to Melbourne Water’s bulk water and sewerage prices, including cost of debt adjustments.<sup>52</sup>

Our draft decision accepts South East Water’s proposal to continue the existing uncertain and unforeseen events mechanism. We noted in our guidance that we propose that the mechanism continue in its current form.<sup>53</sup>

---

<sup>50</sup> Submission from Mike Vallis, 9 November 2017.

<sup>51</sup> See page 9 of South East Water’s price submission available at [www.esc.vic.gov.au](http://www.esc.vic.gov.au).

<sup>52</sup> Provided in response to a request for further information. Email received 13 November 2017.



South East Water has not included adjustments to reflect movements in the cost of debt, as set out in our guidance. We require South East Water to resubmit revised price adjustment formulas, allowing for adjustments to reflect movements in the cost of debt.

Our draft decision also approves the other price adjustment mechanisms proposed by South East Water. We have approved them for our draft decision on the basis that they are consistent with efficiency objectives, and reflect a continuation of current arrangements.<sup>54</sup>

## **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 businesses and developers to negotiate a site-specific arrangement.

South East Water's proposed prices for new customer contributions are set out at page 87 of its price submission. South East Water proposed to maintain all standard new customer contribution charges at the 2017-18 level until 2022-23 and will continue to apply the NCC pricing principles to negotiated customer contributions.<sup>55</sup>

We have reviewed South East Water's proposed charges and consider they are consistent with the requirements of our guidance. For this reason, our draft decision proposes to accept South East Water's proposed new customer contribution prices.

South East Water proposed to increase its existing base level sewerage backlog connection charge from \$1500 in 2017-18 to \$2500 in 2018-19 to move towards a more cost reflective charge.<sup>56</sup> South East Water proposed to maintain its existing method of calculating brought-forward backlog charges in areas of the Mornington Peninsula.

Our draft decision proposes to accept South East Water's increase to the base level backlog charge as it represents a move towards greater cost reflectivity. Our draft decision also proposes to accept South East Water's proposed continuation of its existing calculation of brought forward backlog charges.

---

<sup>53</sup> Essential Services Commission 2016, *Guidance paper*, op. cit., pp. 59-61.

<sup>54</sup> WIRO clauses 14(1)(a)(vi) and 14A(B)(viii)

<sup>55</sup> South East Water provided further information and modelling in response to a request for information.

<sup>56</sup> South East Water provided further information in response to a request for further information.

## Financial position

In approving prices, we must have regard to the financial viability of the water industry.<sup>57</sup> 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 high level of certainty that each water corporation can maintain an investment grade credit rating. Further, prices should enable each corporation to generate cash flow to service financing costs arising from investments to meet service expectations.

South East Water provided estimates of key indicators of forecast financial performance in a manner consistent with our guidance. We have reviewed these indicators and assessed that South East Water's forecast financial position, given its proposed prices, is consistent with an investment grade credit rating.

South East Water received a credit opinion on its proposed price submission by an independent credit rating agency. The credit opinion supports our initial view that South East Water's financial position is consistent with an investment grade credit rating.

---

<sup>57</sup> WIRO clause 8(b)(ii) and Essential Services Commission Act s.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 draft decision is to accept South East 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. Below, we set out our preliminary assessment of South East Water's proposed PREMO rating.

#### Our review of South East Water's PREMO self-rating

South East Water's proposed PREMO rating, and our draft decision is summarised below:

**Table 3.1** PREMO Rating

	Overall PREMO rating	Risk	Engagement	Management	Outcomes
South East Water's rating	<b>Advanced</b>	Advanced	Advanced	Advanced	Advanced
Commission's rating	<b>Advanced</b>	Advanced	Advanced	Advanced	Advanced

We agree with South East Water's proposed overall PREMO self-rating of 'Advanced'. This is reflected in the return on equity we have accepted for South East Water at page 19. We agree with South East Water's proposed self-rating for the Risk, Engagement, Management and Outcomes elements of PREMO, for the reasons set out in its price submission.<sup>58</sup>

---

<sup>58</sup> See from page 94 of South East Water's price submission available at [www.esc.vic.gov.au](http://www.esc.vic.gov.au)

In particular, we note:

- South East Water's efficiency level and forecast improvement rate for operating expenditure, which are high relative to other water corporations. This contributes to the price declines proposed by South East Water.
- South East Water's proposed changes to tariffs, including reducing the number of tiers in the inclining blocks for its residential variable water tariff from three to two, and reducing the sewerage disposal charge. These changes support customer understanding of tariffs and efficiency.
- South East Water's engagement program, which included a customer consultation committee. We consider that the committee provided important direction and accountability for South East Water's engagement.
- The independent credit rating report provided by South East Water, providing additional assurance about the corporation's financial position.
- The detail provided in South East Water's price submission supporting its proposed PREMO ratings (see from page 94 of South East Water's price submission).
- While some corrections were needed to South East Water's financial model, the overall quality of South East Water's written submission enabled us to assess its proposals relatively quickly and release an early draft decision.

## 4. We invite feedback on our draft decision

We invite feedback from stakeholders on our draft decision before we make a final decision and price determination. Our final decision and price determination will be made in May or June 2018.

Stakeholders may comment on any aspect of our draft decision, including the information we have relied upon in our assessment (such as South East Water's price submission). Feedback may also cover:

- additional matters or issues we should consider before making our final decision
- whether our draft decision to accept South East Water's price submission has adequate regard to the matters in clause 11 of the WIRO and our guidance.

How to provide feedback:

### **Attend a public forum**

We may hold a public forum in February or March 2018. Forums provide an opportunity for interested parties to discuss key features of our draft decisions. We will publish details of public forums at [www.esc.vic.gov.au/waterpricereview](http://www.esc.vic.gov.au/waterpricereview).

### **Provide written comments or submissions**

Written comments or submissions in response to this draft decision will be due in early March 2018. We would prefer to receive comments and submissions via our website at [www.esc.vic.gov.au/waterpricereview](http://www.esc.vic.gov.au/waterpricereview).

Alternatively, you may send comments and submissions by mail to:

2018 Water Price Review  
Essential Services Commission  
Level 37, 2 Lonsdale Street  
Melbourne VIC 3000

We usually make all comments and submissions publicly available in the interests of transparency. If you wish part or all of your submission to be private, please discuss with commission staff.

If you cannot access documents related to our price review, please contact us to make alternative arrangements (phone (03) 9032 1300).

We invite feedback

## Next steps

Indicative dates are provided below. To keep up to date, visit our website at [www.esc.vic.gov.au/waterpricereview](http://www.esc.vic.gov.au/waterpricereview).

- February or March 2018 – public forum.
- 9 March 2018 – closing date for submissions on our draft decision.
- May or June 2018 – release date for final decision and price determination.

## APPENDIX A – submissions received

Name or organisation	Date received
Mike Vallis	9 November 2017
Consumer Action Law Centre	16 November 2017
Mr G Mallon	7 November 2017