



# Westernport Water draft decision

2018 Water Price Review

7 December 2017



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# Summary

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

This draft decision sets out our preliminary views on Westernport Water's price submission.<sup>1</sup> Our draft decision is to accept Westernport Water's proposed revenue requirement of \$113.4 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 Westernport 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)	80	\$1,118*	\$1,141	\$1,141
Residential (Tenant)	80	\$130*	\$159	\$159
Non-residential (Small)	400	\$1,978	\$1,996	\$1,996
Non-residential (Medium)	1000	\$4,995	\$4,994	\$4,994

\* Following a \$30.50 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 Westernport Water's price submission.<sup>3</sup>

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<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.

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

## **We have released an early draft decision for Westernport Water**

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

Based on our assessment, we accept Westernport Water's proposals.

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 Westernport Water's prices in May or June 2018.

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

Our draft decision should allow Westernport 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 Westernport Water plans to improve outcomes for customers are by:

- improving the security of water availability by investing in a new supply system
- investing in asset renewals to maintain service levels
- improving support for customers experiencing payment difficulty.

## **Tariff structures are the same**

Our draft decision approves Westernport Water's proposed tariff structures, which are the same as its current tariff structures.

For water services, Westernport Water proposed a fixed service charge and a variable component that depends on water used. For sewerage services, Westernport Water proposed a fixed charge only.

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<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.

We propose to approve Westernport Water’s proposed ‘price cap’ form of price control. This means its maximum prices are fixed subject to updates for inflation, and any other price adjustments we approve in our price determination.

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

Our draft decision is to accept Westernport Water’s PREMO self-rating of its price submission as ‘Standard’.





# 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, Westernport 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 Westernport 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, 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

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<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.

- 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 Westernport Water to inform its price submission. The guidance set out how we will assess Westernport Water's submission against the matters we must consider under clause 11 of the WIRO.

If we consider the price submission has adequate regard for the matters in clause 11 of the WIRO and complies with our guidance, we must approve Westernport Water's proposed prices.<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.

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

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

<sup>8</sup> Essential Services Commission 2017, *Westernport 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.

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

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 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.

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

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<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.

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

‘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
- we consider any changes required in response to allow us to accept prices are relatively minor
- we agree with the overall PREMO rating proposed in the price submission.

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

## 2. Our assessment of Westernport Water's price submission

We have made our draft decision on Westernport Water's price submission after considering: Westernport 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 Westernport Water's price submission are available on our website (to the extent the material is not confidential).

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

For these reasons, we were able to form an early view to accept Westernport 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 Westernport 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 Westernport Water until June 2018.

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

Westernport 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

Westernport Water proposed a five year regulatory period. Our draft decision approves Westernport 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 Westernport Water to engage with customers to inform its price submission.

The engagement by Westernport Water:

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

More detail on Westernport Water's engagement is available in its price submission.<sup>19</sup>

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

- customer feedback in workshops informing the nature of its asset renewals program
- increasing the number of grants available to customers experiencing financial hardship, reflecting feedback about the importance of accessible and affordable services
- maintaining the current mix of fixed and variable charges in residential customer bills, reflecting feedback from customers that they did not support increasing variable charges.

The influence of Westernport Water's engagement on its proposals supports the objectives in our pricing framework relating to efficiency and the interests of consumers.<sup>20</sup>

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<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> Westernport Water's price submission is available on our website at [www.esc.vic.gov.au](http://www.esc.vic.gov.au). See pages 4 to 11.

<sup>20</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 Westernport Water proposes to deliver over the five year period starting 1 July 2018 are:

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

Westernport Water proposed measures and targets that it will use to report on performance against each outcome. These are set out at pages 13 to 16 of its price submission. If it does not meet the outcome targets it has set, Westernport Water has committed to provide customers with a rebate, payable in 2023-24. The rebate varies depending on the number of targets missed.

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 Westernport Water and the measures it will use to report on performance.<sup>21</sup> We will engage with Westernport 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.

Westernport Water's proposed GSLs are set out on pages 19 and 20 of its price submission. It has proposed changes to its GSLs, including increases in rebate amounts. We note that Westernport Water's proposed GSLs were informed by the results of customer surveys and the discussion in its customer workshops.<sup>22</sup>

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>

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<sup>21</sup> Essential Services Commission 2017, *Customer Service Code Urban Water Businesses*, April.

<sup>22</sup> Justification for Westernport 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](http://www.esc.vic.gov.au).

<sup>23</sup> Essential Services Commission 2017, *Customer Service Code*, op. cit.

## 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>

Westernport Water proposed a revenue requirement of \$113.4 million over a five year period starting 1 July 2018. Our draft decision proposes to accept the revenue requirement proposed by Westernport Water as set out at Table 2.1. This reflects our assessment of each element that comprises the revenue requirement.

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, Westernport Water must update its revenue requirement and prices following our April 2018 updates to estimates for the cost of debt and inflation.

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, Westernport Water should update its price submission and also provide us with an updated financial model. Any updates will be publicly available on our website.

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

	2018-19	2019-20	2020-21	2021-22	2022-23	Total
Operating expenditure	15.0	15.0	14.9	14.7	14.6	74.3
Return on assets	4.9	5.0	5.0	5.1	5.2	25.1
Regulatory depreciation	2.3	2.5	2.8	3.0	3.3	14.0
Tax allowance	0.0	0.0	0.0	0.0	0.0	0.0
<b>Revenue requirement</b>	<b>22.2</b>	<b>22.5</b>	<b>22.8</b>	<b>22.9</b>	<b>23.1</b>	<b>113.4</b>

Note: Numbers have been rounded

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



## Operating expenditure

Operating expenditure is an input to the revenue requirement. Westernport Water's forecast operating expenditure is provided at Table 2.2 broken down into controllable and non-controllable components. Westernport Water's price submission provides detail on its forecast operating expenditure from pages 40 to 51.

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 and 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>	13.3	13.3	13.3	13.3	13.3
Non-controllable costs <sup>b</sup>	1.7	1.7	1.7	1.4	1.4
- Bulk services <sup>c</sup>	0.6	0.6	0.6	0.4	0.4
- Environmental contribution <sup>d</sup>	1.0	1.0	1.0	1.0	0.9
- Licence fees <sup>e</sup>	0.04	0.04	0.04	0.04	0.04
- Other	0.1	0.1	0.1	0.1	0.1
<b>Operating expenditure</b>	<b>15.0</b>	<b>15.0</b>	<b>14.9</b>	<b>14.7</b>	<b>14.6</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 covers 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

Note: Numbers have been rounded

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

Baseline controllable operating expenditure:

- Westernport Water has proposed downward adjustments to its actual 2016-17 baseline year controllable operating expenditure, producing a starting point for forecast annual operating expenditure. The resultant figure of \$13.67 million is 6 per cent above the benchmark of \$12.87 million allowed for 2016-17 in the previous price determination. Westernport Water advised total water consumption across the 2013–18 period rose 15 per cent above the forecast, which is consistent with the higher value for 2016-17 controllable operating expenditure. These increased costs from higher demand exceed the efficiency gains made by Westernport Water during the current period, resulting in the 2016-17 baseline being above the benchmark.

Our assessment

- In a benchmarking study undertaken for the commission, Westernport Water ranks highest among Victorian urban water corporations on technical efficiency.<sup>25</sup> This also indicates Westernport Water's baseline controllable operating expenditure reflects a reasonable benchmark.

#### Efficiency improvement:

- Westernport Water's proposed efficiency improvement rate on controllable operating costs is 2.7 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 also exceeds Westernport Water's forecast connection growth rate of 1.9 per cent per annum, giving a declining annual baseline operating cost.

#### Proposed cost changes:

- Westernport Water has not sought any additional operating expenditure to its annual baseline cost. Forecast increases in wages (above inflation), electricity and IT costs will be managed by Westernport Water within its efficiency improvement rate and growth rate allowance.

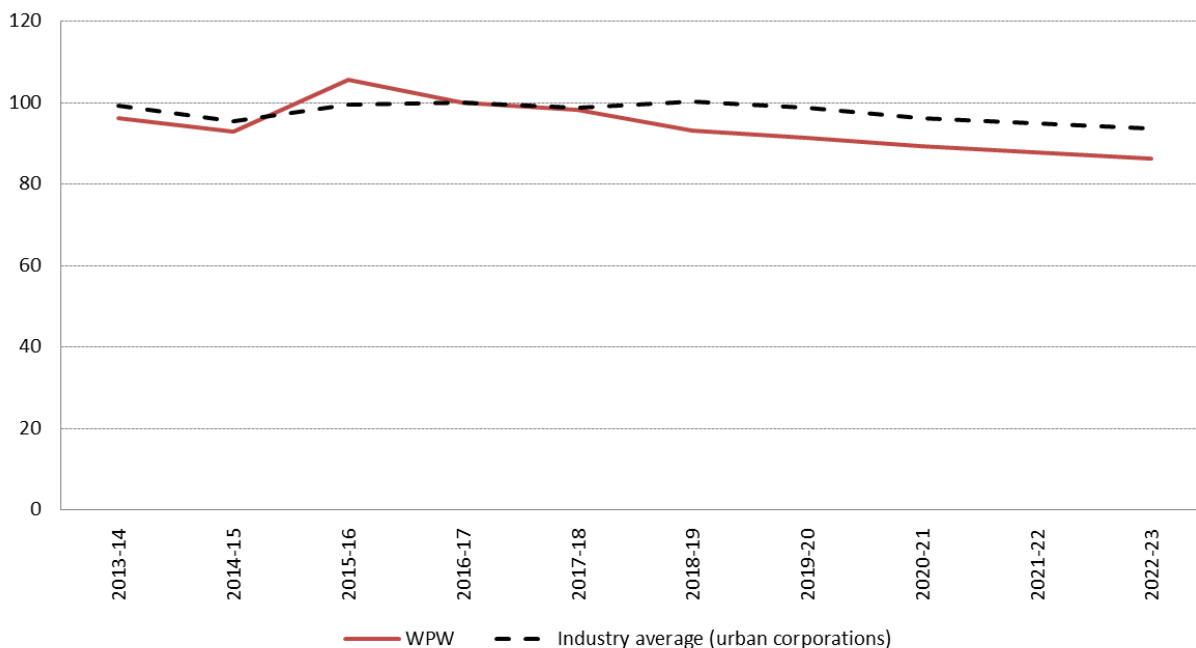
We consider Westernport Water's approach to forecasting its operating expenditure is consistent with the requirements of our guidance, and we are satisfied that its proposed forecast represents efficient controllable operating expenditure. Although starting with a higher baseline than the benchmark for the current 2013–18 period, there is evidence that the corporation has significantly tested its controllable expenditure requirements, resulting in a forecast decline (in real terms) in controllable operating expenditure per customer connection. 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).

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<sup>25</sup> Economic Insights 2014, *Victorian Urban Water Utility Benchmarking*, 31 July. Available at [www.esc.vic.gov.au](http://www.esc.vic.gov.au)

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

Index: 2016-17=100



Non-controllable operating expenditure increases by \$0.78 million in 2018-19, the first year of the fourth regulatory period, predominantly due to the introduction of external bulk charges for Westernport Water’s Thompson River entitlement. This charge is then forecast to reduce by \$0.23 million per year for the final years of the period (2021-22 and 2022-23). We have verified the charge and price path are consistent with Melbourne Water’s current price determination.

Non-controllable licence fees are forecast to remain flat throughout the regulatory period. The environmental contribution will increase by \$0.21 million in 2018-19 as advised by the Department of Environment, Land, Water and Planning, and then decline in real terms across the period.

The initial \$0.78 million increase in non-controllable costs exceeds the value of the 2017-18 rebate (\$0.54 million per year) and is a key factor for the net increase in customer bills from 2018-19 once the rebate ends. This addresses a concern raised by the Consumer Action Law Centre in its submission, where it questioned whether Westernport Water had permanently captured the efficiency gains underpinning its rebate, given the proposed price path increase.<sup>26</sup>

<sup>26</sup> Consumer Action Law Centre 2017, *Initial Feedback, 2018 Price Review*, November.

We will accept Westernport Water's proposed non-controllable operating expenditure for our draft decision. Prior to making our final decision, we will update the forecast licence 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 Westernport Water's proposed operating expenditure forecasts 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 Westernport Water to propose its:

- closing regulatory asset base at 30 June 2017
- forecast regulatory asset base for each year of the regulatory period from 1 July 2018.

### Closing regulatory asset base

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

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

We compared Westernport Water's actual net capital expenditure for 2012-13 to 2016-17 with the forecast used to approve maximum prices for the period from 1 July 2013.<sup>27</sup>

Westernport Water's net capital expenditure was about the same as its forecast.<sup>28</sup> It also calculated its closing regulatory asset base in accordance with the requirements of our guidance. For these reasons, our draft decision accepts Westernport Water's proposed closing regulatory asset base for 30 June 2017 of \$116.9 million.

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<sup>27</sup> Net capital expenditure is calculated by deducting government and customer contributions from gross capital expenditure.

<sup>28</sup> We take a risk-based approach to including past capital expenditure in the regulatory asset base. We undertake a prudence and efficiency review where a water corporation has exceeded its net capital expenditure forecasts by more than 10 per cent. We believe this approach is reasonable given capital expenditure can be relatively 'lumpy' in nature.

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

	2012-13	2013-14	2014-15	2015-16	2016-17
Opening RAB 1 July	98.6	109.5	110.9	113.8	115.1
Plus gross capital expenditure	14.5	4.4	5.4	4.3	5.3
Less government contributions	0.0	0.0	0.0	0.0	0.0
Less customer contributions	0.9	0.5	0.4	0.4	0.8
Less proceeds from disposals	0.1	0.6	0.04	0.3	0.1
Less regulatory depreciation	2.6	1.9	2.1	2.3	2.5
<b>Closing RAB 30 June</b>	<b>109.5</b>	<b>110.9</b>	<b>113.8</b>	<b>115.1</b>	<b>116.9</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 Westernport Water's proposed opening regulatory asset base from 1 July 2018.<sup>29</sup> Our draft decision is to accept Westernport 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>29</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	116.9	120.3	122.7	125.0	127.0	128.1
Plus gross capital expenditure	6.6	5.3	5.5	5.4	4.8	5.5
Less government contributions	0.0	0.0	0.0	0.0	0.0	0.0
Less customer contributions	0.6	0.6	0.6	0.6	0.6	0.5
Less proceeds from disposals	0.1	0.05	0.05	0.05	0.05	0.04
Less regulatory depreciation	2.6	2.3	2.5	2.8	3.0	3.3
<b>Closing RAB 30 June</b>	<b>120.3</b>	<b>122.7</b>	<b>125.0</b>	<b>127.0</b>	<b>128.1</b>	<b>129.7</b>

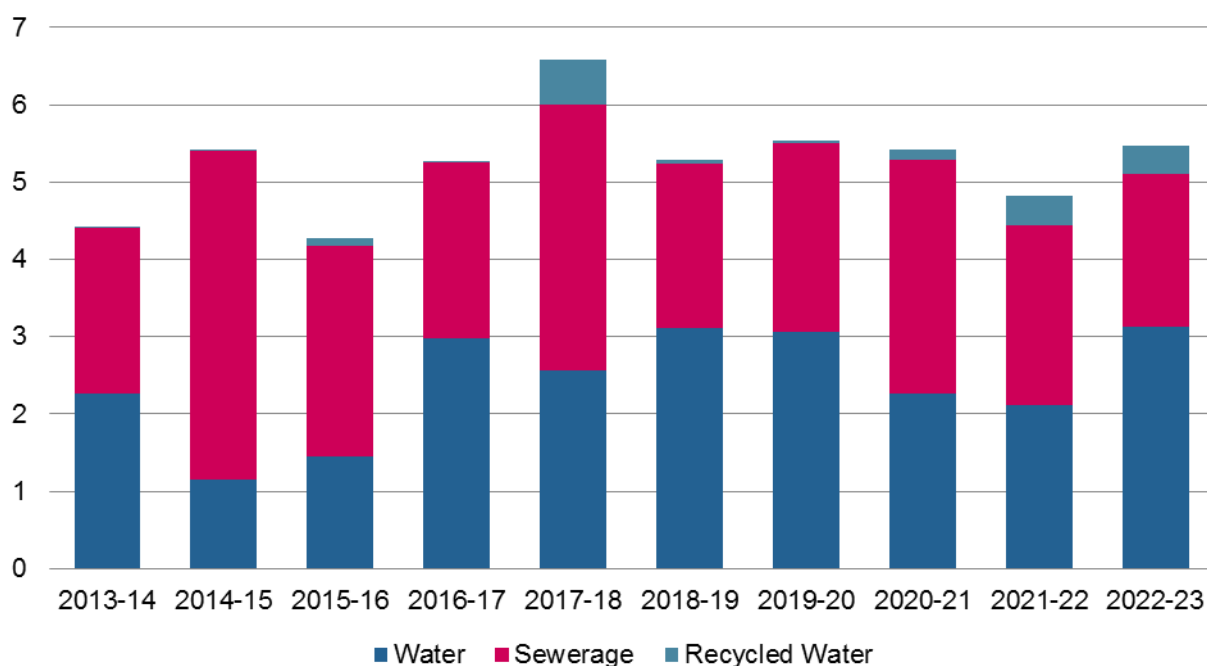
Note: Numbers have been rounded

### Capital expenditure

Capital expenditure is an input to estimating the regulatory asset base. Westernport Water's forecast capital expenditure and supporting information is provided at pages 22 to 40 of its price submission. A summary of capital expenditure for the 2013–18 and 2018–23 periods is provided in Figure 2.2.

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

\$ million 2017-18



Note: actuals for 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 Westernport Water for our draft decision on its revenue requirement:

- Westernport Water’s price submission provided evidence that its forecasts for capital expenditure are efficient. Westernport Water’s proposed capital expenditure is on par with the current regulatory period, predominantly driven by renewals.
- We requested selected documents from Westernport 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 Westernport Water has a robust approach for developing project scope, the timing of works and cost estimates.
  - We requested and reviewed the business cases for the Phillip Island water supply security project and the San Remo basin renewal project, which are two of Westernport Water’s three largest projects for the period. We also reviewed business cases for the water main replacement program and the sewer pump station electrical switchboard upgrades program.
- We consider the planned capital expenditure program is achievable, given Westernport Water’s past track record delivering its capital expenditure program. Over the current 2013–18 regulatory period, Westernport Water is expected to deliver most of its planned major projects,

Our assessment



with the San Remo basin cover replacement deferred until 2020-21 based on a more recent condition assessment.

- Where there is uncertainty in timing, cost, scope and benefits of capital expenditure, Westernport Water has excluded speculative projects from its price submission, but has included planning costs where appropriate to inform projects needed from 2023. This is consistent with our guidance for managing uncertain expenditure. For our draft decision, we accept Westernport Water's proposal for addressing uncertainty, noting the following:
  - Westernport 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.
- We consider Westernport 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 Westernport Water's proposed benchmark, as set out in Table 2.4.

### Customer contributions

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

We compared Westernport Water's forecast for customer contributions with past outcomes, and its forecasts for growth in customer connections.<sup>30</sup> We consider Westernport Water's forecast contributions are reasonable, having regard to past trends and its growth forecasts.

Our draft decision proposes to accept Westernport Water's forecasts for customer contributions.<sup>31</sup>

### Cost of debt

Our guidance required Westernport Water to use estimates of the cost of debt provided by the commission to estimate its revenue requirement. Westernport Water used the cost of debt values we specified to calculate its revenue requirement. For this reason, our draft decision approves the cost of debt proposed by Westernport Water, as set out in Table 2.5.

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<sup>30</sup> Growth in customer connections can be used as an indicator of growth in customer contributions.

<sup>31</sup> The outcome of further review of Westernport Water's proposed New Customer Contributions may influence total customer contributions.

**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-day approach.<sup>32</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**

Westernport Water rated its price submission as ‘Standard’. Based on its PREMO self-rating, Westernport Water proposed a rate of return on equity of 4.5 per cent per annum. This reflects the maximum return rate allowed in our guidance for a price submission rated as ‘Standard’.<sup>33</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>34</sup>

Our draft decision accepts Westernport Water’s PREMO self-rating and proposed return on equity of 4.5 per cent per annum. Our assessment of Westernport Water’s proposed PREMO rating is set out in Chapter 3.

### **Regulatory depreciation**

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

Westernport Water’s forecast regulatory depreciation was calculated using a straight line depreciation profile. We noted in our guidance that we prefer this approach.<sup>35</sup> Westernport Water also calculated regulatory depreciation in a manner consistent with our guidance.

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<sup>32</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>33</sup> Essential Services Commission 2016, *Guidance paper*, op. cit., p. 49.

<sup>34</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.

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

## **Tax allowance**

The tax allowance is an input into the revenue requirement. Westernport Water has proposed no allowance for tax in its revenue requirement. Our draft decision is to accept the forecast as it was calculated consistently with the method required by our guidance.<sup>36</sup>

## **Demand**

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

Westernport Water’s demand forecasts are set out at pages 52 to 58 of its price submission, and are also included in its financial model. Our draft decision proposes to accept Westernport Water’s demand forecasts for the purpose of approving maximum prices as we consider they were estimated in a manner that is consistent with the requirements of our guidance. This includes basing demand forecasts on the latest *Victoria In Future* population growth forecasts issued by the Victorian Government.

## **Form of price control**

Westernport Water proposed a price cap form of price control. It currently uses a price cap.

Our draft decision is to accept Westernport Water’s proposed form of price control. A price cap will allow Westernport Water to recover sufficient revenue to cover the forecast efficient costs of providing services. A price cap also provides customers with price certainty, and means a water corporation is managing demand risk on behalf of its customers. We consider demand risk is more efficiently managed by a water corporation, rather than its customers.<sup>37</sup>

## **Prices and tariff structures**

Westernport Water’s proposed tariffs are set out at pages 75 and 76 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.

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<sup>35</sup> Essential Services Commission 2016, *Guidance paper*, op. cit., p. 42.

<sup>36</sup> Essential Services Commission 2016, *Guidance paper*, op. cit., pp. 50-51.

<sup>37</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.

From 2014-15, Westernport Water’s residential customers receiving a bill including water usage charges received an annual rebate. The rebate reflects the outcomes of a government efficiency review, and ends after 2017-18. While Westernport Water proposes a fall in prices for most customers from 2018-19, the removal of the rebate means some customer 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>38</sup>

We note Westernport Water has sought to address the impact of the rebate removal on customers. It has proposed to expand its support for customers experiencing payment difficulty.

**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)	2.00	1.98	1.98	1.98	1.98	1.98
Fixed (20mm) (\$/year)	388.68	386.26	386.26	386.26	386.26	386.26
<b>Non-residential</b>						
Variable (\$/kL)	2.00	1.98	1.98	1.98	1.98	1.98
Fixed (20mm) (\$/year)	388.68	386.26	386.26	386.26	386.26	386.26

<sup>38</sup> Consumer Action Law Centre 2017, op. cit.

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

	2017-18	2018-19	2019-20	2020-21	2021-22	2022-23
<b>Residential</b>						
Fixed (\$/year)	599.22	595.49	595.49	595.49	595.49	595.49
<b>Non-residential</b>						
Fixed (1 cistern) (\$/year)	599.22	595.49	595.49	595.49	595.49	595.49

We consider Westernport 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>39</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. We note Westernport Water’s finding that customers generally supported its existing tariff structures.

Westernport Water proposed to maintain its existing tariff structures. For residential and non-residential water services, Westernport Water proposed a two-part tariff with a fixed service charge and a variable usage component that depends on water use. For residential and non-residential sewerage services, Westernport Water proposed a fixed service charge only.

We consider the two-part structure proposed by Westernport Water for its water service tariffs will promote efficient use of services. The two-part structure for water tariffs sends customers a signal about costs of their water use, and is an approach that is commonly applied in other states and territories.<sup>40</sup> We also consider two-part tariff structures are easy to understand.

Westernport Water has confirmed its proposed tariffs for recycled water, trade waste and miscellaneous services are calculated in accordance with the pricing principles referenced in our guidance.<sup>41</sup>

Westernport Water proposed a new standpipe tariff for water carting, with the price set to match the lowest rate offered by neighbouring water corporations. We agree with Westernport Water’s

<sup>39</sup> Essential Services Commission 2016, *Guidance paper*, op. cit., p. 55.

<sup>40</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>41</sup> Following a request from the commission for further information.

justification for the new standpipe variable tariff, as set out at page 74 of its price submission. We consider that the tariff is easy to understand and provides appropriate price signals to customers about the efficient costs of accessing water.<sup>42</sup>

A submission by the Consumer Action Law Centre<sup>43</sup> 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’.

In response, we note Westernport Water has committed to expand its support for low income and vulnerable customers by increasing the number of hardship grants, set out at page 15 of its price submission.

For the reasons set out above, our draft decision approves Westernport Water’s proposed tariff structures as set out at pages 75 and 76 of its price submission.

Prior to our final decision and price determination, Westernport Water must submit:

- updated prices to reflect our draft decision on the revenue requirement
- 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.

## **Adjusting prices**

Westernport Water proposed price adjustment mechanisms at pages 77 to 79 of its price submission. It proposed:

- to continue with its existing uncertain and unforeseen events mechanism<sup>44</sup>
- a new cost pass-through for any usage of its entitlement in the Greater Yarra–Thomson system, where any costs would be evenly shared by Westernport Water and its customers
- new price adjustment formulas that allow for its proposed pass-through mechanisms.

Our draft decision accepts Westernport Water’s proposal to continue the existing uncertain and unforeseen events mechanism. We noted in our guidance that we propose that the mechanism continues in its current form.

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<sup>42</sup> In its price submission, Westernport Water noted that currently, a customer accessing a hydrant is charged a rate equivalent to its non-residential variable water tariff. This is lower than the rate applying in neighbouring water corporations. As a result, customers of neighbouring water corporations have been accessing water from Westernport Water’s hydrants. It says this has led to complaints and dissatisfaction from residential households.

<sup>43</sup> Consumer Action Law Centre 2017, op. cit.

<sup>44</sup> Westernport Water confirmed with us that it intends to continue with the existing mechanism. Its proposal to continue the mechanism was not included in its price submission.

We agree with Westernport Water's justification for its proposed pass-through, as set out at page 77 of its price submission. In particular, we note that the pass-through provides for cost reflective pricing and appropriate risk sharing between Westernport Water and its customers.

We do not consider Westernport Water's proposed price adjustment formulas are easy to understand. Also, Westernport Water has not included adjustments to reflect movements in the cost of debt, as required by our guidance. We invite Westernport Water to submit revised price adjustment formulas that allow prices to adjust to changes in the cost of debt, and better support customer understanding of price changes.

## **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.

Westernport Water's proposed prices for new customer contributions are set out at pages 59 and 60 of its price submission. Westernport Water proposed the following charges:

- for water, a standard charge of \$1,011 per connection in 2018-19 (increasing with inflation each year) decreasing from \$2,315.05 in 2017-18
- for sewerage, a standard charge of \$713 per connection in 2018-19 (increasing with inflation each year) increasing from \$513.20 in 2017-18.

For negotiated new customer contributions, Westernport Water proposes to continue to calculate a charge in accordance with the requirements of our new customer contribution principles.

We have reviewed Westernport Water's proposed charges and consider they are consistent with the requirements of our guidance.<sup>45</sup> For this reason, our draft decision proposes to approve Westernport Water's proposed new customer contribution prices.

## **Financial position**

In approving prices, we must have regard to the financial viability of the water industry.<sup>46</sup> We interpret the financial viability requirements under the ESC Act and the WIRO to mean that the prices we approve should provide a high level of certainty that each water corporation can maintain

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<sup>45</sup> Provided in response to a request for further information.

<sup>46</sup> WIRO clause 8(b)(ii) and ESC Act s.8A(1)(b).

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.

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



### 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 approve Westernport Water's proposed return on equity of 4.5 per cent, based on the justification provided for the level of ambition in its price submission. Below, we set out our preliminary assessment of Westernport Water's proposed PREMO rating.

#### Our review of Westernport Water's PREMO self-rating

Westernport Water's proposed PREMO rating, and our draft decision is summarised below.

Table 3.1 PREMO Rating

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

We agree with Westernport Water's proposed overall PREMO self-rating of 'Standard'. This is reflected in the return on equity we have approved for Westernport Water at page 17.

In support of its proposed PREMO rating, we note Westernport Water's efficiency improvement target for operating expenditure, which is high relative to other water corporations. External benchmarking also ranks Westernport Water high on its level of technical efficiency.

Westernport Water has also provided evidence that customers influenced its proposals. It demonstrated how feedback received during its engagement changed its original approach to the share of variable tariffs in customer bills.

Based on the information provided to us, we consider Westernport Water could have done more to explain to customers how their bills would be affected when the annual rebate ends in 2017-18. Westernport Water's typical annual bill for a residential owner occupier is estimated to rise by \$23 in 2018-19, partly due to the end of the rebate (and the increase in non-controllable operating expenditure discussed on page 12).

Customers do not appear to have been provided with this information during the engagement program. We consider this is important information for customers.

In assessing whether to accept Westernport Water's self-rating of 'Advanced' for Engagement, we weighed its approach to engaging on bills against other aspects of its engagement. Factors supporting Westernport Water's 'Advanced' self-rating include:

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

Given these factors, we have accepted on balance Westernport Water's 'Advanced' self-rating for Engagement.

## 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 Westernport 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 Westernport 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
Consumer Action Law Centre	16 November 2017
Mr G Mallon	7 November 2017