

# 2023 water price review

Guidance paper

26 October 2021 (August 2022 amendment)



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# Contents

<b>Summary</b>	<b>iv</b>
<b>1. About this guidance</b>	<b>1</b>
1.1. Our role	1
1.2. About this paper	2
1.3. Water pricing framework and approach	3
1.4. Amendments to this guidance	4
1.5. Structure of this guidance	5
1.6. Interpretation of this guidance	5
<b>2. Our approach to the price review</b>	<b>7</b>
2.1. How we will regulate prices	7
2.2. Approach and methodology for assessing the price submissions	9
2.3. Approach to assessing PREMO price submission ratings	10
2.4. Our consultation process during the 2023 price review	11
2.5. 2023 price review process and timeline	12
<b>3. Required contents of a price submission</b>	<b>15</b>
3.1. Managing risk	16
3.2. Regulatory period	18
3.3. Customer engagement	20
3.4. Outcomes	22
3.5. Service standards relating to reliability and faults	25
3.6. Guaranteed service levels	25
3.7. Revenue requirement	27
3.8. Forecast operating expenditure	28
3.9. Forecast capital expenditure	32
3.10. Return on regulatory asset base	37
3.11. Forecast regulatory asset base	37
3.12. Regulatory depreciation	39
3.13. Cost of Debt	39
3.14. PREMO rating	42
3.15. Return on equity	47
3.16. Tax allowance	47
3.17. Demand	49
3.18. Form of price control	50
3.19. Prices and tariff structures	51
3.20. Adjusting prices	57
3.21. New customer contributions	59
3.22. Financial position	60
3.23. Additional requirements	61
<b>Appendix A – Approach for making a price determination</b>	<b>65</b>
<b>Appendix B – Matters to include in guidance</b>	<b>67</b>
<b>Appendix C – Matters businesses and the commission must have regard to</b>	<b>69</b>

<b>Appendix D – Risk management</b>	<b>71</b>
Types of risk	71
Regulatory risk mitigation tools	72
<b>Appendix E– Establishing a PREMO rating</b>	<b>73</b>
PREMO rating process	73
PREMO assessment tool	74
An approach to establishing a PREMO rating	87

# Summary

The 2023 water price review will set the maximum prices that 15 Victorian water businesses can charge for their water and sewerage services from 1 July 2023. It is the second price review under our PREMO framework for these businesses.<sup>1</sup> Most of the price submission requirements will remain the same as for the 2018 price review. However, there are two notable differences for this second round of PREMO:<sup>2</sup>

1. We are introducing the backward-looking Performance element of PREMO, which holds businesses accountable for their proposals from the previous price review.
2. Price submissions need to demonstrate how water businesses are building on their previous proposals to deliver great value to their customers.

PREMO incentives provide up-front rewards for an ambitious business proposing better customer value. However, a business is accountable for delivering on its commitments.

The Performance element of PREMO effectively closes the loop on the current pricing period by addressing two key questions:

- Did the business deliver on its promises?
- Did customers get what they paid for?

This also establishes a continuum from one pricing period to the next as businesses seek to maintain or improve customer value, and to address any shortfalls in performance going forward. Customers should expect no less.

Price submissions need to consider major challenges confronting the community – namely the impacts of the coronavirus pandemic and climate change. Both are increasing the uncertainty in forward planning. The pandemic has heightened the uncertainty the businesses will face in preparing their expenditure and demand forecasts, also impacted customer debt.

While we anticipate these events, and related matters, will be prominent in price submission considerations, they don't materially affect the nature of our guidance. We still expect businesses

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<sup>1</sup> We first introduced our new PREMO (Performance, Risk, Engagement, Management and Outcome) framework at our 2018 price review of 17 water businesses, and for Melbourne Water's 2021 price review.

<sup>2</sup> An independent review by farrierswier found that PREMO was successful in providing incentives for water businesses to deliver better outcomes for their customers. This reflected extensive engagement by water businesses, so price submissions were better informed by customer priorities.

to justify their forecasts and show how they have sought to manage the risks of this uncertainty on behalf of their customers.

Price submissions must also incorporate the efficient cost of meeting legislative and government obligations.

This guidance sets out how we will assess price submissions. We will do so in line with the requirements of the Water Industry Regulatory Order 2014.

Water businesses can also benefit from streamlined price reviews. This includes fast-tracking high quality price submissions through our assessment process.

The PREMO framework affords greater autonomy for businesses that demonstrate clear ownership of their proposals. Key to this is the requirement in our guidance that each business's board attests to:

- the quality and accuracy of its price submission
- its commitment to the customer outcomes proposed.

**Ultimately, we expect each business's price submission to reflect its 'best offer' to its customers (irrespective of PREMO price submission ratings).**

Price submissions must be lodged with us by **Friday 30 September 2022**.

# 1. About this guidance

## 1.1. Our role

We will undertake a review of the maximum prices that 15 water businesses can charge for their water and sewerage services for the regulatory period from 1 July 2023 (the **2023 price review**).<sup>3</sup>

The review covers Barwon Water, Central Highlands Water, Coliban Water, East Gippsland Water, Gippsland Water, Goulburn Valley Water, GWMWater, Greater Western Water,<sup>4</sup> Lower Murray Water, South East Water, South Gippsland Water, Southern Rural Water, Wannon Water, Westernport Water and Yarra Valley Water.

Melbourne Water and Goulburn-Murray Water are not included in this review, having completed price reviews in 2021 and 2020, respectively. North East Water had an eight-year regulatory period approved in 2018, so its next price review will be in 2026.<sup>5</sup>

Our pricing powers and functions in Victoria's water industry are governed by the Water Industry Regulatory Order 2014 (**WIRO**),<sup>6</sup> which sits within the broader context of the *Water Industry Act 1994* (Vic) (**WI Act**) and the *Essential Services Commission Act 2001* (Vic) (**ESC Act**).

Subject to legislation change, rural tariffs pertaining to rural infrastructure services currently regulated under the Commonwealth Water Charge Rules 2010 are to be assessed against the principles in clause 11 of the WIRO from 1 July 2023.<sup>7</sup> Legislation is proposed to enable these prices to be regulated under the WIRO from 1 July 2023. Accordingly, it is intended that this guidance will apply to the affected businesses and the relevant infrastructure charges.

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<sup>3</sup> Under our most recent price determinations (2018) for these 15 water businesses, approved prices are scheduled to cease on 30 June 2023.

<sup>4</sup> On 1 July 2021 Greater Western Water was formed by bringing together Western Water and City West Water.

<sup>5</sup> On 14 October 2022, we received a request from Greater Western Water to have the current determinations for City West Water and Western Water (the entities that combined to form Greater Western Water from 1 July 2021) extended by one year; that is, to end on 30 June 2024 rather than 30 June 2023. The request is available on our website via [www.esc.vic.gov.au](http://www.esc.vic.gov.au). Greater Western Water proposes extending the determinations by one year will enable it to deliver the long-term benefits of the integration and greater value for customers. We intend to publish our response to the business's request by early December 2021.

<sup>6</sup> The WIRO is available at <http://www.gazette.vic.gov.au/gazette/Gazettes2014/GG2014G043.pdf#page=45>, pp. 41-51.

<sup>7</sup> Previously, the commission was accredited by the Australian Competition and Consumer Commission to regulate the rural infrastructure prices applying in the Murray Darling Basin.

We must make a price determination which determines the maximum prices (or the manner in which prices are to be calculated, determined or otherwise regulated) that a water business may charge for prescribed services during a regulatory period.<sup>8</sup>

Clause 14 of the WIRO (provided at **Appendix A**) requires us to assess a price submission prepared by a water business, and form an opinion on whether the price submission:

- complies with the guidance issued by the commission under clause 13 of the WIRO
- has adequate regard for the matters specified in clause 11 of the WIRO.

If we form a view that a price submission satisfies the guidance and WIRO criteria, then we must approve a water business's price submission — otherwise, the WIRO affords us discretion to specify maximum prices, or the manner in which prices are to be calculated, determined or otherwise regulated.<sup>9</sup>

## 1.2. About this paper

This paper is the guidance we are required to issue to water businesses under clause 13 of the WIRO (clause 13 is provided at **Appendix B**). To comply with clause 13 of the WIRO, the guidance sets out our approach to the price review and information requirements for price submissions.<sup>10</sup>

Much of this guidance remains unchanged from the guidance we issued in 2018 following extensive consultation with the sector and key stakeholders. Our consultation for this guidance therefore focused on the key changes we were proposing.

Where possible we have sought to minimise compliance costs for water businesses.<sup>11</sup> In considering the information required to support a price submission, much of the information should be readily available to a water business and relevant for other purposes such as corporate planning or project justification and prioritisation.

Much of the supporting information detailed in this guidance can be provided by completing the financial model template (issued by us) that forms part of a water business's price submission. We encourage businesses to keep their price submissions as clear and succinct as possible. To this

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<sup>8</sup> WIRO, clause 10(a). The prescribed services are listed at clause 7(b) of the WIRO.

<sup>9</sup> WIRO, clause 14.

<sup>10</sup> Clause 13 of the WIRO also requires us to provide guidance following consultation with the regulated entities. Over the course of 2021, we consulted on the various elements of this guidance.

<sup>11</sup> Under section 4C (a) of the WI Act we have an objective to ensure the costs of regulation do not exceed the benefits, wherever possible.

end, a business need not include all the supporting information for the claims made in its submission. However, it must be able to provide any supporting information requested by us.

### **1.3. Water pricing framework and approach**

We implemented our PREMO water pricing approach for the first time at the 2018 water price review. The PREMO incentive framework includes financial, reputational and procedural incentives to align the interests of water businesses and the customers they serve.

PREMO stands for Performance, Risk, Engagement, Management, and Outcomes. Water businesses must demonstrate their level of ambition in delivering value-for-money for customers in their price submissions across the five elements:

- Performance — have the performance outcomes to which the business committed in the previous regulatory period been met or exceeded?
- Risk — has the business sought to allocate risk to the party best positioned to manage that risk? To what extent has the business accepted risk on behalf of its customers?
- Engagement — how effective was the business’s customer engagement to inform its price submission?
- Management — is there a strong focus on efficiency? Are controllable costs increasing, staying the same, or decreasing? Is the price submission succinct and free of material errors?
- Outcomes — do proposed service outcomes represent an improvement, the status quo, or a reduction of service standards?

Key elements of the pricing approach are:

- an emphasis on the role of customer engagement to inform and influence the price submissions of water businesses
- linking the return on equity earned by a water business to the level of ambition in its price submission for Performance, Risk, Engagement, Management and Outcomes
- flexibility mechanisms to help ensure the pricing approach accounts for the diversity of the water businesses and their customers, and to allow for streamlined price review processes.

An independent review found PREMO was successful in contributing to better outcomes for Victorian water customers at the 2018 water price review, including through lower prices and better targeted services.<sup>12</sup>

The 2023 water price review will be the second time price submissions from the same water businesses have been assessed under PREMO. A key change for 2023 is the introduction of the 'Performance' element of PREMO, which involves a backward look at how well a business has performed relative to the commitments it made at its previous review. We have updated our price submission requirements to reflect where core requirements of the framework will already be in place following the 2018 review. We have revised the PREMO assessment tool accordingly, in some instances 'raising the bar' on our requirements for a Standard rating and corresponding higher PREMO ratings. And we have introduced new requirements to demonstrate inclusive engagement with First Nations people and with customers experiencing vulnerability.

We have also updated the return on equity values in the PREMO matrix (see Section 3.14), informed by latest market observations and recent decisions by other regulators.

Other than these changes, the PREMO incentive framework remains essentially unchanged.

The high-level PREMO incentive framework is set out in a paper published by the commission in 2018.<sup>13</sup> This guidance is informed by our framework and approach paper. Where there are any inconsistencies however, our guidance takes precedence for the purpose of informing price submissions.

## **1.4. Amendments to this guidance**

This guidance was prepared in consultation with the water businesses, including through a series of themed workshops.<sup>14</sup> Our consultation focused on the key changes associated with a second price review under PREMO, and refinements we proposed to make based on our experience with PREMO price reviews. We have also had discussions with other related regulators and government departments, and customer representative groups.

We may issue additional guidance or amend this guidance during the price review. The need to issue additional guidance or amend guidance may arise from any changes to law, regulations, or in

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<sup>12</sup> Farrierswier 2019, Victoria's water sector: The PREMO model for economic regulation, 28 March.

<sup>13</sup> Essential Services Commission 2016, Water pricing framework and approach: Implementing PREMO from 2018, October.

<sup>14</sup> Clause 13 of the WIRO requires us to provide guidance following consultation with the regulated entities.

the economic environment, for example. We will consult with stakeholders where any additional guidance or amendment to the guidance is required.

## **1.5. Structure of this guidance**

The guidance is structured as follows:

- Chapter 2 sets out:
  - the manner in which we propose to regulate prices
  - our approach and methodology to assessing a price submission and making a price determination
  - the impact of PREMO on price submission information requirements
  - our approach to consultation during the review process
  - the assessment process and the 2023 price review timeline.
- Chapter 3 sets out:
  - the ‘governing criteria’ for each of the components of the building block methodology which will inform the nature and scope of the matters to be included in the price submission, and form the basis of our assessment of the price submission
  - the supporting information required to be included in the price submission.

## **1.6. Interpretation of this guidance**

If a water business requires clarification or interpretation on any matters relating to our pricing framework or this guidance, it should contact commission staff.



## 2. Our approach to the price review

This chapter sets out:

- the manner in which we will regulate prices<sup>15</sup>
- our approach and methodology to assessing a water business's price submission and making a price determination<sup>16</sup>
- the impact of PREMO on price submission information requirements
- our approach to consultation during the price review process<sup>17</sup>
- timelines for the 2023 price review process.<sup>18</sup>

### 2.1. How we will regulate prices

Clause 12(b) of the WIRO provides that a price determination may specify maximum prices, or the manner in which prices are to be calculated, determined or otherwise regulated, for regulated services in a manner consistent with section 33(5) of the ESC Act — that is, in any manner we consider appropriate.

We will use a building block methodology to determine the revenues that will provide a water business with a reasonable opportunity to recover a rate of return on prudent and efficient capital expenditure on assets, a return of the cost of investing in those assets (through depreciation), prudent and efficient operating costs, a benchmark tax allowance and recovery of costs required to comply with relevant health, safety, environmental, social and other regulatory obligations over the next regulatory period.<sup>19</sup> (A list of obligations is shown in Section 3.7)

For a defined regulatory period the building block methodology involves the following steps:

- first, outcomes that a water business proposes to deliver to its customers will be assessed to validate that they reflect government (and technical regulator) obligations or demonstrated customer needs
- second, the following 'building blocks' will be determined in accordance with governing criteria for each element (specified in Chapter 3), to:

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<sup>15</sup> WIRO, clause 13(a)(i).

<sup>16</sup> WIRO, clause 13(a)(ii).

<sup>17</sup> WIRO, clause 13(a)(iv) and 13(a)(viii).

<sup>18</sup> WIRO, clause 13(a)(vi) and 13(a)(vii).

<sup>19</sup> Next regulatory period covers the period from 1 July 2023.

- establish an efficient benchmark level of forecast operating expenditure for the next regulatory period
- establish an efficient benchmark level of forecast capital expenditure for the next regulatory period
- roll-forward the regulatory asset base
- apply a rate of return to the regulatory asset base, calculated using:
  - a benchmark cost of debt estimated using a 10-year trailing average approach
  - a benchmark return on equity value determined by a business’s PREMO rating
- establish a return of capital through a regulatory depreciation allowance
- establish a benchmark tax allowance.

These ‘building blocks’ will determine the forecast revenue that is required for a water business to deliver on its service outcomes and obligations.

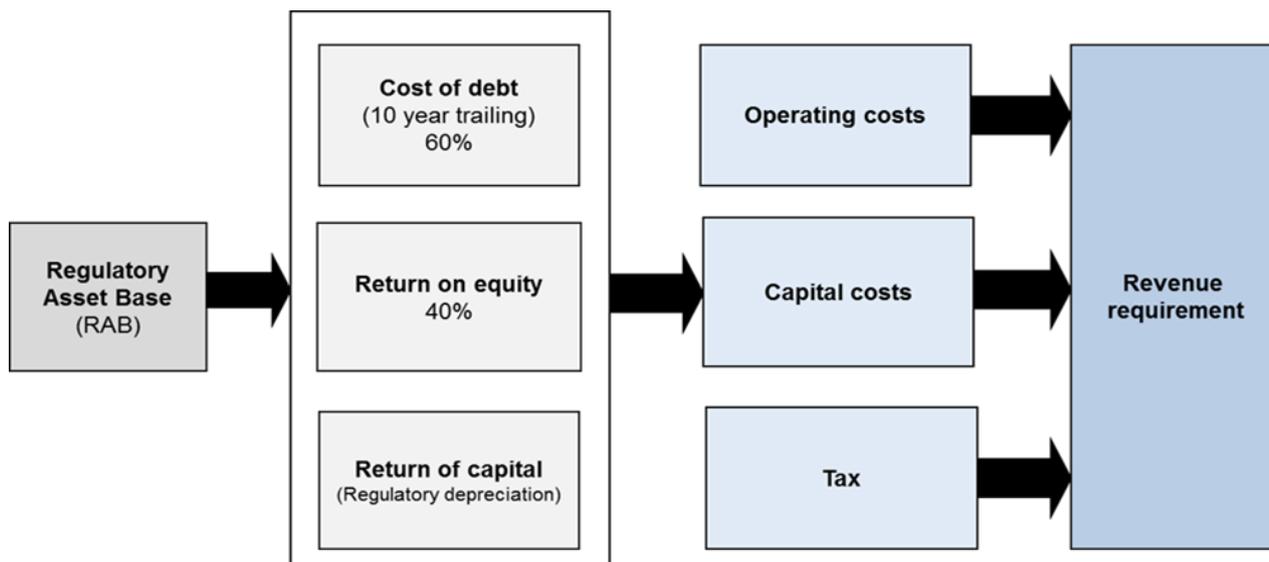
A summary of the building block methodology is shown in Figure 2.1.

Once the revenue requirement for the regulatory period has been determined using building blocks, the form of price control that will be applicable to each water business specifies how this revenue is to be translated into customer prices.

The prices charged by Victorian water businesses have previously been regulated under various forms of price control, including price caps (that is, fixed maximum prices), revenue caps (which allow prices to vary with changes in demand during the period to recover the maximum revenue), tariff baskets and hybrid forms of control. We will continue to provide water businesses with discretion to propose the form of price control to be applied for a regulatory period.

Our price determination will specify the prices that are to apply for the year commencing 1 July 2023, and the prices or the manner in which prices will be calculated for the remaining years of the regulatory period.

**Figure 2.1 Revenue under building blocks**



## 2.2. Approach and methodology for assessing the price submissions

Our regulatory task is to assess a water business’s price submission and form a view about whether or not the price submission:<sup>20</sup>

- has adequate regard for the matters specified in clause 11 of the WIRO
- complies with guidance we issue under clause 13 of the WIRO.

### Assessing the extent to which the submission has regard for matters specified in Clause 11

Clause 11 of the WIRO refers to matters specified in the ESC Act, the WI Act, the guidance we issue under clause 13 of the WIRO, and a number of pricing principles (at clause 11(d)) that we must have regard to in making a price determination.<sup>21</sup>

To facilitate our assessment, a water business is required to support the proposals in its price submission by reference to the matters in clause 11 of the WIRO.

In doing so, a water business is required to place particular emphasis on the matters in clause 8(b) of the WIRO which primarily relate to the promotion of various types of efficiency.<sup>22</sup> Chapter 3 sets

<sup>20</sup> WIRO, clause 14(b)(i).

<sup>21</sup> The matters referred to in clause 11 of the WIRO have been grouped into themes in Appendix C.

<sup>22</sup> In summary, clause 8(b) of the WIRO provides that in having regard to the overarching objectives in the ESC Act, particular emphasis is to be placed on:

- (i) ‘the promotion of efficient use of prescribed services by customers;

out a number of discrete considerations a price submission must address in order to demonstrate a water business has fully and meaningfully addressed clause 11 of the WIRO.

### Assessing compliance with this guidance

A water business must lodge its price submission with us by **30 September 2022**. We expect the price submission (including the financial model template provided by the commission) to comply with Chapter 3 of this guidance. We will assess whether each water business has sufficiently justified its proposals in accordance with the governing criteria in Chapter 3, and satisfied all of the information requirements.

### Consequences if we assess non-compliance with this guidance

Consistent with clause 14 of the WIRO, if we form a view that a price submission complies with our guidance, and has adequate regard for the matters specified in clause 11 of the WIRO, then we must approve the proposals in the price submission. Otherwise, clause 14 of the WIRO allows us discretion to specify maximum prices, or the manner in which its prices are to be calculated, determined or otherwise regulated.<sup>23</sup> This may include us specifying prices for a shorter regulatory period than proposed by a water business.

While we expect that a water business's price submission will comply with the requirements of this guidance, our review will generally focus on matters that have a material impact on the prices customers pay or the services customers receive. We will work with water businesses to facilitate this outcome.

In practice, where a price submission has not fully complied with the guidance, our intention is to provide water businesses with an opportunity to provide the required information before we make a draft decision.

## 2.3. Approach to assessing PREMO price submission ratings

The PREMO incentive mechanism links the return on equity reflected in approved prices to the level of ambition expressed in a price submission.<sup>24</sup> The return on equity will depend on whether the price submission is rated as 'Leading', 'Advanced', 'Standard' or 'Basic'.

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- (ii) the promotion of efficiency in regulated entities as well as efficiency in, and the financial viability of, the regulated water industry; and
  - (iii) the provision to regulated entities of incentives to pursue efficiency improvements.'

<sup>23</sup> WIRO, clause 14(b)(i).

<sup>24</sup> See our pricing approach paper for further context: Essential Services Commission 2016, Water pricing framework and approach: Implementing PREMO from 2018, October.

Section 3.14 discusses the manner in which a water business should assess its price submission to decide on the submission's PREMO rating, and therefore the return on equity to be reflected in its proposed prices. Appendix E includes a PREMO assessment tool that water businesses must use to inform their PREMO ratings.

The tool includes a set of guiding questions that set out the matters to be considered in assessing a price submission PREMO rating, and examples of what might constitute a 'Leading', 'Advanced', 'Standard' or 'Basic' rating for each element of PREMO

Informed by its assessment for the five elements of PREMO, a business must propose an overall PREMO rating for its price submission. The assessment tool guides a water business to consider its level of ambition in relation to matters covered in its price submission, such as proposals related to operating and capital expenditure, form of price control, tariffs, and demand.

A price submission must meet all of the requirements set out in Chapter 3 of this guidance, which represents the minimum requirements for a 'Standard' overall PREMO rating.

We will also rate a price submission with the outcome determining the benchmark return on equity to be reflected in approved prices.

Water businesses should have confidence that well justified PREMO self-ratings – those that provide credible information supporting the self-ratings – will be assessed reasonably by us. We want to reward ambition that provides improved value to customers.

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

## **2.4. Our consultation process during the 2023 price review**

A greater focus on customer engagement by water businesses under PREMO should result in less need for direct engagement by us with their customers. This is consistent with our objective to emphasise the business and customer relationship, and to provide businesses with greater autonomy.

We expect price submissions to be heavily informed by customer engagement. As in past price reviews, we will invite submissions from interested parties on the proposals contained in a water business's price submission prior to making a draft decision.

Following the release of our draft decision, we will invite submissions and intend to engage with customers, either by holding public meetings and/or through online platforms, before we make our final decisions and issue price determinations.<sup>25</sup>

We will consult with agencies such as the Department of Environment, Land, Water and Planning, the Department of Health and the Environment Protection Authority Victoria.

We will make our papers (including the reports of consultants assisting with our review), water businesses' price submissions, and submissions from other interested parties, available on our website ([www.esc.vic.gov.au](http://www.esc.vic.gov.au)) in accordance with our submissions policy.<sup>26</sup>

If there is information that a water business or customer does not want disclosed publicly, because it is confidential or commercially sensitive, the matter should be discussed with commission staff before lodging the submission.

## 2.5. 2023 price review process and timeline

A water business must lodge its price submission with us by **30 September 2022**.<sup>27</sup> If a water business fails to lodge its submission by this date, we may use our discretion to specify maximum prices.<sup>28</sup>

We will assess price submissions using a three-stage review process:

- **Stage 1** — Initial evaluation of all price submissions to verify the quality and strength of the submission and the proposed outcomes for customers, and to establish what further verification work might be required to inform our draft decision. If very little is required, we may fast track those submissions through the assessment process and make an earlier draft decision to accept prices, or propose relatively minor changes, effectively bypassing stage 2.
- **Stage 2** — Verification work is tailored to the quality of each price submission that is not fast tracked, which may range from simple requests for further information through to a full review of cost forecasts by an expert consultant. We may make our draft decision for these businesses once we have completed the additional review (or reject the price submission if unable to reach a draft decision based on the information submitted).

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<sup>25</sup> WIRO, clause 16(b).

<sup>26</sup> View our submissions policy at <https://www.esc.vic.gov.au/about-us/our-policies/our-submissions-policy>.

<sup>27</sup> Clause 13(vi) of the WIRO requires us to provide guidance on the timing and processes we propose to follow in making a price determination. Clause 13(vii) also requires us to specify the date by which the water businesses are to deliver their price submissions to us.

<sup>28</sup> WIRO, clause 14(b)(ii).

- **Stage 3** — Public consultation on our draft decision, leading to our final decision and a price determination for each business. Earlier final decisions for the fast tracked businesses may be made where consultation does not result in further review being required after the draft decision.

Figure 2.2 sets out our assessment process and timeline for the 2023 price review. All dates other than the price submission due date (30 September 2022) are indicative and will be confirmed later in the price review.

### **Fast tracking price submission assessments**

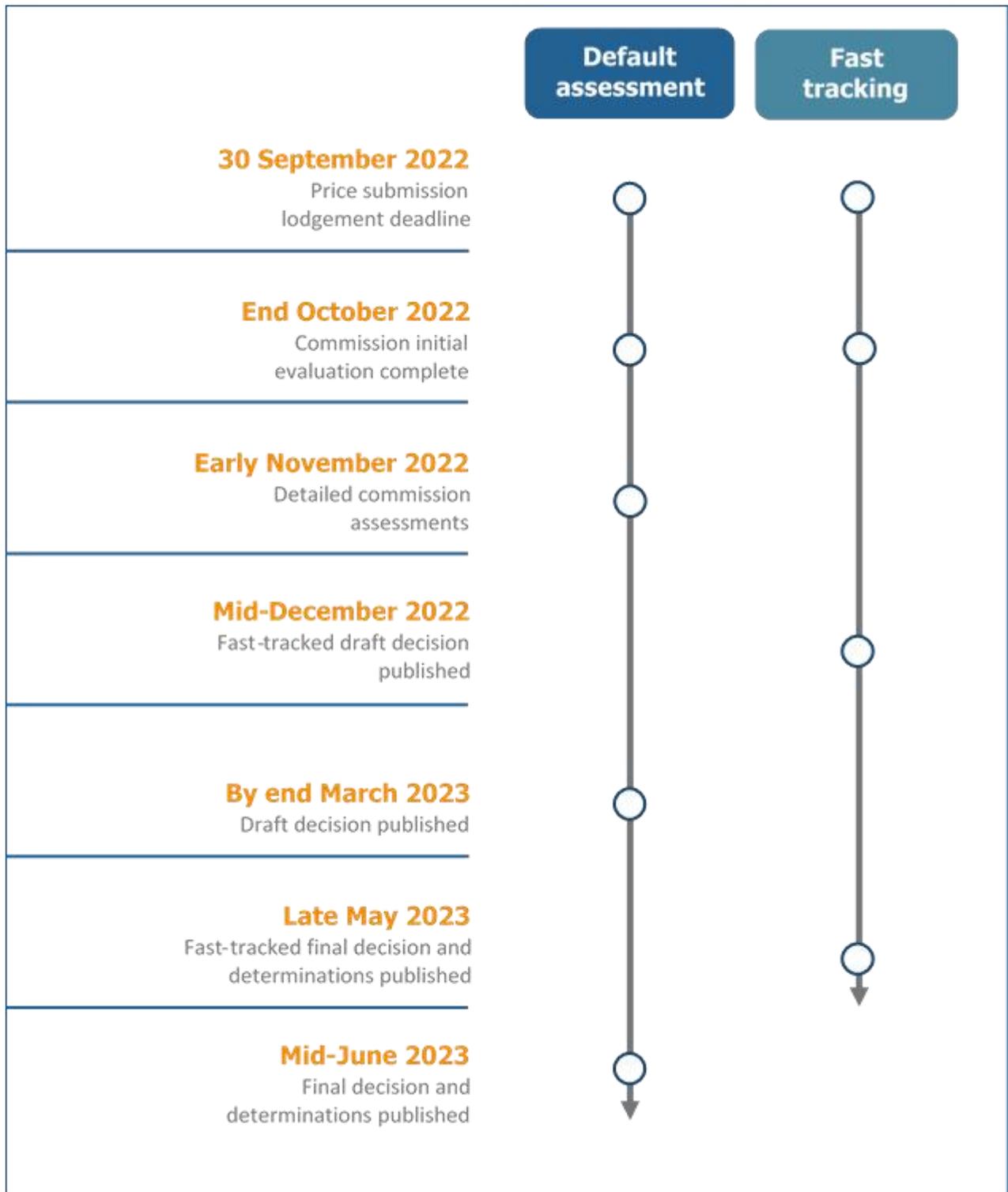
By fast tracking high quality price submissions to an earlier draft decision, we provide those businesses with early certainty over their price proposals and allow them to focus their resources on delivering their services to customers with a reduced regulatory burden.

As highlighted above, to facilitate a quick and simple stage 1 assessment (and the possibility of fast tracking), a price submission must clearly convey its key messages and data to us. This guidance informs businesses on what to include in their price submissions, consistent with this stage 1 assessment. The financial model template (Section 3.23.3) must also be accurately completed for a water business to be eligible for fast tracking.

The decision to fast track a price submission remains at our discretion, taking into account the quality and accuracy of the submission and any other matter we consider is relevant. Our decision on fast tracking will be heavily informed by how well a business demonstrates it has captured the views of its customers and explains how it has considered feedback.

Following the release of a fast-tracked draft decision, if our review process finds there are issues that need to be further explored, we may revert a price submission back to the default assessment process described in Figure 2.2.

Figure 2.2 Price review timeline and assessment process



### 3. Required contents of a price submission

Pursuant to clause 13(a)(iii) and 13(a)(v) of the WIRO, this chapter sets out the governing criteria and supporting information requirements for the major components of a water business's price submission, covering the regulatory period commencing 1 July 2023 (the next regulatory period).

A water business should prepare its price submission with the commission as its target audience. Although the price submission will be released publicly, the content and language should be tailored to facilitate our review. A water business may consider other ways – such as fact sheets – to communicate its proposals to other stakeholders, including its customers.

Price submissions must clearly and succinctly identify and explain how a business's proposals demonstrate value for money for customers — that is, what outcomes will be delivered to customers in return for the prices they pay, and how this reflects what customers value most.

The information requirements specified in this chapter reflect the information we need to undertake the 2023 price review consistent with the WIRO. Much of the information requested would already exist within normal business practice — for internal planning and corporate reporting, for example. Also, much of the detail can be provided by completing the financial model template (issued by us) that forms part of a water business's price submission (see Section 3.23.3).

To support clear and succinct price submissions, a business need not include all the supporting information for the claims made in its submission. However, it must be able to provide any supporting information requested by us. For example, a business may reference a consultant's report in its submission without providing the full report as an attachment. We may request copies of material supporting a price submission, including (where need be) through the issue of compulsory information notices under the ESC Act.

We expect businesses' price submissions will focus on those matters having a material impact on the prices customers pay or the services customers receive.

Under our PREMO framework, a price submission must address all of the requirements set out in this guidance to achieve a 'Standard' rating or higher.

### 3.1. Managing risk

The WIRO requires us to place particular emphasis on matters relating to various efficiencies in undertaking our regulatory functions in Victoria's water sector.<sup>29</sup>

Efficiency is promoted when risk is adequately identified, quantified, and allocated. Prices should reflect the costs incurred in delivering services, incorporating reasonable assumptions about risk.

A water business's price submission must be informed by a robust risk identification process, taking into account a long term planning horizon. We anticipate such analysis is undertaken by businesses as part of their normal business planning. Significant risks must be identified in price submissions. Price submissions must also demonstrate that risk has been allocated appropriately, and where a business has decided it is best placed to do so, identify the approaches it proposes to manage the risk.

Appendix D summarises some of the major risks facing a water business, and potential approaches that a water business may propose to deal with risk. Some of these relate to climate change, including operational risks related to asset security, and we anticipate water businesses will propose initiatives aimed at addressing climate change in response to their own planning and government policy.

The coronavirus pandemic has also added to uncertainty, including in relation to demand forecasting risk. There are mechanisms in the framework that enable businesses to deal with uncertainty in relation to demand forecasts (see Appendix D). There are also provisions in determinations (which we propose to continue) to enable reconsideration of pricing within a regulatory period due to uncertain or unforeseen events, including where revenues or costs vary significantly from forecasts.

In past reviews, we observed many water businesses adopting overly risk-averse assumptions in price submissions, which implies that customers are expected to bear more than an efficient allocation of risk (one result of this is that proposed prices are higher than they need to be).

For example, in past price submissions some water businesses have:

- proposed to include the costs for highly uncertain projects and large contingencies in capital expenditure forecasts (and therefore, prices)
- sought to justify price increases on the basis of financial viability concerns, without providing evidence they have fully explored other avenues to manage financial performance.

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<sup>29</sup> WIRO, section 8(b).

Rather than including upfront allowances for uncertain projects and contingencies, a water business should seek alternative ways to mitigate construction and capital forecasting risk, such as through better project or contract management.

Alternatively, businesses could exclude planned but not fully scoped projects from upfront cost recovery, noting that actual prudent and efficient capital expenditure will be rolled into its asset base at the end of the regulatory period.

The water sector already adopts techniques such as real options analysis to inform decision making as circumstances unfold, including in relation to infrastructure works. We note evidence of use of options analysis (or similar methods), along with a business's approach to dealing with uncertainty and allocating risk in relation to demand, can be used to support a water business's PREMO price submission rating.

Businesses concerned about financial viability should demonstrate their financial risks through credit rating assessments undertaken by an independent credit rating agency. Water businesses should also demonstrate that they have sought to manage their financial risks before transferring them to customers.

In later sections of Chapter 3, we have specified where we require information on a water business's consideration of risk to support the business's proposals in specific areas including length of the regulatory period, expenditure, demand, form of price control, and tariffs. Given the pandemic, we are particularly interested in evidence businesses have considered a range of possible demand outcomes. Expenditure proposals related to climate change adaptation and mitigation need to consider our expenditure guidance in Chapter 3.

We are also seeking evidence that water businesses have given strategic consideration to risk and identified those that may have a material impact on the prices customers pay, or the services they receive. This is the focus of the information requirements in Section 3.1.1.

### **3.1.1. Supporting information**

In its price submission a water business must:

- identify any significant risks that may impact on customer prices or services, and if requested, make available to us scenario analysis for each risk including an assessment of the nature and scale of the risk and its probability of occurring
- identify how it has addressed significant risks through its proposals, explain how the business considered the allocation of risk, and demonstrate how its proposals support efficiency
- provide evidence that the business has given strategic consideration to the allocation and management of risk in developing its price submission — this may involve providing references and making available to us material on the business's risk identification and management framework or processes, rather than including detail in its price submission.

Upon request, a water business must also make available to us the following information about significant risks the water business proposes to manage that require cost allowances:

- the categorisation of the risk (as operational or financial risk, for example)
- measurement of the risk including:
  - the nature and scale of the risk
  - the probability of the risk event occurring
  - factors influencing the probability of the risk event occurring
  - the financial or service impact of the risk if it occurs
- options considered for allocating the risk
- rationale for the allocation of the risk, given alternative options
- an explanation of why the regulatory risk mitigation tools listed in Appendix D do not adequately mitigate the risk
- the role customers will be expected to play in dealing with these risks and how customers will be engaged in this process.

## **3.2. Regulatory period**

### **3.2.1. Criteria**

We are required to set the term of the regulatory period over which a water business's price determination will apply.<sup>30</sup> We propose to set a five-year regulatory period starting 1 July 2023, but remain open to alternatives proposed in a price submission.

A default five-year regulatory period provides the following benefits:

- a relatively long period of certainty for a water business's customers about the outcomes to be delivered and prices to be charged
- sufficient time for a water business to focus on service delivery and achieving the customer outcomes it has set for the period.

A risk associated with a regulatory period longer than we have proposed is that revenue or expenditure outcomes could diverge significantly from the benchmarks used to establish prices, possibly resulting in customers paying prices which are significantly above, or below, those required to recover efficient costs. Accordingly, a business that proposes a regulatory period longer than five years is required to demonstrate that the benefits of a longer period outweigh the potential risks. The level of justification required to support a proposed regulatory period will be

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<sup>30</sup> WIRO, clause 9.

greater for a price submission proposing a period longer than five years. The submission should propose checks and balances that will apply during the longer period to ensure customers are receiving value for money.

Relatively short regulatory periods can increase costs of reviews for stakeholders and weaken the autonomy businesses have to focus on service delivery for their customers.

A water business considering a regulatory period other than five years should engage with us as soon as possible.

### **3.2.2. Supporting information**

If a water business proposes a five-year regulatory period, it needs only to state this in its price submission. If a business proposes a different term, then the submission must:

- provide reasons for the proposed regulatory period length, having regard to the benefits and risks identified in Section 3.2.1, including demonstrating that the benefits of a longer or shorter period outweigh the risks and costs from a customer's perspective
- outline the results of customer engagement on the length of regulatory period, and how feedback has been taken into account.

In addition, for proposed regulatory periods longer than five years, a price submission must:

- Demonstrate that the expenditure forecasts and asset management plans underpinning the price submission are sufficiently robust, particularly having regard to the capacity of the assets and demand forecasts towards the end of the proposed regulatory period.
- Include details of mechanisms that will provide both us and customers with confidence that prices reflect value for money and efficient service delivery after year five of the proposed regulatory period.
- Describe how the business will keep customers engaged throughout the longer regulatory period, including how it will update customers on performance.
- Describe how the business will adapt to changing customer needs during the regulatory period, within the constraints of the determination. For example, the approach to re-aligning capital programs in response to customer preferences.
- Outline the business's approach to dealing with uncertainty and risk during the regulatory period, particularly financial viability risk, having regard to the mechanisms for mitigating risk outlined in Appendix D.

### 3.3. Customer engagement

The WIRO requires us to set out our expectations regarding customer consultation by a water business in developing its price submission.<sup>31</sup> A water business must engage with its customers to inform its price submission.<sup>32</sup> The purpose of this engagement is for the water business to understand the priorities of its customers, including the nature of products and services expected. This is to enable the water business to deliver outcomes that matter most to its customers.

Water businesses are best placed to design and undertake engagement to suit their circumstances and those of their customers. Accordingly, we have not prescribed how a water business should engage.

Generally, we have retained the same principles and assessment criteria that we specified at the 2018 price review. We have however, included an additional focus on engagement by businesses with First Nations people and people experiencing vulnerability.<sup>33</sup> This recognises the importance of inclusive engagement approaches – which we know businesses have already prioritised.

The following key principles should guide the engagement undertaken by water businesses:

- The form of engagement undertaken by a water business should be tailored to suit the content on which it is seeking to engage, and to the circumstances facing the water business and its customers and community, including First Nations people and people experiencing vulnerability.
- A water business must provide participants in its engagement process with appropriate information, given the purpose, form and the content of the engagement, and a reasonable and fair opportunity to participate as part of the process.
- A water business's engagement process should give priority to matters that have a significant influence on the services provided and prices charged by the business.
- A water business should start engagement early in its planning. The engagement should be ongoing, to keep testing proposals with customers.

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<sup>31</sup> WIRO, clause 13(a)(iv).

<sup>32</sup> We recognise water businesses deliver services that impact the community or parts of the community, and encourage them to engage with these groups in the development of their submissions.

<sup>33</sup> This guidance progresses some actions of the commission's 'Getting to fair' strategy relating to the water industry. See Essential Services Commission 2021, Getting to fair: Breaking down barriers to essential services, August.

We note that insights from a water business's engagement may complement its justification for forecast operating or capital expenditure. However, customer support should not be used on its own to justify the prudence and efficiency of expenditure proposals. Refer to Sections 3.8 and 3.9 for our expenditure criteria.

### 3.3.1. Criteria

The assessment criteria set out below relate to the principles set out above.

Our assessment will consider:

- The business's justification for its decisions on how and when to engage, and the matters that it decided to engage on, including for First Nations people and people experiencing vulnerability. This includes how a business has justified its engagement was sensitive and appropriate for the people it was seeking to engage with, including First Nations people and people experiencing vulnerability.
- Whether customers, and others who are affected by the outcomes of the price submission were given a reasonable and fair opportunity to participate, particularly in relation to matters that have a significant influence on the services provided and prices charged by the business. This includes consideration of the time available, and information provided to support input by participants.
- How feedback received through engagement was taken into account by the business in reaching its proposals (and what feedback was provided to customers).
- The business's justification for how it will address customer and community expectations that will not or cannot be met.

### 3.3.2. Supporting information

A price submission must:

- Describe and justify how and when the business engaged with its customers and community. It must explain how the business ensured engagement was universal and inclusive of customers and community affected by the outcomes proposed in the price submission, including First Nations people and people experiencing vulnerability. The submission must also explain how engagement was sensitive and appropriate for the people it was seeking to engage with.
- Describe and justify the matters covered by its engagement processes.
- Explain what the business learned from customer engagement, and how it satisfied itself that customers were given a reasonable and fair opportunity to participate, and that any views expressed were sufficiently representative of its customers.
- Explain how feedback was taken into account by the business in reaching its proposals.
- Explain how the business will address expectations that will not or cannot be met.

Required contents of a price submission

A business must make available, or provide on request, resources and materials provided to customers during its engagement, and any customer feedback about the engagement program.

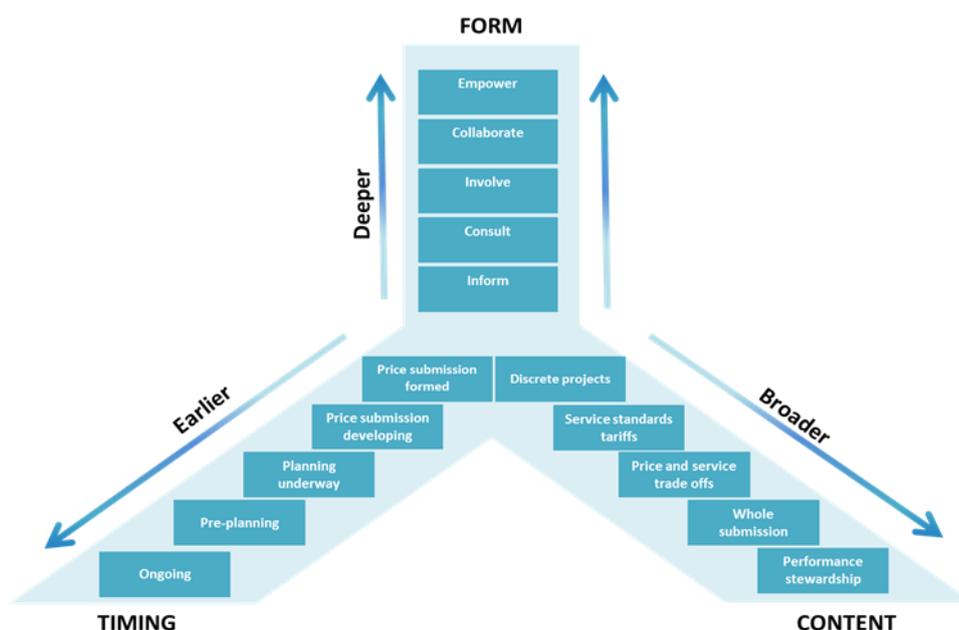
### 3.3.3. Customer engagement and PREMO

As noted above, we have not prescribed how a water business engages with its customers and community. While not ‘second guessing’ the method of engagement decided on by the business, we note that adopting forms of engagement that provide for deeper participation and influence for customers will support a business achieving a higher PREMO Engagement rating.

A water business may use the customer engagement diagram (Figure 3.1) as a descriptive tool of its overall program, or of individual activities. For example, it can show how engagement has evolved since the 2018 price review, to support PREMO price submission ratings.

More detail on our PREMO assessment for Engagement can be found in the assessment tool in Appendix E.

**Figure 3.1 Customer engagement diagram**



## 3.4. Outcomes

A water business must propose a set of outcomes that represent the value its customers will receive during the next regulatory period. A business must define output measures, with associated annual targets, that will be monitored during the next regulatory period to demonstrate the achievement of each outcome.

This set of outcomes and performance targets is essentially a water business’s commitment to its customers for the regulatory period. Actual performance against these output measures and

targets will allow a water business to clearly demonstrate whether its customers received the value they paid for. It will also inform the rating for the Performance element of PREMO at the next price review.

A water business must report at least annually to its customers on its performance against the specified output measures for each outcome. We expect water businesses will already have established self-reporting practices in place, for reporting directly to customers as soon as practical after the completion of each reporting year. We will also report water businesses' annual performance against their outcome commitments through our annual Outcomes Report published on our website.

### **Outcomes in subsequent PREMO reviews**

Water businesses will already have in place a set of outcomes, output measures and targets that were established in the 2018 price review. For the regulatory period beginning in 2023, we don't expect businesses will need to start over to establish a new set of outcomes from scratch. Rather, this is an opportunity for businesses to re-test customer expectations, with a mind to refresh, update and evolve their outcome commitments in line with their customer's evolving preferences.

Accordingly, this price submission should account for the business's actual performance against its outcome commitments for the current period (which informs the business's Performance PREMO rating), and explore the changes in outcome commitments from the current regulatory period to the next.

#### **3.4.1. Criteria**

Proposed outcomes must demonstrate linkages to customer preferences, as revealed through the business's customer engagement program.

Proposed output measures for each outcome must:

- be relevant to, or be a reasonable proxy for, the delivery of the outcome they represent
- be measurable
- be clearly defined and unambiguous
- be easy for customers to understand
- have performance targets listed for each year of the regulatory period.

The water business must outline how it will address shortfalls in meeting an outcome. The business must also commit to reporting at least annually to its customers on its performance against its proposed output measures for each outcome.

An example of how an outcome links to outputs and deliverables, programs and activities, and inputs is provided in Table 3.1.

**Table 3.1 Example – Outcomes measurement and delivery**

Safe clean drinking water for all customers

Outcome	Safe clean drinking water for all customers
<b>Outputs and deliverables</b> <ul style="list-style-type: none"> <li>Measures and targets</li> <li>Key projects</li> </ul>	<ul style="list-style-type: none"> <li>Compliance with E. coli and turbidity standards</li> <li>No boil water notices required</li> <li>Water quality complaints per 100 customers</li> <li>Percentage of customers that trust the safety of water supply</li> <li>Completion of specific water quality related capital projects</li> <li>Publish annual water quality report</li> </ul>
<b>Activities and processes</b> <ul style="list-style-type: none"> <li>Business programs</li> <li>Specific actions to be developed/implemented</li> </ul>	<ul style="list-style-type: none"> <li>Catchment to tap water quality management</li> <li>Upgrade treatment plant to implement dual barrier protection in accordance with Safe Drinking Water Act 2003</li> <li>Water mains cleaning program</li> <li>Protections to avoid down time at water treatment plants</li> <li>Hazard Analysis and Critical Control Points (HACCP) certification</li> <li>Pass water quality regulator’s audit (Department of Health)</li> <li>Undertake water quality testing in accordance with regulations</li> <li>Investigate water quality complaints</li> </ul>
<b>Inputs</b> <ul style="list-style-type: none"> <li>Costs and/or cost movements</li> <li>Resources required</li> </ul>	<ul style="list-style-type: none"> <li>\$ - opex and capex costs, or cost changes, to deliver or improve the specific programs</li> <li>Price impact</li> <li>Resources</li> <li>Business unit responsibility</li> </ul>

Source: ESC 2016, *Water Pricing Framework and Approach*, October, p. 20.

### 3.4.2. Supporting information

A price submission must:

- present a set of customer outcomes, linked to customer preferences, each with clear and unambiguous output measures and associated targets
- for each output measure state the performance target for each year of the regulatory period and provide past performance (for at least the last two years before the regulatory period)
- explain how the outcomes, output measures and targets were informed by the business’s customer engagement program

Required contents of a price submission

- specify the key actions, activities and programs that the business will undertake to meet its targets (and consequently outcomes)
- demonstrate the connection between the output measures, key actions, activities and programs proposed and achievement of a specified outcome
- present and explain any cost increases or savings for operating or capital expenditure that correspond to each outcome (Sections 3.8 and 3.9)
- explain how the cost increases or cost savings are reflected in prices charged to customers
- explain how the business will respond to underperformance in delivery of its outcomes
- outline a process by which it will report at least annually to its customers on its performance against the specific output measures for each outcome.

A business may also choose to describe in its price submission how the business might adapt its outcomes, output measures and targets to respond to changing customer preferences, including an ongoing customer engagement program to inform business priorities throughout the next regulatory period.

### **3.5. Service standards relating to reliability and faults**

We require each water business to provide a list of service standards relating to reliability and attending faults that align with provisions in our urban water customer service code.<sup>34</sup>

A business must also explain how any proposed changes in service levels or targets relative to equivalent service levels or targets in the current regulatory period were informed by customer preferences, and the resulting impacts on expenditure forecasts and customer value.

### **3.6. Guaranteed service levels**

Our review requires each urban water business to propose guaranteed service levels (GSLs) for the regulatory period from 1 July 2023 (a GSL scheme). GSLs define a business's commitment to deliver a specified service level to individual customers. For each GSL, a business commits to a payment or a rebate on bills to those who have received a level of service below the guaranteed level.<sup>35</sup>

A price review provides the business with an opportunity to review the nature of its GSLs, and the payment or rebate amount that will apply in the event of a breach of a GSL. The rebate amounts should be reviewed in consultation with customers.

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<sup>34</sup> Essential Services Commission 2020, Customer service code: Urban water businesses, August, clause 9.2.

<sup>35</sup> Essential Services Commission 2016, Water pricing framework and approach: Implementing PREMO from 2018, October, p. 21.

A water business may use its proposed GSL scheme to support its rating for the 'Risk' element of PREMO. The customer payment or rebate amounts established under the GSL scheme can indicate the extent to which a business is taking on revenue risk to provide incentives for it to deliver efficient levels of service to customers.

### 3.6.1. Criteria

A GSL scheme will:

- reflect the main service priorities and concerns of customers, informed by a water business's customer engagement
- provide incentives for the business to provide efficient service levels to all customers.
- Each GSL must be objectively defined, easily understandable, and able to be reported.

The GSL scheme must include the payment difficulty information disclosure GSL that has been in place since 2010.<sup>36</sup> That is, a payment or rebate will be made available to customers if a business breached its service level obligation by:

Restricting the water supply of, or taking legal action against, a residential customer prior to taking reasonable endeavours to contact the customer and provide information about help that is available if the customer is experiencing difficulties paying.

### 3.6.2. Supporting information

A price submission must specify each GSL and the corresponding payment or rebate amount that will apply where a customer has received a level of service below the guaranteed level. A price submission must identify and justify any changes to the GSL scheme compared with those approved for the current regulatory period.

For any new or amended GSL, a price submission must:

- explain the basis for the GSL, including how it has been informed by customer engagement
- specify whether benefits to customers will take the form of payments or rebates
- explain the reasons for the proposed size of the customer payment or rebate that applies to each GSL.

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<sup>36</sup> Previously known as the hardship related GSL, refer to: Essential Services Commission 2012, Hardship related Guaranteed Service Level review: Final decision, May. The latest (3 February 2015) check-list for minimum 'reasonable endeavours' at the time of this paper can be found at <https://www.esc.vic.gov.au/water/codes-and-guidelines/hardship-related-guaranteed-service-level-measures-review-2011>

A water business must also justify any proposal to remove a GSL that was in place during the current regulatory period, including how the proposal has been informed by customer engagement.

### 3.7. Revenue requirement

Our decision on a water business's revenue requirement for the next regulatory period must meet the WIRO objectives of promoting and providing incentives for efficiency in the regulated entities, as well as efficiency in, and the financial viability of, the regulated water industry.<sup>37</sup>

The revenue requirement proposed in a price submission must provide the water business with sufficient revenue to efficiently meet all of its legislative, regulatory and policy obligations. This includes, but is not limited to, the items listed in Box 3.1 below.

#### Box 3.1 Legislative, regulatory and policy obligations

- Legislation and matters administered by the Essential Services Commission
- Legislation and matters administered by the Environment Protection Authority Victoria
- Legislation and matters administered by the Department of Health
- Legislation and matters administered by the Department of Environment, Land, Water and Planning
- Health and safety legislation
- Gender Equality Act
- The Victorian Government Climate Change Strategy

#### 3.7.1. Criteria

The required revenue for a water business for the next regulatory period will be estimated by the building block approach, under which the building blocks are:

- prudent and efficient forecast operating expenditure — determined in accordance with Section 3.8
- prudent and efficient forecast capital expenditure — determined in accordance with Section 3.9
- return on the regulatory asset base (RAB) — determined in accordance with the sections below:
  - the 'roll forward' of the RAB — determined in accordance with Section 3.11
  - the cost of debt — determined in accordance with Section 3.13
  - return on equity — determined in accordance with Sections 3.14 and 3.15

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<sup>37</sup> WIRO, section 8(b).

- return of capital through a regulatory depreciation allowance — determined in accordance with Section 3.12
- a benchmark tax allowance — determined in accordance with Section 3.16.

The revenue requirement is net of any additional revenue earned from regulated assets, outside of scheduled tariffs — revenue from the sale of water entitlement allocations, for example. The revenue requirement is also net of any revenue earned from non-prescribed services (discussed at Section 3.23.9).

We note the coronavirus pandemic has contributed to increased customer aged debt. Water businesses may seek to justify increases in the allowance for bad debt in their submissions.<sup>38</sup> Any changes need to have regard to the trend in customer arrears, the impacts of business support measures for payment difficulty, and the economic outlook.

### **3.7.2. Supporting information**

The price submission must specify a water business’s forecast total revenue requirement for each year of the next regulatory period.

The price submission must also provide an estimate of the required revenue for each year after the next regulatory period to at least 2032-33. It must provide a brief explanation of the trend in the forecast over the ten-year period from 1 July 2023.

## **3.8. Forecast operating expenditure**

### **3.8.1. Criteria**

The forecast operating expenditure to be included for the purposes of calculating the revenue requirement is operating expenditure which would be incurred by a prudent service provider acting efficiently to achieve the lowest cost of delivering on service outcomes over the regulatory period, taking into account a long-term planning horizon (prudent and efficient forecast operating expenditure).

We consider that a prudent and efficient operating expenditure forecast has the following characteristics:

- baseline year expenditure is reflective of efficient operating costs and is used as a basis to forecast expenditure

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<sup>38</sup> The financial model template field for ‘revenue not collected’ allows businesses to input estimates of customer debts not recovered.

- forecast operating expenditure incorporates reasonable expectations for expenditure growth and cost efficiency improvement
- expenditure requirements above the baseline year (adjusted for growth and efficiency improvements) are fully explained and justified.

### **Operating expenditure with uncertain outcomes**

If a business seeks additional operating expenditure for investments where the outcomes are uncertain (pilot or demonstration projects, for example) we expect it to consider how risk is being shared if customers are being asked to cover all additional expenditure. Businesses should also clarify how they will demonstrate the value of these investments to customers.

At the next price review, the business would need to demonstrate the prudence and efficiency of this expenditure if seeking to have it included in the baseline, or to support new or ongoing expenditure in its price submission.

### **3.8.2. Supporting information**

A price submission must include a forecast of total prudent and efficient operating expenditure for each year of the next regulatory period. Forecast operating expenditure is to be presented separately for each major service category.<sup>39</sup>

For total and annual forecast operating expenditure and for each major service category, forecast operating expenditure for each year of the next regulatory period, and beyond to 2032-33, must be further broken down where relevant, in the financial model template for:

- operations and maintenance
- bulk charges (further broken down into bulk charges by type and system, for example, transfer charges, Greater Yarra System – Thompson River fixed charges, Victorian Desalination Plant – Water Order variable charges)
- treatment
- customer service and billing
- GSL payments
- licence fees (Essential Services Commission, Department of Health, and EPA Victoria)
- corporate costs
- other operating expenditure.

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<sup>39</sup> Depending on the business, the major service categories may include water, sewerage, recycled water, bulk water, rural water, irrigation, drainage, domestic and stock, and diversions.

Forecasts for the environmental contribution must also be provided in the financial model template. Where future amounts are not yet available, businesses must use the last known annual amount as their annual forecast in subsequent years.

A water business must also provide actual operating expenditure for the current regulatory period (using latest forecasts for 2022-23), categorised in the same way as above, in the financial model template.

Forecast operating expenditure must be presented relative to a reference or baseline operating year (Box 3.2), with allowance for expenditure growth (e.g. based on customers or demand growth) and cost efficiency improvements over the next regulatory period. Any significant changes in the forecast years' costs relative to this baseline year must be clearly presented and explained, including how they are reflected in the proposed customer outcomes and how they represent improved customer value (Section 3.4).

Our financial model template sets out the forecast operating costs consistent with this approach.

### **Box 3.2 Baseline controllable operating expenditure**

In preparing forecast operating expenditure, a price submission must establish a baseline controllable operating expenditure which comprises efficient recurring controllable costs from the last full year of actual data (2021-22) for those activities and services that are expected to be incurred throughout the next regulatory period.

The baseline is established from the actual prescribed operating expenditure for 2021-22, adjusted as follows:

- remove any non-controllable expenditure<sup>40</sup>
- remove any one-off or non-recurring expenditure items incurred in that year, or add any normally occurring items that did not occur in that year
- remove any further ongoing cost savings or efficiency commitments that will be realised in the final year of the current regulatory period (2022-23).

A price submission must justify the adjustments proposed to the baseline year in order to establish the baseline controllable operating expenditure, and demonstrate that this represents efficient ongoing operating costs (consistent with any efficiency targets for the current regulatory period). Where actual prescribed operating expenditure for 2021-22 is above the benchmark allowance from the 2018 price review, the price submission must explain whether

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<sup>40</sup> Controllable costs are those that can be directly or indirectly influenced by a water business's operational decisions. Examples of non-controllable costs include: bulk water costs (where prices are set by the commission), regulatory licence fees, and the environmental contribution.

this has resulted from expenditure growth above forecast, unmet efficiency targets, or a combination of these. The price submission should also highlight how this has impacted customers.

A water business's baseline year actual expenditure must reconcile with the business's audited regulatory account data.

Using the 2021-22 baseline controllable operating expenditure, a water business must propose and justify:

- its forecast expenditure growth rate assumptions (for each year)<sup>41</sup>
- its annual cost efficiency improvement rate (for each year)
- how proposed cost changes deliver improved customer value.

### **Relationship between growth allowance and efficiency improvement rate**

In previous price reviews, water businesses have mostly based their operating expenditure growth rate on forecast customer growth over the relevant regulatory period. The coronavirus pandemic has significantly impacted customer growth rates over the past two years, with some businesses experiencing customer growth above forecast and others below. Based on the information currently available to us, it is unclear whether the direct relationship between customer growth and operating expenditure growth has continued or could reasonably be expected in the next regulatory period.

As such, we expect that businesses will use their price submissions to clearly justify why the proposed operating expenditure growth rate chosen is most appropriate, particularly whether a growth factor other than customer growth is more accurate. This should be supported by recent evidence (e.g. based on the latest expenditure, customer number and usage data).

By taking a more targeted approach to forecasting operating expenditure we believe there will be a flow on benefit of producing efficiency improvement rates that will better reflect the value that customers will ultimately receive. Where operating expenditure forecasts have been higher or lower than actual expenditure, businesses should consider confirming the actual efficiency gains achieved with their customers.

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<sup>41</sup> Businesses should draw on Victoria in Future forecasts, Australian Bureau of Statistics data, and other information as required.

A price submission must also:

- demonstrate why any proposed cost increases are not covered within the growth allowance, or by inflation, or absorbed within the stated net efficiency improvement rate
- demonstrate how proposed cost changes relate to the proposed customer outcomes and the associated outputs and deliverables (Section 3.4), and in particular:
  - identify and explain operating expenditure savings or new operating expenditure arising from capital expenditure and projects, and how they relate to the forecast cost efficiency improvement rate
  - explain any trend or major annual variations in forecast operating expenditure (including identifying cost items that are having an upward or downward influence on operating expenditure) compared with historic operating expenditure<sup>42</sup>
- demonstrate that proposed costs associated with new or revised regulatory obligations and policy requirements are prudent and efficient
- set out and where relevant justify the non-controllable cost forecasts including:
  - bulk water purchases from other water businesses
  - regulatory licence fees
  - environmental contribution
  - any other proposed non-controllable costs.

The price submission should explain the business's approach to allocating shared costs, or reference documentation that may be requested by the commission to verify the business's approach.

### **3.9. Forecast capital expenditure**

Capital expenditure forecasting essentially involves anticipating the scope, timing and costs for a large number of various sized projects, ranging from the replacement of existing assets at the end of their lives to the construction of major new assets and facilities.

In preparing capital forecasts, water businesses should avoid including speculative capital expenditure in its price submission forecasts. Where capital projects are not fully scoped, costed or internally approved (via an approved business case, for example) at the time of preparing the price

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<sup>42</sup> Including, but not limited to, assumptions and trends relating to:

- wage and salary escalations, total labour costs and employee number assumptions
- electricity and energy costs, and underlying volume and load assumptions
- information technology costs
- other risks that have been identified.

submission, a business should consider the following options so that customers are not asked to bear the full cost should the project scope or timing change:

1. Include sufficient expenditure to cover only the development costs of the project, with efficient actual construction costs incurred during the period to be rolled into the RAB at the end of the period, along with any accumulated interest. This provides sufficient revenue allowance for the project to proceed during the next regulatory period, with cost recovery to commence in the following regulatory period at no net loss to the business.
2. Include development costs and a notional allowance for construction, with the balance of efficient construction costs (plus associated interest if required) to be rolled into the RAB at the end of the period. This allows a reasonable portion of the project, based on the various options and cost estimates at the time of preparing the price submission, to be included in prices.
3. Identify the project as a possible 'uncertain or unforeseen event' to be addressed via the mechanisms outlined in Section 3.20 during the regulatory period.

Businesses should also consider the above options for projects where the benefits are unclear or have not been fully defined, or where the linkages to customer value have not been established.

### 3.9.1. Criteria

The forecast capital expenditure to be included for the purposes of determining the required revenue is capital expenditure that would be incurred by a prudent service provider acting efficiently to achieve the lowest cost of delivering service outcomes, taking into account a long-term planning horizon (prudent and efficient forecast capital expenditure).

We consider that prudent and efficient capital expenditure has the following characteristics which reduce the risk borne by customers:

- required expenditure is based on a P50 estimate, in which there is an equal likelihood of project costs being higher or lower than forecast (noting a P50 estimate may not be appropriate where a business's proposed capital program is dominated by one or two major projects)
- contingency allowances are optimised
- forecast capital expenditure for renewals incorporates expectations for a reasonable rate of improvement in cost efficiency
- risks of project delays and cost overruns are managed through contractual agreements with service providers.

Where actual construction costs are found to exceed their efficient level, we will not roll these inefficient expenditures into the regulatory asset base. Inefficient costs will be borne by the water business and will not be recovered from customers.

### 3.9.2. Supporting information

A price submission must include a forecast of total prudent and efficient capital expenditure for the next regulatory period, including forecast capital expenditure for each year of the next regulatory period, and beyond to 2032-33.

Forecast capital expenditure is to be presented by major service category and by the following cost drivers:<sup>43</sup>

- forecast capital expenditure to maintain service standards — that is, renewals
- forecast capital expenditure to expand services — that is, growth
- forecast capital expenditure to make improvements or upgrades to existing services or to comply with existing or changed government or regulator obligations — that is, improvements/compliance.

The business's financial model template must also specify actual capital expenditure for the current regulatory period (including a forecast for 2022-23), categorised in the same way as above. The business's price submission must identify and explain any material cost or timing discrepancies between actual capital expenditure in the current regulatory period and the level of capital expenditure approved in its current price determination. This must include a reconciliation showing how the business has met its commitments to delivering its major capital projects in the current regulatory period, consistent with the annual major project reporting that has occurred over the period. Impacts on customer service levels and value due to non-delivery must also be identified. This information will form part of our assessment of a water business's Performance element under the PREMO framework.

We also expect that businesses will report to both customers and the commission on the outcomes that have been achieved from capital expenditure in trials or pilots in the current regulatory period, and in particular, an assessment of customer value for money. As well as providing an assessment of customer value for money arising from trials or pilots, where relevant, price submissions must identify how the outcomes of these trials or pilots have informed proposed future projects and expenditure. This is necessary to inform whether it is efficient to support any expansion of pilot programs into future capital expenditure.

Capital expenditure will fall into one of three key types:

- Major capital projects — large, discrete capital investment projects (may be completed within a regulatory period, or may span more than one period).

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<sup>43</sup> Depending on the business, the major service categories may include water, sewerage, recycled water, bulk water, rural water, irrigation, drainage, domestic and stock, and diversions.

- Capital programs — ongoing programs of capital expenditure allocation, containing multiple works or projects (for example; water main renewals, sewer odour management, ICT equipment upgrades, etc.).
- Other capital expenditure — typically smaller discrete projects and programs.

A price submission must present the capital expenditure forecasts set out according to these three key types, as follows:

**Major capital projects** — comprising the ‘top 10’ discrete capital projects, by total capital cost, to be started or completed during the next regulatory period. A business may also include significant discrete projects that fall outside the top 10 by cost but are scheduled for the next regulatory period. For each of these major projects, provide:

- the project name and scope, and relevant major service and asset category
- justification for the project, including the cost driver
- start and completion dates
- total capital cost (itemising any government or customer contributions), and expenditure by year
- objectives of the project, including how the project aligns with the various customer outcomes proposed (Section 3.4) or addresses any major risks (Section 3.1)
- and have available:
  - a business case outlining the options considered for achieving the identified objectives and the approach to identifying the optimal solution<sup>44</sup>
  - risk analysis of the selected option and plans to mitigate the identified risks to ensure the project can be delivered on budget and on time
  - the incentive and penalty payment arrangements with contractors<sup>45</sup>
  - information to identify whether the project has (or will be) the subject of competitive tendering.

**Capital programs** — all key capital expenditure programs or allocations that will be ongoing throughout the regulatory period (excluding any discrete projects separately specified in the ‘top 10’ above). For each program, provide:

- the program (or cost allocation) name, and relevant major service category
- the cost driver
- total capital cost (itemising any contributions), and expenditure by year

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<sup>44</sup> This should also include an assessment of a ‘do nothing’ option. Cost comparisons of various options should consider P5, P50 and P95 estimates. Forecasts for capital expenditure must be based on the P50 estimate.

<sup>45</sup> A business’s proposed prices must reflect incentive and penalty payment arrangements that are based on a symmetrical sharing of risk for delivery or non-delivery of projects.

- objectives of the program, including how the program aligns with the various customer outcomes proposed (Section 3.4) or addresses any major risks (Section 3.1)
- historical annual costs, and an explanation for significant increases or decreases in the forecast average annual expenditure
- and have available:
  - the list of projects included within the program or cost allocation for the next regulatory period, and business cases and options analyses
  - a description of the methodology for assessing risk and prioritising projects within the program
  - the cost estimation basis.

**Other capital expenditure** — all other capital expenditure not associated with a defined major project or major capital program should be grouped into one or more programs as appropriate, to be included under the capital programs list, as above.

Consistent with the above capital expenditure breakdowns (by type and major service category) in the price submission or financial model template where appropriate, a water business must also:

- for each year of the next regulatory period, and beyond to 2032-33, provide annual forecasts for capital expenditure separately identifying (where appropriate) and reconciling:
  - total capital expenditure
  - contributions (government and customer)
  - gifted assets
  - proceeds from asset sales
  - written down value of assets disposed
  - net capital expenditure.
- explain the methodology used to estimate forecast capital expenditure
- identify and explain the key assumptions which underpin the capital expenditure forecasts by each major service category, and how any risks or uncertainties have been addressed
- justify the timeframe for delivering the proposed new capital expenditure given the business's delivery of major projects in the past
- explain the reasons for the trend or any major annual variations in forecast capital expenditure (including identifying cost items that are having an upward or downward influence on capital expenditure), compared with historic capital expenditure
- justify the total forecast capital expenditure against the criteria in Section 3.9.1, taking into account:
  - forecast demand
  - any relevant industry or economy-wide benchmarks of expenditure

- the substitution possibilities between forecast operating expenditure and forecast capital expenditure.

Our financial model template sets out the forecast capital expenditure consistent with the breakdowns and methodology described above.

### **3.10. Return on regulatory asset base**

A regulatory rate of return is applied to the regulatory asset base (RAB) to calculate the annual return on the RAB to be included in the revenue requirement. The regulatory rate of return comprises two components: a return on equity and a cost of debt.

The benchmark cost of debt will be determined based on a trailing average approach. A benchmark gearing level of 60:40 debt to equity will apply.

The formula for the regulatory rate of return (post-tax, real) is therefore:

$$\text{Regulatory rate of return (RRR)} = \text{Re } 0.4 + \text{Rd } 0.6$$

Where: Re = PREMO rate of return on equity

Rd = benchmark 10 year trailing average rate for the cost of debt.

The benchmark regulatory rate of return must be calculated in nominal terms, and then converted to real terms.<sup>46</sup>

### **3.11. Forecast regulatory asset base**

#### **3.11.1. Criteria**

The regulatory asset base (RAB) calculated for the purposes of determining the revenue requirement must reflect capital expenditure (less regulatory depreciation, contributions and/or asset disposals) which would be incurred by a prudent service provider acting efficiently to achieve the lowest cost of delivering on service outcomes, taking into account a long-term planning horizon (prudency criteria).

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<sup>46</sup> The Fisher equation will be used to convert cost of debt from nominal to real estimates; that is:  $(1 + \text{nominal rate}) = (1 + \text{real rate}) * (1 + \text{inflation rate})$ . Refer to Section 3.13.1. for our approach to estimating the forecast inflation in the financial model template.

The opening RAB must be calculated as follows:

Opening RAB 1 July 2023 = RAB at 1 July 2018 (adjusted to reflect 2017-18 actual)

- + Actual capital expenditure (gross) 2018-19 to 2021-22
- + Forecast capital expenditure (gross) 2022-23\*
- Actual contributions 2018-19 to 2021-22
- Forecast contributions 2022-23\*\*
- Forecast regulatory depreciation 2018-19 to 2022-23\*
- Proceeds from disposal of assets 2018-19 to 2021-22
- Forecast proceeds from disposal of assets 2022-23\*\*

(\* denotes the forecast used in the 2018 price determination, and 2020 price determination for South Gippsland Water)

(\*\* denotes the latest available forecast for 2022-23)

Where the up-to-date 2022-23 gross capital expenditure forecast is lower than the forecast benchmark for that year in the 2018 price determination, then the business must use the lower amount.

The same approach must be used to determine the opening value on 1 July for each subsequent year in the next regulatory period, using the forecasts for capital expenditure, customer and government contributions, regulatory depreciation and asset disposals.

In addition, the opening RAB (at 1 July 2018) must be adjusted for inflation (based on the Consumer Price Index – all Groups, Australia) over the current regulatory period.

### **3.11.2. Supporting information**

A price submission must propose:

- the closing value for the RAB at 30 June 2022 (using actual data)
- the opening value of the RAB at 1 July 2023 (calculated according to the criteria above)
- the forecast value of the RAB for each year of the next regulatory period, in accordance with the prudence criteria set out above
- the forecast value of the RAB for each year after the next regulatory period until at least 2032-33.

A price submission must also:

- provide estimates for regulatory depreciation (Section 3.12)

Required contents of a price submission

- provide separate data and justify estimates for:
  - government contributions — federal, state and local government contributions towards the capital cost of a project
  - customer contributions — upfront cash payments made by new customers
  - the value of gifted assets — assets constructed and then handed over to the water business to operate and maintain
- include estimates of revenue expected from disposal of assets for each year from 1 July 2023, to be deducted from the roll forward of the RAB.

To assist with our review, we may seek further information on a water business’s justification for capital expenditure in 2017-18 and in the period from 2018-19 to 2021-22. We may also request a reconciliation of actual net capital expenditure against the benchmarks allowed in the water business’s 2018 and 2020 price determinations (Section 3.9.2), including for any expenditure related to trials or pilot programs.<sup>47</sup>

### **3.12. Regulatory depreciation**

We recognise a return of capital expenditure (regulatory depreciation) for an asset when the asset enters service. We prefer a straight-line depreciation profile.

The estimates and profiles for regulatory depreciation should reflect reasonable assumptions about asset life and utilisation.

Water businesses can propose an alternative approach to straight-line depreciation having regard to the following assessment principles:

- the depreciation rate should account for technological change, projected future demand and any other factors that may affect the value of the assets in the future
- the technical lives of assets
- impact on prices over the long-term.

### **3.13. Cost of Debt**

We will use a 10 year trailing average approach to estimate the benchmark cost of debt. The trailing average approach will determine the whole cost of debt (covering the risk free rate and debt

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<sup>47</sup> Our 2018 review required any expenditure above the allowances made for trials and pilots to be subject to prudence and efficiency assessment. For example, see Essential Services Commission 2018, Coliban Water draft decision: 2018 water price review, March, p. 21; Essential Services Commission 2017, South East Water draft decision: 2018 water price review, December, p. 17 and Essential Services Commission 2017, Yarra Valley Water draft decision: 2018 water price review, December, p. 16.

risk premium). We use a Reserve Bank of Australia (RBA) data set to estimate the cost of debt, and also add an amount to reflect debt raising costs. The averaging period will be the 10 years preceding the year in which the rate applies.

Each year, the 10 year trailing average cost of debt will be updated by rolling forward the data series by one year, such that:

- the cost of debt for the roll-forward (previous) year reflects the yields of the RBA 10 year BBB rated corporate bond – Reserve Bank of Australia Table F3 series FNFYBBB10M
- the annual update is a simple average of 12 months of the RBA 10 year BBB rated corporate bond over 1 April to 31 March and the assumption of 0.15 per cent per year for debt raising costs
- the trailing average is a simple average of 10 years of cost of debt
- the cost of debt is calculated in nominal terms.

The historical data series for the cost of debt calculated using the method described above is set out in Table 3.2.

**Table 3.2 Historical cost of debt (annual values for calculating trailing average)**  
Nominal values

	2013-14	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20	2020-21	2021-22	2022-23
Cost of debt	7.1%	5.4%	5.3%	4.9%	4.5%	4.6%	3.3%	3.0%	3.7%	3.7% <sup>a</sup>

<sup>a</sup> The cost of debt for 2022-23 will be updated to reflect annual averages based on actual data, prior to the final decision. Data source: Treasury Corporation Victoria and the Essential Services Commission.

**Note:** Table updated in August 2022. This corrected for errors in the table for the cost of debt values prior to 2016-17. We also updated for the most recent cost of debt outcome for 2021-22.

A business is not required to submit information on the cost of debt in its price submission, because the cost of debt will be determined on the basis of the data outlined above. However, the business must use the values above to estimate its revenue requirement and prices, subject to any updates before we make a price determination (the values in Table 3.2 will be reflected in the financial model template we provide businesses).

### 3.13.1. Forecast for expected inflation

The forecast for expected inflation is an input to calculating the trailing average cost of debt.<sup>48</sup> We need to convert the nominal cost of debt to real terms consistent with our real post-tax pricing model. Our approach to estimating expected inflation is:

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<sup>48</sup> The Fisher equation will be used to convert cost of debt from nominal to real estimates; that is:

- We estimate expected inflation based on the midpoint of 'RBA geometric' and 'bond breakeven' inflation rates.
- The 'RBA geometric' inflation rate is the RBA forecast consumer price index inflation rate for year one and two of the regulatory period, and the midpoint of the RBA target inflation band of two to three per cent from years three to ten.
- The 'bond breakeven' inflation rate is implied by the difference between the yields on 10-year nominal and indexed (inflation-linked) Commonwealth Government Securities.

We will estimate expected inflation using this methodology closer to the release of the financial model templates to the water businesses, and we intend to re-estimate the expected inflation at the draft decision and the final decision.

This approach is consistent with the approach we have adopted at recent price reviews.

### **3.13.2. Approach to forecasting the cost of debt for the revenue requirement**

To establish a revenue requirement, we need to adopt an assumption for the future nominal cost of debt, noting estimates are 'trued up' for actual outcomes annually during the regulatory period.

In past reviews, to calculate the revenue requirement at the time of our price determination we have used the 10 year trailing average figure used for the first year of the next regulatory period, for all years of the regulatory period.

To estimate the revenue requirement for the next regulatory period, we will adopt the most recent annual outcome for the cost of debt (at the time of our determination) as the new figure that is rolled in to the 10 year trailing average. This is in response to feedback from water businesses noting that adopting the most recent annual outcome will result in reduced variation from the revenue requirement (and prices) established during our price reviews, as actual figures replace the forecasts. It is also consistent with the principle that the current cost of debt is a better predictor of the future cost of debt than the average rate over the prior 10 year period.

For price submissions, we will provide the water businesses with the actual cost of debt for 2021-22 (and the March quarter 2022 consumer price index outcome) around mid-April 2022, and then we will update for the actual cost of debt for 2022-23 for our final decision.

In Section 3.20, the guidance notes that businesses must propose an annual adjustment mechanism to allow prices to adjust as actual cost of debt outcomes replace the forecasts.

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Real cost of debt =  $(1 + \text{nominal cost of debt}) / (1 + \text{forecast inflation rate}) - 1$

### **3.14. PREMO rating**

The return on equity to be reflected in prices will be established via the PREMO incentive mechanism, under which a water business's return on equity will be linked to the level of ambition expressed in its price submission.

Under PREMO, a water business must self-assess the level of ambition of its price submission as either 'Leading', 'Advanced', 'Standard' or 'Basic'. We will also independently assess the price submission and also rate it as 'Leading', 'Advanced', 'Standard' or 'Basic'. This two-stage PREMO assessment and rating process will determine the return on equity to be reflected in approved prices.

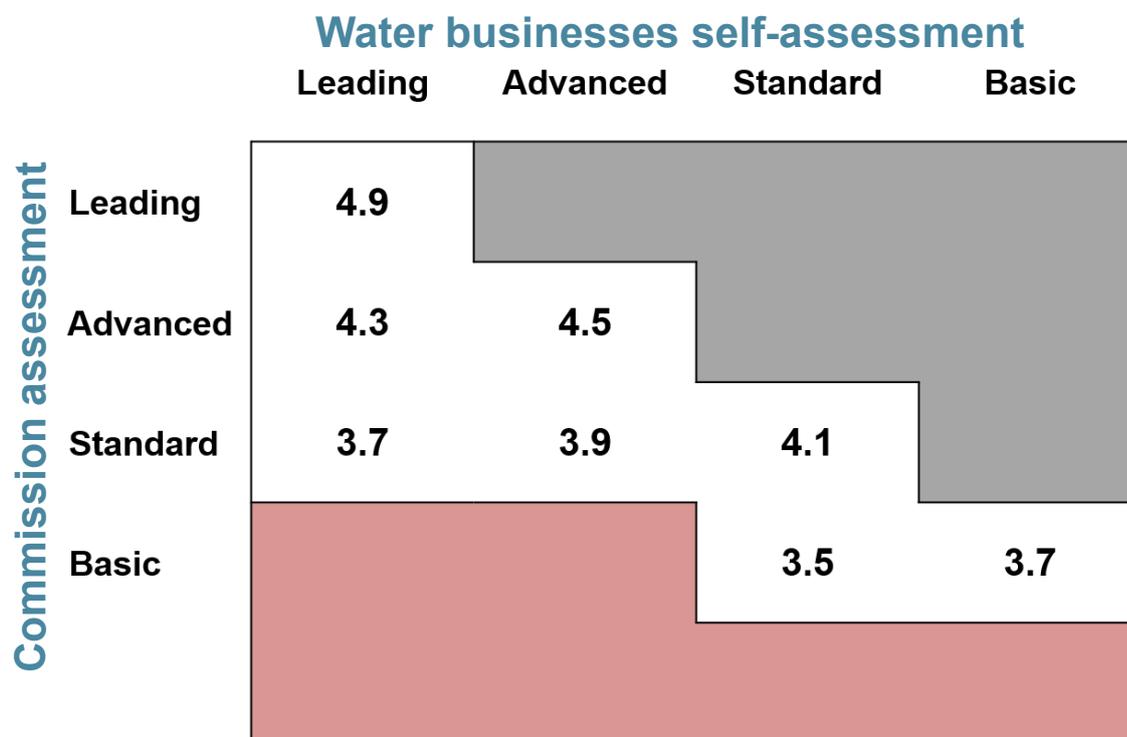
The range of possible outcomes (in real terms) for the return on equity resulting from the two-stage assessment and rating process is provided in Figure 3.2.

The values in the matrix are lower than those established for the 2018 review. Other economic regulators have recently set the return on equity benchmark below the 2018 rates we used. A key reason for the lower benchmarks is reductions in the real risk-free rate. Compared to the 2018 rates, we have lowered the return on equity benchmarks to reflect a lower real risk free rate. However, reflecting our long-term approach, we have not fully reflected these reductions in the return on equity benchmarks.

We note that the lowest value in the matrix is comfortably above the estimated cost of debt for water businesses, and therefore supports revenue sufficiency for the water businesses.

**Figure 3.2 Regulated return on equity**

Real per year rate (per cent)



Note: A water business must self-assess its price submission before lodging with us. We then complete our assessment of the price submission.

The best outcomes for a water business in terms of the return on equity will be achieved when the commission and the business align in their respective assessments. Situations of aligned assessments are represented by the upper diagonal of the matrix shown in Figure 3.2. The more ambitious the submission according to both the business and the commission, the greater will be the allowed return on equity.

The grey shaded area above this diagonal indicates where we will not assess a price submission more favourably than the water business’s self-assessment. This provides an incentive for the business to put forward its best offer, and to provide an honest assessment of the appropriate price submission rating.

If we find a water business has overstated its ambition, then the return on equity will be lower than had the water business accurately assessed itself. This can be seen in the diminishing values moving left along each row in Figure 3.2.

Consistent with the WIRO, we consider that the incentives embedded in the return on equity matrix at Figure 3.2 are in the best interests of Victorian water customers, as it reduces the likelihood of water businesses being allowed rates of return that are not commensurate with the outcomes it

proposes to achieve. It also supports an incentive-based framework that will deliver better consumer outcomes.

The (red) shaded zone at the bottom of the matrix represents an area within which we will reserve our discretion. For example, we may require the water business to resubmit its proposal, or approve a shortened regulatory period if we rate a business's submission to be in this part of the matrix.

Together, the design features of the matrix provide the businesses with a strong incentive to assess their price submissions accurately and honestly.

If during its price submission assessment the commission downgrades a business's PREMO rating, the commission (at its discretion) may elect to include specific conditions or performance criteria in the price determination that, if met, would allow the business to apply to have its original PREMO rating restored. This would likely involve the business demonstrating efficiency improvements or better service during the regulatory period, over a timeframe we specify. A successful application to the commission may result in an increase in revenue requirement corresponding to the higher equity return rate, which would in turn be reflected in prices.

For the 2023 price review, the ambition expressed in a price submission will be rated according to all five elements of PREMO — Performance, Risk, Engagement, Management and Outcomes.

A water business must self-rate its price submission for each of these five elements, and use these ratings to arrive at its overall PREMO rating and corresponding return on equity.

### **3.14.1. Criteria**

A price submission must identify the water business's self-rating of its submission as 'Leading', 'Advanced', 'Standard' or 'Basic'. A price submission must also identify the rating for the Performance, Risk, Engagement, Management and Outcomes elements of PREMO.

We will agree with a water business's self-ratings where the business provides transparent and credible evidence to justify the ratings. The guiding questions in Table 3.3 set out the matters we will consider in assessing a water business's proposed PREMO ratings.

Appendix E includes a PREMO assessment tool that water businesses must use to inform their PREMO ratings. The tool includes examples of what might constitute a 'Leading', 'Advanced', 'Standard' or 'Basic' rating for each element of PREMO. Informed by the assessment for each element of PREMO, a business must propose an overall PREMO rating for its price submission. Appendix E also includes a scoring methodology to assist businesses with this rating process, noting use of the scoring methodology is not mandatory.

A price submission must address all of the requirements set out in this guidance to achieve a 'Standard' rating or higher.

**Table 3.3 Guiding questions for PREMO assessment**

PREMO Element	Guiding questions
<b>Performance</b>	<ul style="list-style-type: none"> <li>• To what extent has the business demonstrated delivery of its customer outcomes commitment over the current regulatory period? Did its customers get what they paid for?</li> <li>• How does actual operating expenditure across the current period compare with the established benchmark allowance, and to what extent has the business rationalised any discrepancies?</li> <li>• How does actual capital expenditure across the current period compare with the established benchmark allowance, and to what extent has the business rationalised any discrepancies?</li> <li>• To what extent does customer sentiment demonstrate satisfaction in the business’s performance over the current regulatory period? Are customers happy with the value they receive from their water business?</li> </ul>
<b>Risk</b>	<ul style="list-style-type: none"> <li>• To what extent has the business demonstrated a robust process for identifying risk, and how it has decided who should bear these risks? i.e such that customers are not paying more than they need to.</li> <li>• To what extent does the proposed guaranteed service level (GSL) scheme provide incentives for the business to be accountable for the quality of services delivered, and provide incentives to deliver valued services efficiently?</li> </ul>
<b>Engagement</b>	<ul style="list-style-type: none"> <li>• To what extent has the business justified how the form of engagement suits the content of consultation, the circumstances facing the water business and its customers?</li> <li>• To what extent has the business demonstrated that it provided appropriate instruction and information to customers about the purpose, form and content of the customer engagement?</li> <li>• To what extent has the business demonstrated that the matters it has engaged on are those that have the most influence on the services provided to customers and prices charged?</li> <li>• To what extent has the business explained how it decided when to carry out its engagement?</li> <li>• To what extent has the business demonstrated how its engagement with customers has influenced its submission?</li> </ul>

- To what extent has the business demonstrated that its engagement was inclusive of consumers experiencing vulnerability?
- To what extent has the business demonstrated that its engagement was inclusive of First Nations people?

#### **Management**

- To what extent has the business demonstrated how its proposed prices reflect only prudent and efficient expenditure?
- To what extent has the business justified its commitment to cost efficiency or productivity improvements?
- To what extent has the business justified or provided assurance about the quality of the submission, including the quality of supporting information on forecast costs or projects?
- To what extent has the business provided evidence that there is senior level, including Board level, ownership and commitment to its submission and its outcomes?
- To what extent has the business demonstrated its price submission is an “open book”?

#### **Outcomes**

- Has the business provided evidence that the outcomes proposed have taken into account the views, concerns and priorities of customers?
- Has the business provided sufficient explanation of how the outcomes it has proposed align to the forecast expenditure requested?
- Has the business proposed outputs to support each of its outcomes, which are measurable, robust and deliverable?
- Has the business provided evidence that the outputs it has proposed are reasonable measures of performance against stated outcomes?
- Has the business demonstrated a process to measure performance against each outcome and to inform customers?

### **3.14.2. Supporting information**

A price submission must provide information that satisfies the procedural requirements set out in the criteria above. A price submission must also:

- identify the reasons for the self-ratings for the Performance, Risk, Engagement, Management and Outcomes elements of PREMO, with reference to the guiding questions above
- identify the reasons for the price submission’s overall PREMO rating.

### 3.15. Return on equity

The price submission PREMO rating proposed by a water business will correspond with a value for a return on equity to be reflected in its price submission (Table 3.4).

**Table 3.4** Maximum return on equity for each PREMO rating

Real per year rate (per cent)

	Leading	Advanced	Standard	Basic
Maximum return on equity to be reflected in business's proposed revenue requirement	4.9	4.5	4.1	3.7

#### 3.15.1. Criteria

A water business's proposed revenue requirement must incorporate a value for the return on equity that is no higher than the value specified in Table 3.4 for its proposed price submission rating. For example, an 'Advanced' rating will correspond with a maximum return on equity of 4.5 per cent. No further supporting information regarding the water business's return on equity is required.

### 3.16. Tax allowance

#### 3.16.1. Criteria

The tax allowance included for the purposes of determining the required revenue must reflect an estimate of the corporate income tax to be paid, less the imputation credits that would be received by a hypothetical private investor in the water business. In estimating the value of imputation credits the water business must multiply the annual estimated corporate income tax bill by an imputation factor.<sup>49</sup> This is consistent with the income tax calculation in the financial model template.

#### 3.16.2. Calculating the tax allowance

Once the financial model template is populated by the water business, it will estimate the business's future nominal tax allowance based on the following formula:

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<sup>49</sup> While franked dividends are not generally paid by government businesses, in order to maintain competitive neutrality, it is necessary to make an assumption of the value of imputation credits for a hypothetical private investor in the regulated entity. Therefore, it will be necessary to assume a value of imputation credits in the tax calculation.

$ETC_t = (ETI_t \times r_t) (1 - \gamma)$ , where:

- $ETC_t$  is an estimate of the future nominal tax allowance
- $ETI_t$  is an estimate of the taxable income for each regulatory year
- $r_t$  is the expected statutory income tax rate for each regulatory year
- $\gamma$  is the value of imputation credits (which will be at the rate of \$0.50 for every \$1 of company tax paid, as in past price reviews).

In relation to the estimate of  $ETI_t$  for each year of the next regulatory period:

- the revenue and expenditure estimates used in the calculation are the same revenue and expenditure estimates used to establish maximum prices (except that customer contributions and gifted assets are treated as revenue)
- the interest expenses (deductions) reflect the nominal cost of debt and the assumed stock of debt (that is, gearing multiplied by the regulatory asset base)<sup>50</sup>
- the calculation allows for an adjustment to reflect tax depreciation.

The financial model template adjusts the nominal tax allowance for inflation in order to derive the real tax allowance for each regulatory year. This estimate must be used by the water business as the basis for its tax allowance forecasts. The forecast tax allowance may also be informed by the business's latest estimate of tax to be paid over the next regulatory period.

The financial model template allows the tax rate to be entered for each year of the next regulatory period, to allow a business to reflect any expected changes in the applicable tax rate. Businesses must estimate the applicable tax rate and include it in the relevant input fields in the financial model template.

### **3.16.3. Supporting information**

The price submission must propose a total tax allowance for the next regulatory period. An estimate must also be provided for each year of the next regulatory period.

The price submission must also:

- state the basis on which the tax allowance for the next regulatory period has been calculated
- in the financial model template, provide an estimate of the income tax for each year after the next regulatory period up until at least 2032-33

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<sup>50</sup> The tax allowance benchmarks in the price determination will be kept constant for the regulatory period, and will not vary with the cost of debt.

- make available to us the business’s latest corporate forecasts for annual tax payments for the next regulatory period, and the basis for the forecasts.

### **3.17. Demand**

The coronavirus pandemic has increased the uncertainty in relation to demand forecasts. As well as considering the risk mitigation tools available in the regulatory framework (see Appendix D), as in past reviews, businesses need to make available to us evidence that a range of supply and demand scenarios have been modelled. How a business proposes to manage the uncertainty in its demand forecasting will be a key input into its PREMO Risk rating.

#### **3.17.1. Criteria**

Demand forecasts proposed by a water business must represent the best available estimates derived from an appropriate forecasting methodology. Assumptions on the key drivers of demand over the next regulatory period must be well explained and reasonable. These assumptions must be based on the latest data and evidence available.

#### **3.17.2. Supporting information**

A price submission must summarise its demand forecasts, including expected trends for the next regulatory period, as well as outline the key assumptions adopted to develop those forecasts. A business should use at least a ten year horizon for demand forecasting and scenario work, and reflect this in its price submission.

A price submission must also include:

- a description of the key demand forecasting issues that lists and justifies the most important assumptions adopted in generating the forecasts — demand forecasts should be based on the latest available Victoria In Future estimates provided by the Victorian Government, with variations and underlying assumptions clearly explained <sup>51</sup>
- a description of the forecasting methodology used, and the justification for using the methodology
- reference to any external reports or information relied upon
- a description of how forecasts have accounted for the impact of any proposed changes to tariff structures or form of price control expected in the next regulatory period

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<sup>51</sup> We expect water businesses will base their forecasts on the latest Victoria In Future (VIF) information, giving careful consideration to how it will apply to their particular situation to reflect the impacts of the coronavirus pandemic and the anticipated economic recovery paths.

- details on the levels of restrictions or nature of any permanent water conservation measures reflected in the forecast
- written information on where price elasticity was applied, the input assumptions used, and how the assumptions were translated into the business's demand forecasts
- an explanation of how demand forecasts are consistent with proposed expenditure (in terms of the level and nature of expenditure).

A water business must also make available evidence that a range of supply and demand scenarios were modelled. This should include low, normal and high water inflow scenarios, and consideration of a range of 'low' to 'high' population growth assumptions. Written justification must be provided for the selection of the forecasts proposed.

The financial model template will require a water business to provide detailed demand forecasts for every tariff and tariff category, by residential and non-residential customers. If detailed forecasts at this level are unavailable, a business must explain why and provide estimated demand for these services. The detail in the model does not need to be reproduced in the price submission.

### **3.18. Form of price control**

We recognise various options for water businesses to consider in terms of the form of price control. Most businesses currently use a price cap, revenue cap, or tariff (or price) basket form of price control. A different form of price control may be used for the different services delivered by a water business.

In considering whether to approve a proposed price control, we will have particular regard to whether the proposal involves a continuation of an existing form of control or the introduction of a new price control.

Where an existing price control structure is being continued, the justification requirements below may be satisfied more easily. Where a change is proposed, however, the water business will need to provide evidence to demonstrate that the new price control better satisfies the requirements in clause 11 of the WIRO than the existing structure.

#### **3.18.1. Criteria**

We will assess proposals against the following factors:

- the business's justification for the proposed form of control, including its consideration of efficiency and risk allocation and management
- the business's approach to consultation on the form of control and how the views of customers were taken into account

- where a change to the form of price control is proposed, whether the business has considered and demonstrated that appropriate transition strategies will be implemented for affected customers
- the administrative complexity of the proposed form of control
- the ability of customers to understand the resulting tariffs and tariff movements throughout the regulatory period.

In assessing a business's proposed form of price control, in particular where a change is proposed, we will place a strong weighting on the feedback a water business receives from customers.

### **3.18.2. Supporting information**

A price submission must:

- clearly state the proposed form of price control to apply to each service over the next regulatory period
- include the formula to give effect to the form of price control, including any proposed side constraints if the water business is proposing a revenue cap form of price control
- if applicable, specify and justify which tariffs are subject to the tariff basket form of control and how those tariffs are grouped (according to similar cost structures, customer class).

If changes to the form of price control are proposed, then a price submission must:

- explain how the proposed form of control would operate and services affected
- demonstrate the business has consulted with potentially affected customers, and explain how the feedback from customers informed its proposals, and how the change benefits customers
- provide data and supporting information that describes how the proposed form of price control is consistent with providing signals about the efficient cost of delivering services and how it is likely to impact on price stability
- explain how the business considered risk allocation and management (including demand and financial risk)
- explain how a transition to a new form of price control may impact customers and the water business's approach to minimising any adverse impacts.

## **3.19. Prices and tariff structures**

We typically provide businesses with a large degree of discretion to decide on tariff structures. This recognises that businesses are often best placed to consider the interests of their customers in designing tariffs and that existing tariff structures have been developed over time to deal with a variety of local circumstances. We intend to continue this approach. If a water business proposes tariff reforms, it should engage with its customers and take into consideration their views in its proposal.

Required contents of a price submission

A price submission must list each of its proposed tariffs to apply in the next regulatory period and include:

- each element of a multi-part tariff structure
- a price for each tariff
- where relevant, the pricing principles that it proposes to apply in setting prices.

We anticipate prices for recycled water and unique services such as trade waste and miscellaneous services will be set with reference to pricing principles. The pricing principles for miscellaneous services are outlined in Section 3.19.4.

There may be instances where tariffs are proposed that relate to a very small proportion of revenue or are applicable to very few customers (for example, for some rural tariffs). In these cases, a water business may propose specific pricing principles.

In developing their pricing proposals, we encourage water businesses to consider the tariff assessment principles listed in Table 3.5.

**Table 3.5 Tariff principles**

Principle	Description
Sustainable revenue	Tariff structures, levels and the form of price control should ensure an economically sustainable revenue stream over the regulatory period.
Subsidy free pricing and inefficient bypass	For each tariff class, the revenue expected to be recovered should lie on or between an upper bound representing the stand alone cost of serving the customers in that class and a lower bound representing the avoidable cost of not serving those customers.
Tariff structures	<p>Tariff structures should be simple, understandable and cost reflective.</p> <p><b>Bulk Water Charges Structure</b> — A two part charge comprising a fixed charge and a volumetric component to recover a bulk supplier’s revenue requirement from its customers for each bulk water service.</p> <p><b>Retail Water Tariffs Structure</b> — A two part tariff comprising a fixed charge and a volumetric component to recover a water business’s revenue requirement from each tariff class.</p> <p><b>Sewerage Charges</b> — The tariff structure should reflect the cost structure - and may comprise a one or two part tariff (all fixed, all volumetric or a fixed charge and a volumetric component).</p> <p><b>Trade Waste</b> — Trade waste charges should be load-based where measurement is feasible and where the benefits outweigh the costs.</p>
Determining fixed charges	Fixed charges should be calculated to recover the difference between the total revenue requirement for a tariff class and the revenue recovered through volumetric charges.
Determining volumetric charges	The volumetric charge should have regard to the long run or short run marginal costs, where appropriate.
Customer focus	Retail tariff and service offerings, and the form of price control, should have regard to the ability of customers to understand the tariff and service offering and respond to price signals, customer preferences and needs in relation to service standards or new services, the costs of implementing the tariff offering, including administration and marketing costs and price path stability.
Locational and postage stamp pricing	<p>Postage stamp pricing comprises retail tariffs that do not reflect any differences in costs of distribution systems by time or location. Postage stamp pricing should be applied when water supply is predominantly interconnected and/or is more equitable and administratively simple.</p> <p>Locational pricing comprises tariffs that vary by location – reflecting the cost structure of water supply, transport and treatment across the business.</p> <p>Locational pricing should be applied when water supply is less integrated and where there are material differences in costs between water networks.</p> <p>The WIRO does not specify whether a business should use locational or postage stamp pricing. It is up to the business to make the case for which is most appropriate.</p>

The principles in Table 3.5 provide guidance for businesses to check their proposed tariffs are consistent with the WIRO, including that tariffs provide signals to customers about the efficient costs of providing services. Compliance with the tariff assessment principles may also support a water business's proposed PREMO rating.

Further, we consider the current variable sewerage tariffs for residential customers of the metropolitan water businesses are difficult for customers to understand, and not cost reflective. Given the low marginal cost of residential sewage treatment, we will consider proposals for a single fixed charge for retail sewage disposal for residential customers favourably.

### **3.19.1. Rural prices**

We recognise that rural water businesses face issues in setting tariff structures and pricing which differ from urban businesses. However, the tariff assessment principles outlined in its framework and approach paper are also relevant to rural tariffs. Subject to legislation change, rural tariffs pertaining to rural infrastructure services currently regulated under the Commonwealth Water Charge Rules 2010 are to be assessed against the principles in clause 11 of the WIRO from 1 July 2023.

We encourage water businesses to continue unbundling and disaggregating their costs to reflect the different elements of the supply chain (that is, storage, transport and retail costs). Unbundled tariffs provide better price signals to customers and assist with benchmarking of costs.

### **3.19.2. Criteria**

We will assess proposals against the following factors:

- the business's consideration of risk and efficiency — particularly how proposed tariffs are consistent with providing signals about the efficient cost of delivering services
- the extent to which proposed new tariffs or tariff structures are consistent with the tariff assessment principles in Table 3.5
- the business's approach to consultation on the tariff structures and how the views of customers were taken into account
- whether the business has considered and demonstrated that appropriate transition strategies will be implemented for any materially affected customers
- where applicable, whether the business has justified changes to its tariff strategy
- the ability for customers to understand the resulting tariffs and tariff movements throughout the regulatory period.

For price levels, we will assess proposals against the following factors:

- the business's justification for the proposed prices, particularly how proposed prices are consistent with providing signals about the efficient cost of delivering services, and providing incentives for the business to pursue efficiency improvements
- how the business has taken into account the interests of customers, in particular low income and vulnerable customers
- whether the business has adequate transition strategies in place to manage the impacts of significant price shocks for affected customers.

In making a decision under clause 11 of the WIRO, we will have particular regard to whether tariffs are continuing in the same form as applied during the last period, or whether changes are proposed.

We recognise that an important objective includes avoiding price shocks for customers where possible. Where an existing tariff structure is being continued, this may be satisfied more easily. Where changes are proposed, however, the water business will need to provide evidence to demonstrate that the amended tariff structure better satisfies clause 11 of the WIRO than the existing structure.

### **3.19.3. Supporting information**

A price submission must:

- Include a tariff schedule listing each tariff and the price (or principles) proposed, including each element of a multi-part tariff structure.
- Outline the business's tariff strategy and highlight any major proposed changes during the regulatory period commencing 1 July 2023.
- Provide indicative bill impacts for key customer groups – for residential (owner occupiers and tenants) and business customers (small, medium and large). Estimates must be provided for each year of the regulatory period using representative consumption amounts, and specified in real terms.
- Include a summary of the business's approach to consultation on its proposed tariffs and how the views of customers informed the price submission.
- For any changes in tariff structures and principles, or new tariffs:
  - state how each tariff is to be applied – for example, frequency of charging, customer class, applying prices through connection or meter size
  - describe the relationship between the proposed price for a service and the associated short run or long run marginal cost

Required contents of a price submission

- provide data and supporting information that describes how proposed tariffs are consistent with providing signals about the efficient cost of delivering services<sup>52</sup>
  - justify how the proposed change delivers better signals to customers about the efficient costs of service provision
  - describe how the business considered risk and its allocation and management
  - provide a summary of the business’s approach to consultation and how the views of customers informed the price submission
  - update the bill calculator in the financial template, reflecting the proposed tariffs and price levels.
- For real price changes of more than 10 per cent for any tariff in any year for the next regulatory period:<sup>53</sup>
    - describe the relationship between the cost of service provision and the proposed price
    - provide a summary of the business’s approach to consultation (including the approach to identifying affected customers)
    - summarise the customer feedback received on the proposed price increase
    - describe the transition arrangements considered, and ultimately proposed, for affected customers.
  - Provide estimated tariffs for each service for each year beyond the next regulatory period up until 2032-33 in the financial model template.
  - Provide the Top 10 miscellaneous charges by forecast revenue for the next regulatory period and the following period up until 2032-33 in the financial model template.
  - Provide supporting information that describes how proposed miscellaneous tariffs are calculated in accordance with requirements in the WIRO and the pricing principles provided below.

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<sup>52</sup> We require the price submission to propose prices that seek to reduce and minimise cross-subsidies. The extent to which this may be achieved will depend on a range of factors, including how well any adverse customer impacts may be managed. These issues will need to be explored in price submissions.

<sup>53</sup> Clause 11(d)(ii) of the WIRO requires the commission to have regard to the principle that prices should provide signals about efficient costs of providing services, while avoiding ‘price shocks’ where possible. For the purposes of the 2018 price review, we defined a price shock as an increase of greater than 10 per cent in any year for any individual tariff. This is consistent with our approach to rural tariffs and Melbourne Water’s tariffs. For any proposed price increases of greater than 10 per cent in any year, it will consider the merits of the increase while having regard to the cost of delivering the particular service (that is, cost reflectivity) and the impacts on customers.

### 3.19.4. Pricing principles for miscellaneous services

Prices for miscellaneous services must be set according to actual costs calculated on the basis of the aggregate of:

- direct third party or contractor invoice cost
- direct marginal internal costs, including labour, materials and transport costs
- a fair contribution to overheads.

For bank dishonour, debt collection and legal fees, the third party costs must be charged directly to the customer with no contribution for internal costs or a contribution to overheads.

### 3.20. Adjusting prices

A price submission must specify any proposed price adjustment mechanisms to apply in the next regulatory period. The 2018 price determinations include common mechanisms that allow for prices to adjust in order to take into account:

- uncertain or unforeseen events
- differences between forecast and actual desalination costs (covering desalination security payments and the cost of any water ordered)
- a 'pass through' of changes in some costs (such as taxes) during the regulatory period
- annual changes to the benchmark cost of debt.

Our view is that these adjustment mechanisms have worked well, and we propose these arrangements will continue. In the past, water businesses have also provided specific price adjustment mechanisms, which we have approved and included in their respective determinations.

The proposed price control formulas must continue to include a mechanism to allow for price adjustments to occur on an annual basis, including desalination water orders for those relevant businesses.

Where a business proposes to continue with the existing adjustment mechanisms, the supporting information requirements will be easily satisfied. Where a change is proposed, however, the water business will need to provide evidence to demonstrate how the new or amended adjustment mechanism satisfies the requirements in clause 11 of the WIRO.

As part of the 'trailing average' approach to estimating the cost of debt (as outlined in Section 3.13), each water business must also propose a price adjustment mechanism (including price control formulas) that allows for prices to adjust on an annual basis to reflect movements in the cost of debt.

We will consider proposals addressing other events that may require a pass-through to adjust prices during the regulatory period, provided a clearly articulated justification is included in the

submission. Where there is a potential policy or regulatory change that is known but uncertain in its impact on a water business's costs, the change may be nominated in a business's price submission as a potential pass-through, or uncertain or unforeseen event. Capital projects which are anticipated, but have not been fully scoped or costed (as described in Section 3.9) may be nominated as an uncertain event.

### **3.20.1. Criteria**

In approving proposed pass-through or uncertain or unforeseen events, we will consider:

- the extent to which the event is outside the business's control and poses significant risk of cost changes during the period
- the extent to which the nominated event is uncertain in its impacts and timing
- whether it is reasonable that customers should bear risk associated with the nominated event
- the impact of the nominated event on efficiency incentives for the water business
- the ability for the business to otherwise manage the risk and cost impact posed by the event – for example, in its form of price control, tariff structures or approach to contracting.

### **3.20.2. Supporting information**

A price submission must:

- specify any proposed price adjustment mechanisms to apply in the next regulatory period, and specify the proposed process and/or formula for adjusting prices
- if proposing new or changed price adjustment mechanisms, then the price submission must:
  - clearly specify and explain how the adjustments would work
  - demonstrate the business has sought to appropriately balance revenue and cost risk between the business and its customers, without materially impacting on price stability
  - justify any proposal against relevant matters in clause 11 of the WIRO and consistency with proposed outcomes.

For any identified pass-through or uncertain and unforeseen events, a price submission must also:

- describe each proposed event, and explain why it is uncertain in its timing or impacts on the water business or its customers
- explain why it is appropriate that customers should bear risk associated with the event
- explain how the business considered the impacts on its incentives to pursue efficiencies
- propose a price adjustment mechanism to implement the pass-through.

## 3.21. New customer contributions

New Customer Contributions (NCC) are a prescribed service for urban water businesses (also known as developer contributions). We introduced a principles-based NCC charging framework which came into effect from 1 July 2013. For detailed guidance on NCC, businesses should continue to refer to our explanatory note, released in December 2013.<sup>54</sup>

### 3.21.1. Criteria

Water businesses must use approved pricing principles (outlined in Box 3.3) to calculate the net incremental cost of connections. NCC will be either standard NCC, which are approved by us in each water business's determination, or negotiated NCC, which are agreed between a developer and water business.

#### Box 3.3 NCC pricing principles

Standard and negotiated NCC charges will:

- have regard to the incremental infrastructure and associated costs in one or more of the statutory cost categories attributable to a given connection<sup>55</sup>
- have regard to the incremental future revenues that will be earned from customers at that connection
- be greater than the avoidable cost of that connection and less than the standalone cost of that connection.

### 3.21.2. Supporting information

A price submission must:

- Specify the proposed NCC charges and how they are to be applied – for example by customer class (water, sewerage, recycled water), location or development type (infill, greenfield).
- Provide the model(s) used to calculate the maximum NCC charges, including accompanying notes describing the data sources and input assumptions used, in order for us to assess that proposed NCC charges have been established in accordance with the NCC pricing principles (Box 3.3). The model(s) must use the same financial parameters as in the financial model template.<sup>56</sup>

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<sup>54</sup> Essential Services Commission 2013, New customer contributions: Explanatory note, December.

<sup>55</sup> Statutory cost categories means costs for works imposed under Division 6 of Part 13 of the Water Act 1989.

<sup>56</sup> Water businesses must update and resubmit their NCC calculation model(s) following our draft decision on parameters such as demand forecasts and expenditure forecasts and the weighted average cost of capital (WACC).

- Provide evidence of consultation with developers and how their views have informed the proposed charges, particularly if proposed Standard NCCs are significantly higher than the existing NCCs.
- Provide details about how the forecast developer contributions in the financial model template have been derived and explain how past outcomes for contributions have been considered, and assumptions about future connections growth.
- Provide a copy of the negotiated new customer contribution framework to be applied for the forthcoming regulatory period, including any proposed changes in track changes.

If water businesses develop and submit bespoke NCC models instead of using the ESC's illustrative working model, we expect comprehensive documentation to facilitate the assessment of the models used.

### **3.22. Financial position**

The financial model template will calculate estimates for the four financial indicators specified in Table 3.6 for each year to 2032-33. A water business must populate the financial model template to enable our assessment of the business's financial position in the context of the prices proposed in its price submission.

A water business should also provide us with the findings of any independent ratings assessments conducted by an independent credit ratings agency since 1 July 2018.

**Table 3.6 Financial indicators**

Indicator	Calculation	Benchmark Range	Description
<b>Primary indicator — used to determine size of any viability adjustments</b>			
FFO interest cover	$(\text{FFO} + \text{net interest}) / \text{net interest}$	> 1.5 times  < 1.8 times used as a caution	Measures the extent of the cash flow buffer a water business has to meet its debt obligations.
<b>Secondary indicators — used only as contextual information to determine whether an adjustment is necessary</b>			
Net Debt / Regulatory Asset Value (%) (Gearing)	$(\text{Interest bearing liabilities} - \text{cash}) / \text{RAV}$	< 70 per cent	Measures the debt component of the regulatory capital structure.
FFO / Net debt (%)	$\text{FFO} / (\text{Interest bearing liabilities} - \text{cash})$	> 10 per cent	Measures the extent to which the serviceability of debt is improving, remaining stable, or declining.
Internal financing ratio (%)	$(\text{FFO} - \text{dividends}) / \text{net capital expenditure}$	> 35 per cent	Measures the extent to which an entity has cash remaining to finance a prudent portion of capital expenditure after making dividends.

Notes: FFO refers to ‘funds from operations’ and RAV refers to the ‘regulatory asset value’. Regarding FFO interest cover, the commission believes the 1.8 times benchmark signals a need for caution from the business and closer observation by the commission in its price reviews and performance reporting. But until a business breaches or is forecast to breach the benchmark of 1.5 times, it is unlikely the commission would make a viability adjustment.

### 3.23. Additional requirements

#### 3.23.1. Executive summary

A price submission must contain a summary which outlines and brings together the key elements of its proposals. The summary should include:

- an overview of proposed prices
- indicative bill impacts of the proposed prices, by key customer group
- an overview of the outcomes proposed for customers, including how services will change from previous levels
- the business’s nominated PREMO rating
- an attestation from the board on the quality and accuracy of information provided in the price submission.

### 3.23.2. Board attestation

Our guidance requires the board of a water business to attest to the quality of its price submission and its compliance with our guidance (in all material respects). Our reason for including the attestation is to promote board involvement and ownership of its business's proposals. This attestation, endorsed by a resolution of the board of directors, must be included in the price submission.

The form of the required attestation is below:

The directors of [name of water business] having made such reasonable inquiries of management as we considered necessary (or having satisfied ourselves that we have no query), attest that, to the best of our knowledge, for the purpose of proposing prices for the Essential Services Commission's 2023 water price review:

- information and documentation provided in the price submission and relied upon to support [name of water business]'s price submission is reasonably based, complete and accurate in all material respects;
- financial and demand forecasts are the business's best estimates, and supporting information is available to justify the assumptions and methodologies used; and
- the price submission satisfies the requirements of the 2023 water price review guidance paper issued by the Essential Services Commission in all material respects.

To support its PREMO rating, a water business may wish to make available to us information on the procedures implemented to ensure its price submission reflects the requirements of our guidance.

The justification for a water business's final PREMO self-rating is always the sole responsibility of the business, even if it engages a third party to review and advise on its proposed PREMO self-rating.

### 3.23.3. Financial model

A water business must complete the financial model template prepared by the commission to accompany its price submission. A water business's price submission must be consistent with the data provided in the financial model template.<sup>57</sup> Where there is any discrepancy between the price submission and the financial model template, we will rely on the data in the financial model

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<sup>57</sup> The financial model template requires the water business to provide detailed information on key assumptions underpinning its prices (such as expenditure estimates) so we can assess its proposal. The model also provides a mechanism for a water business to estimate its revenue allowance and prices. The model will require both historic and forecast data. Historic data must be consistent with a water business's regulatory accounts.

template. The financial model template will clearly identify the cells for which a water business must provide data. A water business must not amend any other cells in the financial model template – this includes adding rows, columns, or information not requested by the commission.

The model will include a forecast inflation rate (refer to Section 3.13.1 for information on our approach to estimating forecast inflation). The inflation rate will be used to estimate components of the regulatory rate of return (see Section 3.10) and estimates for financial indicators (see Section 3.22).

We will provide the following values to each of the water businesses to enter into the financial model template at around end of April 2022:

1. actual March quarter annual CPI value for 2022-23
2. actual cost of debt value for 2021-22 and an updated estimate cost of debt value for 2022-23.<sup>58</sup>

#### **3.23.4. Requirement for reasonably-based information**

All information contained in the price submission (and financial model template – see Section 3.23.3) must be reasonably-based. All financial and demand related information must represent the best available estimates at the time of finalising the submission.

#### **3.23.5. Basis upon which information is provided**

All financial information (including prices, operating and capital expenditure) in a water business's price submission (and financial model template) must be in 2022-23 dollars (with the March quarter 2022 CPI as the base).

All reports, studies or any other materials (for example, research reports, policy documents, and cost benefit analysis or studies) which are relied upon in the price submission must be made available to the commission at lodgement or on request.

#### **3.23.6. Confidentiality**

We will publish a water business's price submission, financial model template and any supplementary information on our website. If there is information that a water business does not want disclosed publicly, because it is confidential or commercially sensitive, then the water business should discuss the matter with commission staff before lodging the price submission. As

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<sup>58</sup> We will replace the cost of debt estimate for 2022-23 with the actual value before making our final decision.

per our submissions policy, we may require a business to provide a redacted version for public disclosure on our website.<sup>59</sup>

### **3.23.7. Accessibility**

The commission intends to use the Engage Victoria platform for its consultation during the 2023 water price review. If not addressed by the water business's price submission lodged with the commission, the water business must provide an accessible version of its price submission and supplements (public versions) **by 7 October 2022**.

### **3.23.8. Notification of changes to assumptions**

During the price review, a water business must promptly advise us if it becomes aware of any event that may require substantial changes to the assumptions underpinning the proposals in its price submission. A water business must also explain the basis for any changes to assumptions, explain the impact on its proposals, and demonstrate compliance with relevant sections of the guidance.

In the event of any changes, a water business must promptly provide us with an updated financial model template, reconciling changes to the financial model template provided to the commission with its price submission as lodged on 30 September 2022.

### **3.23.9. Non-prescribed services**

While we have no role in regulating prices for non-prescribed services, we need to be satisfied that these services have been correctly classified as not related to regulated services, and that the costs of these services are accurately identified and excluded from the regulated cost base. A water business's price submission must provide or reference information that demonstrates that the costs of non-prescribed services have been excluded from its expenditure and price calculations.

Where a water business identifies costs to deliver both prescribed and non-prescribed services, the business's price submission must justify the extent that costs are relevant to prescribed services (and should be recovered from customers through regulated prices).<sup>60</sup>

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<sup>59</sup> View our submissions policy at <https://www.esc.vic.gov.au/about-us/our-policies/our-submissions-policy>.

<sup>60</sup> Prescribed services are set out in WIRO, clause 7(b).

## Appendix A – Approach for making a price determination

### **Excerpt from Water Industry Regulatory Order 2014.WIRO clause 14**

- a) In making a price determination the Commission may either:
  - i. approve the maximum prices the regulated entity may charge for prescribed services, or the manner in which the regulated entity's prices are to be calculated, determined or otherwise regulated, as proposed by the regulated entity in its price submission; or
  - ii. specify the maximum prices the regulated entity may charge for prescribed services, or the manner in which the regulated entity's prices are to be calculated, determined or otherwise regulated.
- b) The Commission may only specify the maximum prices, or the manner in which prices are to be calculated, determined or otherwise regulated, if:
  - i. the price submission of the regulated entity does not, in the Commission's opinion, comply with the guidance provided by the Commission under clause 13 or have adequate regard for the matters specified in clause 11; or
  - ii. the regulated entity failed to submit a price submission to the Commission within the time period specified for this by the Commission.



## Appendix B – Matters to include in guidance

Excerpt from Water Industry Regulatory Order 2014 with references to the Essential Services Commission Act 2001 (Vic).

### **WIRO clause 13(a)**

Before making a price determination and following consultation, including with the relevant regulated entity, the Commission must provide guidance to the regulated entity setting out:

- i. the manner in which the Commission proposes to regulate the prices which the regulated entity may charge for prescribed services for the regulatory period consistent with section 33(5) of the ESC Act and this Order;
- ii. the approach and methodology which the Commission proposes to adopt to assess a price submission and make a price determination for the regulatory period consistent with section 33(2) of the ESC Act and this Order;
- iii. the Commission's expectations of the nature and scope of matters to be addressed by the regulated entity in its price submission;
- iv. the Commission's expectations regarding customer consultation by the regulated entity in developing its price submission;
- v. the Commission's expectations of the information required to be provided by the regulated entity to enable the Commission to make a price determination;
- vi. the timing and processes the Commission proposes to follow in making a price determination consistent with section 35 of the ESC Act and the Commission's Charter of Consultation and Regulatory Practice;
- vii. the date by which the regulated entity is to deliver its price submission to the Commission; and
- viii. any other matter that the Commission considers should be included in the guidance provided to the regulated entity or in the regulated entity's price submission.



## Appendix C – Matters businesses and the commission must have regard to

Economic efficiency and viability matters	Industry/business specific matters	Customer matters
<ul style="list-style-type: none"> <li>• promotion of efficient use of prescribed services by customers [cl 8(b)(i), WIRO]</li> <li>• promotion of efficiency in regulated entities as well as efficiency in, and the financial viability of, the regulated water industry [cl 8(b)(ii), WIRO]</li> <li>• provision to regulated entities of incentives to pursue efficiency improvements [cl 8(b)(iii), WIRO]</li> <li>• efficiency in the industry and incentives for long term investment [s 8A(1)(a), ESC Act]</li> <li>• efficient costs of producing or supplying regulated goods or services and of complying with relevant legislation and relevant health, safety, environmental and social legislation applying to the regulated industry [s 33(3)(b), ESC Act]</li> <li>• financial viability of the industry [s 8A(b)(1), ESC Act]</li> </ul>	<ul style="list-style-type: none"> <li>• particular circumstances of the regulated industry and the prescribed goods and services for which the determination is being made [s 33(3)(a), ESC Act]</li> <li>• return on assets in the regulated industry [s 33(3)(c), ESC Act]</li> <li>• ensure that regulatory decision making and regulatory processes have regard to any differences between the operating environments of regulated entities [s 4C(b), WI Act]</li> </ul>	<ul style="list-style-type: none"> <li>• in performing its functions and exercising its powers, the objective of the Commission is to promote the long term interests of Victorian consumers [s 8(1), ESC Act] without derogating from that objective. The Commission must in seeking to achieve the objective have regard to the price, quality and reliability of essential services [s 8(2), ESC Act]</li> <li>• enable customers or potential customers of the regulated entity to easily understand the prices charged by the regulated entity for prescribed services or the manner in which such prices are calculated, determined or otherwise regulated [cl 11(d)(i), WIRO]</li> <li>• provide signals about the efficient costs of providing prescribed services to customers (either collectively or to an individual customer or class of customers) while avoiding price shocks where possible [cl 11(d)(ii), WIRO]</li> <li>• take into account the interests of customers of the regulated entity, including low income and vulnerable customers [cl 11(d)(iii), WIRO]</li> </ul>

Benchmarking	Health, safety and social obligations	Other
<ul style="list-style-type: none"> <li>any relevant interstate and international benchmarks for prices, costs and return on assets in comparable industries [s 33(3)(d), ESC Act]</li> </ul>	<ul style="list-style-type: none"> <li>the relevant health, safety, environmental and social legislation applying to the industry [s 8A(1)(d), ESC Act]</li> <li>to ensure that regulatory decision making has regard to the health, safety, environmental sustainability (including water conservation) and social obligations of regulated entities [s 4C(c), WI Act]</li> </ul>	<ul style="list-style-type: none"> <li>the degree of, and scope for, competition within the industry, including countervailing market power and information asymmetries [s 8A(1)(c), ESC Act ]</li> <li>consistency in regulation between States and on a national basis [s 8A(1)(f), ESC Act]</li> <li>the benefits and costs of regulation (including externalities and the gains from competition and efficiency) for—(i) consumers and users of products or services (including low income and vulnerable consumers) (ii) regulated entities [s 8A(1)(e), ESC Act]</li> <li>wherever possible, to ensure that the costs of regulation do not exceed the benefits [s 4C(a), WI Act]</li> </ul>

Excerpts from Water Industry Regulatory Order 2014, the Essential Services Commission Act 2001 (Vic), and the Water Industry Act 1995 (Vic).

## Appendix D – Risk management

### Types of risk

Water businesses face a range of risks, both within and outside of their control, for example:

- Inflow risk, which presents as an inability for water businesses to meet customer demand due to extended low rainfall and inflows.
- Demand forecasting risk results where actual customer demand during a regulatory period differs materially from the forecasts. It can be mitigated through effective demand forecasting and scenario modelling, variable tariff structures, or the form of price control.
- Operational risks, such as a water business experiencing a breach of health, environmental or customer performance standards, can result from inadequate processes within water businesses, asset failures or external factors. Water businesses manage these risks through managing operating policies, capital investment, maintenance policies, contracts and insurance.
- Construction risks arise from underestimating costs or project delays. Water businesses can manage these risks through effective forecasting and contract management, as well as including contingency allowances in cost forecasts. Including cost contingencies in water revenue allowances transfers risk of project cost overruns to customers. Businesses should also factor in reasonable timelines for approval processes.
- Regulatory and policy risks result from changes in laws and regulations that materially affect a water business's costs or revenue potential, and are typically mitigated via a pass-through mechanism.
- Financial risks are those arising from factors which affect the whole economy, such as rising interest rates or economic downturn. These risks are reflected in the cost of debt which forms part of the regulatory rate of return.
- Business risks result from a loss of revenue due to new technology or a change in the competitive landscape. Water businesses can mitigate some of these risks through innovative business practices and continually seeking cost efficiencies.

## Regulatory risk mitigation tools

The regulatory regime established through the WIRO and developed in detail through previous reviews generally identifies, categorises and allocates risk in accordance with standard principles and seeks to provide efficiency incentives to the water businesses. The regulatory framework provides the following tools to mitigate or manage risk:

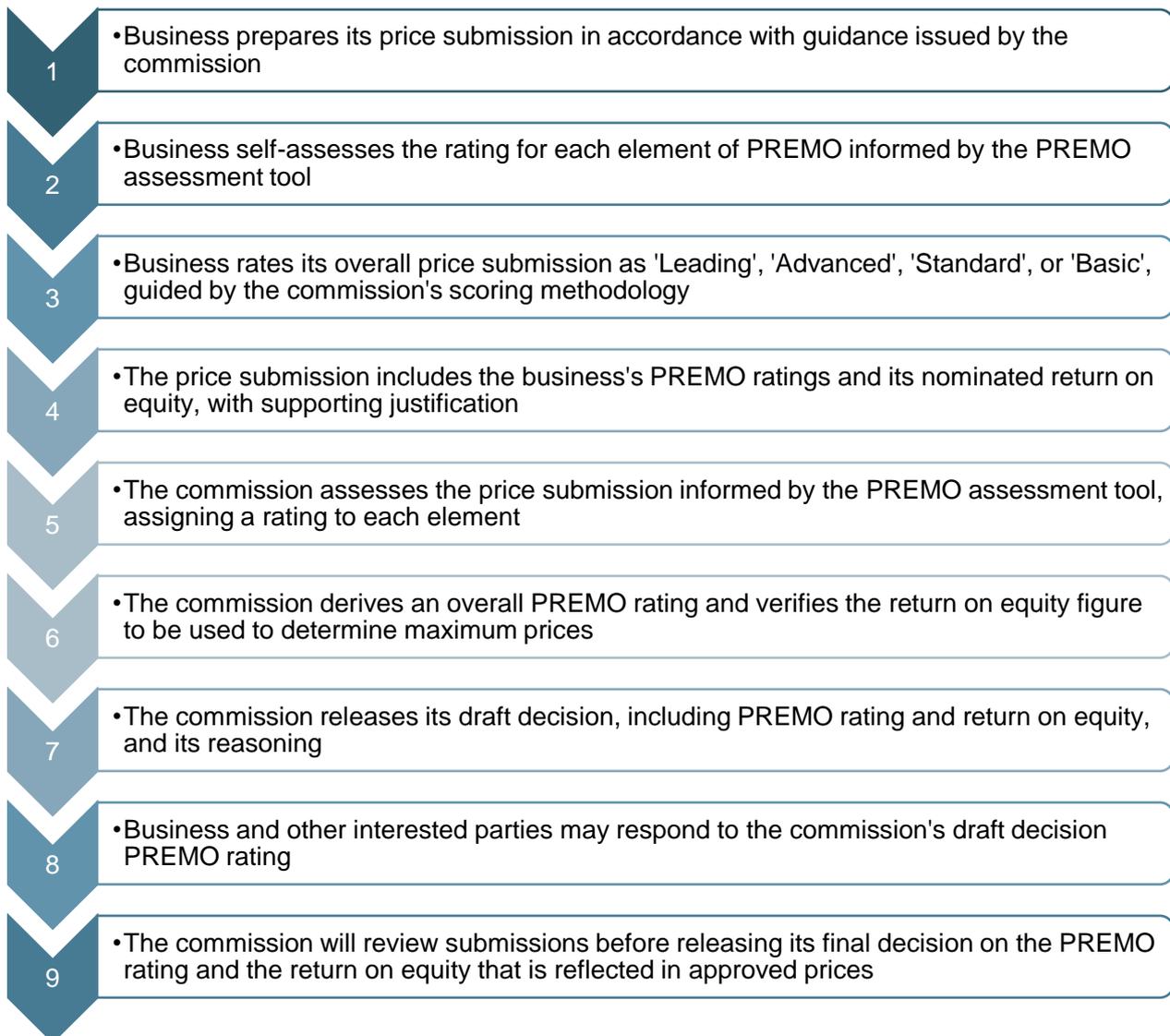
- Recovery of forecast operating and capital expenditure — The forecast expenditure contained within the price submission must be consistent with the risk allocation and incentives provided within the regulatory framework. Therefore, it is important that forecasts are prepared on this basis. Where a water business seeks recovery of costs for managing risks, we expect it to demonstrate the need for this and provide supporting information in its price submission (Sections 3.8 and 3.9).
- Indexation of prices — This ensures that water businesses remain fully responsible for management of controllable costs, and that it does not need to bear the full risk associated with general price inflation.
- Cost of capital — This provides compensation for non-diversifiable risk (Section 3.13).
- Form of the price control — This provides a mitigating tool for water businesses. Section 3.18 contains our views on the form of the price control for the next regulatory period. The commission also notes that the form of price control can assist in managing the risk that actual demand varies from forecast demand.
- Tariff structures — Section 3.19 sets out the guiding pricing principles for new tariff structures. The impacts of any shift in the mix of service and variable charges in tariffs on risk sharing between a water business and its customers will need to be addressed in the price submission.
- Length of the regulatory period — A shorter regulatory period can reduce the risk of forecasting uncertainty (see Section 3.2).
- Pass-through mechanisms — Significant uncertainties that materially affect a water business and that occur within the regulatory period are generally treated as pass-through events. These events must be clearly identified in the price determination. The uncertain or unforeseen events mechanism established by the commission for the 2008 and 2009 water price reviews provides another option for managing and mitigating risks, subject to certain criteria (see Section 3.20).

## Appendix E – Establishing a PREMO rating

### PREMO rating process

The steps for a water business and the commission to establish the PREMO rating for the business's price submission is outlined in figure A below.<sup>61</sup>

**Figure A** Process for rating a price submission



<sup>61</sup> For further information, see Essential Services Commission 2016, Assessing and rating PREMO price submissions: A consultation paper prepared by commission staff, October, pp. 5–7.

## PREMO assessment tool

The PREMO assessment tool provides:

- A set of guiding questions for rating price submissions. These will help businesses understand what evidence and justification we expect.
- Examples to demonstrate what might constitute 'Leading', 'Advanced', 'Standard' or 'Basic' ambition for the PREMO elements.

The assessment tool **does not** provide an exhaustive list of what may be taken into account by a water business or by us in arriving at a price submission rating. Businesses may provide further arguments to support their ratings. Further, if a business considers that it does not meet one of the examples in the tool for a given rating, this does not mean it cannot achieve that overall rating, as a business should consider on-balance how it meets the guiding questions.

The PREMO assessment tool is provided in the following pages for the Performance, Risk, Engagement, Management and Outcomes elements of PREMO.

### Performance

The Performance element is a backward look at how a business has performed relative to its commitments at its previous price review. The Performance rating should therefore reflect the final PREMO rating awarded for the current regulatory period. Accordingly, our assessment tool provides examples in terms of a business's current PREMO rating, rather than in absolute terms of Standard, Advanced and Leading ratings as for the other forward-looking PREMO elements.

The Performance element rating can be considered as follows:

- **Current overall PREMO rating** = Achieved expectations – demonstrated delivery of promised outcomes, account for any material cost variations, and demonstrate customer satisfaction.
- **A higher PREMO rating than current** = Exceeded expectations – demonstrated out-performance whereby customers received significantly higher value than they paid for.
- **A lower PREMO rating than current** = Did not meet expectations – a material shortfall in performance where customers did not receive the value they paid for (or where higher incurred costs will lead to a price rise, and therefore lower value, in the next period).

The Performance element rating may rise or fall by more than one rating level for very large changes in performance and value relative to the business's proposals at the previous price review, as set out in Table A.

**Table A Example rating of the Performance element**

Overall PREMO rating from previous price review	Performance rating in price submission for 2023 water price review		
	Exceeded expectations	Achieved expectations	Did not meet expectations
Leading	Leading	Leading	Advanced/Standard/Basic
Advanced	Leading	Advanced	Standard/Basic
Standard	Leading/Advanced	Standard	Basic
Basic	Advanced/Standard	Standard	Basic

Note: Where a business was rated Basic at the previous price review, achieving expectations would produce a Standard rating for the Performance element.

## Performance

Guiding questions	Examples reflecting a lower rating than current	Examples reflecting achievement of the current rating	Examples reflecting a higher rating than current
<p>To what extent has the business demonstrated delivery of its customer outcomes commitment over the current regulatory period? Did its customers get what they paid for?</p> <p>How does actual operating expenditure across the current period compare with the established benchmark allowance, and to what extent has the business rationalised any discrepancies?</p> <p>How does actual capital expenditure across the current period compare with the established benchmark allowance, and to what extent has the business rationalised any discrepancies?</p> <p>To what extent does customer sentiment demonstrate satisfaction in the business's performance over the current regulatory period? Are customers happy with the value they receive from their water business?</p>	<p>The business underperformed on its outcomes commitments, falling short of delivering the value its customers expected.</p> <p>The business did not adequately own its underperformance or address shortfalls with its customers.</p>	<p>The business has generally delivered on its outcome commitments, by meeting its performance targets for most output measures across the regulatory period.</p> <p>The business clearly took ownership for shortfalls in performance throughout the period, and explained to customers what it would do to address each shortfall.</p> <p>The business's major capital project program was largely delivered as forecast, with material variations clearly explained to customers through its annual reporting processes.</p>	<p>The business consistently met all its outcome commitments, OR Where it fell a little short on some targets, it clearly outperformed on others to deliver great customer value.</p> <p>The business adjusted its revenue recovery to reflect a shortfall in performance or major project delivery, to ensure customers did not pay for infrastructure, services or value they did not receive.</p> <p>The business reviewed and re-tested its proposed outcome measures and performance targets with customers throughout the period, to ensure they were still relevant, and it was still delivering what customers valued. Measures and targets amended through consultation with customers where appropriate.</p>
	<p>The business's controllable operating expenditure exceeded the benchmark allowances, and the additional expenditure did not provide material customer value improvements.</p>	<p>Actual controllable operating expenditure was largely consistent with the benchmark allowances set in the price review</p> <p>Variations to controllable expenditure are clearly identified and explained in terms of its impact on customer value.</p>	<p>The business outperformed the controllable opex benchmarks while meeting its outcome expectations, representing better value for customers going forward.</p>

Continued on the following page

## Performance

Guiding questions	Examples reflecting a lower rating than current	Examples reflecting achievement of the current rating	Examples reflecting a higher rating than current
	<p>The business fell well short of delivering its major capital project program.</p> <p>The program was delivered, but well over budget, resulting in a material increase in the RAB roll-in and upward impact on future prices.</p>	<p>Actual capital expenditure was largely consistent with the benchmark allowances set in the price review.</p> <p>Significant variations to the capital expenditure forecast are clearly identified and explained. This includes uncertain capital expenditure that was excluded from the price benchmarks.</p>	<p>The business delivered its major capital project program (or met its objectives) below the forecast expenditure benchmarks, representing better value for customers going forward through a reduced RAB roll-in.</p>
	<p>The business consistently scores at the lower end of the ESC's quarterly customer perception survey, and cannot counter this with its own customer survey findings.</p> <p>The business reports an ongoing downward trend in customer sentiment across the regulatory period.</p>	<p>The business consistently scores on par with the statewide average in the ESC's quarterly customer perception survey.</p> <p>The business demonstrates a noticeable lift in positive customer sentiment across the period.</p> <p>The business's own customer survey work demonstrates it meets expectations, or shows a positive trend across the period.</p>	<p>The business consistently scores above the statewide average in the ESC's quarterly customer perception survey.</p> <p>The business demonstrates a <b>significant</b> lift in positive customer sentiment across the period.</p> <p>The business's own customer survey work demonstrates it exceeded expectations, or shows a significant positive trend across the period.</p>

## Risk

Guiding questions	Examples for a Basic submission	Examples for a Standard submission	Examples for an Advanced submission	Examples for a Leading submission	
<p>To what extent has the business demonstrated a robust process for identifying risk, and how it has decided who should bear these risks? i.e such that customers are not paying more than they need to.</p> <p>To what extent does the proposed guaranteed service level (GSL) scheme provide incentives for the business to be accountable for the quality of services delivered, and provide incentives to deliver valued services efficiently?</p>	<p>The business has not met the requirements of the commission's Guidance Paper in relation to risk.</p>	<p>The business meets the requirements of the commission's Guidance Paper in relation to risk.</p>	<p>The business has implemented a new approach that reduces prices through better risk management, or through accepting risk on behalf of customers.</p>	<p>The business has implemented an approach that reduces costs through better risk management, to a level that sets it apart from industry peers.</p>	
	<p>The business has sought to transfer risk to customers which is not supported by customer views.</p>				<p>In its price submission, the business proposes correction mechanisms to adjust the return on equity where its performance does not meet the outcomes established at the price review.</p>
	<p>The business has not sought to minimise cost and/or price impacts from risk management.</p>	<p>The business cannot demonstrate compliance with risk standards specified in the Statement of Obligations.</p>	<p>The business demonstrates compliance with risk standards specified in the Statement of Obligations (e.g. ISO 55000).</p>	<p>The business has been accredited for compliance with risk standards specified in the Statement of Obligations.</p>	
	<p>Projects are proposed that have incomplete scope, no business cases, or are not feasible in terms of timelines for delivery.</p>		<p>The business can demonstrate that it has thoroughly evaluated the feasibility of commencement and completion dates for major projects. Business cases are available for all major projects.</p>	<p>The business can demonstrate a robust optimisation process that has informed what projects need to be completed, and the timing of those projects. For example, real options analysis has informed planning and ability to adapt to changing circumstances (e.g. variations in demand from forecast) and is evident in proposals.</p>	
	<p>The business cannot demonstrate that its aggregate capital expenditure forecasts are consistent with a P50 estimate (noting this is likely not to be appropriate where a business's capital program is dominated by one or two projects).</p>	<p>The business has undertaken a Monte Carlo analysis for all major projects.</p> <p>The business can demonstrate that its aggregate capital expenditure forecasts are consistent with a P50 estimate (noting this is likely to be inappropriate where a program is dominated by one or two projects). The estimate must be based on the latest credible information on costs.</p>			

Continued on the following page

## Risk

Guiding questions	Examples for a Basic submission	Examples for a Standard submission	Examples for an Advanced submission	Examples for a Leading submission
		<p>The business uses regulatory tools such as the pass through and uncertain or unforeseen events mechanisms where appropriate for projects with uncertain timing or costs.</p> <p>The business has evaluated whether major projects should be funded via capital or operating expenditure for pricing purposes.</p>		
	<p>The business has not proposed a GSL scheme that reflects the main service concerns and priorities of customers.</p>	<p>The business has proposed a GSL scheme that reflects the main service concerns and priorities of customers.</p>	<p>The business has refined its GSL scheme to provide greater service accountability to customers, or to provide increased incentives to deliver services efficiently.</p> <p>The business has proposed a GSL scheme that compares favourably to industry peers in terms of incentives to deliver services efficiently.</p>	
	<p>The business adopts assumptions that seek to maximise unit rates proposed.</p>	<p>The unit rates used to evaluate projects and options reflect recent historical trends, and/or independently verified market forecasts.</p>		
	<p>The business cannot support its assessment of financial viability by reference to cash flow projections and independent benchmarks (e.g. credit rating metrics).</p>	<p>The business can support its assessment of financial viability by reference to cash flow projections and independent benchmarks (e.g. credit rating metrics).</p>	<p>The water business has had its financial position reviewed by an independent credit ratings agency.</p>	
	<p>The form of price control and/or tariffs over allocates risk to customers (e.g. higher fixed tariffs versus variable may reflect a business putting more volume risk on its customers).</p>	<p>Through the form of price control and tariffs proposed, the submission appropriately balances revenue and cost risk between the business and its customers, without materially impacting on price stability (e.g. higher variable tariffs versus fixed may reflect a business taking on greater volume risk on behalf of customers).</p>		

## Engagement

Guiding questions	Examples for a Basic submission	Examples for a Standard submission	Examples for an Advanced submission	Examples for a Leading submission
<p>To what extent has the business justified how the form of engagement suits the content of consultation, the circumstances facing the water business and its customers?</p> <p>To what extent has the business demonstrated that it provided appropriate instruction and information to customers about the purpose, form and content of the customer engagement?</p> <p>To what extent has the business demonstrated that the matters it has engaged on are those that have the most influence on the services provided to customers and prices charged?</p> <p>To what extent has the business explained how it decided when to carry out its engagement?</p> <p>To what extent has the business demonstrated how its engagement with customers has influenced its submission?</p>	<p>The form of customer engagement is not justified as being fit for purpose given the content and circumstances facing the business and its customers.</p> <p>Information provided to customers was written in technical jargon, and/or was not appropriate for customer use.</p> <p>The business provided selective or incomplete information to customers that biased the responses or did not provide sufficient context for customer input.</p> <p>Engagement has not occurred on matters that are important to customers or significant to the outcomes they receive and prices they are charged.</p>	<p>The form of customer engagement is justified as being fit for purpose given the content and circumstances facing the business and its customers. For example, information was appropriate, participants had time to learn about the issues, form opinions, and influence the business's proposals. Methods supported inclusion and effective participation.</p> <p>The business demonstrates that the information provided to customers was appropriate given the purpose, form and content of customer engagement.</p> <p>The business demonstrates that engagement has occurred on matters that customers reveal are the most important to them.</p>	<p>The onus is on each water business to make the case as to why it might rate its customer engagement as Advanced or Leading. This justification could be based on:</p> <ul style="list-style-type: none"> <li>• Unbiased feedback about the appropriateness of the engagement given the context and quality of the engagement program it delivered. For example, independent participant reviews, or demonstrated use of independent chairpersons.</li> <li>• Participants in the engagement program provide feedback that the business has delivered on the engagement commitments given by the business (e.g. on what matters would participants provide feedback, and the influence they would have on the decisions of the business).</li> <li>• The level of customer influence on proposals. A strong alignment between a business's proposals and the preferences and interests elicited in its engagement program would correspond to a higher rating. This includes undertaking engagement in a way that gives customers a strong voice or helps to overcome power imbalances.</li> <li>• The level and quality of participation of people who are experiencing vulnerability, or whose vulnerability might be exacerbated as a result of the outcomes of the price submission.</li> <li>• The level and quality of involvement of First Nations people in matters that affect them.</li> </ul>	

Continued on the following page

## Engagement

Guiding questions	Examples for a Basic submission	Examples for a Standard submission	Examples for an Advanced submission	Examples for a Leading submission
To what extent has the business demonstrated that its engagement was inclusive of consumers experiencing vulnerability?	Engagement was undertaken late, after the business had developed its key strategies and priorities.	A business demonstrates that engagement was undertaken early, prior to locking in key strategies and priorities.		
To what extent has the business demonstrated that its engagement was inclusive of First Nations people?	The business has failed to demonstrate that its engagement program elicited information that it could use to shape the strategic direction and priorities in its price submission.	A business demonstrates it used engagement methodologies that elicit views that are representative of the customer base.		
	The business has not retested its position and proposals with customers as it developed its price submission.	A business demonstrates that it retested its position and proposals with customers as it developed its price submission.		
	The price submission does not clearly link the outcomes of engagement to the outcomes proposed, and the alignment of outcomes to expenditure and prices.	The price submission describes what was learned from customer engagement, and how this influenced its proposed outcomes, expenditure (composition and level) and prices.		
	The business has not provided reasonable justification for instances where its proposed outcomes are not consistent with customer views.	In any instances where outcomes proposed are not consistent with customer views, the business provides reasonable justification.		

## Management

Guiding questions	Examples for a Basic submission	Examples for a Standard submission	Examples for an Advanced submission	Examples for a Leading submission
<p>To what extent has the business demonstrated how its proposed prices reflect only prudent and efficient expenditure?</p> <p>To what extent has the business justified its commitment to cost efficiency or productivity improvements?</p> <p>To what extent has the business justified or provided assurance about the quality of the submission, including the quality of supporting information on forecast costs or projects?</p> <p>To what extent has the business provided evidence that there is senior level, including Board level, ownership and commitment to its submission and its outcomes?</p> <p>To what extent has the business demonstrated its price submission is an "open book"?</p>	<p>The business has not proposed productivity improvements.</p> <p>Forecast operating expenditure incorporates a rate of efficiency improvement that is below the average rate for a Standard rated business at the 2018 water price review.</p> <p>Proposals relating to major expenditure changes, projects or reforms are not adequately supported by multiple and independent measures to support justification.</p>	<p>Forecast operating expenditure incorporates a rate of efficiency improvement equivalent to the average rate of a Standard rated business at the 2018 water price review (approx. 1.4% pa).</p> <p>Multiple and independent measures are used to support justification for the prudence and efficiency of major expenditure changes, projects or reforms.</p> <p>The price submission/expenditure forecasts include delivery of government policy commitments (reflected at efficient cost).</p>	<p>The business has proposed a significant improvement in the cost efficiency of the services delivered.</p> <p>Forecast operating expenditure incorporates a rate of efficiency improvement equivalent to the average rate of an Advanced rated business at the 2018 water price review (approx. 1.9% pa) Alternatively, evidence is provided that demonstrates the business is at or near to the efficiency frontier for the sector.</p> <p>The operating expenditure forecast places the business well ahead of the industry average in terms of cost efficiency.</p>	<p>The business has proposed a very significant improvement in the cost efficiency of the services delivered.</p> <p>Forecast operating expenditure incorporates a rate of efficiency improvement that is significantly above the average rate of an Advanced rated business at the 2018 water price review. Alternatively, evidence is provided that demonstrates the business is a leader in relation to operating at the efficiency frontier for the sector.</p> <p>Forecast operating expenditure incorporates a rate of efficiency improvement that places the business as a leader in the industry.</p> <p>The operating expenditure forecast places the business as a leader in the industry in terms of cost efficiency.</p>
	<p>The business has not provided timely access to robust business cases that validate the basis for all major projects and capital programs.</p> <p>The business has not proposed efficiency improvements in relation to its capital renewals program.</p>	<p>The business can provide business cases and justification for all major projects and capital programs, including evidence that a range of options have been considered.</p> <p>Forecast depreciation adopts a straight-line calculation approach. Alternative approaches are clearly justified.</p>	<p>The business has proposed a significant improvement in the efficiency of its capital program.</p>	<p>The business has proposed a very significant improvement in the efficiency of its capital program.</p> <p>The rate of improvement in capital expenditure efficiency places the business as a leader in the industry.</p>

Continued on the following page

## Management

Guiding questions	Examples for a Basic submission	Examples for a Standard submission	Examples for an Advanced submission	Examples for a Leading submission
	The Board of Directors has not attested that that it has undertaken appropriate internal procedures to assure themselves of the quality and accuracy of their price submission. The attestation included in the commission's guidance is not included with the price submission.	The Board of Directors has attested that it has undertaken appropriate internal procedures to assure themselves of the quality and accuracy of their price submission. The attestation included in the commission's guidance is provided with the price submission.		
	The price submission does not address all requirements set out in the commission's Guidance Paper	The price submission addresses all requirements specified in the commission's Guidance Paper.		
	The price submission and its supporting documents contain errors and/or omissions of sufficient concern to the commission.	The price submission and its supporting documents contain no material or obvious errors or omissions.		
	The financial model template is incomplete and/or inconsistent with the price submission.	The financial model template provided to the commission is completed with no material error and requires minimal adjustment by us. The financial model template is consistent with the written price submission.		
	The price submission and supporting information are provided to the commission after the time requested.	The price submission and supporting information are provided to the commission by the time requested.		
	The price submission is contradictory across main elements of the submission (e.g. there is inconsistency between the business's demand forecasts and capital works program for example).	The price submission is internally consistent, demonstrating alignment between different elements of the price submission (e.g. there is consistency between the outcomes proposed, and demand and expenditure forecasts).		

Continued on the following page

## Management

Guiding questions	Examples for a Basic submission	Examples for a Standard submission	Examples for an Advanced submission	Examples for a Leading submission
	Forecasts for expenditure (including benchmarks for labour, energy and construction costs) and demand are not based on sound methodologies and assumptions.	Forecasts for expenditure (including benchmarks for labour, energy and construction costs) and demand are based on sound methodologies and assumptions.		
	The business has not provided evidence that it has actively sought to reprioritise its expenditure plans to mitigate the cost and price impacts of any new obligations (whether imposed by government or technical regulator, or to address a new service priority revealed through engagement).	The business can demonstrate that it has actively sought to reprioritise its expenditure plans to mitigate the cost and price impacts of any new obligations (whether imposed by government or technical regulator, or to address a new service priority revealed through engagement).		
	The business has not proposed adequate mitigation strategies to avoid any price shocks.	The business has proposed adequate mitigation strategies to avoid any price shocks.		
	The business has not provided timely access to meaningful and robust supporting documentation, on request from the commission.	The business retains meaningful and robust supporting documentation to justify its proposals, with ongoing access available to the commission.		
	The business is not transparent in providing information to the commission on stakeholder views, or any other information or assessments that may be relevant to the assessment of key initiatives or proposals.	The business is transparent in providing information to the commission on stakeholder views or other information or assessments that may be relevant to the assessment of key initiatives or proposals.		

## Outcomes

Guiding questions	Examples for a Basic submission	Examples for a Standard submission	Examples for an Advanced submission	Examples for a Leading submission
Has the business provided evidence that the outcomes proposed have taken into account the views, concerns and priorities of customers?	The business has proposed degradation in customer outcomes, not justified or supported by customer feedback. This represents a reduction in customer value.	The outcomes proposed are broadly consistent with existing levels of service provided to customers.	The outcomes proposed reflect a significant improvement in customer value delivered. This might be demonstrated by significant improvements in output targets (or performance measures) for outcomes that matter most to most customers, or similar targets at significantly lower prices.	The outcomes proposed reflect a very significant improvement in customer value delivered.
Has the business provided sufficient explanation of how the outcomes it has proposed align to the forecast expenditure requested?				
Has the business proposed outputs to support each of its outcomes, which are measurable, robust and deliverable?	Outcomes are not defined in ways that reflect the customer service experience.	All outcomes proposed have been defined in ways that reflect the customer service experience.	The business proposes outcomes that are well ahead of the industry average or the business's own past performance (measured by reference to output targets).	The business proposes outcomes that lead the industry.
Has the business provided evidence that the outputs it has proposed are reasonable measures of performance against stated outcomes?				
Has the business demonstrated a process to measure performance against each outcome and to inform customers?	The business has proposed outputs that are not appropriate measures of performance for each outcome proposed. Measures and deliverables are not clearly defined.	The business has proposed outputs that are appropriate measures of performance for each outcome proposed. Measures and deliverables are clearly defined and unambiguous.		

Continued on the following page

## Outcomes

Guiding questions	Examples for a Basic submission	Examples for a Standard submission	Examples for an Advanced submission	Examples for a Leading submission
	<p>The outcomes proposed do not clearly reflect customer preferences and priorities revealed through engagement.</p>	<p>The outcomes proposed have been prioritised by a water business in terms of importance to customers as revealed through customer engagement. The business's expenditure forecasts reflect the prioritisation of outcomes.</p>		
	<p>Where applicable, the business has not explained or justified why outcomes proposed are not consistent with customer preferences and priorities.</p>	<p>Where applicable, the business has explained or justified why outcomes proposed are not consistent with customer preferences and priorities.</p>		
	<p>The level and composition of forecast expenditure is inconsistent with the outcomes proposed.</p> <p>The expenditure profile has not changed to reflect customer priorities.</p>	<p>The level and composition of forecast expenditure is consistent with the outcomes proposed.</p> <p>The expenditure profile has changed where required to reflect customer priorities.</p>		
	<p>The business has not committed to a process for monitoring and reporting to customers on its performance against outcomes.</p>	<p>The business has an established customer performance reporting approach that is targeted to customer needs, including across different regions and customer types.</p>	<p>The performance reporting approach is justified as being well ahead of peers in terms of accessibility, transparency and information provided to customers on performance.</p>	

## **An approach to establishing a PREMO rating**

We have developed a scoring methodology to assist businesses to rate their price submission against the five elements of PREMO and to rate their overall price submission. We have provided the following scoring methodology as a guide to accompany the PREMO assessment tool — in other words, it is not mandatory that a water business uses the scoring methodology below to rate its price submission.<sup>62</sup>

### **Weighting**

A water business should give equal weighting to all five elements — Performance, Risk, Engagement, Management and Outcomes — when establishing an overall PREMO price submission rating.

### **Scoring and assessment tool**

It is not an expectation that businesses rate or allocate a score against all the matters listed in the PREMO assessment tool, as these are provided as examples of the matters that should be taken into account. Rather, these examples should be used to guide the rating or score for each of the five PREMO elements.

The scoring methodology is predicated on the level of confidence with which a business or the commission considers an element of PREMO meets a particular ambition rating.

Table B summarises possible scores for each element of PREMO graded by confidence level. The component scores for each element of PREMO would be aggregated to inform an overall price submission rating.

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<sup>62</sup> We do not allocate a score against all the matters listed in the PREMO assessment tool when we assess a water business's price submission.

**Table B An approach to scoring for an overall PREMO rating**

Rating	Possible scores for each element of PREMO		Aggregated score for overall PREMO ratings
Leading	4	Very confident the element is 'Leading'	19 to 20
	3.75	Confident the element is 'Leading'	
Advanced	3.5	Very confident the element is 'Advanced'	14.5 to 18.75
	3.25	Confident the element is 'Advanced'	
	3	Satisfied the element is 'Advanced'	
	2.75	Reasonably confident the element is 'Advanced'	
Standard	2.5	Very confident the element is 'Standard'	9.5 to 14.25
	2.25	Confident the element is 'Standard'	
	2	Satisfied the element is 'Standard'	
	1.75	Reasonably confident the element is 'Standard'	
Basic	1.5	Very confident the element is 'Basic'	5 to 9.25
	1.25	Confident the element is 'Basic'	
	1	Satisfied the element is 'Basic'	

NOTE: The original guidance document published in October 2021 showed the aggregated score range for a Standard rating as 9.5 to 13.25. The correct range is 9.5 to 14.25 as shown above.

To reiterate, the scoring methodology outlined here is only a guide. We will assess a water business's reasoning for its overall price submission PREMO rating. In other words, the score as shown above on its own is not justification for a particular price submission rating. Similarly, businesses ultimately have the discretion to select any PREMO price submission rating, even if it may not correspond with an aggregated score.