



# MELBOURNE WATER 2016 PRICE REVIEW

Guidance paper

April 2015

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

Essential Services Commission 2015, *Melbourne Water 2016 Price Review – Guidance paper*, April.

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# 1 KEY MESSAGES

- The Essential Services Commission of Victoria (the Commission) has commenced its review of the prices Melbourne Water can charge from 1 July 2016.
- This paper is the guidance required to be provided by the Commission to Melbourne Water under clause 13 of the Water Industry Regulatory Order (WIRO). The guidance requires Melbourne Water to lodge a price submission with the Commission by 30 October 2015.
- Recent revisions to the WIRO allow the Commission greater flexibility to decide on the approach used to determine prices.
- The Commission will use the building block methodology to determine the prices that Melbourne Water may charge.
- We have used the additional flexibility provided by the WIRO to reduce the administrative burden on Melbourne Water. Where Melbourne Water proposes to maintain the status quo (e.g. tariff structures) we do not require detailed justification in its price submission. The Commission does not require a draft price submission.
- Melbourne Water must consult with customers to prepare its price submission. The manner in which Melbourne Water consults will be for it to decide, but it must be effective (likely requiring a tailored approach depending on the service in question).
- For the purposes of determining the required revenue, an efficiency hurdle of 2 per cent per annum will apply to controllable forecast operating expenditure.
- The Commission is open to Melbourne Water justifying an efficiency carryover mechanism as an additional or alternative form of efficiency incentive.
- We will use a similar approach to past price reviews for determining the weighted average cost of capital. We are open to considering a proposal from Melbourne Water in relation to the methodology used to calculate the cost of debt.
- The Commission intends to release a draft decision on Melbourne Water's prices in February 2016, and a final decision and price determination by June 2016.



## 2 INTRODUCTION

The Essential Services Commission of Victoria (the Commission) has commenced its review of the maximum prices Melbourne Water can charge for its water, sewerage, waterways and drainage services for its fourth regulatory period from 1 July 2016.<sup>1</sup>

The Commission's pricing powers and functions in Victoria's water industry are informed by the Water Industry Regulatory Order (WIRO),<sup>2</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).

The Commission 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 Melbourne Water may charge for prescribed services.<sup>3</sup> The WIRO requires the Commission to assess a price submission prepared by Melbourne Water, and form an opinion on whether the price submission:

- complies with guidance issued by the Commission, and
- has adequate regard for the matters specified in clause 11 of the WIRO.

If the Commission forms a view that the price submission satisfies the criteria above, then we must approve Melbourne Water's price submission – otherwise, the Commission is afforded discretion to specify maximum prices.<sup>4</sup>

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<sup>1</sup> Under the Commission's most recent price determination for Melbourne Water (2013), approved prices are scheduled to cease on 30 June 2016.

<sup>2</sup> The WIRO is available at <http://www.gazette.vic.gov.au/gazette/Gazettes2014/GG2014G043.pdf#page=45>, pp 41-51.

<sup>3</sup> WIRO, clause 10(a). The prescribed services are listed at clause 7(b) of the WIRO.

<sup>4</sup> WIRO, clause 14.

This paper is the guidance required to be provided by the Commission to Melbourne Water under clause 13 of the WIRO. Clause 13 of the WIRO is provided at **Attachment 1**. Specifically, the guidance sets out the Commission’s approach to the price review and specifies our information requirements for Melbourne Water’s price submission.

In February 2015, the Commission released a paper to provide a basis for us to consult with stakeholders prior to finalising our guidance. We have considered feedback received from stakeholders in developing this guidance. Our response to matters raised in submissions to the consultation paper is available on our website.

## 2.1 STRUCTURE OF THIS GUIDANCE

This guidance is structured as follows:

- Chapter 2 sets out the background to this review process, specifies the timing and processes the Commission proposes to follow in making a price determination, as well as the approach to any amendment of this guidance
- Chapter 3 sets out:
  - the manner in which the Commission proposes to regulate prices, and
  - the approach and methodology that will be used to assess Melbourne Water’s price submission and make a price determination.
- Chapter 4 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
  - the supporting information required to be included in the price submission.
- Chapter 5 sets out our expectations as to the consultation to be undertaken by Melbourne Water in preparing its price submission.

## 2.2 TIMELINES

The timelines for Melbourne Water's 2016 price review are set out in Table 2.1.<sup>5</sup> Melbourne Water must lodge its price submission to the Commission by **30 October 2015**.<sup>6</sup> If Melbourne Water fails to lodge its submission by this date, the Commission may use its discretion to specify maximum prices. The Commission will make a determination in order for new prices to be implemented by 1 July 2016.

All other dates are indicative at this stage. Further guidance will be issued later in the price review to confirm the timing of other steps in the process.

**TABLE 2.1 MELBOURNE WATER 2016 PRICE REVIEW TIMELINE**

Dates	Activity
April 2015 to October 2015	Melbourne Water consults with stakeholders on price submission
30 October 2015	Melbourne Water's price submission must be submitted to the Commission
2 November 2015	The Commission commences assessment of price submission and commences consultation
19 February 2016	The Commission publishes draft decision
22 February 2016 to 21 April 2016	The Commission commences consultation on draft decision
1 June 2016	The Commission publishes final decision
1 July 2016	Melbourne Water's new prices come into effect

<sup>5</sup> Clause 13(vi) of the WIRO requires us to provide guidance on the timing and processes the Commission proposes to follow in making a price determination. Clause 13(vii) also requires use to specify the date by which Melbourne Water is to deliver its price submission to the Commission.

<sup>6</sup> Yarra Valley Water proposed that the Commission bring forward the timing of key stages of the price review by three weeks (compared with the dates proposed in the Commission's consultation paper to inform our guidance). See:

<http://www.esc.vic.gov.au/getattachment/9752540f-7109-468e-adfa-4f92ea955c92/Yarra-Valley-wter.pdf>

While we have brought forward the Commission's draft decision to 19 February 2016 consistent with Yarra Valley Water's proposal, we have brought forward the due date for Melbourne Water's submission by three working days to 30 October 2015. This is to enable sufficient time for Melbourne Water to effectively consult with interested parties and develop its proposals.

## 2.3 AMENDMENTS TO THIS GUIDANCE

The Commission 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 or regulations, for example). We will consult with stakeholders where any additional guidance or amended guidance results in a material change to the methodology or processes we adopt in the price review.

# 3 OUR APPROACH TO THE PRICE REVIEW

This Chapter sets out:

- the manner in which the Commission proposes to regulate prices<sup>7</sup>
- the Commission’s approach and methodology to assessing Melbourne Water’s price submission,<sup>8</sup> and
- our approach to consultation during the review process.<sup>9</sup>

## 3.1 THE MANNER IN WHICH THE COMMISSION PROPOSES TO REGULATE PRICES

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

The Commission will use the building block methodology to determine the revenue that will provide Melbourne Water with a reasonable opportunity to recover efficient costs of providing regulated services and to comply with relevant health, safety, environmental, social and other regulatory obligations, over its fourth regulatory period.

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<sup>7</sup> WIRO, clause 13(a)(i).

<sup>8</sup> WIRO, clause 13(a)(ii).

<sup>9</sup> WIRO, clause 13(a)(viii).

The building block methodology involves the following steps:

- first, the Commission will determine the regulatory period
- second, service outcomes for each of the regulated services that Melbourne Water proposes to deliver will be assessed to validate that they reflect government (including regulator) obligations or demonstrated customer needs, and
- third, the following “building blocks” will be determined in accordance with governing criteria (specified in Chapter 4), to:
  - establish an efficient level of operating expenditure
  - establish an efficient level of capital expenditure
  - calculate the regulatory asset base
  - apply a rate of return to the regulatory asset base, and
  - establish the tax allowance.

These “building blocks” will determine the forecast required revenue for Melbourne Water to deliver on its service outcomes and obligations. The Commission proposes to approve prices to achieve the required revenue, having regard to forecast demand.

A summary of the building block methodology is shown in Figure 3.1.

In the past, the Commission has determined price caps (that is, maximum prices) for the majority of Melbourne Water’s services including tariffs for bulk water storage and transfer, bulk sewerage usage, and waterways and drainage services.<sup>10</sup> These tariffs account for the majority of Melbourne Water’s required revenue. For recycled water, developer charges and miscellaneous charges, we have enabled Melbourne Water to set its prices in accordance with pricing principles.<sup>11</sup>

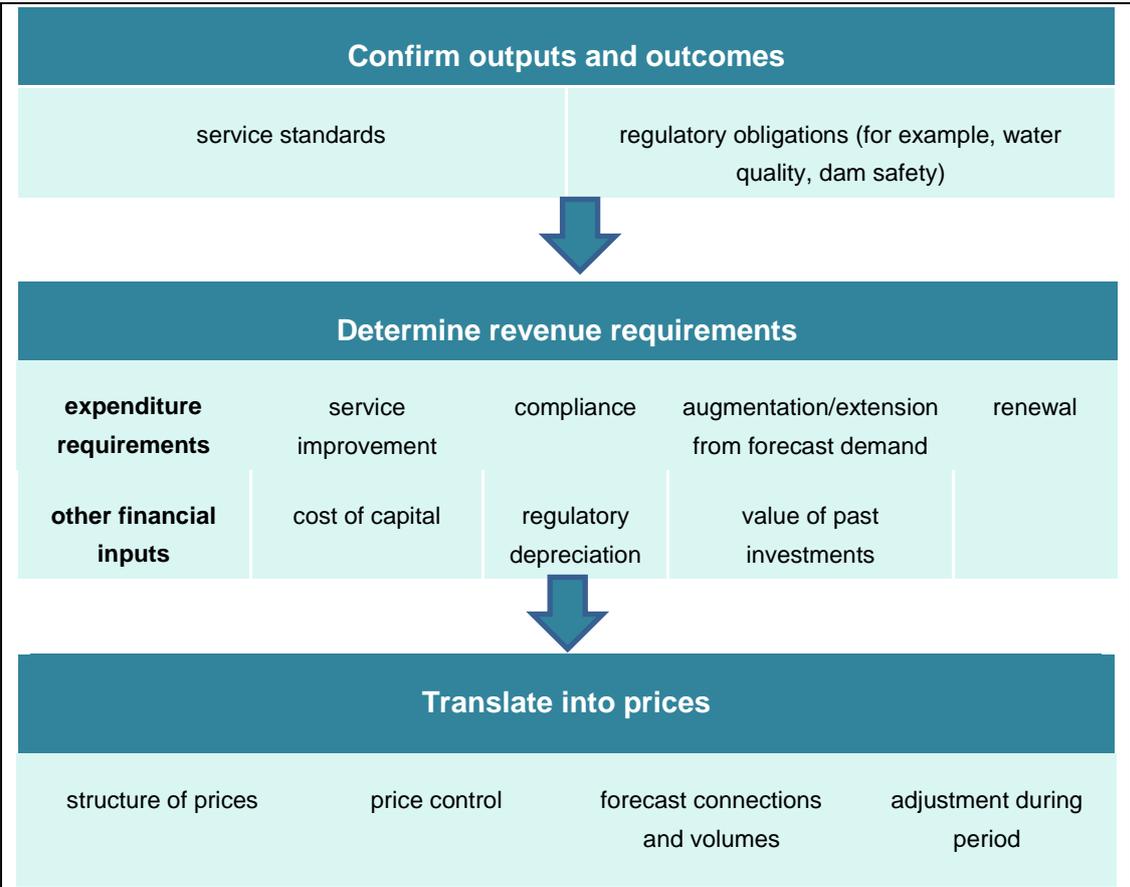
The Commission proposes that the current forms of price control be maintained.

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<sup>10</sup> See, Essential Services Commission 2013, *Metropolitan Melbourne Water Price Review 2013, Melbourne Water Determination 1 July 2013-30 June 2016*, June, Schedule 2.

<sup>11</sup> See, Essential Services Commission 2013, *Metropolitan Melbourne Water Price Review 2013, Melbourne Water Determination 1 July 2013-30 June 2016*, June, Schedule 4.

**FIGURE 3.1 STEPS IN ASSESSING AND APPROVING PRICES FOR THE MAJORITY OF MELBOURNE WATER'S SERVICES**



## **3.2 APPROACH AND METHODOLOGY TO ASSESSING MELBOURNE WATER'S PRICE SUBMISSION**

The Commission's regulatory task is to assess Melbourne Water's price submission and form a view about whether or not the price submission:

- complies with guidance issued by the Commission, and
- has adequate regard for the matters specified in clause 11 of the WIRO.

### **3.2.1 ASSESSING COMPLIANCE WITH THIS GUIDANCE**

The Commission's expectation is that Melbourne Water's price submission will comply with Chapter 4 of this guidance. We will assess whether Melbourne Water has sufficiently justified its proposals in accordance with the governing criteria in Chapter 4, and satisfied all of the information requirements. Melbourne Water must also lodge its price submission to the Commission by 30 October 2015.

### **3.2.2 ASSESSING THE EXTENT TO WHICH THE PRICE SUBMISSION HAS REGARD FOR MATTERS SPECIFIED IN CLAUSE 11**

Clause 11 of the WIRO refers to matters in the ESC Act and the WI Act, and specifies a number of additional matters (at clause 11(d)) that Melbourne Water must have regard to.<sup>12</sup>

Melbourne Water is required to support its proposals in relation to each of the components of the building block methodology by reference to the matters in clause 11 of the WIRO. In doing so, Melbourne Water is required to place particular emphasis on

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<sup>12</sup> We have grouped the matters in clause 11 of the WIRO into themes as set out in Attachment 2.

the matters in clause 8(b) of the WIRO – that is, demonstrate that its price submission has been adequately influenced by the promotion of efficiency.<sup>13</sup>

Chapter 4 sets out a number of discrete considerations which we expect the price submission to cover in order to demonstrate that Melbourne Water has fully and meaningfully addressed the clause 11 matters in its price submission.

We will also assess whether Melbourne Water has adopted an effective approach to considering the WIRO clause 11 matters – for example, through effective stakeholder consultation, regulatory precedent, third party research and analysis.

### 3.2.3 CONSEQUENCES

If the Commission forms an opinion that Melbourne Water’s price submission complies with this guidance and has adequate regard for the matters specified in clause 11 of the WIRO, the Commission will approve Melbourne Water’s proposed maximum prices.

If the Commission forms an opinion that Melbourne Water’s price submission does not comply with this guidance or does not have adequate regard to the matters specified in clause 11 of the WIRO, we may exercise our discretion to reject Melbourne Water’s price submission and specify prices (or the manner in which prices may be calculated, determined or otherwise regulated).<sup>14</sup>

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<sup>13</sup> In summary, clause 8(b) of the WIRO provides that in having regard to the overarching objectives in the ESC Act and the WI Act, particular emphasis is to be placed on:

- (i) the promotion of efficient use of prescribed services by customers;
- (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>14</sup> WIRO, clause 14(b)(i).

### 3.3 CONSULTATION BY THE COMMISSION

The Commission will undertake its own consultation in order to test Melbourne Water's proposals against the matters in clause 11 of the WIRO. The Commission will engage with interested parties as broadly as practicable, and tailor our consultation to reflect stakeholder comments and work undertaken by Melbourne Water.

The Commission will establish a Water Price Review Customer Panel (along similar lines to the Panel established during our 2013 water price review) to inform our assessment of Melbourne Water's proposals. We will also consult with agencies such as the Department of Environment, Land, Water and Planning, the Department of Health and Human Services, and the Environment Protection Authority Victoria. The Commission will also consult with the Energy and Water Ombudsman (Victoria).

The Commission will make its papers (including the reports of consultants assisting us in our review), Melbourne Water's submissions, and submissions from other interested parties, available on our website ([www.esc.vic.gov.au](http://www.esc.vic.gov.au)) subject to any confidentiality issues.

# 4 REQUIRED CONTENTS OF MELBOURNE WATER'S PRICE SUBMISSION

This Chapter sets out mandatory requirements on Melbourne Water in the preparation of its price submission. In particular, this Chapter sets out governing criteria and supporting information requirements for:

- the regulatory period (section 4.1) and service outcomes (section 4.2), and
- each of the building blocks which comprise the required revenue (sections 4.3 to 4.10), as well as forecast demand (section 4.11).

Information requirements are also specified for the form of price control, prices and tariff structures, price adjustment mechanisms (sections 4.12 to 4.14), and developer charges (section 4.15).

General requirements relating to financial indicators, the basis upon which information is provided, and other requirements are specified in sections 4.16 to 4.18.

Melbourne Water's price submission is required to fully and clearly document, explain and justify its proposed maximum prices for prescribed services over its fourth regulatory period. While the Commission expects that Melbourne Water will provide a fully supported price submission, our review process seeks to minimise the compliance costs for Melbourne Water.

Where Melbourne Water is proposing the status quo (for example, in terms of service outcomes or tariff structures) we do not require detailed justification in the price submission. Further, in considering the information required to support its price submission, the Commission notes that much of that information should be readily available to Melbourne Water, and relevant for other purposes such as corporate planning or project justification and prioritisation.

## 4.1 REGULATORY PERIOD

### 4.1.1 CRITERIA

The Commission is required to set the term of the regulatory period over which Melbourne Water's price determination will apply.<sup>15</sup> We propose to approve a five year regulatory period starting 1 July 2016, but remain open to alternative proposals.

A five year regulatory period provides the following benefits:

- a relatively long period of certainty for Melbourne Water's customers about the outcomes to be delivered and prices to be charged
- sufficient time for Melbourne Water to focus on service delivery and for the incentive mechanisms within the pricing framework to be implemented, and
- certainty for water retail businesses in terms of their bulk charges.

A risk associated with a longer regulatory period than proposed by the Commission is that revenue or expenditure outcomes 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).

### 4.1.2 SUPPORTING INFORMATION

If Melbourne Water proposes a five year regulatory period, it needs only to state this in its price submission.

If the price submission proposes a different term, then the price submission must:

- provide reasons having regard to the benefits and risks identified by the Commission in section 4.1.1, and
- outline the results of Melbourne Water's consultation with the water retail businesses and how this has been taken into account.

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<sup>15</sup> WIRO, clause 9.

## 4.2 SERVICE OUTCOMES

### 4.2.1 CRITERIA

Service outcomes must reflect government obligations (including obligations imposed by technical regulators) or a demonstrated customer need.

For service outcomes not relating to clearly defined government (including regulator) obligations, it will be critical for Melbourne Water's price submission to demonstrate that proposed service outcomes are supported by reference to clear evidence of customers' willingness to pay for those outcomes.

Only forecast expenditure related to clearly defined obligations, or supported by clear evidence of customers' willingness to pay, will be approved by the Commission.

### 4.2.2 SUPPORTING INFORMATION

Melbourne Water's price submission must specify:

- each service which is to be supplied by Melbourne Water and regulated by the Commission as part of this review,<sup>16</sup> and
- proposed service outcomes.

Melbourne Water's price submission must also:

- for each proposed service outcome, identify whether it reflects:
  - a government obligation (including obligations imposed by technical regulators) such as those set out in Statements of Obligations, or
  - a customer need, demonstrated via cost benefit analysis, evidence of customer willingness to pay, or similar evidence or study.
- where the proposed service outcome reflects a customer need:

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<sup>16</sup> The prescribed services in respect of which the Commission has power to regulated prices are set out in clause 7(b) of the WIRO.

- explain how consultation with customers (including water retail businesses for Melbourne Water’s water and sewerage services, and residential and non-residential customers for waterways and drainage services) has informed the proposed service outcomes, and
- provide evidence of customer willingness to pay for that standard of service (for example, via a willingness to pay study or similar evidence), and
- identify any proposed changes to service outcomes from the third regulatory period and provide justification for the changes.

## 4.3 REQUIRED REVENUE

### 4.3.1 CRITERIA

Melbourne Water’s required revenue for its fourth regulatory period must be determined using the building block methodology, under which the building blocks are:

- prudent and efficient forecast operating expenditure – determined in accordance with section 4.4 (and having regard to matters in sections 4.5 and 4.7)
- prudent and efficient forecast capital expenditure – determined in accordance with section 4.5 (and having regard to matters in section 4.7)
- the regulatory asset base – determined in accordance with section 4.8
- the rate of return – determined in accordance with section 4.9, and
- the tax allowance – determined in accordance with section 4.10.

### 4.3.2 SUPPORTING INFORMATION

The price submission must specify Melbourne Water's forecast total revenue required for the fourth regulatory period. The forecast revenue required must also be provided for each year of the fourth regulatory period.

The price submission must also provide an estimate of the required revenue for each year after the fourth regulatory period to 2025-26, providing a brief explanation of the trend in the forecast over the ten year period from 1 July 2016.<sup>17</sup>

## 4.4 FORECAST OPERATING EXPENDITURE

### 4.4.1 CRITERIA

The forecast operating expenditure to be included for the purposes of determining the required revenue 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**).

### 4.4.2 SUPPORTING INFORMATION

Melbourne Water's price submission must include total prudent and efficient forecast operating expenditure for the fourth regulatory period, including a forecast for each year of the fourth regulatory period. Prudent and efficient forecast operating expenditure is to be presented separately for each major service category; that is, water, sewerage and drainage and waterways.<sup>18</sup>

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<sup>17</sup> An additional five years of financial data (beyond the fourth regulatory period) is needed by the Commission to provide a longer-term context for Melbourne Water's proposed prices for the fourth regulatory period. This longer term data may inform the Commission's decision on prices for the fourth regulatory period.

<sup>18</sup> The figures presented must reconcile to the total, which will require a separate estimate to be derived for other services delivered by Melbourne Water including recycled water and diversions.

For total and annual forecast operating expenditure and for each major service category, forecast operating expenditure should be further broken down into the following cost categories:

- operations and maintenance
- desalination payments
- treatment
- licence fees
- customer service and billing
- corporate costs, and
- other operating expenditure.

In preparing forecast operating expenditure, Melbourne Water must establish baseline operating expenditure which comprises controllable costs from the last full year of actual data (2014-15). The baseline must be adjusted for:

- any one-off or non-recurring expenditure items incurred in that year, and
- efficiency commitments made by Melbourne Water following its efficiency review in 2014.<sup>19</sup>

Using the 2014-15 baseline, Melbourne Water must propose annual changes to operating expenditure for each year of the fourth regulatory period, including forecast customer growth assumptions.

Melbourne Water must also specify actual operating expenditure for the third regulatory period (using forecasts for 2015-16), categorised in the same way as above.

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<sup>19</sup> All Victorian water businesses undertook an efficiency review in 2014 as part of Fairer Water Bills.

Melbourne Water's price submission must also:

- explain and justify the methodology used to develop the forecast operating expenditure (including adjustments made to the baseline year of operating expenditure and the approach to allocating shared costs)<sup>20</sup>
- identify and explain the key assumptions which underpin Melbourne Water's forecast operating expenditure forecasts (total and for each major service), referring to the cost categories listed above and other cost drivers<sup>21</sup>
- explain the reasons for the trend or any major annual variations in forecast operating expenditure (including identifying cost items that are having an upward or downward influence on operating expenditure), as compared to historic operating expenditure
- justify the forecast operating expenditure against the criteria in section 4.4.1, taking into account:
  - proposed service outcomes, and in particular, the service needs of customers as identified in the course of consultation
  - forecast customer growth
  - the impact of proposed capital projects
  - the Commission's requirement for a 2 per cent annual efficiency improvement (section 4.5)
  - any relevant industry or economy-wide benchmarks of expenditure (Melbourne Water must provide any benchmarking reports to the Commission)
  - the substitution possibilities between forecast operating expenditure and forecast capital expenditure, and

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<sup>20</sup> Including the method and rationale for allocating indirect costs between Melbourne Water's regulated activities and other non-regulated activities/functions and the allocation of indirect costs across regulated services.

<sup>21</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
- carbon tax repeal, and
- information technology costs.

- provide an estimate of total forecast operating expenditure for each year after the fourth regulatory period up until 2025-26 (including a breakdown by service category and cost category, as above).

## 4.5 FORECAST EFFICIENCY IMPROVEMENTS

### 4.5.1 CRITERIA

For the purposes of determining the required revenue, an efficiency adjustment factor of 2 per cent per annum must be applied to the 2014-15 baseline operating expenditure defined in 4.4.2.<sup>22</sup> The adjustment factor will apply to prudent and efficient controllable operating expenditure in 2015-16 and each subsequent year.

### 4.5.2 SUPPORTING INFORMATION

The price submission must:

- provide a brief description of Melbourne Water's current and expected efficiency programs (separately identifying the efficiency programs arising from the 2014 efficiency review, including shared services initiatives), and
- for each current and expected efficiency program, identify the forecast efficiency saving and which major service category that saving relates to (that is, water, sewerage, waterways and drainage services).

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<sup>22</sup> In past price reviews, the Commission has used a 1 per cent efficiency factor. We have decided on a 2 per cent efficiency factor to reflect the approach of other regulators. See: Essential Services Commission 2015, *Proposed approach to Melbourne Water's 2016 price review – Consultation paper*, February, pp 33-34. Further, a shareholder review of the efficiency of Melbourne Water following the 2013 price review identified cost savings of more than 1 per cent per annum.

Separately, the Commission is open to Melbourne Water proposing an efficiency carryover mechanism as an additional or alternative form of efficiency incentive. If Melbourne Water proposes an efficiency carryover mechanism, the price submission must:

- clearly articulate why an efficiency carryover mechanism is needed
- explain how the mechanism would work, and
- explain how the mechanism will deliver stronger incentives for efficiency gains and deliver benefits for customers.

Further, our expectation is that any efficiency carryover would be symmetrical; that is, the carryover mechanism should treat any cost overruns as an inefficient outcome, and penalise the business for these in the same way it rewards the business for outperforming the forecast cost level.

## 4.6 FORECAST CAPITAL EXPENDITURE

### 4.6.1 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 on service outcomes, taking into account a long-term planning horizon (**prudent and efficient forecast capital expenditure**).

### 4.6.2 SUPPORTING INFORMATION

Melbourne Water's price submission must include total prudent and efficient forecast capital expenditure for the fourth regulatory period, including prudent and efficient forecast capital expenditure for each year of the fourth regulatory period.

Prudent and efficient forecast capital expenditure is to be presented separately for each major service category; that is, water, sewerage and waterways and drainage.<sup>23</sup>

In addition, forecast capital expenditure in total, and for each major service category, must be separated into the following: (i) forecast capital expenditure to maintain service standards (that is, renewals) and (ii) forecast capital expenditure to improve or expand services (that is, growth, improved services, and to comply with changed government or regulator obligations).

Melbourne Water must also specify actual capital expenditure for the third regulatory period (including a forecast for 2015-16), categorised in the same way as above.

Melbourne Water's price submission must also:

- for each year of the fourth regulatory period, provide annual forecasts for capital expenditure (for forecast capital expenditure relating to each major service category, and in total) separately identifying and reconciling:
  - total capital expenditure
  - contributions (government and customer)
  - gifted assets
  - proceeds from asset sales
  - written down value of assets disposed, and
  - net capital expenditure.
- explain the methodology used to estimate forecast capital expenditure
- base the capital expenditure forecast on P50 cost assumptions<sup>24</sup>
- identify and explain the key assumptions which underpin Melbourne Water's capital expenditure forecasts by each major service category, and how any risks or uncertainties have been addressed
- 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

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<sup>23</sup> The figures presented must reconcile to the total, which will require a separate estimate to be derived for other services delivered by Melbourne Water including recycled water and diversions.

<sup>24</sup> P50 is the estimate for which there is an equal probability that the cost of a project will be higher or lower.

downward influence on capital expenditure), as compared to historic capital expenditure

- justify the forecast capital expenditure forecast against the criteria in section 4.6.1, taking into account:
  - proposed service outcomes, and in particular, the service needs of the water retail businesses (for water and sewerage services) and residential and non-residential customers (for waterways and drainage services) as identified in the course of consultation
  - forecast demand
  - any relevant industry or economy-wide benchmarks of expenditure
  - the substitution possibilities between forecast operating expenditure and forecast capital expenditure, and
- provide an estimate of total capital expenditure for each year after the fourth regulatory period up until 2025-26 (including a breakdown by service category and cost category, and identifying and reconciling total capital expenditure, contributions (government and customer), gifted assets, proceeds from asset sales, written down value of assets disposed, and net capital expenditure).

Separate information must be provided for Melbourne Water's major capital projects.<sup>25</sup>

The price submission must also:

- identify the major capital expenditure projects proposed, for each providing:
  - the project name and scope
  - justification for the project, including the cost driver
  - start and completion dates
  - total capital cost (itemising any contributions), and expenditure by year
  - outcomes to be delivered, and
  - the incentive and penalty payment arrangements with contractors.<sup>26</sup>

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<sup>25</sup> This includes the top 15 discrete capital projects (by total project cost) to be started or completed during the fourth regulatory period, comprising the top five projects in the three main asset categories of water, sewerage and waterways and drainage, as well as any other individual projects with a total value over \$50 million.

<sup>26</sup> Melbourne Water'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.

- for each major capital expenditure project, make available:
  - a business case outlining the options considered for achieving the identified outcomes and the approach to identifying the optimal solution,<sup>27</sup> and
  - any risk analysis of the selected option and plans to mitigate the identified risks to ensure the project can be delivered on time.

Melbourne Water’s price submission must itemise major ongoing capital renewal programs (for example, water main renewals) separately to the major projects.

## 4.7 TREATMENT OF DESALINATION SECURITY PAYMENTS

### 4.7.1 CRITERIA

For the purposes of determining the required revenue, Melbourne Water must propose an approach to the recovery of forecast annual security charges associated with the Victorian desalination plant (**desalination security payments**) that:

- reflects reasonably based assumptions about the operating and capital-related components of the desalination security charge, and
- adopts a time profile for recovery of the capital-related component of the desalination security charge which best meets the following:
  - that prices provide signals about the efficient costs of providing services to current and future customers
  - the alignment of the recovery of costs by Melbourne Water with the time period over which the security service will be provided
  - the views of customers (the water retail businesses and their customers), and
  - the financial viability of Melbourne Water (taking into account the financial indicators specified in section 4.16).

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<sup>27</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 must be based on the P50 estimate.

## 4.7.2 SUPPORTING INFORMATION

Melbourne Water's price submission must, in relation to the annual security payments associated with the Victorian desalination plant, specify the amount attributed to forecast operating and capital expenditure.

Melbourne Water's price submission must also:

- describe and quantify capitalisation scenarios considered, including in terms of:
  - estimated impact on residential and non-residential water and sewerage customers, and
  - Melbourne Water's financial position (in accordance with the Commission's financial indicators specified in section 4.16)
- identify its preferred approach to recovering the desalination security payments and justify how this approach best meets the matters raised in section 4.7.1
- provide a description of how Melbourne Water consulted with customers, and a summary of the views received from customers, and
- describe how the views received from customers were taken into account in determining the time profile for recovering the desalination security payments.

The price submission must also include, and justify, all assumptions used in modelling various scenarios. This includes assumptions about:

- forecasts for desalination security payments (including assumptions about estimates of the breakdown of the desalination security payments between operating costs and the capital-related costs), and
- depreciation (asset life) assumptions for the desalination plant.

## 4.8 FORECAST REGULATORY ASSET BASE

### 4.8.1 CRITERIA

The regulatory asset base (**RAB**) to be included for the purposes of determining the required revenue 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.

### 4.8.2 CALCULATING THE ROLL-FORWARD OF THE RAB

Melbourne Water's price submission must propose:

- the opening value of the RAB at 1 July 2016, and
- the forecast value of the RAB for each year of the fourth regulatory period,

in accordance with section 4.8.1.

The opening RAB must be calculated as follows:

$$\begin{aligned} \text{Opening RAB 1 July 2016} &= \text{RAB at 1 July 2013} \text{ adjusted to reflect 2012-13 actual} \\ &+ \text{Actual capital expenditure (gross)} \text{ 2013-14 to 2014-15} \\ &+ \text{Forecast capital expenditure (gross)} \text{ 2015-16}^* \\ &- \text{Actual contributions} \text{ 2013-14 to 2014-15} \\ &- \text{Forecast contributions} \text{ 2015-16}^* \\ &- \text{Forecast regulatory depreciation} \text{ 2013-14 to 2015-16}^* \\ &- \text{Proceeds from disposal of assets} \text{ 2013-14 to 2014-15} \\ &- \text{Forecast proceeds from disposal of assets} \text{ 2015-16}^* \end{aligned}$$

(\* denotes the forecast benchmark in Melbourne Water's 2013 price determination)

The same approach must be used to determine the opening value on 1 July for each subsequent year in the fourth 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 2013) must be adjusted for inflation (based on the Consumer Price Index – all Groups, Australia) over the third regulatory period.

### 4.8.3 SUPPORTING INFORMATION

Melbourne Water's price submission must also:

- provide justification that capital expenditure in 2012-13 and in the period 2013-14 to 2014-15 meets the criteria in section 4.6.1 (for it to be included in the roll-forward of the opening RAB for 1 July 2016)
- provide a reconciliation of actual net capital expenditure against the benchmarks allowed in Melbourne Water's 2013 price determination, as well as for each of the major capital projects identified in the determination
- provide estimates for regulatory depreciation, and justify that the estimates reflect reasonable assumptions about asset life and utilisation (noting regulatory depreciation must not be claimed for any asset until the asset is in service)
- 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, and
  - the value of gifted assets – assets constructed and then handed over to the water business to operate and maintain, and
- include estimates of revenue expected from disposal of assets for each year from 1 July 2016, to be deducted from the roll forward of the RAB.

## 4.9 REGULATORY RATE OF RETURN

### 4.9.1 CRITERIA

The percentage rate used to calculate a rate of return (on the RAB), and included for the purposes of determining the required revenue must be established via a weighted average cost of capital (**WACC**) determined in accordance with the following criteria:

- the cost of equity is to be estimated using the domestic capital asset pricing model based on the Officer model
- the formula for the WACC is:

$$\text{WACC} = \text{Re} ( E / V ) + \text{Rd} ( D / V )$$

Where:

Re = cost of equity

Rd = cost of debt

E = market value of the business's equity

D = market value of the business's debt

V = E + D

E/V = proportion of financing that is equity

D/V = proportion of financing that is debt.

- the cost of equity is to be calculated using a market risk premium of 6 per cent
- the risk free rate is to be based on the yield of a Commonwealth Government Security bond (of a specified term to maturity)
- the cost of equity is to be calculated using an equity beta of 0.65, and
- the benchmark debt risk premium is to be estimated on the basis of a benchmark gearing level of 60:40 debt to equity on the yields of BBB rated corporate bonds.

Market-based estimates reported in nominal terms (such as bond rates) must be converted to real terms.<sup>28</sup> The Commission will use latest market forecasts for the inflation rate to convert the nominal estimates to real estimates.

Melbourne Water has indicated that it would prefer the use of a “trailing average”<sup>29</sup> approach to estimating the cost of debt, rather than the “on the day approach”<sup>30</sup> previously used by the Commission. We are open to exploring a change in our approach to the cost of debt. Any change must be justified by Melbourne Water in its price submission. We will also take into account the views of other interested parties.

#### 4.9.1 SUPPORTING INFORMATION

If Melbourne Water’s price submission proposes that the cost of debt be calculated using the trailing average approach, then the submission must:

- explain the methodology proposed
- specify whether the trailing average will relate to the calculation of (i) the risk free rate, (ii) the debt risk premium, or both, and justify the proposed approach
- specify the proposed averaging period, and explain why the proposed averaging period was preferred among the options considered
- specify whether the calculation of the cost of debt via the trailing average approach will be weighted to reflect Melbourne Water’s borrowing profile (rather than using an arithmetic mean), and the reasons why/why not
- specify the term to maturity of bonds used to establish the risk free rate and debt risk premium, including the reasons for preferring the proposed term to maturity
- explain any transition arrangements that will be put in place, and
- justify how the proposed approach better meets the matters in clause 11 of the WIRO.

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<sup>28</sup> The Fisher equation will be used to convert from nominal to real estimates; that is:

$$(1 + \text{nominal rate}) = (1 + \text{real rate}) * (1 + \text{inflation rate})$$

<sup>29</sup> Typically estimated by averaging the estimated daily risk free rate over a 5 or 10 year period.

<sup>30</sup> Typically estimated by averaging the estimated daily risk free rate over a 20 or 40 working day period.

## 4.10 TAX ALLOWANCE

### 4.10.1 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 Melbourne Water. In estimating the value of imputation credits Melbourne Water must multiply the annual estimated corporate income tax bill by an imputation factor.

This is consistent with the income tax calculation in the Commission's financial model.

### 4.10.2 CALCULATING THE TAX ALLOWANCE

Once populated by Melbourne Water, the financial model will include an estimate of Melbourne Water's future nominal tax allowance based on the following formula:

$ETC_t = (ETI_t \times r_t) (1 - \gamma)$ , 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 (currently 30 per cent), and
- $\gamma$  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 fourth regulatory period:

- the revenue and expenditure estimates used in the calculation is consistent with the 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 (implied in the WACC estimate) and the assumed stock of debt (that is, gearing multiplied by the regulatory asset base), and
- the calculation allows for an adjustment to reflect tax depreciation.

The financial model provides an adjustment to nominal tax allowance for inflation, in order to derive the real tax allowance for each regulatory year. This estimate must be used by Melbourne Water as the basis for its tax allowance forecasts. The forecast tax allowance may also be informed by Melbourne Water's latest estimate of tax to be paid over the fourth regulatory period.

#### **4.10.3 SUPPORTING INFORMATION**

Melbourne Water's price submission must propose a total tax allowance for the fourth regulatory period. An estimate must also be provided for each year of the fourth regulatory period.

The price submission must also:

- clearly state the basis on which the tax allowance for the fourth regulatory period has been calculated
- provide an estimate of the income tax for each year after fourth regulatory period up until 2025-26, and
- provide Melbourne Water's latest corporate forecasts for annual tax payments for the fourth regulatory period, and make available to the Commission the basis for the forecasts.

## 4.11 DEMAND

### 4.11.1 CRITERIA

For the purposes of determining maximum prices, demand forecasts must represent the best available estimates derived from an appropriate forecasting methodology. Reasonable assumptions must also be used about the key drivers of demand over the fourth regulatory period. The forecasts must also have been developed in consultation with the metropolitan water retail businesses.

### 4.11.2 SUPPORTING INFORMATION

Melbourne Water's price submission must include forecast demand for each year of the fourth regulatory period. Demand forecasts must be provided for each tariff.

Melbourne Water's price submission must also:

- provide information that describes the methodology used, identifies the key demand forecasting issues and lists and justifies the key assumptions adopted in generating the forecasts (including the use of desalination water)
- explain where price elasticity assumptions were applied, the inputs used, and how the assumptions were translated into the demand forecasts
- provide evidence that a range of supply and demand scenarios were modelled, including low, normal and high scenarios
- explain why the demand forecasts adopted were chosen over other scenarios
- explain how demand forecasts are consistent with proposed prudent and efficient forecast operating and capital expenditure
- outline feedback from water retail businesses on demand forecasts, and explain how their feedback has been taken into account in deriving the forecasts, and
- provide forecasts of demand for each tariff for each year beyond the fourth regulatory period up until 2025-26.

## 4.12 FORM OF PRICE CONTROL

The Commission's intention is to approve Melbourne Water's form of price control if it proposes no change to its current approach. No justification would be required in the price submission if no change is proposed—the submission must only clearly state the proposed form of price control for each service over the fourth regulatory period.

If Melbourne Water plans to alter its form of price control for any regulated service, the price submission must:

- explain how the proposed form of control would operate and services affected
- demonstrate it has consulted with potentially affected customers
- justify the proposed changes taking into account relevant matters in clause 11 of the WIRO, and explain how a transition to a new form of price control may impact customers and Melbourne Water's approach to minimising any adverse impacts.

In assessing any alternative form of price control, the Commission will place a strong weighting on the views of water retail businesses and affected customers.

## 4.13 PRICES AND TARIFF STRUCTURES

Melbourne Water's price submission must specify the structure of each tariff it proposes to apply in the fourth regulatory period and the price to be charged (or the manner in which price will be calculated or otherwise regulated).

Proposed tariffs must support the WIRO principle to provide signals to customers about the efficient costs of providing services. A two part charge comprising a fixed charge and a volumetric component is preferred to recover a bulk supplier's revenue requirement from its customers for each bulk water service.

Melbourne Water's price submission must also:

- include a tariff schedule, listing each tariff proposed and the price to be charged
- for any changes in tariff structures or new tariffs:
  - state how each tariff is to be applied, for example, billing period, customer class, applying prices through connection or meter size

- describe the relationship between the proposed price for a service and the associated long run marginal cost
  - provide data and supporting information that describes how proposed tariffs are consistent with providing signals about the efficient cost of delivering services<sup>31</sup>
  - justify how the proposed change delivers better signals to customers about the efficient costs of service provision, and
  - provide a summary of Melbourne Water’s approach to consultation and how the views of customers informed the price submission.
- for price changes of more than 10 per cent for any tariff in any year for the fourth regulatory period:<sup>32</sup>
    - describe the relationship between the cost of service provision and the proposed price
    - provide a summary of Melbourne Water’s approach to consultation (including the approach to identifying affected customers)
    - summarise the customer feedback received on the proposed price increase, and
    - describe the transition arrangements considered, and ultimately proposed, for affected customers.
  - describe proposed reforms to non-residential waterways and drainage tariffs, and justify reforms against the matters in clause 11 of the WIRO,<sup>33</sup> and
  - provide estimated tariffs for each service for each year beyond the fourth regulatory period up until 2025-26.

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<sup>31</sup> The Commission requires Melbourne Water’s price submission to propose prices that seek to reduce and minimise cross-subsidies. The extent to which this may be achieved in Melbourne Water’s fourth regulatory period 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 its price submission.

<sup>32</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 Melbourne Water’s 2016 price review, we have 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. For any proposed price increases of greater than 10 per cent in any year, we 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.

<sup>33</sup> The Commission requires Melbourne Water to move to more cost-reflective tariffs for non-residential waterway and drainage services. Reform in this area will require consideration of transition strategies for non-residential customers most affected by reforms. The Commission requires the price submission to consider the customer impacts and any appropriate transition strategies to accompany reforms.

## 4.14 ADJUSTING PRICES

Melbourne Water's price submission must specify any proposed price adjustment mechanisms to apply in the fourth regulatory period. The 2013 price determination includes mechanisms that allow for prices to adjust in order to take into account:

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

The Commission's view is that these adjustment mechanisms have worked well.

Melbourne Water's price submission must:

- specify and explain any formulas or processes to be used to adjust prices (only a brief explanation is required if proposing to maintain current adjustment mechanisms), and
- if proposing new or alternative price adjustment mechanisms, then the price submission must clearly explain how the adjustments would work, and justify any proposal against relevant matters in clause 11 of the WIRO.

## 4.15 DEVELOPER CHARGES

Melbourne Water's price submission must state its proposed approach to developer charges. In past price reviews, the Commission has approved a set of principles that determine how developer charges are calculated by Melbourne Water. The existing principles for developer charges for drainage schemes are provided in Box 4.1.

### **BOX 4.1 PRICING PRINCIPLES FOR DEVELOPER CHARGES – MELBOURNE WATER 2013 PRICE DETERMINATION**

Consistent with principles for defining a drainage scheme agreed with the development industry, developer charges will be calculated by:

- identifying future capital expenditure for each year of the expected life of the scheme
- identifying forecast developable hectares for each year using an estimate of development density
- applying a pre-tax real discount rate (consistent with that determined by the Commission) to convert future cash flows into present value terms
- setting the developer charge such that the present value of future income equals the present value of future costs, where future income is equal to the developable hectares in each year multiplied by the developer charge, and
- reviewing the financial assumptions relating to each scheme on an annual basis and reviewing engineering specifications every five years.

In 2014, the Commission (with the assistance of Melbourne Water) completed a desktop review of the approach to Melbourne Water's developer charges. The review found the current approach is reasonable as it recognises that:

- servicing solutions vary across locations, so a one size fits all approach to pricing is not appropriate
- pricing is cost reflective
- Melbourne Water has competitive procurement processes in place
- Melbourne Water consults openly and transparently with stakeholders when designing servicing solutions, and
- generally there is countervailing market power between Melbourne Water and developers.

If Melbourne Water does not propose any changes to these pricing principles for developer charges, the Commission is likely to approve them.

However, if Melbourne Water proposes changes to the pricing principles, then the Commission would assess the changes against the matters in clause 11 of the WIRO.

Melbourne Water's price submission must:

- specify the pricing principles that will apply for developer charges, and
- if changes to the pricing principles are proposed:
  - provide the rationale for doing so having regard for relevant matters in clause 11 of the WIRO and feedback received from customers, and
  - describe the consultation that has occurred with interested parties, and how feedback was incorporated into its proposals.

## 4.16 FINANCIAL POSITION

The Commission's financial model will calculate estimates for the four financial indicators specified in Table 4.1 for each year to 2025-26. Melbourne Water must populate the financial model to enable the Commission to assess Melbourne Water's financial position in the context of the prices proposed in its price submission.

Melbourne Water must also provide the Commission with the findings of any independent ratings assessments conducted since 1 July 2013.

**TABLE 4.1 FINANCIAL INDICATORS<sup>34</sup>**

Indicator	Calculation	Description	Benchmark Range
FFO interest cover	$(\text{FFO} + \text{net interest}) / \text{net interest}$	Measures the extent of the cash flow buffer a business has to meet its debt obligations.	> 1.5 times < 1.8 times used as a caution
Net Debt / Regulatory Asset Value (%)	$(\text{Interest bearing liabilities} - \text{cash}) / \text{RAV}$	Measures the debt component of the regulatory capital structure.	< 70 per cent
FFO / Net debt (%)	$\text{FFO} / (\text{Interest bearing liabilities} - \text{cash})$	Measures the serviceability of debt.	> 10 per cent
Internal financing ratio (%)	$(\text{FFO} - \text{dividends}) / \text{net capital expenditure}$	Measures the extent to which an entity has cash remaining to finance a prudent portion of capital expenditure after making dividends.	> 35 per cent

## Notes:

FFO refers to 'funds from operations' and RAV refers to the 'regulatory asset value'. Regarding FFO interest cover, we believe the 1.8 times benchmark signals a need for caution or closer review of the financial position of a businesses.

<sup>34</sup> The Commission will rank interest cover highest in terms of importance in conducting our financial viability assessment, with gearing ranked second. We will rank funds from operations/net debt and the internal financing ratio the lowest.

## **4.17 GENERAL INFORMATION REQUIREMENTS**

### **4.17.1 REQUIREMENT FOR REASONABLY-BASED INFORMATION**

All information contained in the price submission (and financial model – see section 4.18.2) must be reasonably-based. Any financial or demand-related information must represent the best available estimates at the time of finalising the submission.

### **4.17.2 BASIS UPON WHICH INFORMATION IS PROVIDED**

All financial information (including prices, operating and capital expenditure) in Melbourne Water's price submission (and financial model) must be in 2015-16 dollars (with the March quarter 2015 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.

## **4.18 ADDITIONAL REQUIREMENTS**

### **4.18.1 EXECUTIVE SUMMARY**

Melbourne Water's price submission must contain a summary which outlines and brings together the key elements of its proposals. The summary must include:

- an overview of proposed prices and rationale for price levels
- a brief description of any major changes on the current regulatory period (for example, in terms of tariff structures) and the reasons for the changes
- a summary of forecast operating and capital expenditure, and for operating expenditure, explain how proposed expenditure is consistent with the Commission's requirement for a 2 per cent annual efficiency improvement
- a summary of the main drivers of and reasons for the trend in expenditure

- a description of the proposed approach to recovering desalination security costs, and
- the estimated impact of proposed prices on customers.

#### **4.18.2 FINANCIAL MODEL**

Melbourne Water must complete the financial model prepared by the Commission to accompany its price submission. Melbourne Water's price submission must be consistent with the data provided in the financial model.<sup>35</sup> The financial model will clearly identify the cells for which Melbourne Water must provide data. Melbourne Water must not amend any other cells in the financial model – this includes adding rows, columns, or information not requested by the Commission.

The model will include a forecast inflation rate (based on the Consumer Price Index – All Groups, Australia). The inflation rate will be used to estimate components of the WACC (see section 4.9) and estimates for financial indicators (see section 4.16). The Commission will use the latest market forecasts for inflation.

#### **4.18.3 CONFIDENTIALITY**

The Commission's normal practice is to make submissions publicly available on its website. If there is information that Melbourne Water does not want disclosed publicly, because it is confidential or commercially sensitive, then Melbourne Water should discuss the matter with Commission staff before lodging the price submission.

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<sup>35</sup> The financial model requires Melbourne Water to provide detailed information on key assumptions underpinning its prices (such as expenditure estimates) so the Commission can assess Melbourne Water's proposals. The model also provides a mechanism for Melbourne Water to estimate its revenue allowance and prices. The model will require both historic and forecast data.

#### **4.18.4 NOTIFICATION OF CHANGES TO ASSUMPTIONS**

Melbourne Water must promptly advise the Commission if it becomes aware of any substantial changes to the assumptions underpinning the proposals in its price submission. Melbourne Water must also explain the basis for the changed assumptions, and explain the impact on its proposals (if any).

In the event of any changes, Melbourne Water must promptly provide the Commission with a new financial model, reconciling changes to the financial model provided to the Commission with its price submission on 30 October 2015.

#### **4.18.5 NON-REGULATED SERVICES**

While the Commission has no role in regulating prices for non-regulated services, it needs 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. Melbourne Water's price submission must demonstrate that the costs of non-regulated services have been excluded from its expenditure and price calculations.

## 5 MELBOURNE WATER'S CONSULTATION

Melbourne Water must consult with customers during the development of its price submission. The manner in which Melbourne Water consults will be for it to determine, but it must be effective and fit-for-purpose. The Commission does not require a draft price submission – rather, we are looking for Melbourne Water to consult in a meaningful way to inform its price submission.<sup>36</sup>

The Commission believes it is reasonable for Melbourne Water to consult on all aspects of its price submission with water retail businesses (other than for Melbourne Water's waterways and drainage services). This includes areas where the retailers are well placed to inform and test Melbourne Water's proposals including the scope and timing of major projects and capital expenditure requirements, the time profile for the recovery of its desalination security payments, demand, and service outcomes.

Melbourne Water must consult with residential and non-residential customers on matters where they will have a particular interest. This includes waterways and drainage services and prices, and the time profile for the recovery of its desalination security payments.

The Commission's consultation paper to inform this guidance noted that we believed there were opportunities for Melbourne Water to involve customers to a greater degree in preparing its price submission. We noted that a well-structured customer deliberative forum may be useful to inform Melbourne Water's approach to the recovery of its desalination security payments. The Commission's assessment of Melbourne Water's

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<sup>36</sup> WIRO, clause 13(a)(iv).

price submission will place a greater weighting on customer views received through well-structured deliberative forum-type processes.

Melbourne Water's price submission must demonstrate that it has consulted with customers and other interested parties, and provide information on how their views have been addressed in its submission.

# ATTACHMENT 1

## **MATTERS TO INCLUDE IN GUIDANCE: 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.

# ATTACHMENT 2

## MATTERS THAT WATER 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), 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>