



PROPOSED APPROACH TO MELBOURNE WATER'S 2016 WATER PRICE REVIEW

Consultation Paper

February 2015



An appropriate citation for this paper is:

Essential Services Commission 2015, *Proposed approach to Melbourne Water's 2016 price review – Consultation paper*, February.

Internal ref: c/15/1201

GLOSSARY

Baseline expenditure

The baseline level of operating expenditure is based on the last full year of data. This expenditure excludes once-off or temporary costs associated with major projects.

Capital expenditure

Capital expenditure is incurred when a business spends money either to buy fixed assets or to add to the value of an existing fixed asset. This includes expenditure on new works, renewals or replacements, and other expenditure that would otherwise be referred to as capital.

Fourth regulatory period

The period over which Melbourne Water's prices will be set from 1 July 2016.

Operating expenditure

Ongoing cost of running a product, business, or system.

Regulatory depreciation

An amount set to allow the regulated water businesses to recover the cost of capital investment over time. Also known as Return of Assets.

Revenue requirement

The revenue needed by a water business to cover operating costs and taxes, and provide a return on assets and a return of assets (depreciation).

Tariff structure

The way prices are organised, which can provide different incentives and signals to customers.

Third regulatory period

The period over which Melbourne Water's current prices are set (from 1 July 2013 to 30 June 2016).

Weighted average cost of capital (WACC)

The rate that a company is expected to pay on average to all its security holders to finance its assets.

CONTENTS

GLOSSARY	III
1 INTRODUCTION	1
2 OVERVIEW OF THE PRICE ASSESSMENT FRAMEWORK	5
3 PROPOSED APPROACH AND METHODOLOGY	13
4 ISSUES ARISING FROM THE 2013 WATER PRICE REVIEW	23
5 MELBOURNE WATER'S PRICE SUBMISSION	29
6 PROCESS AND TIMELINES	49
ATTACHMENT A – FINANCIAL VIABILITY ASSESSMENTS	50

1 INTRODUCTION

In 2015, the Essential Services Commission of Victoria (the Commission) will commence a review of the maximum prices Melbourne Water can charge for its water, sewerage, waterways and drainage services from 1 July 2016.¹

The Commission's price review will start when Melbourne Water provides us with a submission setting out its proposed prices.

We must assess Melbourne Water's price submission in accordance with the regulatory framework for price determinations governing water businesses as set out in the *Water Industry Regulatory Order 2014* (WIRO).

Our task is to assess Melbourne Water's price submission against the principles specified in the WIRO, and the guidance we are required to provide to Melbourne Water. We will also take into account the views of other stakeholders including Melbourne Water's customers, retail water businesses, and other interested parties before making a price determination.²

Recent changes to the WIRO require the Commission to issue guidance covering a range of matters to inform Melbourne Water's price submission, and to consult prior to issuing guidance. The matters we must address in our guidance are provided at Box 1.1. As noted above, the guidance will form part of the criteria against which we assess the compliance of Melbourne Water's price submission. We are required to undertake consultation prior to issuing such guidance.

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

² Note that the Commission's price determinations apply only to the prescribed services listed in clause 7 of the WIRO.

The purpose of this paper is to consult with stakeholders on the matters to be covered in the Commission’s guidance for Melbourne Water’s 2016 water price review. We will consider feedback prior to releasing a guidance paper in April 2015.

In preparing our guidance, the Commission will have regard to its overarching objectives in performing its regulatory functions under the WIRO as set out in section 8 of the *Essential Services Act 2001* (Vic) (ESC Act) and section 4C of the *Water Industry Act 1994* (WI Act), placing particular emphasis on the matters set out in clause 8(b) of the WIRO.

This paper has five main parts:

- Chapter 2 describes the pricing framework set out in the WIRO.
- Chapter 3 outlines our current views on the nature of our guidance to be provided under clause 13(a)(i) and (ii) of the WIRO. The Chapter describes our proposed approach and methodology for assessing Melbourne Water’s price submission and making a price determination, including our views on the approach to estimating Melbourne Water’s revenue requirement and prices.
- Chapter 4 summarises discrete matters that we consider should be addressed in Melbourne Water’s price submission.
- Chapter 5 outlines our current views on the nature of our guidance to be provided under clauses 13(a)(iii) to (v) of the WIRO. The Chapter describes our proposed requirements for Melbourne Water’s price submission, including the actions we expect Melbourne Water to take and what needs to be demonstrated in its price submission.
- Chapter 6 sets out the proposed nature of our guidance to be provided under clauses 13(vi) and (vii) of the WIRO. The Chapter outlines our proposed steps in the regulatory process and associated timelines for Melbourne Water’s 2016 water price review.

BOX 1.1 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.

1.1 HOW TO PROVIDE FEEDBACK

Stakeholders may wish to provide feedback before the Commission finalises its guidance. Written comments received by 18 March 2015 will be considered by the Commission.

We would prefer to receive written comments by email to water@esc.vic.gov.au.

You can also send comments by mail to:

Water Team

Essential Services Commission

Level 37, 2 Lonsdale Street

Melbourne VIC 3000

The Commission's normal practice is to publish feedback on our website. If you do not wish us to disclose information publicly, please provide a confidential version and a version that is suitable for publication.

2 OVERVIEW OF THE PRICE ASSESSMENT FRAMEWORK

The Commission must make a price determination in a manner that complies with the WIRO. The WIRO was revised by the Victorian Government in 2014. Therefore, Melbourne Water's 2016 price review will occur under a different decision-making framework to that in place at its 2013 price review. This Chapter provides an overview of the regulatory pricing framework established by the WIRO, and identifies key changes to the WIRO since our 2013 price review.

2.1 SERVICES COVERED BY PRICE DETERMINATIONS

The Commission's consideration of water prices is limited to the prescribed services listed in clause 7(b) of the WIRO. These are:

- i. retail water services;
- ii. retail recycled water services;
- iii. retail sewerage services;
- iv. storage operator and bulk water services;
- v. bulk sewerage services;
- vi. bulk recycled water services;
- vii. metropolitan waterways and drainage services;
- viii. irrigation drainage services;

- ix. connection services;
- x. services to which developer charges apply; and
- xi. diversion services.

The prescribed services have not changed since Melbourne Water's 2013 price review.

2.2 LENGTH OF REGULATORY PERIOD

Clause 9 of the WIRO requires the Commission to set the term of the regulatory period (that is, the period covered by a price determination issued by the Commission). However, the Commission remains open to businesses proposing their preferred term for the regulatory period, informed by consultation with stakeholders.

2.3 LIMITS TO THE COMMISSION'S PRICE SETTING POWERS

The WIRO retains a propose-respond model for price regulation, that is, the price setting process commences with a water business's price submission. The Commission must assess the prices proposed in a price submission and either approve them or specify the prices that will apply (in accordance with clause 14 of the WIRO).

The Commission continues to have limited discretion to specify (that is, not approve) the maximum prices that will apply. Specifically, clause 14(b) of the WIRO allows the Commission to specify maximum prices (or the manner in which the prices are to be calculated, determined or otherwise regulated) if we are of the opinion that a water business's price submission does not have adequate regard to the matters set out in clause 11 of the WIRO (see section 2.4), or does not comply with our guidance.

2.4 MATTERS THAT MUST BE CONSIDERED IN MAKING A PRICE DETERMINATION

The matters that the Commission must have regard to when assessing a price submission and making a price determination have changed since Melbourne Water's 2013 price review. Clause 11 of the WIRO sets out the matters that we must have regard to when assessing a price submission, which includes the objectives set out in the *Essential Services Commission Act 2001* (ESC Act) and the *Water Industry Act 1994* (WI Act). We have grouped the matters in clause 11 into themes (Table 2.1).

TABLE 2.1 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"> • promotion of efficient use of prescribed services by customers [cl 8(b)(i), WIRO] 	<ul style="list-style-type: none"> • 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] 	<ul style="list-style-type: none"> • 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]
<ul style="list-style-type: none"> • 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] 	<ul style="list-style-type: none"> • return on assets in the regulated industry [s 33(3)(c), ESC Act] 	<ul style="list-style-type: none"> • 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]
<ul style="list-style-type: none"> • provision to regulated entities of incentives to pursue efficiency improvements [cl 8(b)(iii), WIRO] 	<ul style="list-style-type: none"> • ensure that regulatory decision making and regulatory processes have regard to any differences between the operating environments of regulated entities [s 4C(b), WIA] 	<ul style="list-style-type: none"> • 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]
<ul style="list-style-type: none"> • efficiency in the industry and incentives for long term investment [s 8A(1)(a), ESC Act] 		<ul style="list-style-type: none"> • take into account the interests of customers of the regulated entity, including low income and vulnerable customers [cl 11(d)(iii), WIRO]
<ul style="list-style-type: none"> • 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] 		
<ul style="list-style-type: none"> • financial viability of the industry [s 8A(b), ESC Act] 		

Benchmarking	Health, safety and social obligations	Other
<ul style="list-style-type: none"> any relevant interstate and international benchmarks for prices, costs and return on assets in comparable industries [s 33(3)(d), ESC Act] 	<ul style="list-style-type: none"> the relevant health, safety, environmental and social legislation applying to the industry [s 8A(1)(d), ESC Act] 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), WIA Act] 	<ul style="list-style-type: none"> the degree of, and scope for, competition within the industry, including countervailing market power and information asymmetries [s 8A(1)(c), ESC Act] consistency in regulation between States and on a national basis [s 8A(1)(f), ESC Act] 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] wherever possible, to ensure that the costs of regulation do not exceed the benefits [s 4C(a), WIA Act]

Consistent with clause 8(b) of the WIRO, in considering price submissions and making a price determination, the Commission will give particular emphasis to matters relating to economic efficiency and the financial viability of the regulated water industry.

2.5 FLEXIBILITY TO DETERMINE PRICING METHODOLOGY

The WIRO is no longer premised upon the adoption of a building block approach to determining a water business's revenue allowance and maximum prices. Clause 12 of the WIRO provides flexibility for the Commission to adopt different approaches to price regulation.

We are proposing to continue to regulate prices for Melbourne Water's fourth regulatory period based on the building block methodology. The limited time between the commencement of the revised WIRO and the end of Melbourne Water's current regulatory period means that the Commission and stakeholders are prevented from giving due consideration of the benefits, costs, and risks of applying a substantially different approach for establishing Melbourne Water's prices from 1 July 2016. We are open to suggested improvements to our application of the building block methodology for Melbourne Water's next price review.

From April 2015 to October 2016, the Commission will commence consulting on the pricing methodology to be used in future water price reviews.

2.6 REQUIREMENT TO ISSUE A DRAFT DECISION

In the past, the Commission has always released a draft price decision in order to test our position with interested parties before making a price determination. This is consistent with the Commission's Charter of Consultation and Regulatory Practice.¹

¹ The Charter is available at: <http://www.esc.vic.gov.au/getattachment/d1757189-87ce-4af5-b24e-2e460030d75e/Charter-of-Consultation-and-Regulatory-Practice-20.pdf>

Clause 16 of the WIRO now requires the Commission to release a draft decision, and to consider submissions in response to the draft decision prior to making a price determination. The Commission will release a draft decision, and test our views with stakeholders, prior to issuing Melbourne Water's price determination.

2.7 INFORMATION PROVISION BY BUSINESSES

The Commission may at any time require a water business to provide information on any matter relevant to the making of a price determination (clause 15(a) of the WIRO). If a water business does not comply with an information request, clause 15(b) allows the Commission to make reasonable assumptions in relation to the subject of the information request, for the purpose of determining prices. The Commission also has information gathering powers under part 4 of the ESC Act.

2.8 RELATIONSHIP BETWEEN THE PRICING FRAMEWORK AND REGULATORY ENVIRONMENT

The role of the Commission, in applying the pricing framework, is to test the validity of businesses' claims on desirable service outcomes and associated expenditures.

Price outcomes are influenced by the pricing framework (set by the Government and regulated by the Commission) and the management of the water business through oversight by the shareholder and businesses' Boards.

Within this context, economic regulation works best when an independent economic regulator and a strong and active shareholder are functioning alongside each other to deliver efficiency gains. Gains are likely to be maximised when:

- regulated businesses engage with their customers to determine required services and service levels (and customers' willingness to pay for those services levels)
- government policy objectives are articulated clearly and in a way that allows outcomes to be reported, measured and verified
- Boards and management are responsible for developing and implementing plans for meeting customer and policy-maker expectations

- the independent regulator approves prices that reflect justified expenditure in order to meet those service delivery requirements, and
- the Board provides strong incentives for business management to outperform the regulatory benchmarks used to approve prices.

In coming months, the Commission will seek to engage with Boards of all water businesses to ensure that there is a common understanding of the roles and responsibilities of the Commission and the businesses so customers receive services that they are willing to pay for at the lowest possible long-term cost.

3 PROPOSED APPROACH AND METHODOLOGY

This Chapter sets out the Commission’s proposed approach and methodology for assessing Melbourne Water’s submission on the prices that will apply from 1 July 2016. In doing so, the Chapter outlines the Commission’s current views on the nature of our guidance to be provided under clause 13(a)(i) and (ii) of the WIRO.

3.1 APPROACH TO REGULATING MELBOURNE WATER’S PRICES

Clause 12(b) of the WIRO provides the Commission with flexibility to approve or specify maximum prices or the manner in which prices are calculated or determined in a manner which it considers appropriate.

In the past, Melbourne Water has proposed and we have approved price caps for the majority of its services; this includes tariffs for bulk water storage and transfer, bulk sewerage usage, and waterways and drainage services. These tariffs account for the majority of Melbourne Water’s revenue. Melbourne Water’s recycled water, developer charges and miscellaneous charges are currently determined according to pricing principles.

If Melbourne Water is exploring changing its form of price control, it is expected to discuss this with customers and the Commission as soon as possible. Any change in approach will need to be justified in its price submission in accordance with the WIRO framework.

3.2 METHODOLOGY FOR DETERMINING REVENUE AND PRICES

The Commission proposes, for this price review, to use the building block methodology to determine Melbourne Water's revenue allowance from which prices are derived. As noted in section 2.5, the Commission will soon begin consulting on alternative pricing methodologies: this means a different approach may be used at future price reviews for all water businesses.

The building block methodology sets revenue to reflect efficient costs of service provision. Further, it provides for the financial viability of the regulated business. Thus, it is consistent with the efficiency and financial viability matters in the WIRO.

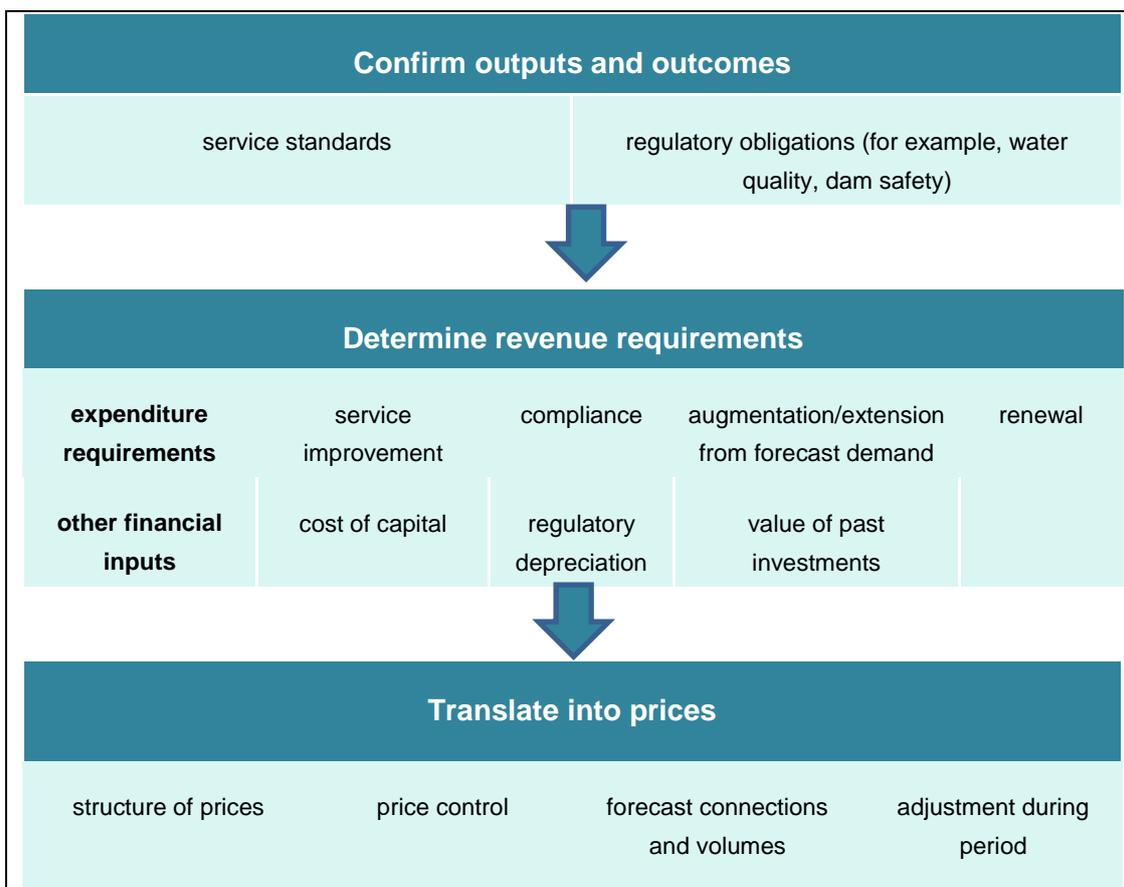
The first step in the building block involves validating the service outcomes that Melbourne Water proposes to deliver and recover costs through customer prices (Figure 3.1). The Commission will then determine the revenue required for Melbourne Water to deliver on its validated service outcomes. The revenue requirement will be calculated by:

- establishing an efficient level of operating expenditure
- establishing an efficient level of capital expenditure
- updating the regulatory asset base to reflect efficient capital expenditure
- applying a rate of return to the regulatory asset base
- establishing regulatory depreciation (which depends on the regulatory asset base), and
- establishing the tax allowance.

The Commission will establish that prices will generate Melbourne Water's revenue requirement by considering demand forecasts. The Commission will then assess the appropriateness of Melbourne Water's proposed tariff structures.

The Commission seeks ideas on any improvements to our application of the building block methodology for Melbourne Water's 2016 water price review.

FIGURE 3.1 STEPS IN ASSESSING AND APPROVING PRICES



3.3 LENGTH OF REGULATORY PERIOD

In the past, the Commission has approved regulatory periods ranging from three to five years. For Melbourne Water’s regulatory period commencing 1 July 2016, the Commission’s preference is for a five or six year regulatory period. This will allow:

- 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 the incentives of the pricing framework to work
- the business to focus on service delivery, and

- greater certainty of the bulk charges facing water retailers as they develop their next price submissions.¹

A risk associated with relatively long regulatory periods is the possibility that revenue or expenditure outcomes diverge significantly from the benchmarks used to establish prices (possibly resulting in a business achieving windfall gains or losses which impact on its ability to deliver services).

In its price submission, Melbourne Water will need to propose and justify a preferred term for its fourth regulatory period. The proposed term must have regard to the views of the water retailers.

3.4 ADJUSTING PRICES WITHIN A REGULATORY PERIOD

Melbourne Water's 2013 price determination includes mechanisms that allow for prices to adjust in order to account for uncertain and unforeseen events (clause 4), and specifically, to take into account differences between forecast and actual desalination costs (covering desalination security payments and the cost of any water ordered).

The Commission's view is that these adjustment mechanisms have worked well. Therefore, we intend to retain these mechanisms in their current form.

3.5 DEFINING A "PRICE SHOCK"

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. The Commission's guidance

¹ In the past, the regulatory periods for Melbourne Water and the water retailers has been aligned. Thus, the capacity for the water retailers to constructively engage with Melbourne Water may have been constrained due to the retailers focusing on their own pricing submissions. Different regulatory periods for Melbourne Water and the retailers should allow more scope for the retailers to test Melbourne Water's proposals.

will need to define a price shock for the purposes of Melbourne Water’s 2016 price review.

A price shock may have a different numerical value in different circumstances. For Melbourne Water, the impact of price rises on both end-use customers and its retail water business customers should be considered.

In the past, to prevent sharp changes in prices, the Commission has used “rebalancing constraints” which limit the extent of tariff increases in any one year. For rural businesses, this has included upper limits on increases of 10 per cent for specific tariffs. For metropolitan retailers, limits for increases have been lower, at two to three per cent, although these have been limits on the increase in annual revenue rather than for specific tariffs.

The Commission seeks views on how the WIRO principle on “price shock” should be interpreted for Melbourne Water’s 2016 water price review.

3.6 ASSESSING FINANCIAL VIABILITY

In 2014 we consulted with water businesses and other interested parties on our approach to financial viability assessments. The details of our consultation and additional background are provided at Attachment A.

The Commission will use the four quantitative indicators in table 3.1, and the specified ranges for each, to undertake our financial viability assessment for Melbourne Water. 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.

The Commission will consider any adjustments proposed by Melbourne Water to the inputs used in our tests (such as for leases) on a case-by-case basis, allowing only material adjustments proposed and substantiated by Melbourne Water.

Given the consultation already conducted on our financial viability assessments, we are not seeking further feedback on our approach for Melbourne Water's 2016 water price review.

To assist in our viability assessment, Melbourne Water (as part of its price submission) will be required to provide the Commission with the findings of any independent ratings assessments conducted since 1 July 2013 (the start of the third regulatory period). Melbourne Water's price submission must also demonstrate that its proposed prices are consistent with financial viability.

TABLE 3.1 FINANCIAL INDICATORS

Indicator	Calculation	Benchmark Range	Description
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 business has to meet its debt obligations.
Net Debt / Regulatory Asset Value (%)	$(\text{Interest bearing liabilities} - \text{cash}) / \text{RAV}$	< 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:

- 1) FFO refers to 'funds from operations' and RAV refers to the 'regulatory asset value'.
- 2) 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,

3.7 CONSULTATION BY THE COMMISSION

The Commission will undertake its own consultation (in addition to consultation undertaken by Melbourne Water) in order to test Melbourne Water's proposals. We will aim to engage with interested customers as broadly as practicable. The Commission will tailor its consultation to reflect stakeholder comments and work already undertaken by Melbourne Water.

The Commission will establish a Water Price Review Customer Panel to inform our assessment of Melbourne Water's proposals (like for the 2013 water price review). We will also seek advice from the Commission's new Customer Insights Panel.

The Commission will make its papers (including the reports of consultants assisting the Commission in our review) and Melbourne Water's submissions available on our website (www.esc.vic.gov.au). We will also consult with agencies such as the Department of Environment, Land, Water and Planning, the Department of Health, the Environment Protection Authority Victoria, and the Energy and Water Ombudsman (Victoria).

3.8 CUSTOMER CONSULTATION BY MELBOURNE WATER

The Commission's guidance will require Melbourne Water to 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.

The Commission believes it is reasonable for Melbourne Water to consult on all aspects of its price submission with retailers. Areas where the retailers are particularly well placed to inform and test Melbourne Water's proposals include the scope and timing of major projects and capital expenditure requirements, demand, and service outcomes.

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

Melbourne Water must also assess whether its proposals result in any material impacts on end-use customers in terms of water and sewerage service levels or prices. In these cases, Melbourne Water should ensure the retailers and end-use customers are consulted, and their views are addressed in its submission.

3.8.1 OPPORTUNITIES FOR GREATER END-USE CUSTOMER INVOLVEMENT IN SHAPING PROPOSALS

The Commission believes there are opportunities for Melbourne Water to involve end-use customers to a greater degree in forming its price proposals. There is increasing interest (among economic regulators, businesses and customer representatives) in engagement methods such as deliberative forums and customer juries.

Yarra Valley Water's proposals for its current regulated period were influenced by the results of deliberative customer forums. In our view, these forums were well structured and provided customers with an opportunity to participate meaningfully and make informed contributions in areas such as tariff structures.

During the 2013 water price review, Melbourne Water held a series of end-use customer focus groups to explore community views on options for the treatment of its desalination security payments. Due to the complexity of information presented and the limited options given to customers, the Commission considered that the focus group findings, while of interest, could not be relied upon to represent end-use customer views regarding the treatment of Melbourne Water's payments. As noted in section 4.1, a well-structured customer deliberative forum may be useful to inform Melbourne Water's approach to the recovery of its desalination security payments.

Generally, the Commission's assessment of Melbourne Water's price submission will place a high weighting on customer views received through well-structured deliberative forum-type processes.

The Commission is interested in receiving views on areas where Melbourne Water may provide customers with an increased ability to influence its proposals, and how Melbourne Water might go about this. For instance, a deliberative customer forum may be well suited for Melbourne Water to receive end-use customer input on its approach to the recovery of its desalination security payments.

3.9 OUR EXPECTATIONS OF RETAIL WATER BUSINESSES

The Commission expects the retail water businesses to represent the interests of their customers during Melbourne Water's 2016 price review. The Commission expects each of the retailers to make public submissions in response to Melbourne Water's price submission. These submissions should identify where Melbourne Water's proposals are supported or otherwise, with reasons. The Commission also expects the retailers to respond to the Commission's draft decision.

In some cases Melbourne Water may need the assistance of the retailers to ascertain end-use customer views. The Commission encourages all parties to work together to ensure the interests of end-use customers are taken into account in Melbourne Water's proposals.

4 ISSUES ARISING FROM THE 2013 WATER PRICE REVIEW

There are a number of matters arising from the Commission's 2013 price review, and in the period thereafter, that we propose our guidance to require consideration by Melbourne Water in its price submission.

4.1 TREATMENT OF DESALINATION SECURITY PAYMENTS

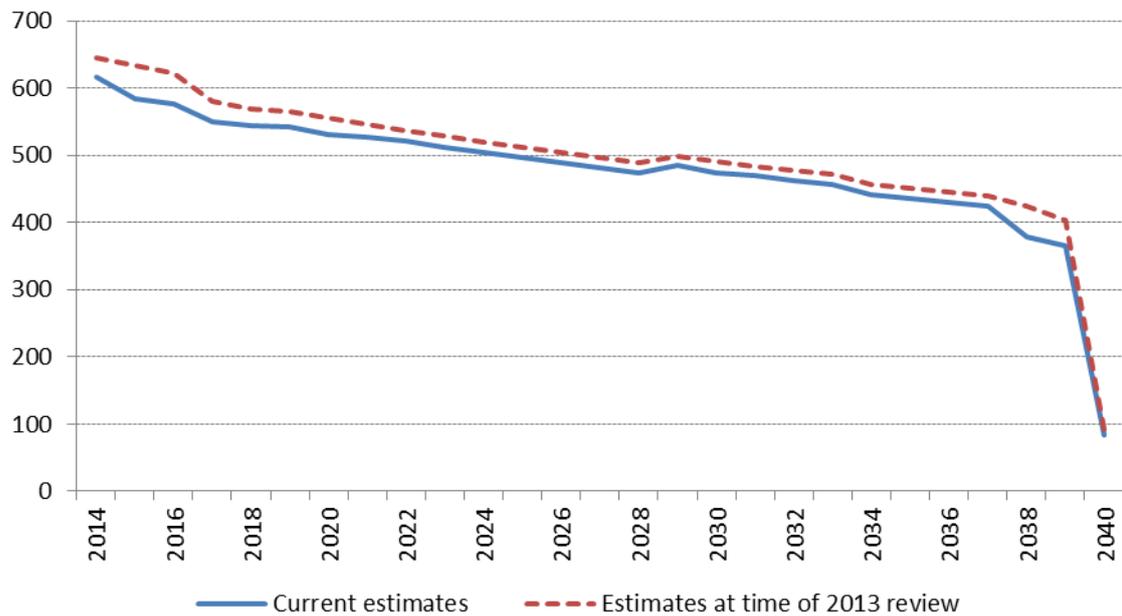
Melbourne Water is contractually obliged to cover all costs associated with the construction and operation of the Victorian desalination plant. This includes payments for the desalination security service, and any water ordered from the plant.

Melbourne Water's security payments reflect a 27 year contractual payment profile, after which Melbourne Water will take full ownership of the desalination plant. The desalination plant is expected to have (at least) a further 23 year operating life after Melbourne Water takes ownership.

Melbourne Water's desalination security payments are forecast to decline in real terms over the longer-term, thus exerting a downward influence on end-use customer bills. Since our 2013 price review, Melbourne Water's forecast desalination security payments have been revised downwards, by an average of around \$30-\$35 million per year over the next five years (Figure 4.1).⁵

⁵ Based on estimates produced by PricewaterhouseCoopers for the Department of Environment, Land, Water and Planning.

FIGURE 4.1 FORECAST DESALINATION SECURITY PAYMENTS (\$M REAL)



During the 2013 water price review, the Commission asked that Melbourne Water consider the benefits and risks of spreading the recovery of its desalination security payments over a period that approximates the plants useful life, via capitalisation of at least some of the payments. This approach was consistent with the recommendations in a NERA Economic Consulting and Farrier Swier Consulting report, prepared for the Commission.⁶

While capitalisation implies Melbourne Water would need to borrow in the near term (as prices would be set at a level lower than what would be required to fund Melbourne Water’s contractual payment obligations), it would be no worse off as its borrowing costs would be covered by the regulatory rate of return.

⁶ NERA Economic Consulting and Farrier Swier Consulting 2013, *Recovery of Desalination Security Charges*, March.

The Commission's 2013 final decision confirmed the need for Melbourne Water to capitalise a proportion of its desalination security payments. However, the Commission was not in the position to decide on the amount to be capitalised given material but unclear changes to the modelling assumptions made by Melbourne Water following our draft decision. The Commission decided to shorten the regulatory period for Melbourne Water to three years (rather than five) so that the matter could be properly examined and decided upon during Melbourne Water's next price review.

The Commission's guidance will require Melbourne Water to propose an approach to the recovery of its desalination security payments, and in particular, the time period over which it the costs will be recovered. Melbourne Water will need to consider the trade-off specified in our 2013 water price review final decision, that is:

- spreading the recovery of desalination security payments over a period that better matches the expected life of the desalination plant and
- introducing a potential risk that either Melbourne Water's service obligations would be compromised or its prices may increase erratically (noting that should Melbourne Water's financial viability be threatened, it would eventually seek to re-open the regulator's price decision ahead of the next scheduled review).⁷

In considering the trade-off above, there are materiality thresholds that need to be considered, namely the extent to which spreading desalination security payments result in material benefits and risks to customers.

Melbourne Water must seek customer views (including end-use customers) through a well-structured consultation process on the trade-off above. The Commission will place a high weighting on customer views received through a well-structured consultation process (for example, a deliberative customer forum).

⁷ Essential Services Commission 2013, *Price Review 2013: Greater Metropolitan Water Businesses – final decision*, June, p. 24.

4.2 MINIMISING CROSS-SUBSIDIES

The Commission is aware that Melbourne Water's current maximum prices imply a cross-subsidy from sewerage to water services; that is, Melbourne Water is collecting more revenue from customer prices for its sewerage services than it needs to cover sewerage costs. These funds are used to deliver its water services, for which prices are lower than what is needed to cover costs.

Since the Commission's 2013 water price review, water businesses undertook an efficiency review that (for the metropolitan Melbourne water retailers and Western Water) resulted in a commitment to deliver end-use customers an annual rebate of \$100 on their water bill. The Commission is aware that at least some of this rebate has been funded via contributions from revenue received for Melbourne Water's waterways and drainage services, creating an additional cross-subsidy.

The existence of cross-subsidies is a concern as they represent pricing inefficiencies and can distort the investment decisions of the water retailers and end-use customers.

The Commission expects Melbourne Water's price submission will propose prices that seek to reduce and eliminate 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.

4.3 WATERWAYS AND DRAINAGE OBLIGATIONS AND EXPENDITURE

The Commission's 2016 price review will place greater scrutiny on Melbourne Water's proposals in relation to waterways and drainage expenditure. Melbourne Water's price submission must demonstrate, by reference to clear and unambiguous evidence, that its proposed expenditure is prudent and efficient.

Evidence of customer willingness to pay must be provided where expenditure does not relate to clearly defined government or regulator obligations (for example, expenditure related to the amenity or ecological state of waterways).

4.4 WATERWAYS AND DRAINAGE PRICING REFORM

The Commission looks forward to Melbourne Water's proposals to move to a more cost-reflective pricing framework for non-residential waterway and drainage pricing. The Commission will carefully examine the outcomes of the following investigations Melbourne Water committed to undertake at the 2013 price review including:

- investigating the suitability of charges being based on measures relating to the proportion of a catchment area covered by impervious surfaces (that is roofs and paved surfaces) that are directly connected to the waterways and
- working with the Valuer-General to ensure data gained from property valuations can better facilitate customer impact modelling of any changes to the non-residential charge for waterways and drainage services (outcomes would inform reform approaches for its fourth regulatory period).

Reform in this area will require particular consideration of transition strategies for those non-residential customers most affected by reforms. The Commission will expect detailed consideration of customer impacts and appropriate transition strategies to accompany Melbourne Water's reforms.

The Commission seeks views on any other issues the Commission should focus on, and include in our guidance, as part of Melbourne Water's 2016 price review.

5 MELBOURNE WATER'S PRICE SUBMISSION

This Chapter sets out the Commission's current views on what our guidance will require Melbourne Water to demonstrate and include in its price submission. This has regard for the approach and methodology outlined in Chapter 3, and the additional matters raised in Chapter 4. In doing so, the Chapter outlines our current views on the nature of our guidance to be provided under clauses 13(a)(iii) to (v) of the WIRO.

A significant amount of the information the Commission requires should be readily available to Melbourne Water and relevant for other purposes such as corporate planning or project justification and prioritisation. Consequently our price review process seeks to minimise the costs of our review for Melbourne Water. Note that 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.

5.1 HIGH LEVEL REQUIREMENTS

Melbourne Water's price submission needs to explain and justify its proposed prices. The submission must demonstrate how Melbourne Water has had regard to the matters in clause 11 of the WIRO, while giving emphasis to matters related to economic efficiency and financial viability (consistent with clause 8 of the WIRO).

Melbourne Water must provide the Commission with a price submission which is clear and concise, and includes all relevant supporting information. This will enable the Commission to assess the price submission in an efficient and timely

manner. The submission must only include information that is material relevant to its proposals or information requested in the Commission's guidance.

Unless otherwise specified in our guidance, where Melbourne Water is proposing the status quo (for example, in terms of service outcomes and tariff structures), we do not require detailed justification in the price submission.

5.2 ASSESSING PRUDENT AND EFFICIENT EXPENDITURE

The Commission's guidance will require Melbourne Water's price submission to propose maximum prices that reflect only prudent and efficient expenditure. Reasons must be provided in the submission to demonstrate why the proposed expenditure is prudent and efficient. This will require the submission to specify and substantiate proposed service outcomes, operating expenditure, and capital expenditure.

The Commission seeks views from stakeholders on any information that may assist us in reviewing the efficiency of Melbourne Water's proposals. This could include any benchmarks or indexes relevant to our assessment of its forecast expenditure.

Melbourne Water's price submission must include annual historic and forecast data (covering a 10 year outlook period) for all expenditure assumptions and its revenue requirement. The calculation of the revenue requirement must be consistent with the information requirements and approach set out at sections 5.4 to 5.9.

Any adjustments made by Melbourne Water to the assumptions underpinning prices following the price submission must be adequately explained. The Commission will not consider approving any changes to the pricing assumptions if sufficient reasons for the changes are not provided.

5.3 SERVICE OUTCOMES

Melbourne Water's proposed service outcomes can reflect either government or other regulator obligations, or the service needs of its customers. Service outcomes are drivers of the efficient levels of operating and capital expenditure.

Melbourne Water's service commitments to its water retail customers are set out in agreements or contracts, such as the Bulk Water Services Agreement, which includes targets for the quality and reliability for water supplied to the retailers. Melbourne Water's service commitments to its waterways and drainage customers are developed according to legislative requirements and customer consultation, and set out in an operating charter.

The Commission intends to allow Melbourne Water to recover efficient costs associated with service outcomes if its price submission demonstrates that they reflect government or regulatory obligations (such as those set out in a Statement of Obligations) or a validated customer need (demonstrated via cost benefit analysis or evidence of consultation on customers' willingness to pay). It is critical then that all service outcomes are clearly defined so the Commission can assess the efficiency of associated expenditure. Where government or regulatory obligations are unclear, Melbourne Water should clarify expectations with the appropriate entity as soon as practicable.

The Commission's guidance will also require Melbourne Water's price submission to:

- specify and define all proposed service outcomes (whether they are new or existing outcomes), and indicate whether these reflect government or regulator obligations, or service outcomes sought by water retailers and/or end-use customers, and
- in relation to existing service outcomes, identify any proposed changes and provide justification for the changes (such as through willingness to pay studies).

5.4 OPERATING EXPENDITURE

Operating expenditure will be assessed similarly to previous price reviews. However, the Commission will assess Melbourne Water's water, sewerage and waterways and drainage services as discrete businesses.

Accordingly, Melbourne Water's price submission should present separate expenditure information for each service. This will require a clear basis for the allocation of shared corporate costs, which must be explained in the submission.

Actual expenditure for 2014-15 (the last full year of actual costs that will be available during the price review), adjusted for any non-recurring costs, will be taken as the baseline operating cost. The baseline operating cost will be used to determine the forecasts for each year of the fourth regulatory period. Cost savings committed to by Melbourne Water following its efficiency review in 2014⁸ must be captured in this 2014-15 baseline.

The baseline may be adjusted upwards each year to reflect increased costs associated with forecast growth, however Melbourne Water will need to demonstrate the relationship between growth and forecast cost escalations. The Commission would not expect a one to one relationship between growth and costs. The baseline must also be adjusted downwards each year to demonstrate efficiency gains (section 5.6).

Melbourne Water must separately identify and justify any changes to forecast operating expenditure beyond the adjusted baseline costs as described above.

In addition, the Commission expects Melbourne Water's price submission will:

- specify actual operating costs for the current regulatory period and compare these to the benchmarks used to establish prices
- outline expenditure by cost category (see below), discuss major cost items (see below) and any substantial divergence in individual cost categories from past trends and

⁸ All Victorian water businesses undertook an efficiency review in 2014 as part of the Fairer Water Bills initiative.

- outline expenditure by regulatory account cost allocation.

For each asset category of water, sewerage, recycled water, waterways and drainage, and diversions, operating expenditure should be broken down into the following cost categories:

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

The price submission must explain trends and assumptions in a number of major operating expenditure cost items, including:

- wage and salary escalations, total labour costs and underpinning employee number assumptions
- electricity and energy costs, and underlying volume and load assumptions
- carbon tax repeal, and
- information technology costs.

5.5 PRODUCTIVITY AND EFFICIENCY

Clause 8(b)(iii) of the WIRO requires the Commission to place particular emphasis on providing incentives for businesses to pursue efficiency improvements. For previous price reviews the Commission has imposed a flat productivity hurdle on controllable operating expenditure in the form of an annual reduction of the baseline (1 per cent per year for the 2013 price review).

Melbourne Water's price submission should therefore propose specific annual ongoing efficiency improvement targets for both capital and operating expenditures.

Operating expenditure efficiency improvements may be in the form of clearly identified cost reductions, or through applying a downward adjustment to the baseline operating expenditure. The price submission should identify specific programs aimed at generating efficiencies, and include estimates of the impact on expenditure. This must identify programs arising from the 2014 efficiency review, such as shared services and competitive procurement initiatives.

The productivity hurdle rates and approaches for some recent price decisions are shown in table 5.1. We would expect Melbourne Water to aim for an annual efficiency gain in the order of two per cent per annum.

TABLE 5.1 PRODUCTIVITY HURDLES APPLIED BY AUSTRALIAN WATER REGULATORS

Regulator	Productivity Hurdle	Applied to
ESCOSA	1%, 2%, 2% over 3 years 0.6% pa	Total Opex Capex
ERA WA	2% pa over 5 years	BAU Opex
ESC Vic – 2013 price review	1% pa over 3 or 5 years	Controllable BAU Opex
IPART – Hunter Valley Water price review	Nil hurdle, but HVW proposed \$20m reduction in opex over 4 year period = 4% reduction of previous opex	Opex

The Commission is open to Melbourne Water proposing an efficiency carryover mechanism as an additional or alternative form of efficiency incentive. Our expectation would be that any efficiency carryover is 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 beating the forecast cost level.

5.6 CAPITAL EXPENDITURE

For its 2016 water price review, the Commission expects Melbourne Water to consult heavily with the water retailers on its planned projects and timelines. The

results of this consultation, and an explanation of how it influenced Melbourne Water's capital expenditure plans, must be included in its price submission.

As with operating expenditure, the Commission will consider capital expenditure for the waterways and drainage component of the business separately, so Melbourne Water should provide separate but parallel capital expenditure forecasts for its water, sewerage and waterways services.

Capital expenditure proposals will be assessed on whether they are prudent, efficient and deliverable. The Commission expects Melbourne Water's price submission will outline key drivers of capital expenditure, linking proposed spending with the intended service outcomes, the need for the proposed capital expenditure, and why it must occur during the fourth regulatory period.

The price submission should identify at least fifteen discrete capital projects (by total project cost) to be started or completed over 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. The expenditure amounts proposed should be those based on P50 cost assumptions. The Commission will monitor progress against plan for these major projects as a key part of its annual performance reporting.

Major allocations of capital assigned to ongoing programs (for example, water main renewals, sewer main renewals, flood mitigation) effectively constitute a "baseline" capital expenditure, and should be itemised separately. Separating out the major projects (as above) should help address the "lumpy" nature of capital investment and smooth out the baseline. For each program, Melbourne Water should identify and justify actual deviations from forecast allocations during the third regulatory period, as well as deviations in the forecast relative to previous allocations. Melbourne Water should also provide clear justification for the cessation of an existing capital program or the introduction of a new one.

5.7 REGULATORY ASSET BASE

The regulatory asset base (RAB) represents the unrecovered cost of prudent capital expenditure. This is the value on which Melbourne Water can expect to earn a return (return on capital), and the value that is returned to the business over the economic life of the assets (as regulatory depreciation). The RAB is updated each year to reflect any additional capital expenditure net of contributions (from government and customers), proceeds from asset disposals, and regulatory depreciation. It is also adjusted for inflation.

When assessing Melbourne Water's price submission, the Commission will establish:

- 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.

Melbourne Water's price submission must propose a RAB value for each year of its fourth regulatory period.

To determine the opening RAB value at 1 July 2016, actual figures will be used for the completed years 2013-14 and 2014-15, while the forecast figures in the 2013 price determination will be used for the incomplete (at the time of our price review) 2015-16 year. An adjustment will be made for any difference between assumed and actual net capital expenditure during 2012-13 when the opening RAB was calculated for 1 July 2013. A similar adjustment will be made in calculating the opening RAB at the beginning of Melbourne Water's fifth regulatory period, adjusting for actual expenditure in 2015-16.

The RAB will continue to be calculated as follows:

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

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

Melbourne Water will need to demonstrate that capital expenditure in 2012-13 and in the period 2013-14 to 2014-15 was both prudent and efficient for it to be included in the roll-forward into the opening RAB for 1 July 2016. This should also include reconciliation against the capital expenditure benchmarks allowed in Melbourne Water's 2013 price determination, as well as for each of the major capital projects identified in the determination.

Estimates for regulatory depreciation should reflect reasonable assumptions about asset life and utilisation. Melbourne Water will only receive depreciation when an asset comes into service.

For pricing purposes, capital contributions are removed from the RAB. The price submission should provide separate data and information on:

- 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.

Melbourne Water should provide estimates of the total contributions by type and identify any contributions to major projects for both past and forecast projects.

Melbourne Water's price submission must include estimates of revenue expected from disposal of assets for each year from 1 July 2016, to be deducted from the RAB roll forward.

The opening RAB will also be adjusted to compensate investors for inflation (based on the Consumer Price Index – all Groups, Australia) over the third regulatory period, and to reflect inflation when projecting costs and revenue for the fourth regulatory period.

5.8 DETERMINING A REGULATORY RATE OF RETURN

The rate of return is used to calculate a return on a business's investments in regulated assets. The Commission will decide what rate of return is used for Melbourne Water for its fourth regulatory period, based on the approach in our 2013 water price review final decision. The Commission will set a real post-tax Weighted Average Cost of Capital (WACC) within the following parameters:

- 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

R_d = cost of debt

E = market value of the business's equity

D = market value of the business's debt

$V = E + D$ = firm value

E/V = percentage of financing that is equity

D/V = percentage 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 10 year Commonwealth Government Security bond (the Commission will use an averaging period of 40 business days commencing as close as practically possible to the start of the regulatory period)
- 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+ to BBB- rated corporate bonds with 10 year maturity.

The Commission will determine a WACC that takes into account prevailing market conditions and recent decisions by other regulators. The Commission will include a WACC estimate in the financial model that it will provide to Melbourne Water for preparing its price submission. This WACC estimate will be updated prior to the final decision to reflect prevailing market conditions.

5.9 TAX ALLOWANCE

The WACC provides a post-tax return, so Melbourne Water's revenue requirement (which is defined in pre-tax terms) must include an allowance for

expected taxation. The Commission's financial model will include an estimate of Melbourne Water's future nominal tax liabilities. The nominal estimate will be based on the following:

- the rate of tax – the statutory corporate tax rate (currently 30 per cent)
- revenue and expenditure used to calculate tax — these will be consistent with those used to establish prices (except that customer contributions and gifted assets are treated as revenue) and
- Interest expenses (deductions) — will reflect the nominal cost of debt (based on the real cost of debt estimated for the WACC) and the assumed stock of debt (that is, gearing multiplied by the regulatory asset base).

The tax estimate will be adjusted to reflect tax depreciation and imputation credits (which will be at the rate of \$0.50 for every \$1 of company tax paid, as in past price reviews). The financial model converts the nominal tax liabilities into real terms: the estimate must be used by Melbourne Water to calculate its revenue requirement.

5.10 DEMAND

Changes in demand for Melbourne Water's services can arise from changes in consumption by existing end-use customers, or changes in the number of end-use customers. Demand forecasts are a key input into the determination of prices and are relevant to the Commission's assessment of expenditure.

The Commission will assess whether Melbourne Water's demand forecasts:

- are based on an appropriate and unbiased forecasting methodology
- are based on reasonable assumptions about the key drivers of demand
- utilise the best available information, including historical data that can identify trends in demand and
- take account of current demand and economic conditions.

The Commission's guidance will require Melbourne Water's price submission to demonstrate its approach to estimating demand satisfies each of the above. Melbourne Water must also consult with the water retailers on demand projections, and demonstrate how feedback from the retailers has been incorporated into its estimates.

The Commission also expects Melbourne Water's price submission to include:

- the annual demand forecasts adopted for each tariff for a period of 10 years from 1 July 2016, and provide comparable historical information
- 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)
- evidence that a range of supply and demand scenarios were modelled, including low, normal and high water inflow scenarios
- an explanation about why the demand forecasts adopted were chosen over other scenarios modelled
- an explanation of where price elasticity was applied, the figures used, and how the measure was translated into the demand forecasts and
- an explanation of how demand forecasts are consistent with proposed expenditure.

5.11 FORM OF PRICE CONTROL

In past reviews Melbourne Water has successfully implemented a price cap form of control (for the majority of its services and covering the bulk of its regulated revenue).

The Commission's guidance will require Melbourne Water to identify its proposed form of price control for each of its services. If Melbourne Water plans changes to its form of price control then its price submission must also:

- explain how the proposed form of control will operate and services affected
- justify the proposed changes against the matters in clause 11 of the WIRO

- demonstrate it has consulted with affected customers and
- explain how a transition to a new form of control may impact customers and how it plans to address those impacts.

If Melbourne Water proposes an alternative form of price control, the Commission would place a strong weighting on the views of water retail businesses. These views would need to be set out in Melbourne Water's price submission.

The Commission would likely approve Melbourne Water's form of price control if it proposed no changes on its current approach. No justification would be required in the price submission.

5.12 TARIFF LEVELS AND STRUCTURES

The Commission's guidance will require Melbourne Water to specify the structure of each tariff Melbourne Water proposes to apply from 1 July 2016, and the price to be charged (or, the manner in which price will be calculated) for each year of its regulatory period. Following the regulatory period, the submission must include an estimate prices for each year in the period to at least 2025-26.

The price submission must provide data and supporting commentary that describes how its proposed prices are consistent with minimising cross-subsidies. Where Melbourne Water is slow to remove a cross-subsidy, rigorous justification will be required in its price submission, including evidence of consultation with end-use customers. The price submission should also consider customer impacts of reducing any cross subsidies, and provide transition strategies where necessary.

Melbourne Water's price submission must also:

- describe proposed reforms to non-residential waterways and drainage tariffs (as per section 4.4), and demonstrate reforms comply with clause 11 of the WIRO
- identify any tariff that exceeds the price shock defined in our guidance paper, and provide justification and

- provide justification for any other proposed changes to tariff structures (or the manner in which prices will be calculated) against clause 11 of the WIRO, and explain how the views of affected customers have informed its proposals.

5.13 DEVELOPER CHARGES

In past price reviews, the Commission has approved a set of principles that determine how developer charges are calculated by Melbourne Water. This is a light handed approach. The existing principles for developer charges for drainage schemes are provided at box 5.1.

BOX 5.1 PRICING PRINCIPLES FOR DEVELOPER CHARGES – MELBOURNE WATER 2013 PRICE DETERMINATION (SCHEDULE 4.3)

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;
- 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 into the way it treats 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.

Melbourne Water's price submission must state its proposed approach to pricing for developer charges. If Melbourne Water proposed an unchanged set of pricing principles for developer charges, the Commission would likely approve them. No further information would need to be provided in the price submission.

However, if Melbourne Water proposes changes to the principles, then this would need to be explained and justified against the principles in clause 11 of the WIRO, and include evidence that stakeholders had been consulted.

5.14 DESALINATION SECURITY PAYMENTS

The Commission's guidance will require Melbourne Water to propose an approach to the recovery of its desalination security payments for the fourth regulatory period. The proposal must not be conditional. ..⁹

⁹ Melbourne Water's response to the Commission's 2013 water price review draft decision proposed amounts for capitalisation that were conditional on the Commission's favourable decisions in relation to other determinants of its allowed revenues. For more detail, see Essential Services Commission 2013, *Price Review 2013: Greater Metropolitan Water Businesses — final decision*, June, pp. 36-37.

Melbourne Water's proposal must be developed in consultation with all interested parties. This consultation should include the water retailers, end-use customers and their representative bodies. The details of consultation, and how it has been reflected in Melbourne Water's proposals, must be addressed in its submission.

Further, Melbourne Water's price submission must:

- demonstrate that it has considered the trade-off discussed in section 4.1, in consultation with interested parties. Specifically, the submission must provide views on whether estimated end-use customer bill reductions warrant the risk of future price instability as a result of any capitalisation of its annual desalination security payments.
- use relevant and up-to-date financial information, including detail on (and quantification of) any financial constraints.
- identify its preferred approach to recovering its desalination security payments over the expected life of the desalination plant, taking into account the economic efficiency objectives in the WIRO. Melbourne Water must include a summary of why the proposed approach has been selected and identify its relative merits against other alternatives considered against all relevant matters in the WIRO.

The price submission must also include all assumptions used in modelling various scenarios, and provide justification for these. This includes:

- Melbourne Water's forecasts for desalination security payments and
- depreciation (asset life) assumptions used for the desalination plant.

5.15 ADJUSTING PRICES

Melbourne Water's price submission must specify its proposed approach to how prices will adjust to account for differences between forecast and actual desalination costs, covering desalination security payments and the cost of any water ordered. If any changes are proposed, this will need to be justified in its price submission, having adequate regard for the matters in clause 11 of the WIRO.

5.16 NON-REGULATED SERVICES

While the Commission has no role in regulating prices for non-regulated services, it needs to be satisfied that these services are correctly classified and 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 price calculations.

5.17 CUSTOMER CONSULTATION

The Commission's guidance will require Melbourne Water's price submission to include the following:

- an outline of the consultation undertaken with customers and other stakeholders
- the key areas where customer input was sought
- a summary of feedback received from customers and other stakeholders
- an explanation of how comments received during consultation have been addressed in the price submission and
- any significant issues of customer interest the Commission should be alerted to in its consideration of the price submission – particularly where Melbourne Water has not sought to address these concerns.

5.18 FINANCIAL MODEL

Melbourne Water will be required to complete a financial model prepared by the Commission to accompany its price submission. Melbourne Water's completed financial model will include detail (such as financial data time series and cost breakdowns) needed for us to assess Melbourne Water's price proposals. Melbourne Water's written submission and the completed financial model must

be consistent (for example, the numbers quoted in the price submission must reconcile to the financial model).

The Commission is working with Melbourne Water to implement improvements to the model for its upcoming price review.

Any changes made by Melbourne Water to its proposals during the price review must be reflected in its financial model. The Commission will not allow any adjustments to the financial model if the reasons for the changes are unclear or not justified.

All financial values in Melbourne Water's price submission and financial model must be in real 2015-16 dollars (with the March quarter 2015 CPI as the base).

6 PROCESS AND TIMELINES

This chapter sets out our proposed process and timelines for Melbourne Water’s price review. In doing so, we set out the proposed nature of our guidance to be provided under clauses 13(vi) and (vii) of the WIRO.

A proposed timetable for the price review consultation process is set out in table 6.1.

TABLE 6.1 PROPOSED TIMELINES

Dates	Activity
18 March 2015	End of consultation period on consultation paper
April 2015	ESC releases 2016 guidance paper
April 2015 to October 2015	Melbourne Water consults with stakeholders on price submission
5 November 2015	Melbourne Water’s price submission submitted to ESC
6 November 2015	ESC commences assessment of price submission and opens consultation
11 March 2016	ESC releases draft decision
14 March 2016 to 6 May 2016	ESC consultation on draft decision
15 June 2016	ESC releases final decision

Stakeholders are invited to provide feedback on the proposed steps and timelines for the price review.

ATTACHMENT A

THE COMMISSION'S APPROACH TO FINANCIAL VIABILITY ASSESSMENTS IN THE WATER INDUSTRY

BACKGROUND

The Essential Services Commission has financial viability objectives set out in the *Essential Services Commission Act 2001* and the Water Industry Regulatory Order. To assist us in meeting these objectives we undertake a financial viability assessment prior to approving prices.

It is possible that the prices estimated via regulatory pricing models (such as building block, benchmarking or index approaches) may not provide a business with sufficient cash flow to remain viable in the short-term. This may reflect a number of factors, such as the use of benchmark finance costs in establishing prices under the building block.

A financial viability assessment allows us to make a 'safety net' adjustment to prices if the regulatory pricing model results in prices that would leave a water business financially unviable. It is in the long term interests of customers that a business is financially viable so it can provide services desired by customers. A business should be in a position to do so when expected revenues enable an efficient water business to pay its bills as they fall due, and undertake its forecast capital program in order to deliver services.

In 2014 we consulted with water businesses and other interested parties on our approach to financial viability assessments. Taking into account our consultation, this short paper sets out the nature of our financial viability assessments for future price reviews.

OUR APPROACH

As part of our financial viability assessments, the Commission will:

- Use the four quantitative indicators in table 1 to undertake our financial viability assessments. The indicators focus mainly on cash flow, which we believe provides the best indication of a business's underlying financial position. Estimates for the indicators will be included in the financial models used by businesses during price reviews.
- Adopt benchmarks for the indicators which are consistent with water businesses achieving an investment grade credit rating.
- Among the set of indicators, rank interest cover highest in terms of importance in conducting our financial viability assessments, with gearing ranked second. We will rank FFO / net debt, internal financing ratio the lowest.
- If a viability test suggests an adjustment to prices is necessary, we will make adjustments on a net present value neutral basis. That is, if prices are adjusted upwards due to viability reasons in the next price period, we will offset the price increase with price reduction(s) in subsequent pricing periods. Not increase customer prices to rectify business decisions – for example, if a business chose to take on high gearing and had no extenuating circumstances. Where business decisions threaten a business's financial viability, primary responsibility rests with a business's management and board to address the issue.
- Use historic and forecast actual data for financial viability assessments as opposed to notional data.

Consider adjustments proposed by businesses to the inputs used in our tests (such as for leases) on a case-by-case basis, allowing only material adjustments proposed and substantiated by businesses.

TABLE 1 FINANCIAL INDICATORS

Indicator	Calculation	Benchmark Range	Description
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 business has to meet its debt obligations.
Net Debt / Regulatory Asset Value (%)	$(\text{Interest bearing liabilities} - \text{cash}) / \text{RAV}$	< 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:

- 3) FFO refers to 'funds from operations' and RAV refers to the 'regulatory asset value'.
- 4) Regarding FFO interest cover, we believe the 1.8 times benchmark signals a need for caution from businesses 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.

PROPORTION OF DISCRETIONARY REVENUE INDICATOR

In our financial models, we will also monitor estimates for a new indicator—the proportion of discretionary revenue indicator (PDRI). The Commission sought views on the indicator as part of our consultation on financial viability assessments.

The indicator reflects the proportion of regulated revenue earned that is available for a business (and its shareholder) to allocate at their discretion. A business can use these discretionary amounts to fund capital works, reduce debt, lower prices and/or pay dividends. The Commission will consider formalising the indicator as part of our financial viability assessments at a later date.

The PDRI calculation is:

$$\frac{(\text{Regulatory Revenue} - \text{Regulated Operating Expenditure} - \text{Actual Tax} - \text{Actual Interest})}{\text{Regulatory Revenue}}$$

There is no benchmark range for the PDRI.