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REVIEW OF REGULATORY ACCOUNTING CODE AND TEMPLATES

CONSULTATION PAPER

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1 INTRODUCTION

1.1 Background

The Essential Services Commission is responsible for the regulation of prices, service standards and conditions of supply for services provided by Victoria's 19 water businesses. In December 2005, the Commission released a Regulatory Accounting Code for the Victorian Water Industry (the Code) requiring businesses to maintain and report specified accounting records.

The purpose of the Code is to enable the Commission to collect regulatory accounting information on the actual expenditure incurred and revenue received by water businesses. This information collected under the Code will allow the Commission to monitor the financial performance of the businesses and provide a basis for assessing expenditure and revenue forecasts. The forecasts are used in approving prices for water, sewerage and related services in future price reviews.

The first issue of the Code was released in December 2005 subsequent to the 2005 Urban Water Price Review. At the time of the release of the Code, the Commission had not completed reviewing the pricing proposals of the rural water businesses. The Code therefore initially applied to metropolitan and regional urban water businesses and these businesses submitted the first set of regulatory accounts in 2006.

In November 2006 the Commission released an amended Code to account for the information requirements relating to the rural water businesses. Further minor amendments were made to the Code in October 2007 to reflect issues that had arisen in the review of the 2005-06 regulatory accounts submitted by the urban businesses. Following the amendments all water businesses submitted 2006-07 regulatory accounts to the Commission for review.

After a review of the 2006-07 regulatory accounts, the Commission has decided that it is timely to undertake an extensive review of the Code. This has been prompted by a number of issues that were identified during the review process and scope for improving the timeliness of the review process itself. Amongst other things, clear differences in the business' regulatory accounts have been identified, which have translated into difficulties with inputting the data for use in the price reviews.

In undertaking this review, the Commission will also take account of the recent VCEC inquiry recommendations for the Commission to develop ring fencing methodologies to separate the costs attributable to water distribution, wastewater collection and retailing, and for the Commission to undertake an inquiry into the development of a third party access regime.

This Consultation Paper has been released as the first step in the review of the processes by which the Commission proposes that regulatory accounting information be recorded, submitted, and reported. This paper details the role of the regulatory accounts, general particulars behind the regulatory accounts, and specific information requirements of the regulatory accounts. A number of issues on which the Commission is seeking feedback on are also identified throughout the paper.

The Commission will consider stakeholder comments received in response to this Consultation Paper and will consider whether it is appropriate to form a working group comprising representatives of water businesses to assist in finalising the Code and the form of the information templates. The Commission anticipates releasing the final decision and the final *Water Industry Regulatory Accounting Code* in June 2009.

1.2 Regulatory framework

The Commission's functions in respect of the Victorian water industry are established by the legislative framework as set out in *The Essential Services Commission Act 2001*, *Water Industry Act 1994*, and the Water Industry Regulatory Order 2003 (the WIRO). The Commission has the power to regulate prices for services which are prescribed services under the WIRO.

The Commission has the authority under section 4F(2)(e) of the *Water Industry Act 1994* to issue a code that requires the businesses to maintain specified accounting records and prepare accounts according to specified principles. The Commission also has general powers under *The Essential Services Commission Act 2001* and the *Water Industry Act 1994* to obtain information from the businesses.

The WIRO provides the Commission with a general power to conduct audits in relation to the reliability and quality of information reported by businesses and conformity with specifications issued by Commission.

1.3 Purpose and structure of this paper

An indicative timing for the review of the Code is shown in Table 1.1. As outlined, the review process is likely to be completed by the end of June 2009. Businesses are scheduled to submit the regulatory accounting statements and supporting information for 2007-08 and 2008-09 by 31 October 2009. Given the proposed timeframes, and in accordance with Clause 2.3.1 of the Code, the Commission proposes to extend the time for businesses to submit their 2007-08 regulatory accounting statements until 31 October 2009.

Table 1.1 **Timetable for Review**

Release consultation/issues paper	October 2008
Visit businesses to discuss issues	November 2008 - January 2009
Responses to consultation paper due	January 2009

Review responses to consultation paper	February 2009 to March 2009
Release draft decision and code	April 2009
Responses to draft decision due	May 2009
Release final decision and code	June 2009
Businesses submit regulatory accounting statements for 2007-08 and 2008-09	31 October 2009

The purpose of this Consultation Paper is to:

- summarise the role of the regulatory accounts
- explain the obligations of the water businesses in relation to the treatment of submissions and preparation of accounts
- discuss and outline issues surrounding the regulatory accounting statement templates, and
- identify the next steps in implementing amendments to the Code and templates.

Following the release of this paper the Commission proposes to meet with each business during the review to work through the initial list of issues identified. It is the Commission’s view that this would lead to better communication and understanding between the Commission and water businesses on the purpose of the RAS and outcomes that are likely to be achieved.

2 ROLE OF REGULATORY ACCOUNTS

2.1 Introduction

The Code sets out the nature of information to be prepared and submitted by businesses on actual financial performance. Firstly, clause 1.2.2 of the Code states that the information provided is intended to enable the Commission to:

(a) exercise its powers under the WIRO to approve prices which a water business may charge for prescribed services or the manner in which such prices are to be calculated or otherwise determined or to specify the prices or manner in which they are to be determined in respect of a subsequent regulatory period which will require:

  (1) a comparison of actual expenditure and revenue of the water business during the current regulatory period against forecast expenditure and revenue; and

  (2) information to enable the forecast of prudent and efficient expenditure during the subsequent regulatory period.

(b) monitor and assess compliance with all arrangements relating to the regulation of the regulated water industry which are in place from time to time;

(c) otherwise give effect to the objectives of the Commission as stated in the Essential Services Commission Act 2001, Part 1A of the WI Act and the WIRO.

The Code also requires the businesses to complete and provide the Commission with a series of templates referred to as regulatory accounting statements (RAS). The information provided in the RAS is audited by the Commission for consistency with the requirements of the Code.

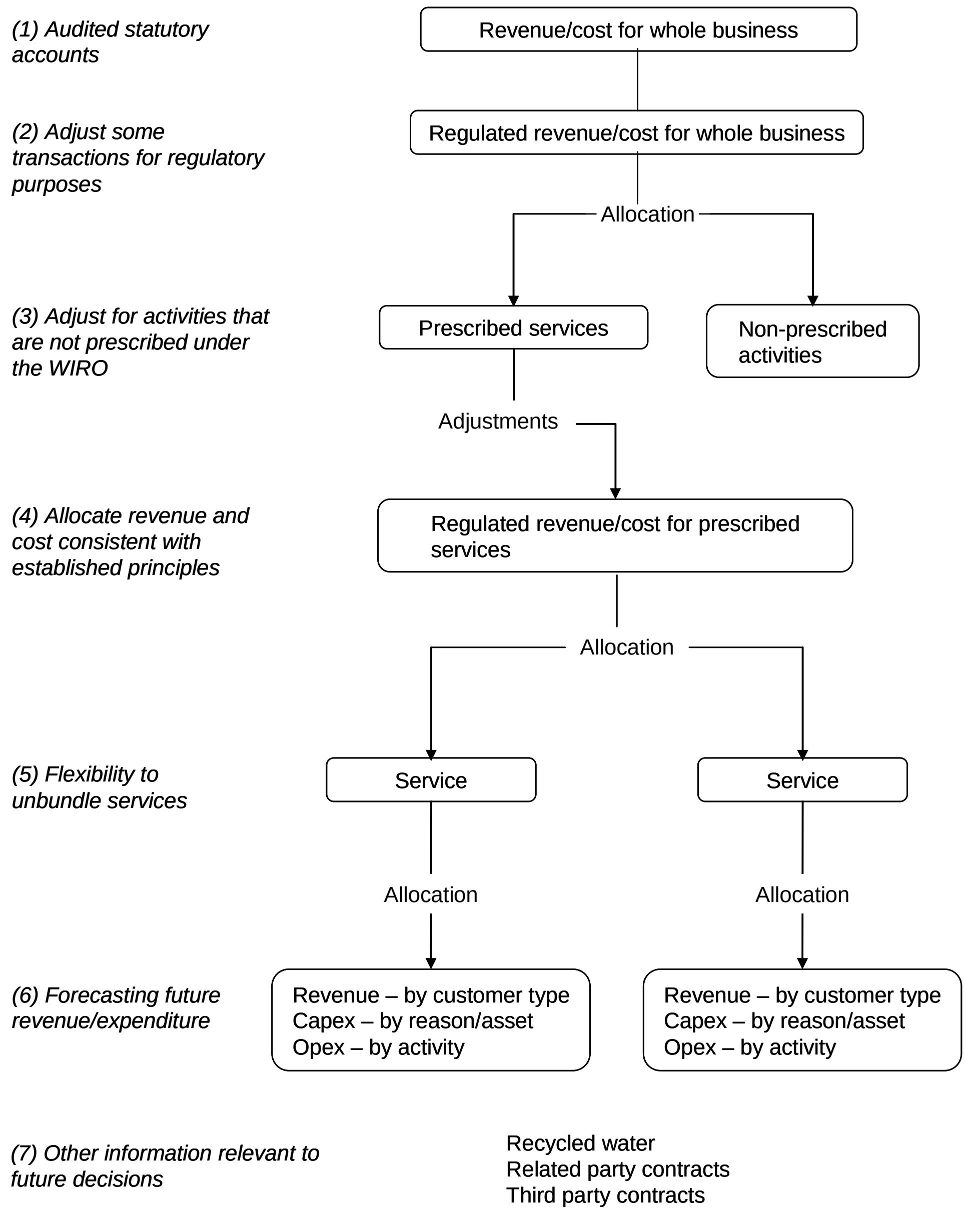
In practise the Commission uses the information collected through the Code to:

- to monitor financial performance overtime
- identify issues regarding the treatment of transactions for the purposes of approving prices
- update the regulatory asset base for the purposes of approving prices
- provides a basis for assessing forecasts used to approve prices in future price reviews.

2.2 Overview of the information collected by the Commission

Figure 2.1 outlines the information collected by the Commission through the regulatory accounting code.

Figure 2.1 **Information collected through the Regulatory Accounts process**



Water businesses' audited statutory accounts provide the starting point for information provided through RAS. The statutory accounts then need to be adjusted to provide the Commission with the information it requires for regulatory purposes. Some transactions are treated differently for financial accounting purposes than for regulatory purposes; such as bad debts are treated as an expense in the RAS though are treated as a revenue offset in the statutory accounts.

The statutory accounts cover all of the businesses activities, including those activities that are not regulated by the Commission. Adjustments need to be made to account for the revenue and expenditure associated with those activities that are not prescribed under the WIRO.

The regulated revenue and expenditure arrived at after steps 2 and 3 includes information on aggregate operating and capital expenditure incurred by a business in delivering prescribed services, as well as information on customer and government contributions and assets disposals. The regulatory asset base is updated for actual expenditure, contributions and disposals at the commencement of each subsequent regulatory period for the purpose of approving prices. Actual operating expenditure also provides information relevant to the starting point for assessing the efficiency of forecasts going forward.

Steps 5 and 6 involve disaggregating financial information by service and activity/ reason/asset. Not all categories are relevant to each business. Obtaining disaggregated information at a service level is useful because it can identify trends at a service level, and is important for unbundling. Disaggregated information by activity/reason/asset also enables the Commission to identify trends in expenditure for specific activity areas. This information can be used by Commission to assess expenditure benchmarks when approving prices.

The RAS also require the provision other information (step 7) that it considered it might require when undertaking future price reviews (new obligations, third party, related party, recycled water etc).

3 GENERAL ARRANGEMENTS

3.1 Review of regulatory accounting information

Clause 4 of the Code sets out the requirements for the review of the RAS and subsequent adjustments required by the Commission. The Commission has followed a similar approach in both reviews of the 2005-06 and 2006-07 accounts. The review process for the 2006-07 RAS generally involved the steps set out in Table 3.1.

The Code provides for the Commission to appoint a consultant to assist or undertake the review of the RAS. For the review of the 2005-06 accounts the Commission appointed Moore Stephens and for the review of 2006-07 accounts Moore Stephens assisted in the review of the urban businesses' accounts and Deloitte for the rural businesses.

Table 3.1 **Review process for the 2006-07 regulatory accounts**

Review Process	*Timeframe*
Water businesses submit their regulatory accounting statements and other information as required the Code	by November 07
Commission staff reviewed the regulatory accounting statements and identified issues for follow up with businesses and consultants	November – December 07
ESC engaged accounting consultants (Moore Stephens and Deloitte) to assist with the review of accounts and to identify issues for follow-up with businesses, and issues with the Code (areas for review)	December - January 08
ESC wrote to businesses with a list of queries and suggested amendments	January – March 08
Businesses responded and resubmitted accounts where required	February – June 08
ESC reviewed revised RAS and identified areas for further follow-up	February – June 08
Once the accounts appeared to be in order, the ESC requested businesses to formally submit the RAS with a signed Director's Responsibility Statement (see Appendix E of the Code)	April – June 08
Businesses submitted the final RAS and Directors' Responsibility Statement	April-July 08

As part of the review process businesses are required to make adjustments that the Commission considers are necessary to bring the RAS into line with the requirements of the Code.

Businesses are sent the adjusted RAS and are required to resubmit the RAS with a director’s responsibility statement. The purpose of the statement is to attest that the regulatory accounts have been prepared in accordance with the Code and that the regulatory accounting statements accurately represent the financial performance of the business.

When it first consulted on the Regulatory Accounting Code a number of businesses suggested that their directors would be reluctant to sign-off on the regulatory accounts before they are reviewed by the Commission as they may be subject to further adjustment. It was suggested that the requirement for a director’s statement be deferred until after the review of regulatory accounts by the Commission is completed.

In practice it appears to the Commission that although businesses are not required to submit a director’s responsibility statement with the initial submission of the RAS most businesses seek board approval before making the initial submission. The business is then required to go back to its board several months later following the completion of the review to obtain the director’s statement. Our understanding is that this causes issues for some businesses, as boards are confused about their role/responsibilities.

The Commission recognises that there have been some issues with timeliness of completion of the review. However, the Commission’s expectation from this review is that by making a number of changes to the Code and establishing better guidance to the businesses, it should help to improve the timeliness of future reviews of the RAS. The Commission also considers that it should continue to undertake the review with assistance of one or two firms as required, as it is important to maintain consistency and compliance with the Code.

> The Commission seeks feedback from businesses on the review process and whether the timeframe for the submission of regulatory accounting information is appropriate. It also seeks feedback on other potential improvements.
>
> The Commission also seeks feedback form businesses on issues surrounding the requirement for a director’s statement.

3.2 Timing and content of submissions

Currently businesses are required to submit regulatory accounts for each financial year by 31 October. This is 4 months after the end of financial year to which the regulatory accounts relate. The Commission considers that this is still an appropriate timeframe because it allows businesses time to prepare the regulatory accounts and provide sufficient time for Commission to undertake its review.

The regulatory accounts consist of the regulatory accounting statements (the templates) and other supporting information. Section 2.3.2 of the Code requires businesses to also submit:

(a) the audited statutory accounts on which the statements are based

(b) the chart of accounts underlying the businesses statutory accounts

(c) a statement of all regulatory accounting principles and policies which were used by the water business to prepare the regulatory accounting statements in accordance with clause 3.6.

The supporting information assists the Commission in reviewing the regulatory accounting statements for completeness and consistency with the Code.

The Commission is concerned that the nature of the supporting information currently provided by businesses is not sufficient as it is not always clear how businesses have gone from the statutory accounts to the RAS. Therefore on the basis of information provided it is often difficult to determine how accounts and amounts have been allocated to the regulatory account categories. As a consequence, this adds time to the review process because the Commission needs to go back to businesses to understand how particular amounts or transactions have been allocated or treated.

The Commission proposes for businesses to map their trial balance accounts and amounts to the regulatory accounting statements through a reconciliation template. It would be expected that businesses would undertake this process in moving from the statutory accounts to the RAS, however providing this information to the Commission would assist its understanding of how allocations to various categories have been derived.

The Commission seeks feedback from businesses on mapping trial balance accounts and amounts to the regulatory accounting statements in a reconciliation template.

3.3 Level of prescription

The Code is a high level document setting out obligations on businesses to submit certain information, prepare regulatory accounting statements, the principles for preparing regulatory accounts and obligations regarding the review and adjustment of accounts. In developing the Code the Commission noted a preference for being less prescriptive.

In reviewing the Code, the benefits of greater prescription (greater certainty and consistency across businesses) need to be weighed against the costs (greater complexity and less flexibility for businesses).

Clause 3.4 of the Code sets out the allocation principles to be used by businesses in allocating amounts/transactions by service and activity/ reason/asset. The Code requires amounts that are directly attributable to a business segment, activity area or revenue source to be allocated to that business segment, activity area or revenue source.

Where amounts cannot be allocated on a directly attributable basis the Code requires them to be attributed on a causation basis. If a causal relationship cannot be reasonably established, amounts can be allocated on a non-causal basis provided that:

- there is a strong positive correlation between the non-causal basis and the actual cause
- cost to derive causal allocation outweighs the benefits
- aggregate of amounts allocated on non-causal basis are not material.

Different businesses have taken different approaches to the basis for allocating amounts between services and activities. For example, some have allocated amounts based on customer numbers or on revenues shares. However it is important that businesses are consistent with the way they allocate year on year and that the Commission understands how businesses have allocated to ensure that it is reasonable and consistent with the Code.

Appendices B, C and D of the Code provide additional guidance to businesses on what should be included in each activity area and revenue source when making allocations. Where a business is unable to allocate base account amounts consistent with the definitions included in these appendices, it must provide information on the basis on which amounts have otherwise been allocated. Regardless of whether businesses have relied on this guidance they should be required to indicate on what basis they have allocated amounts/transactions.

It is the Commission's initial view that further prescription is not warranted, however it expects that issues to do with consistency can be dealt with through mapping the trial balance to the RAS (discussed in 3.1).

It is also the Commission's view that a number of the issues that arise relating to consistent treatment have more to do with businesses' understanding of the relationship between RAS and statutory accounts. Rather than increasing the level of prescription and reduce flexibility for businesses the Commission proposes to develop a guidance/reference paper to assist businesses in completing the RAS templates.

The Code provides high level guidance, yet in practice, it would be useful for both the businesses and ESC staff to have a resource to turn to when filling out and assessing the RAS templates respectively. The guidance/reference paper would include a step by step guide on how to fill out the templates, what information should be included in what cells, and what constitutes an item for regulatory purposes vs statutory purposes and what adjustments should be made.

> The Commission seeks feedback on whether the level of prescription appropriate. The Commission also seeks feedback on whether businesses think a guideline/reference document would be useful and what it should cover.

3.4 Treatment of activities that are not prescribed under the WIRO

Businesses are required to identify the expenditure and revenue associated with activities that are not prescribed under the WIRO. The Commission does not have a role in regulating non-prescribed services and does not approve prices for these services. Generally there are two types of non-prescribed services:

- minor non-prescribed services — provided by almost all businesses and include minor rental or leasing income, revenue from farming activities on sewage treatment plants etc. Revenue from these services is typically generated by assets which also provide ‘core services’ and these services tend to be designed to recoup costs rather than being entered into with the prime purpose of earning a profit.
- major non-prescribed services — often unique to a specific business, typically large in size and usually entered into with aim of earning a return. In addition, the provision of these activities may create some risk to the business in terms of potential costs or profits. Examples of these services include gas reticulation, and timber mill operations.

While the Commission has no role in regulating prices for non-prescribed activities, it needs to be satisfied that these activities are correctly classified and that the costs of these non-prescribed services are excluded from the regulated cost base.

The Commission notes that revenue and expenditure relating to prescribed services need to be aligned to those services as defined in the WIRO and identified in schedules 2 and 3, or based on principles outlined in schedule 4 of the businesses’ determinations, as approved by the Commission. All other revenue and expenses that result from activities that do not fit within these services cannot be allocated as prescribed activity.

During the Commission’s last review of the RAS the issue of what activities should be treated as non prescribed was raised by Goulburn Valley Water (GVW). GVW took the view that there were some activities that should be treated as prescribed because they were incidental to the provision of prescribed services, even though the Commission is not responsible for regulating the prices for these services.

It was agreed that some revenues and expense items of certain activities were undertaken by businesses with a view to reducing the overall costs associated with providing prescribed services. These included the use of land adjacent to sewage treatment plants for agricultural purposes. It was confirmed that the net profit earned from these activities is used to offset the amount that the general customer base is required to pay for prescribed services (water and sewerage etc).

It was agreed that the current definitions of prescribed and non-prescribed services did not adequately address how activities that were incidental to the provision of prescribed services should be allocated.

To address this issue and provide a better distinction between prescribed and activities incidental to the delivery of prescribed services the Commission proposes to create a separate category for these activities in the revenue and expense templates. The Commission will also provide guidance to businesses on the treatment of revenue and operating expenditure between prescribed and non-prescribed services, and revenue that is incidental to the provision of prescribed services. This issue is addressed further in section 4.

The Commission seeks stakeholder views on the proposed approach in categorising activities between prescribed and non-prescribed services, and incidental to the provision of prescribed services.

3.5 Comparative information

Currently businesses are only required to provide information in the RAS on the current year's financial information. The standard practice in presentation of financial accounts is to provide prior year comparative figures.

Provision of comparative data will also assist the Commission to determine whether year on year changes in the reported figures reflect an actual underlying change in a business's operations or are instead due to changes in accounting policy or allocation methodology.

The Commission proposes to include a comparative schedule for templates which contain revenue and expenditure information, which would be populated with the signed off RAS data from the previous year. Businesses would need to indicate in explanatory notes any significant change from the previous period and the impact on the RAS.

The Commission seeks stakeholder views on including comparative year information for templates 4 onwards.

4 SPECIFIC INFORMATION REQUIREMENTS

This chapter outlines the purpose of each RAS template and identifies some areas where they could be improved or whether the template is no longer required.

4.1 Profit and loss statement, balance sheet and cash flow statement

Templates 1 to 3 (Profit and loss statement, balance sheet and cash flow statement) should accurately reflect the numbers contained in the statutory accounts. The amounts for each category should also reflect the amounts in the statutory accounts. For example, the amounts for depreciation, bad debts, and borrowing costs should reflect the amounts contained in the Statutory Accounts.

For 2006-07, the Commission inserted two schedules in template 1 to provide businesses the opportunity to present data regarding the sale of assets (to assist the Commission in confirming the asset sale proceeds and the WDV of assets sold) and any differences in operating expenditure between template 1 (statutory accounts) and template 6 (expenditure for regulatory purposes) which may arise from the elimination/inclusion of expenditure items to arrive at a business's regulatory position.

The Commission proposes to continue with these schedules and include similar schedules for variances in statutory and regulatory revenue in template 1, and in the balance sheet and cash flow templates 2 and 3 to explain any variances in statutory and regulatory accounts from previous years.

> The Commission seeks feedback from stakeholders on the proposed approach. Are there other aspects of these templates that require further clarification?

4.2 Capital expenditure (templates 4 and 5)

Currently, the Code requires businesses to allocate capital expenditure to each business segment and the following activity areas:

- cost drivers — growth, renewal of existing infrastructure, improvements and compliance
- asset categories — headworks, pipelines, channels, treatment, and corporate.

During the 2006-07 review process, businesses took different approaches to what they included in capital expenditure. Some businesses had included additions and others reported additions and movements in work in progress (which is consistent with the Code). Further guidance than what is currently included in the Code could assist with the allocation of capital expenditure in templates 4 and 5.

The Commission seeks feedback from stakeholders on the proposed approach. Are there other aspects of these templates that require further clarification?

4.3 Operating expenditure (template 6)

Currently, the Code requires businesses to allocate operating expenditure to each business segment and the following activity areas:

- operations, maintenance, bulk charges ,treatment, renewals annuity, customer services and billing, GSL payments, licence fees, corporate and other.

Guidance on what should be included in each activity area is provided in appendix B of the Code.

The licence fee activity areas should only include amounts related to the licence fees paid to the ESC, DHS and the EPA, though some businesses included other licence fees in this category. The Commission had to confirm with a number of businesses that only the relevant licence fees had been included, which was made more difficult because the RAS only provides the total amount for licence fees. The Commission proposes to include a schedule requiring businesses to identify the individual amounts paid to each regulator. This would reduce the need to issue a request for further information during the review of the RAS.

The environmental contribution is currently included in corporate expenditure. The Commission proposes to insert a separate line for it in the template, which is consistent with the price review templates.

Other expenditure allows businesses to allocate expenditure that cannot be reasonably allocated to other categories. Currently it is difficult to know what businesses allocate to this category and the Commission has often needed to clarify this with businesses. The Commission therefore proposes to include a schedule for businesses to complete outlining what makes expenditure allocated to this category. As discussed in section 3.4, the Commission also proposes to include a separate category for operating expenditure that is incidental to the provision of prescribed services.

The Commission seeks feedback from stakeholders on the proposed approach. Are there other aspects of these templates that require further clarification?

4.4 Revenue (template 7)

The Code requires that water businesses must allocate revenue items between a number of business segments (such as retail water services, retail sewerage services, and bulk water services etc.) and then further allocate the revenue for each business segment between revenue sources (such as residential, non-residential, trade waste services etc.). Guidance on what should be included in each activity area is provided in appendix D of the Code.

Issues arose during the 2006-07 RAS review regarding the number of business segments and revenue sources provided for in template 7.

Other problems also occurred with the classification of revenue between non-scheduled services, miscellaneous services and other non-prescribed revenue. For example, businesses found it difficult to allocate items such as temporary and permanent water entitlements, asset revaluation gains, recovery of bad debts revenue, defined superannuation benefit scheme gains, write-back of over-provisions etc.

As noted in section 3.4, the Commission proposes to make a clear distinction between revenue from prescribed services as per schedules 2, 3 and 4 of each business's determination, revenue that is incidental to the provision of prescribed services, and revenue from non-prescribed services.

The Commission proposes to include a separate category for other revenue that is incidental to the provision of prescribed services. This will include items such as proceeds from the sale of water entitlements and the proceeds from asset disposals, which had previously caused issues in terms of their allocation between prescribed and non-prescribed. The Commission also proposes to include a separate schedule for this category and other non-prescribed revenue so that businesses identify each item that has been included in these categories. The Commission considers that a guidance paper outlining examples of how items should be allocated in the revenue template would assist with these allocation issues.

Southern Rural Water also argued that it requires a separate category for its licensing function, which the Commission proposes to include for rural businesses.

> The Commission seeks feedback from stakeholders on the proposed approach. Are there other aspects of these templates that require further clarification?

4.5 Provisions (template 9)

The provisions template in the RAS requires that the types of provision items that a business must make allocations to includes the following categories:

(a) Employment entitlement – annual leave

(b) Employment entitlement – long service leave

(c) Insurance

(d) Other

The Commission notes that other employee entitlements such as sick leave and rostered time off have been included in the "other" category. In order to provide greater clarification the Commission proposes to include an 'employment entitlement – other' category for other employee related provisions, reserving the “other” category solely for provision which cannot reasonably be allocated to employee entitlements and insurance.

The Commission also notes that there are allocation differences between employee provisions as reported in the statutory accounts and in the RAS, where the current annual leave provision in the statutory accounts include a portion of unconditional long service leave. The Commission considers the reporting requirements of the RAS should be aligned with statutory accounts.

The Australian Accounting Standards require entities to make a current provision for bad and doubtful debts. Bad and doubtful debts older than twelve months are written off as bad debts. However, the Code requires businesses to indentify under Template 9 ‘Non-current bad and doubtful debts’. The Commission recommends that the treatment of reporting of bad and doubtful debts in the RAS be aligned with Australian Accounting Standards.

> The Commission seeks feedback from stakeholders on the proposed approach. Are there other aspects of these templates that require further clarification?

4.6 Third party transactions (template 10)

Under the Code, businesses are required to report certain information on third party transactions. The Commission considers that it is important to collect information on third party transactions to ensure that it has a more complete understanding of how amounts that have been recorded as the actual cost of providing prescribed services have been determined. Where a business enters into an arrangement with another party to provide services, the contracted amount will generally be recorded as the cost. In most cases, the contracted amounts are likely to be recognised by the Commission as the efficient cost of undertaking a particular activity, particularly where it has been determined through a competitive process or has been market tested.

However, there may be instances where the Commission may need to better understand the basis on which contracted amounts have been determined, particularly where the incentives to minimise the cost of the services may be absent or where the contract is with a single entity to perform a substantial share of the regulated business’s activities. By collecting this information as part of the regulatory accounting statements the Commission will be in a position to identify any issues related to how these transactions are treated in advance of undertaking future price reviews.

Under the Code, businesses are required to provide additional information on third party transactions that in total account for more than 10 per cent of total operating and capital expenditure or $1 million for the financial year, whichever is greater.

When developing the Code the businesses argued that a threshold of greater than 10 per cent of operating expenditure or $1 million for the financial year, whichever is the greater was too low and would result in them having to report a number of transactions.

The Commission's view is that the current threshold expenditure is too low, and it proposes adopting a new threshold of greater than $10 million for businesses to provide additional information on third party transactions.

The Commission seeks feedback from stakeholders on the proposed approach. Are there other aspects of these templates that require further clarification?

4.7 Recycled water (template 12)

The Code requires businesses to allocate expenditure and revenue associated with recycled water projects to either the water or sewerage business segments. This requirement also reflects the fact that costs of providing recycled water are incurred in both the water and sewerage business segments.

Businesses are also required to provide a further breakdown for each type of recycled water project in template 12, consistent with the types of recycled water projects identified through the price review process (least cost, specified and discretionary).

The collection of this information was intended to allow the Commission to monitor costs associated with each type of recycling water project to assist in determining appropriate pricing principles for recycled water in future price reviews. However the template appears to have caused confusion with businesses in terms of what should be allocated to each category. It is also not easy for Commission staff to verify that amounts have been allocated appropriately.

The Commission considers that the information collected in this template does not provide any further detail than that received in other templates. The Commission therefore proposes to remove template 12 from the RAS.

However the Commission still believes that information regarding recycled water should be collected separately. Therefore the Commission proposes to include a separate column for recycled water in the revenue and expenditure templates, which is consistent with the information collected for the price review templates.

The Commission considers that businesses should ensure that the allocation of expenditure and revenue for recycled water between water and sewerage is done based on a primary purpose test. This being where if the main purpose is treatment then the activity should be allocated as sewerage, or if the primary purpose of the activity is the provision of recycled water then the revenue and expenditure should be allocated to recycled water.

The Commission notes that as there may be some ambiguity around the definition of 'recycled water', there may be merit in including a definition of recycled water in the Code. The Commission notes that it will provide guidance to the treatment of recycled water as part of the guidance reference document.

The Commission seeks feedback from stakeholders on the proposed approach. Are there other aspects of these templates that require further clarification?

4.8 New obligations and new miscellaneous services (templates 13 and 14)

The Determinations for the first regulatory period allowed businesses to recover increased expenditure that arose during the regulatory period due to changes in legislative obligations through prices in the following regulatory period. Therefore the Code was set up to allow separate identification and recording in the regulatory accounts of any such expenditure that may be incurred during the regulatory period.

This information was to be used as the basis for adjusting prices going forward. Not too many businesses sort to recover expenditure associated with new obligations. Determinations for the first regulatory period had a specific clause relating to changes in legislative obligations.

Determinations for the second regulatory period deal with changes in legislative obligations as part of the general clause relating to uncertain or unforeseen events, where the Commission would take into account any unforseen event in deciding whether or not to adjust prices.

The Commission proposes removing this template as the additional information related to new obligations is no longer required.

The Determinations for the first period also provided for businesses to introduce new miscellaneous charges during the regulatory period. The current Code requires businesses to set out more specific information related to new miscellaneous charges introduced during the period. This was to provide the Commission with information to ensure that these charges were being introduced consistent with the Determination.

As part of its 2008 price determination the Commission has adopted an alternative approach to regulating miscellaneous charges for the second regulatory period. Under the new approach businesses have identified a core set of miscellaneous services for which there is a scheduled charge. The remaining miscellaneous charges are regulated through pricing principles. Under this approach businesses can introduce a new miscellaneous charge at any time during the regulatory period (without specific approval from the Commission) as long as charges are consistent with the pricing principles.

Therefore determinations do not include a specific provision allowing businesses to introduce new miscellaneous charges. The Commission therefore proposes to remove this template as the additional information related to new miscellaneous services is no longer required.

> The Commission seeks feedback from stakeholders on the proposed approach. Are there other aspects of these templates that require further clarification?

4.9 Unbundled segments (template 15)

This template applies to all businesses except Melbourne Water and the rural only businesses. For this template expenditure and revenue information provided in the earlier templates are allocated to water collection and storage, water treatment, water transport, sewage treatment and sewage transport.

In developing the Code, the Commission noted the possibility that prices for water and sewerage may need to be unbundled in the future to facilitate third party access. Therefore, the Code requires the regional businesses and the metropolitan retailers to allocate some aggregate information (for example, operating expenditure, capital expenditure, customer and government contributions) between segments noted above.

VCEC, in its review of metropolitan retail businesses recommended the introduction of accounting ring fencing for the metropolitan retail water sector. It suggested that sector report on their water distribution, wastewater collection and retail costs, and that ESC develop methodology for implementing, auditing and publishing the information.

The Government in its response to the review supported the recommendation and intends to amend the WIRO to require the Commission to develop methodology for ring fencing.

The Government intends to ask the Commission to develop the methodology within 6 to 12 months. The expectation is that the Commission will publish information as part of its ongoing monitoring role. The Commission notes that it does not currently publish regulatory accounting information as such, except what it might use in the context of a price review.

The Commission therefore considers it is important to continue collecting the information in this template, noting that there are some technical issues to be resolved within the template itself.

> The Commission seeks feedback from stakeholders on the proposed approach. Are there other aspects of these templates that require further clarification?

4.10 Non-prescribed services (template 16)

Template 16 requires businesses to identify any non-prescribed services provided to customers during the year. As it currently stands, it is difficult to confirm the non-prescribed revenue/expenditure for the services that are identified in this template. The Commission considers that it would be useful if this template reflected the amounts for each item so they can be reconciled back to the revenue and expenditure templates as well as the Trial Balance/Stat accounts.

The Commission proposes to amend this template to include a column requiring businesses to include the dollar amount for each identified non-prescribed service revenue or expenditure. To assist with the allocation of non-prescribed services, the Commission will more clearly define non-prescribed as part of the guidance reference document.

> The Commission seeks feedback from stakeholders on the proposed approach. Are there other aspects of these templates that require further clarification?

4.11 RAV roll forward

Not actually referred to in the Code, this template is more for information purposes to show businesses how their Regulatory Asset Base is looking at the end of every financial year.

During the review process, the template caused a number of problems due to the Commission being unable to reconcile numbers for previous years back to previous RAS templates (where they existed), businesses' statutory accounts, and the 2008 Price Review financial templates. Issues also arose around values for previous years being reflected in 01/01/07 dollars.

The Commission suggests that it will populate data for previous years from previously reviewed and 'signed-off' RAS to avoid any issues regarding reliability of data. Businesses would need to present a case as to why data should be changed.

> The Commission seeks feedback from stakeholders on the proposed approach. Are there other aspects of these templates that require further clarification?

4.12 Other Issues

The Commission notes that in its 2006-07 RAS templates Melbourne Water interpreted the Code to mean that all revenue from diversion and drainage services should be recorded as new customer contribution revenue. They recorded it as Miscellaneous Services revenue in 2005-06 and 2006-07 RAS and indicated that it appeared in contrast to the requirements of the Code. The Commission notes that Melbourne Water misinterpreted clause D.3.12 in appendix D of the Code to mean that all revenue from diversion and drainage services be recorded as new customer contributions, rather than only revenue received from new customers for these services. The Commission will consider revising the wording of this clause to ensure that its meaning is clearer.

The Commission also considers that Melbourne Water should allocate its revenue from its annual drainage charges between residential and non-residential rather than allocating it all into miscellaneous services.

5 NEXT STEPS

This consultation paper identifies a number of issues the Commission is seeking stakeholder feedback on in relation to the Regulatory Accounting Code, the RAS templates and the annual review process. Stakeholders can respond to these issues or raise any other issues in relation to regulatory accounts and the Code.

As suggested earlier the Commission is proposing to meet with each business to discuss the issues raised in this paper and any other issues relevant to the Code. This should inform the responses provided to the Commission and responses to this paper can occur after these meetings.

Submissions are due by 31 January 2009 and can be sent preferably via email to water@esc.vic.gov.au or by mail to

Essential Services Commission
Level 2, 35 Spring St
Melbourne VIC 3000

The Commission will also consider forming a working group comprising representatives of the water businesses to assist in finalising the amendments to the Code and subsequent amendments to the templates.

As outlined earlier the Commission is proposing to release a draft decision and Code in March 2009 and a final decision and Code in June 2009. Businesses will then be required to submit RAS for 2007-08 and 2008-09 by 31 October 2009.