

# Central Highlands Water final decision

2023 Water Price Review

23 June 2023

## Acknowledgement

We acknowledge the Traditional Owners of the lands and waterways on which we work and live.

We acknowledge all Aboriginal and Torres Strait Islander communities, and pay our respects to Elders past and present.

As the First Peoples of this land, belonging to the world's oldest living cultures, we recognise and value their knowledge, and ongoing role in shaping and enriching the story of Victoria.

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# Summary

## We have made our final decision on Central Highlands Water's prices for the next 5 years

In April 2023, we released our draft decision on the price submission Central Highlands Water submitted to us in September 2022.<sup>1</sup> The draft decision set out our preliminary views on Central Highlands Water's proposals and invited interested parties to make further submissions. We also held a public forum in April 2023. In addition to a response by Central Highlands Water, we received five written submissions on our draft decision, which are available on our website (see Appendix A of this final decision for details).

After considering that feedback and Central Highlands Water's response, we have made a price determination for Central Highlands Water.<sup>2</sup> The price determination sets out the maximum prices Central Highlands Water may charge for prescribed services (or the manner in which its prices are to be calculated, determined, or otherwise regulated) for the 5-year period from 1 July 2023 (2023-28). This final decision sets out our supporting reasons and analysis for the price determination.



Where our final decision on a particular aspect is unchanged from our draft decision, we have not detailed the supporting reasons in our final decision. Rather, we have noted that our final decision confirms the reasons and position we reached in the draft decision.

Where we have reached a different decision to that proposed in our draft decision, or where new information required our consideration, we have set out our reasons in full in this final decision. This final decision should be read in conjunction with our draft decision.

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<sup>1</sup> Our draft decision for Central Highlands Water is available at [www.esc.vic.gov.au/waterpricereview](http://www.esc.vic.gov.au/waterpricereview).

<sup>2</sup> Before the commencement of a regulatory period, clause 10 of the Water Industry Regulatory Order 2014 requires us to make a price determination which determines the maximum prices a water business may charge, or the manner in which its prices are to be calculated, determined or otherwise regulated during the regulatory period. See Essential Services Commission, *Central Highlands Water Determination: 1 July 2023 – 30 June 2028*, 23 June 2023.

## **We have approved a revenue requirement of \$537.2 million over 5 years**

Our final decision approves a revenue requirement of \$537.2 million over the 5-year period starting 1 July 2023 (see Chapter 4).<sup>3</sup> This is \$8.3 million or 1.7 per cent higher than our draft decision, and mainly reflects our updates to the cost of debt, which we advised businesses of in late April (Section 4.4.1).

This revenue requirement will allow Central Highlands Water to deliver on its customer service commitments, government policy, statements of obligations, and obligations monitored by the Environment Protection Authority Victoria and the Department of Health.

As part of our review, we have considered whether the revenue requirement proposed by Central Highlands Water reflect forecasts for prudent and efficient expenditure. While we have approved many elements of Central Highlands Water's proposals, our final decision approves a lower revenue requirement than proposed by the water business reflecting our review of efficient costs.

## **Typical water and sewerage bills will rise from 1 July 2023**

A summary of approved maximum prices for major services delivered by Central Highlands Water is set out in Section 5.3.2. Reflecting our views on the revenue requirement, our final decision approves slightly lower prices (from 2024-25) than proposed by Central Highlands Water.

Table A shows the estimated typical bills for different customer groups under our final decision, for 2022-23 (the current year) and 2023-24. For a typical residential owner occupier, estimated annual water and sewerage bills (including inflation) will rise from around \$1,231 currently to \$1,298 in 2023-24, which is an increase of around 5.4 per cent. For a typical residential tenant, bills (including inflation) will rise from around \$313 currently to \$330 in 2023-24, which is also an increase of about 5.4 per cent. The bill paid by each customer will vary depending on water use, prices for fixed and variable tariffs, and other charges.

From 2024-25, water and sewerage prices for residential and non-residential customers will generally rise by around 0.6 per cent per year, excluding inflation.

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<sup>3</sup> The revenue requirement is the forecast amount a water business needs to deliver on customer outcomes, government policy, statements of obligations, and obligations monitored by technical regulators including the Environment Protection Authority Victoria and the Department of Health. Along with forecast demand, it is an input to calculating the prices to be charged by a water business.

**Table A**      **Estimated typical annual water and sewerage bills**

Customer group	Average consumption (kL p.a.)	2022-23 (current)	2023-24
		\$2022-23	\$2023-24
Residential – owner occupier	150	\$1,231	\$1,298
Residential – tenant	150	\$313	\$330
Non-residential (small)	200	\$1,348	\$1,421
Non-residential (medium)	1,000	\$3,944	\$4,157
Non-residential (large)	10,000	\$33,148	\$34,942

**Note:** The table shows the average bills for 2023 24 expressed in \$2023 24 terms (which means 7 per cent inflation has been included). Our draft decision included bill estimates based on our draft decision revenue requirement, expressed in \$2022 23 terms as the inflation figure was not available at this time. Our determination for Central Highlands Water sets prices in \$2023-24 terms, with provision for inflation to be added in each of the remaining years of the regulatory period based on the latest inflation data. Dollar amounts have been rounded.

## **Central Highlands Water has committed to delivering outcomes that reflect customer priorities**

Central Highlands Water plans to deliver the following outcomes for customers:

- Customer care
- Equity
- Sustainability.<sup>4</sup>

In response to our draft decision, Central Highlands Water has included a fourth outcome – ‘Reliable water and wastewater services’ – which includes the core business performance measures we considered were missing from its proposal. For more detail on Central Highlands Water’s outcome commitments, see Section 3.2.

Among the key initiatives to deliver on its commitments, Central Highlands Water has proposed to enhance its support for customers experiencing vulnerability, and further develop partnerships with Traditional Owners. Its capital program is driven by accelerated and sustained population growth, renewing assets to secure reliable services, and responding to climate change.

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<sup>4</sup> Central Highlands Water, 2023 water price submission, September 2022, pp. 50–55.

## **Central Highlands Water has considered the impacts of relatively high inflation, lowering prices for 2023-24 compared to its original proposal**

Our draft decision sought further information from Central Highlands Water on how it intends to address impacts of relatively high inflation in 2023-24 on prices, customer bills, and expenditure. In its response to our draft decision, Central Highlands Water explained:

- it proposes to double its customer assistance program to \$2.5 million over the 2023–28 regulatory period through a range of targeted support programs and will divert more resources if required to help customers manage their 2023-24 bills
- due to the different composition of its costs as compared to a ‘household basket of goods’ which the consumer price index measures, the business is seeing some costs increase by less than inflation and some by much more (for example, costs of building materials).

Central Highlands Water’s response to our draft decision proposed a real price reduction of 1.5 per cent for 2023-24, to respond to relatively high inflation. This means customer prices overall will rise by less than inflation in 2023-24.

We commend Central Highlands Water’s proactive response to our draft decision, and consider the proposed real price reduction in 2023-24 is a strong demonstration of Central Highlands Water placing customers first.

More information is available in Central Highlands Water’s response to our draft decision.<sup>5</sup>

### **Tariff structures will remain the same**

Consistent with our draft decision, our final decision approves Central Highlands Water’s proposed tariff structures on the basis that they reflect a continuation of its current approach. For water services, our final decision approves Central Highlands Water’s proposal for a fixed water service charge and a two-tier inclining block variable usage component that depends on water use. For residential sewerage services, our final decision approves Central Highlands Water’s proposal for a fixed charge only. For non-residential sewerage services, our final decision approves a fixed service charge and a variable usage component.

Our final decision also approves Central Highlands Water’s proposed tariff basket form of price control, on the basis that it is a continuation of its current approach. This means a weighted average price cap is applied to a basket of services, with the weighted average price following a

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<sup>5</sup> Central Highlands Water, *submission in response to the Essential Services Commission ‘Central Highlands Water draft decision: 2023 water price review’*, draft decision, 12 May 2023, pp. 20–22.

predetermined price path, adjusted for inflation, return on assets and any approved pass-through mechanisms. For more detail on tariffs and the form of price control, see Chapter 5.

## **We have rated Central Highlands Water’s price submission as ‘Standard’ under the PREMO framework**

Consistent with our draft decision, our final decision is to rate Central Highlands Water’s price submission as ‘Standard’ under the PREMO framework (Table B). This is the same as Central Highlands Water’s self-rating. Factors in support of Central Highlands Water’s PREMO rating include:

- Central Highlands Water has generally met its outcome commitments in the current regulatory period. At the 2018 review, we considered Central Highlands Water generally had more ambitious targets than other businesses. And during the regulatory period it reset some targets to be more ambitious compared to these initial targets – we consider this demonstrated a commitment to improving customer value in the current period.
- Central Highlands Water has proposed to double the payable amounts for not meeting two of its existing guaranteed service levels, and also proposed changes to its guaranteed service levels to reflect customer priorities.
- Central Highlands Water’s engagement methods supported inclusion and effective participation in its engagement process, including customers experiencing vulnerability and its First Nations customers.
- It has deferred almost \$144 million in capital expenditure from the current period, and accepted risk that these may need to be brought forward.
- Central Highlands Water’s efforts to tailor methods and materials to the circumstances of its customers, which had the result of ensuring customers experiencing vulnerability had a reasonable and fair opportunity to influence the issues that affected them.

See Section 1.4 for an explanation of the PREMO framework and Chapter 7 for more detail on our assessment of Central Highlands Water’s price submission.



Our PREMO rating is an assessment of the water business’s price submission and its ambition to deliver outcomes valued by its customers. It is not an assessment of the water business itself.



**Table B**      **PREMO rating**

	Overall PREMO rating	Performance	Risk	Engagement	Management	Outcomes
Central Highlands Water's self-rating	Standard	Standard	Standard	Advanced	Standard	Advanced
Commission's rating	Standard	Standard	Standard	Advanced	Basic	Advanced

# 1. Our role and approach to water pricing

## 1.1 We are Victoria's independent economic regulator

Our role in the water industry is based on the Water Industry Regulatory Order 2014 (WIRO), which is made under the *Water Industry Act 1994* (WI Act) and sits within the broader context of the *Essential Services Commission Act 2001* (ESC Act). Our role under the WIRO includes regulating the prices and monitoring service standards of the 18 water businesses operating in Victoria.

## 1.2 We are reviewing the proposed prices of 14 water businesses

Our review is of the prices that the 14 water businesses propose to charge customers for prescribed services from 1 July 2023.<sup>6</sup> The prescribed services include retail water and sewerage services, and bulk water and sewerage services delivered by the water businesses.<sup>7</sup>

Central Highlands Water provided a submission to us proposing prices for a 5-year period starting 1 July 2023. Our task is to assess the price submission using the legal framework and make a price determination that takes effect from 1 July 2023. We make a price determination after issuing a draft decision and considering feedback from interested parties, including any response to the draft decision from the water business.

The price determination specifies the maximum prices a water business may charge for prescribed services, or the manner in which prices are to be calculated, determined or otherwise regulated. We also issue a final decision that sets out our supporting reasons for our price determination.

## 1.3 We assess prices against the WIRO and other legal requirements

Clause 11 of the WIRO specifies the mandatory matters we must have regard to when making a price determination, including matters set out in the WIRO, the WI Act and the ESC Act, and clause 8 of the WIRO requires that we place particular emphasis on the promotion of efficiency-related matters. In making a price determination, we have had regard to each of the matters required by clause 11 of the WIRO, including:

- the objectives and matters specified in clause 8 of the WIRO, which include economic efficiency and viability matters, industry specific matters, customer matters, health, safety, environmental

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<sup>6</sup> The review excludes Melbourne Water, Goulburn-Murray Water, North East Water and Greater Western Water. In 2021 we approved prices for Melbourne Water to 30 June 2026 and in 2020 we approved prices for Goulburn-Murray Water to 30 June 2024. In 2018, we approved prices for North East Water to 30 June 2026. We have approved an extension to the regulatory period for Greater Western Water to 30 June 2024.

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

and social matters, and other matters which are specified in sections 8 and 8A of the ESC Act and section 4C of the WI Act

- the matters set out in section 33(3) of the ESC Act, which include the return on assets, relevant benchmarking and any other matters that the ESC considers relevant
- the matters specified in our guidance<sup>8</sup>
- the principle that prices should be easily understood by customers and provide signals about the efficient costs of providing services, while avoiding price shocks where possible
- the principle that prices should take into account the interests of customers of the regulated entity, including low income and vulnerable customers.

Appendix B lists the specific objectives and the various matters we must have regard to when making a price determination and provides a guide to where we have done so for our final decision for Central Highlands Water. Table 1.1 summarises the matters we must have regard to and groups them into themes.

In October 2021, we issued guidance to water businesses, including Central Highlands Water, to inform their price submissions. The guidance set out how we would assess Central Highlands Water's submission against the matters we must consider under clause 11 of the WIRO. It also outlined our expectation that Central Highlands Water would comply with certain requirements and specified information that Central Highlands Water must provide to us when submitting its price submission.<sup>9</sup>

If we consider the price submission has adequate regard for the matters in clause 11 of the WIRO and complies with our guidance, we must approve Central Highlands Water's maximum proposed prices it can charge for the prescribed services it provides.<sup>10</sup>

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<sup>8</sup> Essential Services Commission, *2023 water price review: Guidance paper*, 26 October 2021.

<sup>9</sup> Among these expectations are matters that progress our 'Getting to fair' strategy relating to the water industry. See Essential Services Commission, *Getting to fair: Breaking down barriers to essential services*, August 2021.

<sup>10</sup> This is a requirement of the WIRO, clause 14(a).

If we consider the submission does not have adequate regard for the matters specified in clause 11 of the WIRO or does not comply with our guidance, we may specify maximum prices, or the manner in which prices are to be calculated, determined or otherwise regulated.<sup>11</sup>



The power for water businesses to charge fees for services they provide is set out in the *Water Act 1989*.<sup>12</sup> These provisions in the Water Act also govern the processes for and manner in which water businesses may set and impose fees. Each water business must ensure that it complies with these legislative requirements.

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<sup>11</sup> This is provided for under the WIRO, clause 14(b)(i).

<sup>12</sup> See part 13, Division 5 and 6 of the Water Act 1989.

**Table 1.1 Matters businesses and the commission must have regard to**

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

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Table 1.1 (continued)

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

**Note:** References in the table are to the Water Industry Regulatory Order 2014 (WIRO), the Essential Services Commission Act 2001 (ESC Act), and the Water Industry Act 1994 (WI Act).

## 1.4 PREMO

PREMO stands for Performance, Risk, Engagement, Management, and Outcomes. Each element of PREMO is summarised in Box 1.1.

### Box 1.1 PREMO

Water businesses must demonstrate their level of ambition in delivering value for money for customers in their price submissions across the five PREMO elements:

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

First introduced at our 2018 water price review, the purpose of PREMO is to provide incentives for water businesses to deliver outcomes most valued by customers. PREMO includes reputation incentives, via the rating of price submissions as Leading (the highest available rating), Advanced, Standard or Basic, depending on the level of ambition expressed by a water business in its price submission. Financial incentives are provided by linking the return on equity to the PREMO rating.

A key priority under PREMO is to provide incentives for a water business to engage with customers to understand their priorities and concerns and to take these into account in forming the proposals outlined in its price submission. This should be evidenced in price submissions by linking the outcomes proposed with findings from a business’s engagement.

Our guidance specifies the way in which we expect water businesses to assess themselves by reference to the PREMO elements.

Our PREMO framework rewards stronger customer value propositions in price submissions, and an early draft decision is available for price submissions we can assess in a short timeframe.<sup>13</sup>

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<sup>13</sup> In December 2022, we issued early draft decisions for Yarra Valley Water and Westernport Water.

For the 2023 water price review, a water business’s ambition in terms of delivering customer value is being assessed against all five elements of PREMO — Performance, Risk, Engagement, Management and Outcomes. This is the first water price review where we are assessing the Performance element of the PREMO framework. The Performance element assesses businesses against their Outcomes and proposals from the previous price review (for our 2023 review, this means proposals at the 2018 water price review). We did not assess the Performance element in 2018 because it was the first time that we had applied the PREMO framework and so we did not have a set of approved Outcomes to inform our assessment.

Taking into account all five elements of PREMO, a water business must self-assess and propose a rating for its price submission as ‘Leading’, ‘Advanced’, ‘Standard’ or ‘Basic’. Its proposed return on equity will then reflect its proposed PREMO rating. A ‘Leading’ submission has the highest return on equity, and a ‘Basic’ submission the lowest. We assess the self-rating and also assess the price submission more broadly, including the water business’s justification for the proposed PREMO rating, and form our own view of the appropriate rating. This process determines the PREMO rating adopted and the return on equity reflected in the revenue requirement.<sup>14</sup>

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<sup>14</sup> Essential Services Commission, *2023 water price review: Guidance paper*, pp. 41–46.



## 2. Our assessment of Central Highlands Water's price submission

We have made our final decision on Central Highlands Water's price submission after considering:

- Central Highlands Water's price submission
- Central Highlands Water's presentation made directly to commissioners
- Central Highlands Water's responses to our queries and our draft decision
- our consultants' reports
- the views of participants in our public forum held on 28 April 2023<sup>15</sup>
- written submissions from interested parties (a list of submissions responding to our draft decision is provided in Appendix A).

Any reports, submissions or correspondence provided to us that are material to our consideration of Central Highlands Water's price submission are available on our website (to the extent the material is not confidential).

Our guidance included matters water businesses must address in their price submissions. Central Highlands Water's price submission addressed each of these matters, and our initial assessment of those matters is set out in our draft decision.

We consulted on our draft decision, receiving submissions between 12 April and 12 May 2023 and holding an online public forum on 28 April 2023. One topic raised by participants during the forum included the commission's rationale in its draft decision for excluding from Central Highlands Water's forecast capital expenditure \$1.5 million related to planning future projects. This topic is discussed in Section 4.2 1 of this final decision.

Central Highlands Water provided a response to our draft decision, including a revised financial model that reflected the updated cost of debt and inflation figures we provided to businesses in May 2023.<sup>16</sup> In arriving at our final decision, we have considered Central Highlands Water's responses to our draft decision.

This paper sets out our final decision.

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<sup>15</sup> A recording of this forum is available on our website.

<sup>16</sup> All references to Central Highlands Water's price submission in this document refer to Central Highlands Water's original price submission that it provided to us in September 2022 rather than its response to our draft decision.

## 2.1 Final decision paper outline

This final decision paper is structured around the steps we have taken to arrive at our price determination. In summary, these steps were:

- Determine the regulatory period (Section 2.2).
- Confirm the customer outcomes and service levels that Central Highlands Water has committed to over the regulatory period (Chapter 3).
- Establish Central Highlands Water's revenue requirement using a building block methodology (Chapter 4).
- Use demand forecasts and the form of price control to convert the revenue requirement to tariffs and prices (Chapter 5).

Chapter 6 outlines our consideration of Central Highlands Water's financial position, which we have also had regard to.

Chapter 7 outlines our assessment of Central Highlands Water's price submission under the PREMO framework.

Unless otherwise noted, all financial values referred to in this final decision paper are in \$2022-23, which means inflation is excluded.

## 2.2 Regulatory period

Our final decision is to approve a regulatory period of 5 years from 1 July 2023.

We are required to set the term of the regulatory period over which a water business's price determination will apply.<sup>17</sup> Our guidance proposed that we set a 5-year regulatory period, but also noted we were open to justified alternatives proposed in a price submission.<sup>18</sup>

Central Highlands Water proposed, and our draft decision approved, a regulatory period of 5 years.

In a submission on our draft decisions, the Consumer Action Law Centre supported our proposed 5-year regulatory period. It noted that a 5-year period provided customers with predictability around billing and services and that having a uniform period across all businesses included in our current review meant it would be easier to generate public awareness and engagement.<sup>19</sup>

Accordingly, consistent with the reasons outlined in our guidance, and as proposed in our draft decision, our final decision is to set a regulatory period of 5 years.

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<sup>17</sup> This is a requirement of the WIRO, clause 9.

<sup>18</sup> For detail on the reasons for using 5 years as the default regulatory period, see: Essential Services Commission, *2023 water price review: Guidance paper*, p. 18.

<sup>19</sup> Consumer Action Law Centre, *Feedback on standard draft decisions: 2023 Water Price Review*, 5 May 2023, p. 4.

## 3. Customer outcomes

The customer outcomes Central Highlands Water plans to deliver over the regulatory period is a key component of its price submission – confirming its commitments to customers, underpinning its revenue requirement, and feeding in to its PREMO assessment.

This chapter outlines our views on:

- Central Highlands Water’s engagement with its customers in preparing its price submission (Section 3.1)
- whether Central Highlands Water has delivered on the outcomes it committed to for the current regulatory period (2018–23) and the customer outcomes Central Highlands Water is committing to for the next regulatory period (Section 3.2)
- Central Highlands Water’s service standards for the regulatory period (Section 3.3)
- Central Highlands Water’s proposed guaranteed service level scheme for the regulatory period (Section 3.4).

### 3.1 Customer and community engagement

Our guidance required Central Highlands Water to engage with customers to inform its price submission. Our guidance also identified principles to guide Central Highlands Water’s engagement.<sup>20</sup>

As outlined in our draft decision, we consider Central Highlands Water’s engagement with customers and community aligned with these principles in a number of ways. Central Highlands Water’s engagement:

- was informed by ongoing engagement activities since 2018
- involved a range of inclusive engagement methods suitable to its context and the issues it was seeking to engage on, and enable it to receive feedback directly from its First Nations people and people more likely to experience vulnerability
- covered matters that influence services and prices, including support for customers experiencing vulnerability, water quality, drinkable town water priority areas and guaranteed service levels.

Our draft decision outlined several ways in which Central Highlands Water demonstrated that its engagement influenced its proposals. These included:

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<sup>20</sup> Essential Services Commission, *2023 water price review: Guidance paper*, 26 October 2021., p. 20. This guidance includes a focus on engagement by businesses with First Nations people and people experiencing vulnerability which are actions identified in our ‘Getting to fair’ strategy. See Essential Services Commission, *Getting to fair: Breaking down barriers to essential services*, August 2021.

- incorporating all the preferences of its deliberative assembly into its customer outcomes and outputs
- proposing an additional billing cycle for the first two years of the pricing period to reduce bill shock and support customer affordability
- doubling its current commitment in financial support for customers experiencing vulnerability to assist those customers who may be affected by the proposed price increase.

Our draft decision was to accept Central Highlands Water’s ‘Advanced’ self-rating for the Engagement element of PREMO on the basis it had designed and delivered a sound engagement program with strong customer and stakeholder influence on the proposals in its submission. Examples outlined in our draft decision included:

- its use of insights gathered through its established engagement forums to shape its price submission engagement program
- the extent to which it tailored methods and materials to the circumstances of its customers and community, which had the result of ensuring people experiencing vulnerability had a reasonable and fair opportunity to influence the issues that affected them
- its commitment to the findings of its engagement process and to the influence of customers, including by incorporating all of the preferences of its deliberative assembly
- the level of endorsement and positive feedback it received from participants of its engagement program.

In response to our draft decision, we received feedback via an anonymous submission that Central Highlands Water’s consultation on its new customer contributions was too focussed on commercial developers at the expense of residents seeking to add dwellings to their property or to take up vacant land in regional towns.<sup>21</sup> We have considered this feedback in the context of Central Highlands Water’s overall engagement, which did include some consideration of new customer contributions by residential customers as part of its deliberative assembly discussion on growth and development.<sup>22</sup>

On the basis of the above, our final decision is to accept Central Highlands Water’s self-rating of ‘Advanced’ for its price submission engagement.

See Chapter 7 for more detail on our PREMO assessment of Central Highlands Water’s price submission.

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<sup>21</sup> Anonymous, *submission to the Essential Services Commission 2023 ‘Central Highlands Water draft decision: 2023 water price review’*, 12 May 2023.

<sup>22</sup> Central Highlands Water, 2023–28 Price Submission, September 2022, p. 37

## 3.2 Outcomes

Central Highlands Water's proposed set of outcomes indicates the value its customers can expect to receive during the next regulatory period. Actual performance against output measures and targets is monitored during the regulatory period to demonstrate whether customers are receiving the value they paid for. It also informs the rating for the 'Performance' element of PREMO at the next price review.

Central Highlands Water proposed to deliver the following outcomes over the regulatory period starting 1 July 2023:

- Customer Care
- Equity
- Sustainability.

In response to our draft decision, Central Highlands Water proposed a fourth outcome, 'Reliable water and wastewater services', described below.

Central Highlands Water's proposed measures and targets that it will use to report on the performance for each outcome are detailed on pages 50 to 55 of its price submission.

In our draft decision, we agreed with Central Highlands Water's self-assessment that it has, overall, met its outcome commitments for the 2018–23 period to date, and that its reporting to customers during this period met our requirements.

In our draft decision we considered some of Central Highlands Water's measures required considerable reworking to meet our requirements, and we stated our view that the set of measures and targets were less robust than its current 2018–23 set, and may not be the best proxy for the outcomes they represent. Further, Central Highlands Water proposed to drop many of the performance measures it had in place for the current regulatory period and, accordingly, we could not ascertain whether Central Highlands Water's proposal would result in an improvement in customer value consistent with an 'Advanced' PREMO rating. We required Central Highlands Water, in response to our draft decision, to demonstrate how its outcomes proposal is consistent with an 'Advanced' PREMO rating for Outcomes.

In its price submission, Central Highlands Water stated it had updated its proposed outcomes from the previous price review in several ways, including by removing the network reliability and water quality measures and targets. It proposed to remove those measures and targets because customer research indicated that these are baseline expectations of its customers that were already being met such that they need not be included as specific standalone metrics. It explained

that such measures were reported elsewhere and they were not ‘front of mind’ for its customers in terms of providing additional value.<sup>23</sup>

While we understand Central Highlands Water’s rationale behind removing these baseline measures and targets to focus only on those improvements identified by customers, we do not agree that it is appropriate to do so. This is because we consider that a business’s set of measures and targets must provide a broad representation of the underlying value received by all customers according to the business’s performance in any given year.

We have worked with Central Highlands Water to expand its outcome set to include measures and targets that reflect both core business performance, as well as measures that reflect customer preferences. This includes the addition of a fourth outcome ‘Reliable water and wastewater services’ comprising key performance measures which continue from the current regulatory period.

We consider the re-inclusion of these key measures and their associated targets is consistent with an ‘Advanced’ rating.

Following the release of this final decision, we will publish the 2023–28 outcomes reporting template for all water businesses participating in this price review, and we expect water businesses to publish them prominently on their own websites.

Our assessment of Central Highlands Water’s outcomes, measures and targets has informed our final decision rating of its price submission for the Outcomes element of PREMO, which is discussed further in Chapter 7.

### **3.3 Service standards related to service reliability and faults**

Central Highlands Water provided a list of service standards relating to reliability and attending faults that it will include in its customer charter. Service standards are a common set of services applicable to all Victorian consumers as required by clause 18.2 of the Water Industry Standard – Urban Customer Service (Urban Water Industry Standard). Each water business must specify its own targets against each of these service standards. These service standards and corresponding target service levels are the minimum level of service customers can expect to receive.

Our draft decision summarised Central Highlands Water’s proposed service standards and the reasons we considered that they comply with the requirements of the Urban Water Industry Standard.

After considering all submissions received following our draft decision, we have not changed our views expressed in our draft decision on Central Highlands Water’s service standards.

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<sup>23</sup> Central Highlands Water, 2023 water price submission, September 2022, pp. 50–51.

Our final assessment is that the service standards relating to reliability and faults proposed by Central Highlands Water comply with the requirements of the Urban Water Industry Standard.

These service standards and Central Highlands Water's targets until 2028 are set out in Appendix C.

Service standards are set out in our Water Industry Standard. Accordingly, in early 2023-24, we will update the Water Industry Standard to reflect targets set by the water business.

### 3.4 Guaranteed service levels

Our final decision is to accept Central Highlands Water's proposed guaranteed service levels as set out in Appendix D.

Guaranteed service levels define a water business's commitment to deliver a specified level of service. For each guaranteed service level, typically a water business commits to a payment or a rebate on bills to those who have received a level of service below the guaranteed level.

Central Highlands Water's proposed guaranteed service levels are set out on page 58 of its price submission. Our draft decision summarised Central Highlands Water's proposed changes in its scheme from July 2023. These changes included doubling the rebate associated with two guaranteed service levels to \$200 and increasing the rebate for all other guaranteed service levels by 50 per cent.<sup>24</sup>

Our draft decision proposed to accept Central Highlands Water's proposed guaranteed service levels on the basis that they had been developed with customers during its engagement.

The Consumer Action Law Centre commented positively on Central Highlands Water's approach to increase the rebates associated with its guaranteed service levels.<sup>25</sup> After considering all submissions received following our draft decision, we have not changed our views expressed in our draft decision on Central Highlands Water's guaranteed service levels.

On the basis of the above, our final decision is to accept the guaranteed service levels proposed by Central Highlands Water.

Guaranteed service levels are approved in our Urban Water Industry Standard. Accordingly, in early 2023-24, we will update the Urban Water Industry Standard to reflect the guaranteed service levels set out in Appendix D.

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<sup>24</sup> This amount is in nominal terms, that is, it will not increase further with inflation.

<sup>25</sup> Consumer Action Law Centre, *Feedback on standard draft decisions: 2023 Water Price Review*, 5 May 2023, p. 4.

## 4. Revenue requirement

The revenue requirement is the forecast amount a water business needs to deliver on customer outcomes, government policy, statements of obligations, and obligations monitored by technical regulators including the Environment Protection Authority Victoria and the Department of Health.<sup>26</sup> Along with forecast demand, it is an input to calculating prices.

We have used a building block methodology to establish the revenue requirement. This chapter outlines our assessment of Central Highlands Water's revenue requirement based on the following steps:

- establish an efficient benchmark level of forecast operating expenditure for the next regulatory period (Section 4.1)
- establish an efficient benchmark level of forecast capital expenditure for the next regulatory period (Section 4.2)
- roll-forward the regulatory asset base (Section 4.3)
- apply a rate of return to the regulatory asset base, calculated using:
  - a benchmark cost of debt estimated using a 10-year trailing average approach (Section 4.4.1)
  - a benchmark return on equity value determined by Central Highlands Water's PREMO rating (Section 4.4.2)
- establish a return of capital through a regulatory depreciation allowance (Section 4.5)
- establish a benchmark tax allowance (Section 4.6).

Our final decision is to approve a revenue requirement of \$537.2 million. This is \$8.3 million higher than the revenue requirement we approved for our draft decision.

Central Highlands Water proposed a revenue requirement of \$549.2 million over a 5-year period starting 1 July 2023. Our draft decision approved a lower revenue requirement of \$528.9 million, mainly due to our preliminary views on Central Highlands Water's forecast operating expenditure. Our final decision approves a revenue requirement of \$537.2 million (Table 4.1), which reflects our assessment of each element of the revenue requirement, including forecast operating and capital expenditure.

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<sup>26</sup> We met with officers of the Department of Energy, Environment and Climate Action, the Department of Health, and the Environment Protection Authority Victoria, to discuss their expectations of Central Highlands Water in the regulatory period from 1 July 2023. We had regard to their views in arriving at our final decision.



**Table 4.1 Final decision on Central Highlands Water’s revenue requirement**

\$ million 2022-23

	2023-24	2024-25	2025-26	2026-27	2027-28	Total
Operating expenditure	<b>70.3</b>	<b>71.0</b>	<b>71.9</b>	<b>71.9</b>	<b>72.6</b>	<b>357.7</b>
Return on assets	10.5	10.9	11.7	12.6	13.7	59.3
Regulatory depreciation	20.9	21.9	22.9	23.8	24.8	114.3
Tax allowance	-	-	-	-	5.8	5.8
<b>Final decision – revenue requirement</b>	<b>101.7</b>	<b>103.8</b>	<b>106.5</b>	<b>108.3</b>	<b>116.9</b>	<b>537.2</b>

**Note:** Numbers have been rounded.

Since our draft decision, we have updated our estimates for the cost of debt, inflation, licence fees and environmental contribution to reflect the latest available information. We required Central Highlands Water to update its revenue requirement and prices to reflect updates to inflation and the cost of debt and we updated the licence fee and environmental contribution estimates.

In response to our draft decision, as well as updating for inflation and the cost of debt, Central Highlands Water proposed updates to its operating expenditure (including bulk water charges), capital expenditure, regulatory asset base and regulatory depreciation. These updates are discussed in the relevant sections below.

Following its response to our draft decision, Central Highlands Water also updated its forecast operating expenditure to reflect changes announced in the 2023-24 Victorian State Budget (see Section 4.1).

The main reason for the increase in our final decision revenue requirement compared to our draft decision is the updated estimate for the cost of debt, which reflects the rise in borrowing costs since Central Highlands Water prepared its price submission (reflected in the benchmark established for return on assets).

The adjustments to Central Highlands Water’s revenue requirement that we have made in our draft and final decisions are set out in Table 4.2, with the reasons outlined in the following sections.

**Table 4.2 Adjustments to revenue requirement – our draft and final decisions**

\$ million 2022-23

	2023-24	2024-25	2025-26	2026-27	2027-28	Total
<b>A. Central Highlands Water's proposed revenue requirement</b>	<b>104.1</b>	<b>106.9</b>	<b>109.2</b>	<b>110.4</b>	<b>118.6</b>	<b>549.2</b>
<b>B. Total adjustments proposed in our draft decision</b>	<b>-2.1</b>	<b>-3.9</b>	<b>-4.3</b>	<b>-4.7</b>	<b>-5.2</b>	<b>-20.3</b>
Operating expenditure	-2.1	-3.7	-4.0	-4.3	-4.6	-18.8
Return on assets	-0.0	-0.1	-0.1	-0.1	-0.2	-0.6
Regulatory depreciation	-	-0.1	-0.2	-0.3	-0.4	-0.9
<b>C. Draft decision – revenue requirement (C = A+B)</b>	<b>101.9</b>	<b>103.1</b>	<b>104.9</b>	<b>105.7</b>	<b>113.4</b>	<b>528.9</b>
<b>D. Total adjustments in our final decision</b>	<b>-0.2</b>	<b>0.7</b>	<b>1.6</b>	<b>2.6</b>	<b>3.5</b>	<b>8.3</b>
Operating expenditure	0.3	0.3	0.2	0.2	0.2	1.2
Return on assets	-0.5	0.3	1.2	2.1	3.1	6.2
Regulatory depreciation	-	0.1	0.2	0.2	0.3	0.9
Tax allowance	-	-	-	-	-0.1	-0.1
<b>E. Final decision – revenue requirement (E = C + D)</b>	<b>101.7</b>	<b>103.8</b>	<b>106.5</b>	<b>108.3</b>	<b>116.9</b>	<b>537.2</b>

**Note:** Row A shows the total revenue requirement proposed by Central Highlands Water in its price submission. Row B shows the total difference between our draft decision and what Central Highlands Water proposed in its price submission. Row C shows the total revenue requirement we adopted in our draft decision. Row D shows the total difference between our final decision (row E) and our draft decision.

## 4.1 Operating expenditure

Our final decision is to adopt a forecast operating expenditure of \$357.7 million for Central Highlands Water for the 2023–28 regulatory period.

Operating expenditure – comprising both controllable and non-controllable expenditure – is a component of the revenue requirement. Our draft decision proposed to adopt a forecast operating

expenditure of \$356.50 million for the 5-year period, which was \$18.75 million lower than proposed by Central Highlands Water.

Table 4.3 sets out our final decision on Central Highlands Water's forecast operating expenditure, for the purpose of establishing the revenue requirement outlined in Table 4.1.

**Table 4.3 Final decision – operating expenditure**

\$ million 2022-23

	2023-24	2024-25	2025-26	2026-27	2027-28	Total
<b>Controllable operating expenditure</b>	<b>64.87</b>	<b>65.64</b>	<b>66.72</b>	<b>66.84</b>	<b>67.63</b>	<b>331.71</b>
<b>Non-controllable operating expenditure</b>	<b>5.48</b>	<b>5.34</b>	<b>5.20</b>	<b>5.07</b>	<b>4.94</b>	<b>26.03</b>
Bulk services <sup>a</sup>	0.68	0.68	0.68	0.68	0.68	3.41
Environmental contribution <sup>b</sup>	4.32	4.17	4.03	3.90	3.77	20.19
Licence fees – Essential Services Commission <sup>c</sup>	0.08	0.08	0.08	0.08	0.09	0.42
Licence fees – Department of Health <sup>c</sup>	0.04	0.04	0.04	0.04	0.04	0.18
Licence fees – Environment Protection Authority <sup>c</sup>	0.20	0.20	0.20	0.20	0.20	1.01
Temporary water purchases	0.16	0.16	0.17	0.17	0.17	0.82
<b>Final decision – operating expenditure</b>	<b>70.35</b>	<b>70.98</b>	<b>71.92</b>	<b>71.91</b>	<b>72.57</b>	<b>357.74</b>

**Notes:** Numbers have been rounded. <sup>a</sup> Bulk services covers the supply of bulk water and sewerage services.

<sup>b</sup> Environmental contributions are funds collected from water businesses under the *Water Industry Act 1994*. <sup>c</sup> Licence fees are paid to cover costs incurred by the Department of Health, the Environment Protection Authority Victoria, and the Essential Services Commission in their regulatory activities related to the water business.

Table 4.4 sets out the adjustments we have made to controllable and non-controllable operating expenditure for our draft decision, and since our draft decision. Details of our assessment and the reasons for our adjustments are included in Section 4.1.1 (controllable operating expenditure) and Section 4.1.2 (non-controllable operating expenditure).

The operating expenditure that we have adopted for Central Highlands Water does not represent the amount that Central Highlands Water is required to spend or allocate to particular operational, maintenance and administrative activities. Rather, it is a benchmark that represents assumptions about the overall level of operating expenditure (to be recovered through prices) that we consider sufficient to operate the business efficiently, meet its legislative and policy objectives, and to maintain services over the regulatory period.

**Table 4.4 Our adjustments to Central Highlands Water’s operating expenditure for our draft and final decisions**

\$ million 2022-23

	2023-24	2024-25	2025-26	2026-27	2027-28	Total
<b>A. Central Highlands Water’s proposed total operating expenditure</b>	<b>72.17</b>	<b>74.40</b>	<b>75.69</b>	<b>75.98</b>	<b>77.01</b>	<b>375.25</b>
A1 – Our draft decision adjustments to controllable operating costs	-1.53	-1.84	-2.10	-2.42	-2.73	-10.63
A2 – Our draft decision adjustments to non-controllable operating costs	-0.59	-1.85	-1.90	-1.87	-1.90	-8.11
<b>B. Draft decision – total operating expenditure</b>	<b>70.05</b>	<b>70.71</b>	<b>71.68</b>	<b>71.68</b>	<b>72.37</b>	<b>356.50</b>
<b>C. Final adjustments to controllable operating costs (C1 + C2)</b>	<b>0.32</b>	<b>0.33</b>	<b>0.34</b>	<b>0.34</b>	<b>0.35</b>	<b>1.68</b>
C1 – Regulatory accounts reconciliation	0.18	0.18	0.19	0.19	0.19	0.93
C2 – 2023-24 State Budget updates	0.14	0.15	0.15	0.16	0.16	0.75
<b>D. Final adjustments to non-controllable operating costs (D1 + D2 + D3 + D4 + D5)</b>	<b>-0.02</b>	<b>-0.06</b>	<b>-0.09</b>	<b>-0.12</b>	<b>-0.15</b>	<b>-0.44</b>
D1 – Environmental contribution	-0.02	-0.04	-0.06	-0.08	-0.09	-0.29
D2 – Licence fees – Essential Services Commission	0.01	0.01	0.01	0.01	0.01	0.03
D3 – Licence fees – Department of Health	-0.01	-0.01	-0.01	-0.01	-0.01	-0.04
D4 – Licence fees – Environment Protection Authority	-0.04	-0.04	-0.05	-0.05	-0.05	-0.22
D5 – External bulk water charges – Goulburn-Murray Water	0.03	0.02	0.01	0.01	-0.00	0.07

Continued next page

**Table 4.4 (continued)**

	2023-24	2024-25	2025-26	2026-27	2027-28	Total
<b>E. Final decision – total operating expenditure (E = B + C + D)</b>	<b>70.35</b>	<b>70.98</b>	<b>71.92</b>	<b>71.91</b>	<b>72.57</b>	<b>357.74</b>

**Note:** See our draft decision for details of the adjustments we proposed in our draft decision (shown in rows A1 and A2). The adjustments shown in rows C and D (and disaggregated in rows C1 to C2 and rows D1 to D5) are the differences between our draft decision and our final decision and are outlined in Section 4.1.1 (controllable operating expenditure) and Section 4.1.2 (non-controllable operating expenditure) of this final decision. Numbers have been rounded.

### 4.1.1 Controllable operating expenditure

In relation to controllable operating expenditure, our preliminary findings (outlined in Section 4.1.1 of our draft decision) were that:

- We considered Central Highlands Water’s proposal reflects an efficient baseline cost to forecast annual operating expenditure after making a regulatory account adjustment which dropped the baseline by \$1.16 million (\$6.03 million across the regulatory period).
- Central Highlands Water had proposed an efficiency improvement rate of 1.0 per cent per year which is below the average of businesses in the current price review (around 1.3 per cent per year).
- The efficiency improvement rate is also lower than Central Highlands Water’s proposed average cost growth rate of 2.2 per cent per year, effectively delivering a net annual increase to its controllable annual baseline operating costs in each year of the regulatory period due to high growth.
- We considered Central Highlands Water’s forecast cost adjustment additions were prudent and efficient after removing \$0.1 million for more frequent billing (Central Highlands Water reduced its original forecast for the additional billing costs) and removing \$4.5 million for two full time equivalent staff positions each year (nine in total across the 2023–28 period) which were in addition to the four positions each year already provided for under the growth allowance. We did not consider that the further two positions per year included in Central Highlands Water’s proposal had been sufficiently justified.
- We requested that Central Highlands Water quantify the cost savings to be delivered to customers through digital metering, and to demonstrate how these savings are reflected in its financial model and passed through to customers. We also requested it explain any benefits associated with its move to quarterly billing, such as the more frequent collection of revenues, and how this may benefit customers.
- We also asked Central Highlands Water to consider whether it might be more appropriate to capitalise costs associated with contaminated biosolids and lagoon desludging works which

allows for recovery over a suitable longer time period, and to quantify the customer pricing benefits of its chosen approach.

- There is evidence that Central Highlands Water has significantly tested its controllable expenditure requirements.

In its response to our draft decision, Central Highlands Water accepted our removal of \$4.5 million for two additional full time equivalent staff positions above the growth allowance each year, and the reduction of \$0.1 million for more frequent billing. It also responded to our request for further information on digital metering and any benefits associated with its move to quarterly billing, and the costs related to contaminated biosolids and lagoon desludging works, as described below.

Central Highlands Water also reviewed its demand forecasts against the latest Victorian Government population and dwelling growth estimates. However, it did not propose to update its operating expenditure growth factor on the basis that there was not a material difference between those estimates and the figures proposed by Central Highlands Water in its initial price submission.<sup>27</sup> Given there is no material difference, we are satisfied with this approach.

#### **4.1.1.1 Digital metering and customer billing costs**

In response to our draft decision, Central Highlands Water explained that it only recently finalised the contract for its digital metering program, which was publicly announced on 8 May 2023. As the 3-year installation period will commence mid-2023, Central Highlands Water has advised that the benefits of digital metering are not likely to be realised until late in the 2023–28 regulatory period. Central Highlands Water stated that the ongoing costs associated with digital metering have not yet been incorporated into its controllable operating expenditure forecasts, and claimed this is a direct saving to customers represented in the financial model.<sup>28</sup> However, Central Highlands Water did not provide any detail about quantifying the cost savings to customers to be delivered through digital metering and how these are reflected in its financial model.

Central Highlands Water explained the primary benefits of digital metering, which include:

- improving customer experience by encouraging closer involvement, appreciation, and monitoring of their water use
- helping customers detect leaks and monitor their water use
- reduced water consumption (through leak reduction), which may enable future water supply augmentation work to be deferred

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<sup>27</sup> Central Highlands Water, *submission in response to the Essential Services Commission 'Central Highlands Water draft decision: 2023 water price review'*, 12 May 2023, pp. 16-17.

<sup>28</sup> Central Highlands Water, *submission in response to the Essential Services Commission 'Central Highlands Water draft decision: 2023 water price review'*, 12 May 2023, pp. 19-20.

- reducing health and safety risks as well as environmental and time costs from manual meter readings.<sup>29</sup>

Central Highlands Water also emphasised that quarterly meter reading and billing was strongly supported through its customer engagement program as it provides customers the ability to manage bill payments more frequently during the year and results in less bill shock.<sup>30</sup> However, it did not directly respond to our draft decision request to explain the benefit to the business of more frequent collection of revenues associated with the shorter billing cycle.

We are not satisfied Central Highlands Water has adequately addressed our draft decision request to quantify the business benefits and cost savings to customers through its \$13 million investment in digital meters and more frequent billing. However, we do recognise the meter rollout is only just commencing, and it may be too early to quantify the benefits. We are concerned the business response referred to additional ongoing operational costs for the digital metering project that are yet to be included in the financial modelling, rather than ongoing operational savings, given Central Highlands Water's own commitment that this project will be delivered at no additional cost to customers.<sup>31</sup>

Following the completion of its digital metering rollout, we require Central Highlands Water, in its price submission for the 2028 water price review, to detail both the additional operational costs and the quantified cost benefits flowing through to customers from this investment. The price submission must clearly identify how these costs and benefits have been included in its financial model.

#### **4.1.1.2 Biosolids and desludging costs**

Regarding the treatment of \$1 million (\$0.2 million per year) to move a stockpile of contaminated biosolids and the \$1.97 million (\$0.39 million per year) to complete lagoon desludging work, Central Highlands Water considered the opportunity to capitalise these expenses, but has opted to treat these costs in line with its statutory accounting treatment and retain them as operating expenditure in its pricing model.<sup>32</sup> While we accept this is an appropriate treatment of these costs,

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<sup>29</sup> Central Highlands Water, *submission in response to the Essential Services Commission 'Central Highlands Water draft decision: 2023 water price review'*, 12 May 2023, p. 16.

<sup>30</sup> Central Highlands Water, *submission in response to the Essential Services Commission 'Central Highlands Water draft decision: 2023 water price review'*, 12 May 2023, p. 17.

<sup>31</sup> Central Highlands Water, *New data insights to drive customer benefits in digital water meter rollout*, 8 May 2023, <https://www.chw.net.au/news/latest-news/new-data-insights-to-drive-customer-benefits-in-di>.

<sup>32</sup> Central Highlands Water, *submission in response to the Essential Services Commission 'Central Highlands Water draft decision: 2023 water price review'*, 12 May 2023, p. 17.

we encourage businesses to consider capitalising one-off expense items where it is beneficial to customer prices to recover these costs over a timeframe greater than a 5-year regulatory period.

#### 4.1.1.3 Regulatory accounts and other adjustments

Central Highlands Water also acknowledged the discrepancy between the operating expenditure in its 2021-22 regulatory accounts, and the value used for the 2021-22 baseline in its submitted pricing model. It said this was due to incorrectly classifying some costs within its regulatory accounts. In its response to our draft decision, Central Highlands Water requested a further increase of \$1.01 million to its 2021-22 operating expenditure baseline, to reflect additional corrections to its regulatory accounts due to the reclassification of some operating expenditure between prescribed and non-prescribed categories.<sup>33</sup>

We have evaluated these proposed adjustments with our regulatory accounts consultant and have determined that only \$0.18 million should be allowed within the 2021-22 baseline on the basis that insufficient evidence has been provided to substantiate that all costs were incorrectly included in its non-prescribed operating costs, and that several costs did not appear to be recurring or were for non-prescribed activities. Adding this \$0.18 million to the 2021-22 baseline results in an overall operating expenditure increase of \$0.93 million across the regulatory period.

Following the release of the 2023-24 Victorian State Budget on 23 May, we wrote to water businesses to provide them with an opportunity to update their cost forecasts, should they seek to claim any additional costs and reflect these in customer prices.<sup>34</sup>

Central Highlands Water responded with updated cost forecasts to reflect higher payments relating to payroll tax. We have accepted these additional amounts as they are unavoidable costs that the business faces in delivering prescribed services to its customers.

Accordingly, after considering all submissions received in response to our draft decision, on the basis that the expenditure is consistent with our guidance, our final decision is to adopt an updated controllable operating expenditure forecast of \$331.71 million (Table 4.3).

#### 4.1.2 Non-controllable operating expenditure

In relation to non-controllable operating expenditure, our preliminary findings (outlined in Section 4.1.2 of our draft decision) were that:

- Central Highlands Water had partially followed the approach set out in our guidance paper to forecast its non-controllable operating costs in its price submission but had forecast minor non-

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<sup>33</sup> Central Highlands Water, *submission in response to the Essential Services Commission 'Central Highlands Water draft decision: 2023 water price review'*, 12 May 2023, p. 5-6.

<sup>34</sup> Victorian Government, *Budget papers '2023/24 State Budget papers'*, 23 May 2023



material but stable increases for external licence fees, and an increased environmental contribution in 2023-24 followed by a material increase in 2024-25 before declining in real terms.

- We had requested Central Highlands Water respond to our draft decision by updating its forecast bulk charges for the period 2022-23 to 2027-28 by using the approved prices for Goulburn-Murray Water in 2022-23.

We noted in our draft decision that we would update the forecast non-controllable operating expenditure for our final decision, and also adjust for the latest inflation and external bulk charges data.

For the environmental contribution, we have used the 2022-23 value provided by the Department of Energy, Environment and Climate Action and assumed that this will remain flat in nominal terms (decline in real terms) across the 2023–28 regulatory period.

We have assumed the licence fees for the Department of Health and the Environment Protection Authority Victoria remain flat in real terms across the period.<sup>35</sup>

For our Essential Services Commission licence fee, we have taken our forecast fee estimate schedule, which is based on the expected work program across the 2023–28 regulatory period (which is in nominal dollars) and deflated it into 2022 23 dollars to express the fee in real terms.<sup>36</sup>

In response to our draft decision, Central Highlands Water updated its financial model to reflect the Goulburn-Murray Water bulk charges for 2023-24 and followed our request to maintain the forecast bulk charges at a flat rate in real terms for the next regulatory period. We have also verified Central Highlands Water’s forecast bulk charges were consistent with our annual tariff approval for 2023-24 and Goulburn-Murray Water’s 2020 price determination. We have adopted Central Highlands Water’s latest forecast external bulk charges of \$3.41 million over the next regulatory period.

We have reduced Central Highlands Water’s forecast non-controllable operating expenditure by \$0.44 million across the 2023–28 period, resulting from the following adjustments:

- \$0.22 million decrease for licence fees after considering the latest information received from the relevant regulatory authorities

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<sup>35</sup> For the Safe Drinking Water Administration levy, we have used the 2021-22 value provided by the Department of Health and indexed it by the annual rate for fees in 2022-23 (1.75 per cent), as set out by the Department of Treasury and Finance’s cost recovery guidelines (<https://www.dtf.vic.gov.au/financial-management-government/indexation-fees-and-penalties>). We have applied the same approach to the 2021-22 licence fee provided by the Environment Protection Authority Victoria.

<sup>36</sup> These fees are yet to be determined by the Minister for Water.

- \$0.29 million decrease for the environmental contribution to account for the latest data on inflation.
- \$0.07 million increase for external bulk water charges as revised by Central Highlands Water to reflect the Goulburn-Murray Water bulk charges for 2023-24 and maintaining that charge at a flat rate in real terms for the next regulatory period.

Accordingly, consistent with the reasoning in our guidance paper, our final decision is to adopt a revised non-controllable operating expenditure of \$26.03 million over the next regulatory period.

## 4.2 Capital expenditure

Our final decision is to adopt a forecast capital expenditure of \$250.86 million.

Capital expenditure is an input to estimating the regulatory asset base, which is an input to the revenue requirement. Our draft decision proposed to adopt a forecast capital expenditure of \$244.7 million for the 5-year period, which is \$11.3 million lower than the \$256 million proposed by Central Highlands Water.

The reasons for our draft decision were that:

- Central Highlands Water demonstrated it has adopted a reasonable approach to developing its capital program, and that its capital expenditure forecasts are largely prudent and efficient.
- We reallocated the forecast costs for the Ballarat Sewer Growth Project (\$1.12 million) and the Ballarat Water Growth Project (\$0.43 million) for the Western and North-Western growth area, to the beginning of the 2028–33 regulatory period, given timing uncertainty regarding the rezoning of required land (discussed further in Section 4.2.1).
- We adjusted the forecast expenditure for the Growth and Development Upsizing and Efficiency program down by \$4.9 million across the 2023–28 regulatory period, given its cost forecast was based on actual costs during the 2018–23 regulatory period which included the delivery of two high-cost projects, along with an annual contingency allowance of \$0.5 million (discussed further in Section 4.2.2).
- We adjusted the forecast expenditure for the Information and Communications Technology (ICT) Business Solutions Enhancements program down by \$4.9 million across the 2023–28 regulatory period, given the scope and associated benefits of the program were still in development and required further refinement (discussed further in Section 4.2.3).
- We considered the remaining planned capital expenditure program is achievable, given Central Highlands Water’s track record delivering its capital expenditure program.
- We considered Central Highlands Water’s approach to forecasting its capital expenditure, other than the adjustments described above, was consistent with the requirements of our guidance.

**Table 4.5 Adjustments to forecast capital expenditure – our draft and final decisions**  
\$ million 2022-23

	2023-24	2024-25	2025-26	2026-27	2027-28	Total
<b>A. Central Highlands Water's proposed forecast capital expenditure</b>	<b>45.99</b>	<b>48.00</b>	<b>50.01</b>	<b>54.01</b>	<b>57.99</b>	<b>256.00</b>
A1 – Ballarat Water Growth Project – Western and North-Western growth area	0.00	0.00	0.00	0.00	-0.43	-0.43
A2 – Ballarat Sewer Growth Project – Western and North-Western growth area	0.00	0.00	0.00	-0.35	-0.77	-1.12
A3 – Growth and Development Upsizing and Efficiency Program	-1.30	-0.90	-0.90	-0.90	-0.90	-4.90
A4 – ICT Business Solutions Enhancements	-1.13	-1.00	-0.63	-1.26	-0.87	-4.90
<b>B. Draft decision – total capital expenditure</b>	<b>43.56</b>	<b>46.10</b>	<b>48.48</b>	<b>51.50</b>	<b>55.02</b>	<b>244.66</b>
<b>C. Total adjustments in our final decision</b>	<b>2.43</b>	<b>1.00</b>	<b>0.63</b>	<b>1.26</b>	<b>0.87</b>	<b>6.20</b>
C1 – Growth and Development Upsizing and Efficiency Program	1.30	0.00	0.00	0.00	0.00	1.30
C2 – ICT Business Solutions Enhancements	1.13	1.00	0.63	1.26	0.87	4.90
<b>D. Final decision – total forecast capital expenditure (D = B + C)</b>	<b>45.99</b>	<b>47.10</b>	<b>49.11</b>	<b>52.76</b>	<b>55.89</b>	<b>250.86</b>

**Note:** Row A shows the total forecast capital expenditure proposed by Central Highlands Water in its price submission. Row B shows the total forecast capital expenditure we adopted in our draft decision. Row C shows the total difference between our final decision (row D) and our draft decision. Numbers have been rounded.

In response to our draft decision, Central Highlands Water sought that we reverse the adjustments we made in our draft decision, and provided further information and justification to support its request. Our further consideration of these adjustments is outlined in the sections below.

#### 4.2.1 Ballarat Sewer Growth Project and the Ballarat Water Growth Project

As described above, in our draft decision, we reallocated Central Highlands Water's forecast costs for the Ballarat Sewer Growth Project (\$1.12 million) and the Ballarat Water Growth Project (\$0.43 million) for the Western and North-Western growth area, to the beginning of the 2028–33 regulatory period, given timing uncertainty regarding the re-zoning of required land.

In response, Central Highlands Water stated that the proposed expenditure reflects reasonable assumptions regarding development timelines and only includes relevant planning and design costs, given the City of Ballarat's resolution to seek the rezoning of the relevant land.<sup>37</sup> Land developer Integra also provided a submission in support of both projects, stating that the expenditure should be included in Central Highlands Water's capital forecast given the intent of the City of Ballarat council, and the importance of future development works to meet growth in the business area in response to falling levels of available land for development.<sup>38</sup>

Our expenditure consultant reviewed the additional information provided by Central Highlands Water however did not change its view that recovery of this expenditure should be deferred to the 2028–33 regulatory period because of the underlying uncertainty in the timing of future growth and land development needs, given the relevant re-zoning application remains pending.

For our final decision we retain our draft decision to exclude the forecast expenditure for the planning and development works from the revenue requirement, and therefore customer prices, for the 2023–28 regulatory period. We agree with our consultant's view on the existing uncertainty around the rezoning application. However, noting Integra's concern about delaying the project until the 2028–33 regulatory period, we reiterate that our final decision does not in any way preclude Central Highlands Water from conducting any required capital planning and development works to meet its obligations if and when a rezoning application is approved.

We also note that Central Highlands Water has forecast this expenditure for the last 2 years of the regulatory period, and that any capital expenditure above the benchmarks we approve may be reviewed at the end of the regulatory period and included in its regulatory asset base, subject to establishing its prudence and efficiency. Given this, we consider it is reasonable for the business to carry the risk of incurring these costs for a year or two, especially when compared with the total investment cost when the land development works proceed.

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<sup>37</sup> Central Highlands Water, *submission in response to the Essential Services Commission 'Central Highlands Water draft decision: 2023 water price review'*, 12 May 2023, pp. 7-8.

<sup>38</sup> Integra, *Response to ESC Draft Decision on CHW PR23*, 12 May 2023, p. 1.

#### 4.2.2 Growth and Development Upsizing and Efficiency program

As indicated above, in our draft decision we adjusted the forecast expenditure for the Growth and Development Upsizing and Efficiency program down by \$4.9 million across the 2023–28 regulatory period, given its cost forecast was based on actual costs during the 2018–23 regulatory period which included the delivery of two high-cost projects, along with an annual contingency allowance of \$0.5 million.

In response to our draft decision, Central Highlands Water provided further information in support of its proposed forecast for its Growth and Development Upsizing and Efficiency program.<sup>39</sup> While acknowledging the presence of some uncertainty around the timing and scope of the works included in this program, Central Highlands Water sought the reinstatement of the \$4.9 million we removed in our draft decision for several reasons, including:

- Previously existing spare capacity to service new developments is now being utilised, and elevated growth rates and future projections are driving the need for further investment.
- It has identified investments exceeding the \$2.8 million forecast in 2023-24, relating to four development projects.
- Central Highlands Water is required to service major growth and facilitate increases in capacity in line with major events and projects including the 2026 Commonwealth Games, 'Keep Ballarat Moving' projects, and Roads and Drainage Upgrade Programs with local councils.

Our expenditure consultant reviewed the additional information provided by Central Highlands Water on this program and considered that the forecasted costs for 2023-24 should be reinstated to the proposed amount of \$2.8 million, given the four major land development projects identified by the business for delivery in that year.

However, our consultant remained of the view put forward in its final report on Central Highlands Water's expenditure, that the forecast allowance for the following 4 years of the period should remain at a level of \$1.5 million per year, given the uncertainty in growth drivers for this work and uncertainty in the scope of works to be performed in the latter years.

We have reviewed our consultant's advice and the information provided by Central Highlands Water and our final decision is to accept Central Highlands Water's forecast of \$2.8 million for 2023-24 (reinstating the \$1.3 million of this amount that was removed in our draft decision), because the specific projects identified by the business provide greater certainty in relation to the nature of costs and works to be performed. However, we consider that the annual allowance for

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<sup>39</sup> Central Highlands Water, *submission in response to the Essential Services Commission 'Central Highlands Water draft decision: 2023 water price review'*, 12 May 2023, pp. 9-11.

this program over the last 4 years of the regulatory period should remain at \$1.5 million per year, for the same reasons outlined in our draft decision.

Our final decision sets a benchmark for capital expenditure, but does not preclude Central Highlands Water from conducting any required growth and development works to meet its obligations and commitments during the regulatory period. Central Highlands Water's actual capital expenditure above the benchmark may be reviewed at the end of the regulatory period and included in its regulatory asset base, subject to its prudence and efficiency being established.

#### **4.2.3 ICT Business Solutions Enhancements program**

As described above, in our draft decision we adjusted the forecast expenditure for the ICT Business Solutions Enhancements program down by \$4.9 million (to \$10 million) across the 2023-28 regulatory period, given the scope and associated benefits of the program were still in development and required further refinement.

In response to our draft decision, Central Highlands Water sought the reinstatement of the \$4.9 million to deliver its ICT Business Solutions Enhancements program (totalling \$14.9 million), given its *2040 Strategy – More than Water* has now been fully endorsed by its board in April 2023 which has allowed for the final development of its overarching ICT & Digital Strategy.

In the further information provided by Central Highlands Water, it indicated that it now considers a revised total of \$19.1 million would be prudent and efficient to deliver this program. However, it is only seeking its original forecast of \$14.9 million to be included in its capital forecast. Central Highlands Water provided further information in support of its forecast capital expenditure in relation to the ICT Business Solutions Enhancement program, including a breakdown of its revised cost estimates, and a copy of its final ICT & Digital Strategy.<sup>40</sup> Central Highlands Water also stated that its proposed expenditure to deliver this program is necessary to address previous levels of under-investment in its digital capability and ICT.

Our expenditure consultant reviewed the additional information provided by Central Highlands Water and considered the new information provided greater clarity and certainty for the program over the first 3 years of the 2023–28 regulatory period. Our consultant recommended the forecast capital expenditure allowance for this program be reinstated to the levels proposed by Central Highlands Water in its price submission for the first 3 years of the regulatory period. However, our consultant considered the forecast allowance for the remainder of the period should remain at the reduced figure of \$2.0 million per year given greater uncertainty associated with the ongoing delivery of the complex program in the later years.

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<sup>40</sup> Central Highlands Water, *submission in response to the Essential Services Commission 'Central Highlands Water draft decision: 2023 water price review'*, 12 May 2023, pp.11–14, 25–39.

However, Central Highlands Water's updated project forecast included in its response to our draft decision exceeds the original proposal of \$14.9 million, even while holding years 4 and 5 at the draft decision allowance of \$2.0 million. Accordingly, our final decision is to accept Central Highlands Water's request to reinstate the price submission proposed forecast of \$14.9 million, given the increased confidence and clarity now available for deliverables and costs of this program, and Central Highlands Water's willingness to carry the risk of the additional expenditure it expects to incur during the regulatory period.

Central Highlands Water also raised that it has classified its Software as a Service (SaaS) expenditure as capital expenditure, for the purposes of regulatory pricing, rather than operating expenditure consistent with accounting standards which changed during the current period.<sup>41</sup> We provided guidance to water businesses consistent with these new accounting standard changes, which indicated the development and implementation costs of a new IT system might be justified as capital expenditure in pricing models and recovered over the expected life of the new system, while any licensing and ongoing operating costs would remain as operating expenditure. We expect Central Highlands Water will treat its IT costs consistent with this guidance in its regulatory accounts and future pricing models.

#### **4.2.4 Our final decision on capital expenditure**

After considering all submissions received in response to our draft decision, for the reasons outlined above, our final decision is to adopt a forecast capital expenditure of \$250.86 million for the 5-year period (Table 4.5), which is \$6.20 million higher than we adopted for our draft decision and \$5.14 million lower than that proposed by Central Highlands Water. This decision reflects reinstating \$1.30 million for the growth and development upsizing and efficiency program, and \$4.90 million for the ICT Business Solutions Enhancements program.

We consider this benchmark is consistent with our guidance and the principles in the Water Industry Regulatory Order (2014). Our final decisions on Central Highlands Water's forecast regulatory asset base (Table 4.7) and revenue requirement (Table 4.1) reflect this benchmark.

The benchmark that we propose to adopt for Central Highlands Water does not represent the amount that Central Highlands Water is required to spend or allocate to particular projects. Rather, it represents assumptions about the overall level of expenditure (to be recovered through prices) that we consider sufficient to operate the business and to maintain or improve services over the regulatory period. Where we have made an adjustment to exclude a project's capital expenditure from Central Highlands Water's revenue requirement, we are not requiring the business to remove

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<sup>41</sup> Central Highlands Water, *submission in response to the Essential Services Commission 'Central Highlands Water draft decision: 2023 water price review'*, 12 May 2023, p. 14.



that project. Central Highlands Water determines how to best manage the allocation of its revenue and priority of its expenditure within a regulatory period.

### 4.3 Regulatory asset base

A water business's regulatory asset base is the value of the business's assets for regulatory purposes.<sup>42</sup> The regulatory asset base is used to estimate the return on assets (discussed in Section 4.4) and regulatory depreciation (discussed in Section 4.5). Both the return on assets and regulatory depreciation are components of the revenue requirement.

Our guidance required Central Highlands Water to propose:

- the closing value of its regulatory asset base at 30 June 2022 (using actual data)
- the opening value of its regulatory asset base at 1 July 2023 (calculated according to the criteria outlined in the guidance)
- the forecast value of its regulatory asset base for each year of the regulatory period (2023-24 to 2027-28), in accordance with the prudence criteria outlined in the guidance.

#### 4.3.1 Closing regulatory asset base

Our final decision is to approve a closing regulatory asset base at 30 June 2022 of \$409.4 million.

We update the regulatory asset base to reflect actual gross capital expenditure, less government and customer contributions, and asset disposals for the period from 2017-18 to 2021-22.<sup>43</sup> This helps to ensure prices reflect the actual net expenditure of a water business.<sup>44</sup>

Our draft decision accepted Central Highlands Water's proposed closing regulatory asset base because it was calculated in accordance with the requirements of our guidance.

After considering all submissions received in response to our draft decision, our final decision is the same as our draft decision. Therefore, our final decision is to approve a closing regulatory asset base at 30 June 2022 of \$409.4 million (Table 4.6).

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<sup>42</sup> These values were set initially for the water businesses by the Minister for Water and are adjusted on an ongoing basis to account for new investments, asset disposals, depreciation and inflation.

<sup>43</sup> See Section 4.2 for a discussion of Central Highlands Water's capital expenditure.

<sup>44</sup> Net capital expenditure is calculated by deducting government and customer contributions from gross capital expenditure. Customer contributions reflect revenue earned from new connections made to the water business's water, sewerage or recycled water networks.



**Table 4.6 Final decision – closing regulatory asset base (RAB)**

\$ million 2022-23

	2017-18	2018-19	2019-20	2020-21	2021-22
<b>Opening RAB 1 July</b>	<b>375.6</b>	<b>381.8</b>	<b>391.4</b>	<b>401.7</b>	<b>405.6</b>
Plus gross capital expenditure	25.2	30.4	32.9	28.1	29.1
Less government contributions	-	-	-	0.4	0.4
Less customer contributions	1.9	2.0	3.3	3.7	4.1
Less proceeds from disposals	0.3	0.6	0.2	0.6	0.6
Less regulatory depreciation	16.8	18.2	19.0	19.5	20.2
<b>Closing RAB 30 June</b>	<b>381.8</b>	<b>391.4</b>	<b>401.7</b>	<b>405.6</b>	<b>409.4</b>

**Note:** Numbers have been rounded.

### 4.3.2 Forecast regulatory asset base

Our final decision is to adopt a forecast regulatory asset base as set out in Table 4.7

The forecast regulatory asset base is calculated having regard to the closing regulatory asset base, and forecasts for capital expenditure, government and customer contributions, and asset disposals.

Our draft decision did not accept Central Highlands Water's forecast regulatory asset base for the period from 1 July 2023 due to changes we proposed to its forecast capital expenditure and customer contributions.

In response to our draft decision, Central Highlands Water proposed an updated forecast regulatory asset base that reflected proposed updates to its customer contributions forecasts (see Section 4.3.2.1), but not to its capital expenditure forecasts (choosing instead to maintain its price submission forecast).

While our final decision is to accept Central Highlands Water's updated customer contributions forecasts (Section 4.3.2.1), we have not accepted its capital expenditure forecasts, as discussed above at Section 4.2. Accordingly, we have not accepted the forecast regulatory asset base that it proposed and have instead accepted a forecast regulatory base that reflects our decision on its proposed capital expenditure forecasts.

Our final decision on Central Highlands Water’s forecast regulatory asset base reflects our final decisions on its closing regulatory asset base and the components of the forecast regulatory asset base, which are outlined in the following sections of this final decision paper:

- Section 4.2 (capital expenditure)
- Section 4.3.2.1 (customer contributions)
- Section 4.5 (regulatory depreciation).

Table 4.7 sets out our final decision on Central Highlands Water’s forecast regulatory asset base from 1 July 2023.<sup>45</sup>

**Table 4.7 Final decision – forecast regulatory asset base (RAB)**

\$ million 2022-23

	2022-23	2023-24	2024-25	2025-26	2026-27	2027-28
<b>Opening RAB 1 July</b>	<b>409.4</b>	<b>421.1</b>	<b>441.7</b>	<b>460.7</b>	<b>479.2</b>	<b>498.6</b>
Plus gross capital expenditure	37.5	46.0	47.1	49.1	52.8	55.9
Less government contributions	0.4	-	-	-	-	-
Less customer contributions	4.1	4.2	5.7	7.4	9.2	11.4
Less proceeds from disposals	0.6	0.4	0.4	0.4	0.4	0.4
Less regulatory depreciation	20.5	20.9	21.9	22.9	23.8	24.8
<b>Closing RAB 30 June</b>	<b>421.1</b>	<b>441.7</b>	<b>460.7</b>	<b>479.2</b>	<b>498.6</b>	<b>517.9</b>

**Note:** Numbers have been rounded.

<sup>45</sup> Our guidance required water businesses to provide an estimate of the components of their regulatory asset base for 2022-23. This was so we could assess the opening asset base for 1 July 2023. Our guidance noted that where the 2022-23 forecasts for net capital expenditure (gross capital expenditure less government and customer contributions) is lower than the forecast benchmark for that year in its 2018 price determination, the lower amount must be used. The estimates for 2022-23 will be confirmed at the price review following the 2023 water price review. Essential Services Commission, *2023 water price review: Guidance paper*, p. 38.

### 4.3.2.1 Customer contributions

Our final decision is to adopt the benchmarks for customer contributions as set out in Table 4.7.

Revenue from customer contributions is deducted from gross capital expenditure so it is not included in the regulatory asset base.<sup>46</sup>

Our draft decision proposed not to accept Central Highlands Water's forecast revenue from customer contributions because we did not accept Central Highlands Water's proposed new customer contributions and because Central Highlands Water's forecasts for customer contributions in the financial model and the new customer contributions model did not match.

We asked Central Highlands Water to update its customer contribution forecasts in response to our draft decision and to ensure that the forecast customer contributions in the financial model and new customer contributions model reconcile.

As discussed in Section 5.4, our final decision accepts Central Highlands Water's proposed new customer contributions. In response to our draft decision, Central Highlands Water has also provided an updated financial model with forecast customer contributions revenues that are consistent with the forecast revenue to be generated by its proposed new customer contributions. Accordingly, we consider that the proposed forecast revenue from customer contributions has been calculated consistently with the requirements of our guidance.

After considering all submissions received in response to our draft decision, and for the reasons set out above, our final decision accepts Central Highlands Water's revised benchmark revenue from customer contributions as set out in Table 4.7.

## 4.4 Rate of return

In establishing the return on assets component of Central Highlands Water's revenue requirement, we have applied a rate of return to Central Highlands Water's regulatory asset base. The rate of return is calculated using a benchmark cost of debt (discussed in Section 4.4.1) and a benchmark return on equity value (discussed in Section 4.4.2).

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<sup>46</sup> Revenue from new customer contributions reflects revenue earned from new connections made to the water business's water, sewerage or recycled water networks.

#### 4.4.1 Cost of debt

Our final decision is to accept the updated cost of debt figures used by Central Highlands Water to calculate its revenue requirement.

Our draft decision approved the cost of debt proposed by Central Highlands Water as it used the cost of debt values we specified in our guidance to calculate its revenue requirement. We also noted that our estimate of 3.75 per cent for the cost of debt in 2022-23 would be updated to reflect the latest available data.

In May 2023, we provided Central Highlands Water with an updated cost of debt value from 3.75 per cent to 6.76 per cent for 2022-23.<sup>47</sup> This reflects the rise in borrowing costs over the past 12 months. Central Highlands Water used this updated value to recalculate its revenue requirement. For the above reasons, our final decision adopts the updated figures for the benchmark cost of debt as set out in Table 4.8.

This increase in the cost of debt is the main contributor to the increase in our final decision revenue requirement compared to our draft decision.

**Table 4.8** Final decision – 10-year cost of debt

	2013-14	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20	2020-21	2021-22	2022-23
Cost of debt (nominal)	7.05%	5.36%	5.27%	4.91%	4.53%	4.61%	3.31%	3.05%	3.75%	6.76%

**Note:** Numbers have been rounded.

#### 4.4.2 Return on equity

Our final decision is to adopt a return on equity of 4.1 per cent in real terms, which reflects Central Highlands Water's PREMO rating.

Under our PREMO incentive mechanism, which we have applied since 2018, the return on equity we adopt to calculate the revenue requirement is linked to a business's PREMO rating. See Chapter 7 for an explanation of PREMO and our assessment of Central Highlands Water's PREMO rating. As outlined in our guidance, the return on equity we adopt depends on a water business's self-rating and whether we accept that rating.

<sup>47</sup> These updated figures were based on data from Treasury Corporation Victoria on the actual trailing average cost of debt for 2022-23.

Our guidance included a matrix proposing the return on equity we would adopt, based on the combination of the business's self-rating and our rating.<sup>48</sup>

Central Highlands Water rated its price submission as 'Standard'. Based on this PREMO self-rating, Central Highlands Water proposed a real return on equity of 4.1 per cent per year. This reflects the maximum return rate allowed in our guidance for a price submission rated as 'Standard'.<sup>49</sup>

Our draft decision adopted Central Highlands Water's proposed return on equity, which reflected our preliminary overall PREMO rating of its price submission.

After considering all submissions received in response to our draft decision, our final decision on Central Highlands Water's overall PREMO rating remains the same as our draft decision.

Therefore, our final decision is to adopt Central Highlands Water's proposed return on equity of 4.1 per cent per year, reflecting our final decision on the overall PREMO rating of its price submission (see Chapter 7).

#### 4.4.3 Long-term inflation forecast

A long-term inflation forecast is needed to convert the nominal cost of debt (outlined in Section 4.4.2 above) to real terms. A higher rate of inflation means a lower cost of debt in real terms, which would flow through to a lower revenue requirement and lower prices, all other things being equal. Conversely, a lower long-term inflation rate will flow through to increased prices, all other things being equal.

In addition to updating our estimate for the cost of debt, in May 2023 we also updated businesses on our long-term inflation forecast. We advised businesses that the long-term inflation rate we calculated was 3.5 per cent.<sup>50</sup> All businesses adopted this amount to calculate prices in their responses to our draft decision. We checked this estimate again for our final decision, based on the method below.

While we have estimated inflation based on the outcome of the two methods specified in our guidance – the 'RBA geometric mean' and the 'bond breakeven' methods – we have varied our approach given the relatively high near-term inflation environment. While our guidance indicated that our calculation of long-term inflation would cover a 10-year forecast period, we consider in the current high inflation environment, that this would lead to outcomes that underestimate inflation in the 2023–28 regulatory period, which would not be in the interests of customers. Accordingly, we

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<sup>48</sup> Essential Services Commission, *2023 water price review: Guidance paper*, 26 October 2021, pp. 42-43.

<sup>49</sup> Essential Services Commission, *2023 water price review: Guidance paper*, 26 October 2021, p. 42.

<sup>50</sup> The inflation rate adopted in our draft decision was 3 per cent.

have adopted an averaging period of 5 years. This is consistent with the time period adopted by other economic regulators, including the Australian Energy Regulator.

Estimates we have adopted for each year of the 2023–28 regulatory period under the ‘RBA geometric mean’ approach are set out in Appendix E. Using the ‘RBA geometric mean’ approach we estimate an inflation rate of 3.8 per cent.<sup>51</sup>

For the ‘bond breakeven’ approach, we estimate a 5-year average rate of 3.3 per cent, with the estimates adopted for each year of the 2023–28 regulatory period also set out in Appendix E.<sup>52</sup>

The average outcome under the two approaches is 3.5 per cent, which we have adopted for our final decision.

However, to manage the risk that inflation falls well below our forecast, our price determinations include a provision that allows for a reconsideration of the inflation forecast adopted, if inflation falls below 2.5 per cent by 2026-27.<sup>53</sup> The updated inflation estimate, if needed, would be based on a 5-year averaging period.

## 4.5 Regulatory depreciation

Our final decision is to adopt the benchmarks for regulatory depreciation as set out in Table 4.7.

Regulatory depreciation is a component of Central Highlands Water’s revenue requirement and is also an input to calculating the regulatory asset base.

As indicated in our draft decision, Central Highlands Water’s forecast regulatory depreciation was calculated using a straight-line depreciation profile, which is our preferred this approach.<sup>54</sup>

However, given our draft decision to adopt a different forecast regulatory asset base than proposed by Central Highlands Water, we required it to recalculate its depreciation in its response to our draft decision.

In its response to our draft decision, Central Highlands Water updated its regulatory depreciation forecasts to reflect its proposed update to its regulatory asset base, which incorporated changes to its customer contributions but not to its capital expenditure.

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<sup>51</sup> We have decided to use a rate of 7 per cent for 2023-24, because it is consistent with the rate used to inflate 2023-24 prices in our price determination.

<sup>52</sup> Similar to the ‘RBA geometric mean’ approach, we have adopted a rate of 7 per cent for 2023-24, because it is consistent with the rate used to inflate 2023-24 prices in our price determination.

<sup>53</sup> With inflation measured by the Australian Bureau of Statistics Consumer Price Index – all groups.

<sup>54</sup> Essential Services Commission, *2023 water price review: Guidance paper*, 26 October 2021, p. 39.

As our final decision is to not accept Central Highlands Water’s proposed capital expenditure and therefore its updated regulatory asset base, our final decision is also to not accept its updated regulatory depreciation forecasts.

The benchmarks we have adopted for regulatory depreciation reflect our final decisions on Central Highlands Water’s forecast capital expenditure (Section 4.2) and forecast regulatory asset base (Section 4.3.2).

After considering all submissions received in response to our draft decision, and for the reasons set out above, our final decision adopts the benchmarks for regulatory depreciation as set out in Table 4.7 in Section 4.3.2.

## 4.6 Tax allowance

Our final decision is to adopt Central Highlands Water’s forecast tax allowance for the 2023–28 regulatory period as set out in Table 4.1.

The tax allowance is a component of the revenue requirement. Our draft decision was to not accept Central Highlands Water’s forecast tax allowance of \$5.9 million for the 2023–28 regulatory period as our draft decision proposed adjustments to its revenue requirement. While our draft decision used this proposed amount for the purpose of calculating the revenue requirement in our draft decision, we required Central Highlands Water to provide an updated estimate in response to our draft decision on its revenue requirement.<sup>55</sup>

In its response to our draft decision, Central Highlands Water updated its estimates of forecast tax to reflect further adjustments to its revenue requirement and proposed an updated tax allowance of \$5.8 million. We consider Central Highlands Water’s updated estimates were calculated in a manner consistent with our guidance.

After considering all submissions received in response to our draft decision, and for the reasons set out above, our final decision adopts a forecast tax allowance proposed by Central Highlands Water of \$5.8 million for the 5-year regulatory period, as set out in Table 4.1.

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<sup>55</sup> Essential Services Commission, *2023 water price review: Guidance paper*, 26 October 2021, pp. 47–48.

## 5. Demand, tariffs and prices

Once Central Highlands Water's revenue requirement is established, demand forecasts and the form of price control are used to translate the revenue requirement into tariffs and prices.

### 5.1 Demand

Our final decision is to accept Central Highlands Water's demand forecasts.

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

In our draft decision, we accepted Central Highlands Water's proposed demand forecasts but required Central Highlands Water in its response to our draft decision to demonstrate how it has considered the updated Victorian Government population and dwelling growth estimates that had been made available to water businesses.

In response to our draft decision, Central Highlands Water advised that it had reviewed the updated Victorian Government estimates and considered the changes between the updated forecasts and those Central Highlands Water has relied upon in its price submission were minor and that its proposed forecasts were still appropriate. We consider Central Highlands Water's approach is appropriate given the closeness between its forecasts and the Victorian Government estimates.

On that basis, our final decision approves Central Highlands Water's demand forecasts because they were estimated consistently with the requirements of our guidance.

### 5.2 Form of price control

Our final decision is to accept Central Highlands Water's proposed tariff basket form of price control.

Our draft decision accepted Central Highlands Water's proposal to retain a tariff basket form of price control on the basis that it is the same as its current approach, consistent with the requirements of our guidance and because, under the tariff basket approach, Central Highlands Water carries most of the demand risk, which we consider is more efficient than customers managing that risk.

We adjusted Central Highlands Water's price path as outlined in Section 5.3.2. Central Highlands Water can use its tariff basket form of price control to rebalance its tariffs during the regulatory period.



After considering all submissions received in response to our draft decision, and for the reasons set out above, our final decision approves Central Highlands Water's proposed tariff basket form of price control.

## 5.3 Tariff structures and prices

Our draft decision accepted Central Highlands Water's proposed tariff structures but, like all our draft decisions in this review, did not approve prices for each tariff, because Central Highlands Water needed to update its proposed prices to reflect our updates to inflation and cost of debt estimates.

Our final decision on tariff structures and prices is set out below.

### 5.3.1 Tariff structures

Our final decision is to approve Central Highlands Water's proposed tariff structures.

As outlined in our guidance, we have provided the water businesses with a large degree of discretion to decide on individual tariff structures.<sup>56</sup> This recognises water businesses are often best placed to consider the interests of customers in designing tariffs, and that existing tariff structures have been developed over time to deal with a variety of local circumstances.

Our draft decision accepted Central Highlands Water's proposal to retain its existing tariff structures, including:

- for residential water services – a two-part tariff with a fixed water service charge and a two-tier inclining block variable usage component that depends on water use, where price increases in the second block
- for residential sewerage services – a fixed service charge only
- for non-residential water services – a two-part tariff with a fixed service charge and a variable usage component that depends on water use
- for non-residential sewerage services – a fixed service charge and a variable usage component.

Our draft decision accepted Central Highlands Water's proposed tariff structures, on the basis that they are generally a continuation of Central Highlands Water's current approach and are generally supported by its customers. In our draft decision, we considered the two-part structure for water services will promote the efficient use of services and it sends customers a signal about the costs

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<sup>56</sup> Essential Services Commission, *2023 water price review: Guidance paper*, 26 October 2021, p. 51.

of their water use. We also considered a two-part tariff structure is easy to understand and is an approach that is commonly applied in other states and territories.<sup>57</sup>

In our draft decision, in relation to sewerage services, we considered the proposed fixed charge for residential customers was easy to understand and that the two-part tariff for non-residential customers sends these customers signals about efficient costs.<sup>58</sup>

A submission from the Consumer Action Law Centre expressed support towards water businesses generally retaining the balance between fixed and variable charges in particular, given the disproportionate impact on tenants when more weight is assigned to variable charges.<sup>59</sup> We consider that Central Highlands Water's proposal retains such a balance.

A submission from the Registered Accommodation Association of Victoria asked us to consider multiple room rooming houses being charged based on the number of rooms.<sup>60</sup> This reflects the current inclining block pricing structure whereby a typical rooming house would generally always be paying at a higher inclining block rate, with little ability to respond to pricing signals. As noted above, businesses are often best placed to consider the interests of their customers in designing tariffs and that existing tariff structures have been developed over time to deal with a variety of local circumstances. We consider a different approach to charging rooming houses might be considered by the business in future periods. However, we note that any such approach may be administratively complex, given the variation in the number of rooms in rooming houses.

After considering all submissions received in response to our draft decision, for the reasons set out above, our final decision is to approve Central Highlands Water's proposed tariff structures.

### 5.3.2 Prices

Our final decision is to not accept Central Highlands Water's proposed prices, and instead adopt the prices set out in our determination.

In our draft decision, we noted that Central Highlands Water would need to propose updated prices to reflect our updates to inflation and cost of debt estimates as well as our draft decision and any updates to its revenue requirement.

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<sup>57</sup> Includes the tariffs of Icon Water, Sydney Water, Hunter Water, Central Coast Council, Power and Water Corp, Urban Utilities, Unity Water, SA Water and TasWater.

<sup>58</sup> Our reasons are outlined in our 2013 draft decisions on price review 2013-14 to 2017-18.

<sup>59</sup> Consumer Action Law Centre, *Feedback on standard draft decisions: 2023 water price review*, 5 May 2013, p. 2.

<sup>60</sup> Registered Accommodation Association of Victoria, submission on water pricing for rooming houses in Victoria, 25 May 2023.

Following our draft decision, Central Highlands Water proposed revised prices that reflect the updates to our inflation and cost of debt estimates, and to bulk water charges (see Section 4.1). Central Highlands Water's revised prices also reflect changes to its revenue requirement as a result of its response to our draft decision and to changes announced in the Victorian State Budget (See Section 4.1).

In a submission on our draft decision, the Consumer Action Law Centre suggested businesses consider how revenue is recovered over the regulatory period to avoid bill shock, supporting the approach of deferring larger price increases until future years, with the caveat that price increases in future years should not be more than inflation.<sup>61</sup> In its response to our draft decision, Central Highlands Water proposed a real price reduction in 2023-24 (of 1.5 per cent, lower than initially proposed in its price submission) to help address the impacts of inflation on affordability. It proposed real price increases later in the period.

While we note the Consumer Action Law Centre's views on future prices, our role is to ensure maximum prices reflect forecasts for prudent and efficient costs. This helps to ensure customers continue to receive quality and reliable water and sewerage services.

As part of our review, we have considered whether the prices proposed by Central Highlands Water reflect prudent and efficient expenditure. While we have approved many elements of Central Highlands Water's proposals, our final decision approves a lower revenue requirement than proposed by the water business (Chapter 4).

Accordingly, and to ensure maximum prices reflect forecast efficient costs, our final decision is to not accept the revised prices proposed by Central Highlands Water and instead adopt the prices set out in our determination. Maximum prices for major tariffs approved in our determination are set out in Tables 5.1 and 5.2. For 2023-24, we have approved the prices proposed by Central Highlands Water, but have lowered increases in later years for major water and sewerage services tariffs slightly to align with its approved revenue requirement. From 2024-25, water and sewerage prices for residential and non-residential customers will generally rise by around 0.6 per cent per year, excluding inflation.

Our price determination for Central Highlands Water sets out the maximum prices it may charge for the 5-year period from 1 July 2023 (or the manner in which its prices are to be calculated, determined, or otherwise regulated).

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<sup>61</sup> Consumer Action Law Centre, *Feedback on standard draft decisions: 2023 Water Price Review*, 5 May 2023, p. 2.

**Table 5.1 Final decision – water prices**

\$ 2023-24

	2023-24	2024-25	2025-26	2026-27	2027-28
<b>Residential</b>					
Variable 0-175kL (\$/kL)	2.1987	2.2118	2.2250	2.2383	2.2517
Variable >175kL (\$/kL)	2.6387	2.6545	2.6704	2.6864	2.7025
Fixed (\$/year)	230.60	231.98	233.37	234.77	236.17
<b>Non-residential</b>					
Variable (\$/kL)	2.1987	2.2118	2.2250	2.2383	2.2517
Fixed (\$/year)	230.60	231.98	233.37	234.77	236.17

**Notes:** These prices have been expressed in \$2023-24 terms, which means 7 per cent inflation has been factored into the prices for 2023-24. For the remaining years shown, inflation will be added each year based on the latest inflation data. The figures in other tables of this report are expressed in \$2022-23, which means inflation has not been accounted for in 2023-24 or the remaining years of the 2023–28 regulatory period.

**Table 5.2 Final decision – sewerage prices**

\$ 2023-24

	2023-24	2024-25	2025-26	2026-27	2027-28
<b>Residential</b>					
Fixed (\$/year)	737.53	741.95	746.40	750.87	755.37
<b>Non-residential</b>					
Variable (\$/kL)	1.2861	1.2938	1.3015	1.3093	1.3171
Fixed (\$/year)	737.53	741.95	746.40	750.87	755.37

**Notes:** These prices have been expressed in \$2023-24 terms, which means 7 per cent inflation has been factored into the prices for 2023-24. For the remaining years shown, inflation will be added each year based on the latest inflation data. The figures in other tables of this report are expressed in \$2022-23, which means inflation has not been accounted for in 2023-24 or the remaining years of the 2023–28 regulatory period.

### 5.3.3 Addressing the interests of low income and vulnerable customers

In making our price determination, we must have regard to whether Central Highlands Water's prices take into account the interests of customers, including low income and vulnerable customers.<sup>62</sup>

In our draft decision we considered that Central Highlands Water had taken into account the interests of customers, including low income and vulnerable customers by:

- proposing a price path that includes real price reductions in 2023-24
- doubling its support for vulnerable customers to \$2.5 million over the regulatory period
- proposing an additional billing cycle for the first 2 years of the pricing period to avoid potential bill shock and support customer affordability.<sup>63</sup>

The Consumer Action Law Centre was supportive of Central Highlands Water's proposal to significantly increase its investment in hardship assistance during the 2023–28 regulatory period.<sup>64</sup> A submission from Luke Kirk commented on the high cost of wastewater services and that water bills were making it difficult to afford other essential services.<sup>65</sup>

We consider this updated price path, along with its earlier commitments around billing frequency and doubling of its customer support are sufficient to demonstrate that Central Highlands Water has taken into account the interests of low income and vulnerable customers.

### 5.3.4 Other services

Central Highlands Water has confirmed that its proposed tariffs for trade waste and miscellaneous services are calculated in accordance with the pricing principles referenced in our guidance.

Given this, our final decision accepts Central Highlands Water's proposed tariffs for trade waste and miscellaneous services.

## 5.4 New customer contributions

Our final decision is to accept Central Highlands Water's proposed new customer contributions and its proposed negotiating framework for negotiated new customer contributions.

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<sup>62</sup> Water Industry Regulatory Order 2014 clause 11(d)(iii).

<sup>63</sup> Central Highlands Water, 2023–28 Price Submission, September 2022, p. 34.

<sup>64</sup> Consumer Action Law Centre, *Feedback on standard draft decisions: 2023 Water Price Review*, 5 May 2023, p. 3.

<sup>65</sup> Luke Kirk, *submission to the Essential Services Commission 2023 'Central Highlands Water draft decision: 2023 water price review'*, 31 May 2023.

New customer contributions (or developer charges) are levied by water businesses when a new connection is made to its water, sewerage or recycled water networks in a given part of its service area. New customer contributions can be either standard or negotiated. Standard charges apply to new connections in areas where infrastructure requirements and growth rates are relatively well known and designated by the water business. The purpose of standard new customer contributions is to reduce the administrative burden as well as improve the timeliness and predictability of costs faced by developers.<sup>66</sup> Negotiated charges allow water businesses and developers to negotiate a site-specific arrangement where standard charges are not fair and reasonable or where a new connection is outside the areas eligible for standard charges.<sup>67</sup>

As outlined in our draft decision Central Highlands Water proposed using a model based on average incremental cost to estimate its new customer contributions rather than the net incremental cost approach it has used in the past.

Our draft decision did not approve Central Highlands Water's proposed new customer contributions as Central Highlands Water had not provided us with adequate information or justification to enable us to be satisfied that its proposal complied with our guidance requirements. We indicated in the draft decision that Central Highlands Water must:

- explain how it has allocated its capital expenditure to new customer contributions
- explain its transition plan towards achieving full cost reflectivity for each service including the timeframes of this plan and provide reasons for adopting this transition plan and its timing
- set out how it proposes to fund any shortfall in revenue from new customer contributions, compared to the estimated costs of providing the service
- explain how it considered setting new customer contributions that distinguish between infill and greenfield growth areas and its reasons for not proposing charges to reflect this distinction
- ensure that its proposed new customer contribution charges and connection numbers by service reconcile between its new customer contributions model and financial model
- explain how its proposed new customer contribution is greater than the avoidable cost of that connection and less than the standalone cost of that connection.

In our draft decision, we also gave Central Highlands Water the opportunity to recalculate its new customer contributions using the current (net incremental cost) methodology for calculating new customer contributions.

In response to our draft decision Central Highlands Water:

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<sup>66</sup> Essential Services Commission, *New customer contributions: explanatory note*, December 2013, p. 3.

<sup>67</sup> Essential Services Commission, *New customer contributions: explanatory note*, December 2013, p. 3.

- retained unchanged its proposed new customer contributions from its original price submission, these being a proposal to:
  - introduce separate water and wastewater contributions for new and existing growth zones
  - increase its new customer contribution for water services in the new growth zones from \$1,504 to a capped \$4,000 per lot and introduce a new customer contribution for sewer services to be set at \$4,000 (capped)
  - phase in the new customer contributions until it reaches the \$4,000 cap per lot in year 3 of the regulatory period (2025-26)
  - increase new customer contributions by 1 per cent annually from 2024-25 to 2027-28
  - setting existing growth zone contributions at 43 per cent of the new growth zone contributions in 2023-24 and then transitioning these up to 65 per cent in 2027-28
- provided new customer contribution calculation models for the proposed contribution pricing zones (its original proposal provided models reflecting different water systems)<sup>68</sup>
- described its cost allocations process for attributing costs to new customer contribution calculations, and undertook to document this formally after our determination
- defended its cost allocators as a pragmatic and adequate approximation of growth-related expenditure, reliant on observable allocators (and therefore more transparent), and consistent with the practice of other water businesses
- provided updated forecast customer contribution revenue forecasts to reconcile in both the contribution calculation models and the financial model
- provided an annual transition path for proposed contributions to reach calculated cost reflective levels by 2025-26 for new growth zones and by the next regulatory period for infill new customer contributions.<sup>69</sup>

We have reviewed Central Highlands Water’s new customer contribution proposal against the guidance paper requirements.<sup>70</sup>

In coming to our final decision, we have had regard to if and how Central Highlands Water’s proposal is consistent with the aims of the new customer contributions framework, which are to:<sup>71</sup>

- send signals to developers about the costs of developing in different locations

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<sup>68</sup> The original model calculated the new customer contributions attributed to each of the Ballarat, Avoca, Beaufort, Daylesford, Maryborough and other systems and used the weighted average new customer contributions of these systems as the basis of its proposed capped new customer contributions.

<sup>69</sup> Central Highlands Water, *submission in response to the Essential Services Commission ‘Central Highlands Water draft decision: 2023 water price review’*, 12 May 2023, p. 23.

<sup>70</sup> Essential Services Commission, *2023 water price review: Guidance paper*, 26 October 2021, p. 59.

<sup>71</sup> Essential Services Commission, *New Customer Contributions Explanatory Note Final*, December 2013, p. 2.

- share the costs and benefits of growth between new and existing customers
- administer new customer contributions in a transparent way.

We have carefully considered the impact of the issues relating to cost reflectivity, avoidable costs, locational cost reflectivity and low confidence rating for some assets regarding allocation of growth capital expenditure to new customer contributions. We have also carefully considered the reasonableness and transparency of the proposal and whether it is supported by customers and whether the proposal as a whole advances the aims of our new customer contributions framework.

On balance, we consider that we can approve Central Highlands Water's proposal for it has sufficiently addressed the pricing principles in our guidance and its proposal meets the aims of the new customer contributions framework. Our final decision is to approve Central Highlands Water's proposed standard new customer contributions.

We wish to highlight that, to the extent necessary, the new customer contribution framework allows water businesses and developers to negotiate new customer contribution in lieu of using the standard new customer contributions.

Our draft decision did not approve Central Highlands Water's negotiating framework as we were still assessing the implementation of the proposed average incremental cost approach used by Central Highlands Water to calculate new customer contributions. We consider Central Highlands Water's proposal in response to our draft decision addresses these implementation issues better than its original proposal. Our final decision approves Central Highlands Water's proposed standard new customer contributions and its negotiated new customer contributions framework.

If there is a dispute between a developer and a water business (whether in relation to a standard or negotiated new customer contributions), developers may use the dispute resolution offered by a water business as part of its new customer contribution negotiating framework. In addition, developers may follow the *Water Act 1989* process to object and seek internal review by the water business, and to pursue unresolved matters through the Victorian Civil and Administrative Tribunal.<sup>72</sup>

#### **5.4.1 Stakeholder submissions**

We received three submissions responding to our draft decision regarding Central Highlands Water's new customer contributions.

The Consumer Action Law Centre reiterated its support for water businesses moving to higher more cost reflective new customer contributions. The Consumer Action Law Centre supported our

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<sup>72</sup> *Water Act 1989*, section 271.



draft decision call for clarity on the full proposed terms for transitioning to cost reflectivity and on businesses providing greater justification where they have not used our net incremental cashflow approach to calculate their proposed contributions.<sup>73</sup>

As noted above, Central Highlands Water has now outlined how it will transition to full cost reflectivity, including setting out the annual movements in new customer contributions to get there.<sup>74</sup> Central Highlands Water's response to our draft decision (page 51) has also provided some public justification for adopting an average incremental cost calculation approach.<sup>75</sup>

An anonymous submission welcomed our draft decision to reject Central Highlands Water's proposed new customer contributions citing the increases as excessive and stating that land buyers had not expected increases above inflation. The submission stated that Central Highlands Water's 'consultation too narrowly focussed on big developers their engineering consultants and Ballarat'.<sup>76</sup> While we have set a maximum contribution, we encourage Central Highlands Water to consider the introduction of a charge for small lot developments for small towns, similar to what Coliban Water has proposed, within the regulatory period (the business has flexibility to do this, if it is below the maximum we have set).

A developer submission from Integra supported new growth area new customer contributions where accompanied by robust planning and delivery outcomes to provide permanent assets that accommodate new growth, noting these could be higher if needed. However, it also raised concerns that revised (increased) contributions within the existing growth areas would drive inequality.<sup>77</sup>

As noted above, on balance we consider that Central Highlands Water has had regard to a fair and reasonable allocation of incremental infrastructure and associated costs when determining its proposed contributions for both its new growth zones and its existing growth zones.

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<sup>73</sup> Consumer Action Law Centre, *Feedback on standard draft decisions: 2023 Water Price Review*, 5 May 2023, p. 3.

<sup>74</sup> Central Highlands Water, *Response to ESC's Central Highlands Water draft decision 2023 water price review*, 12 May 2023, p. 58.

<sup>75</sup> Central Highlands Water, *submission in response to the Essential Services Commission 'Central Highlands Water draft decision: 2023 water price review'*, 12 May 2023, p. 70.

<sup>76</sup> Anonymous, *submission to the Essential Services Commission 'Central Highlands Water draft decision: 2023 water price review'*, 12 May 2023, p. 1.

<sup>77</sup> Integra, *Response to ESC Draft Decision on CHW PR23*, 12 May 2023, p.2

## 5.4.2 Review of the framework for new customer contributions

Our guideline for new customer contributions establishes our expectations for standard new customer contributions and bespoke negotiated new customer contributions. However, in light of issues we identified during our 2023 water price review, we believe that a review of the regulatory framework for new customer contributions is necessary. Our review will aim to identify and address key implementation issues for water businesses, establish consistency in setting new customer contributions across the sector, and define the purpose and content of the negotiating framework.

### 5.4.2.1 Current issues

Our experience reviewing the new customer contributions proposals of water businesses in the current price review has identified varied practices across businesses in terms of their approach and substantiation of proposed charges to meet our guidance and the objectives of the framework. This includes varied approaches to the inclusion of costs in new customer contributions, differentiated pricing, and use of negotiated new customer contributions.

A number of businesses in the current price review also based their new customer contributions on an average incremental cost methodology, rather than the net incremental cost approach adopted in the past. We want to explore the issues associated with having different underlying approaches and how this affects confidence and transparency in the way new customer contributions are arrived at.

Other issues we have identified in the current review – such as varied approaches to locational and incremental cost reflectivity – and the transparency of new customer contributions and the nature of engagement, may also be covered in the review.

### 5.4.2.2 Next steps

In 2023-24, we intend to initiate a review of the framework for new customer contributions by issuing a consultation paper. This paper will outline the proposed scope of the review and seek feedback from stakeholders. We encourage stakeholders to suggest any other important matters that they believe should be included in the review.

Throughout the review process, we will actively engage with industry and stakeholders to gather their input.

## 5.5 Adjusting prices

Our final decision is to accept Central Highlands Water's proposed price adjustment mechanisms for uncertain and unforeseen events and cost of debt.

Our final decision is to not accept Central Highlands Water's proposed energy pass-through mechanism.

Our draft decision accepted Central Highlands Water's proposal to continue using its existing uncertain and unforeseen events mechanism and cost of debt mechanism on the basis that they are a continuation of its existing approach, which we have approved in the past.

Our draft decision proposed to not accept Central Highlands Water's proposed energy pass-through mechanism because:

- we considered it unclear whether Central Highlands Water requires a pass-through mechanism for its urban customers for energy costs above its proposed forecasts
- the existing uncertain and unforeseen events mechanism provides for a reopening of Central Highlands Water's determination if a material event arises over the pricing period, as assessed by the commission.

No new considerations were presented by Central Highlands Water or in submissions received following our draft decision.

After considering all submissions received in response to our draft decision, for the reasons set out above, our final decision is to accept Central Highlands Water's proposed price adjustment mechanisms but not accept its proposed energy pass-through mechanism.

## 6. Financial position

We have reviewed key indicators of Central Highlands Water's financial performance and consider that Central Highlands Water will generate sufficient cash flow to deliver on its service commitments.

In approving prices, we must have regard to the financial viability of the water industry.<sup>78</sup> We interpret the financial viability requirements under the *Essential Services Commission Act 2001* and the *Water Industry Regulatory Order (2014)* to mean that the prices we approve should provide a high level of certainty that each water business can generate sufficient cash flow to deliver on its service commitments, including financing costs arising from investments to meet service expectations.

Our guidance set out key indicators of forecast financial performance. We have reviewed forecasts for these key indicators based on our final decision on Central Highlands Water's prices. We have assessed that under our final decision, Central Highlands Water will generate sufficient cash flow to deliver on its service commitments, including financing costs arising from investments to meet service expectations.

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<sup>78</sup> WIRO clause 8(b)(ii) and ESC Act s.8A(1)(b).

## 7. PREMO rating

PREMO is an incentive mechanism that links the return on equity used to calculate a water business's revenue requirement to that business's level of ambition expressed in its price submission. Our guidance required Central Highlands Water to self-assess the level of ambition of its price submission for each element of the PREMO mechanism and arrive at an overall self-rating.<sup>79</sup> We required Central Highlands Water to self-rate its price submission as either 'Leading', 'Advanced', 'Standard' or 'Basic', with 'Leading' being the most ambitious and 'Basic' the least.

The assessment tool included in our guidance directed Central Highlands Water to consider its level of ambition in relation to matters covered in its price submission, such as proposals related to operating and capital expenditure, the form of price control, and tariffs.

We assessed and rated Central Highlands Water's price submission. As outlined in our guidance, the combination of Central Highlands Water's self-rating and our rating has determined the return on equity we have adopted to calculate Central Highlands Water's revenue requirement in our final decision.

### 7.1 Our PREMO assessment of Central Highlands Water's price submission

Our final decision is to rate Central Highlands Water's price submission as 'Standard' under PREMO, which is the same as Central Highlands Water's self-rating.

Central Highlands Water's self-rating for each of the PREMO elements and its overall self-rating are shown in Table 7.1. This table also includes our draft and final ratings of Central Highlands Water's price submission.

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<sup>79</sup> This is the first price review we have done where the rating has been based on all five elements of PREMO. In our 2018 price review, our PREMO assessment was against only four of the elements — Risk, Engagement, Management and Outcomes.

**Table 7.1**      **PREMO rating**

	Overall PREMO rating	Performance	Risk	Engagement	Management	Outcomes
Central Highlands Water's self-rating	Standard	Standard	Standard	Advanced	Standard	Advanced
Commission's draft decision rating	Standard	Standard	Standard	Advanced	Basic	Advanced
Commission's final decision rating	Standard	Standard	Standard	Advanced	Basic	Advanced

Our preliminary PREMO assessment is set out in our draft decision and summarised below.

Our final decision is to agree with Central Highlands Water's proposed overall PREMO self-rating of 'Standard'.

In summary, the following factors support this PREMO rating:

- Central Highlands Water has generally met its outcome commitments in the current regulatory period. At the 2018 review, we considered Central Highlands Water generally had more ambitious targets than other businesses. And during the regulatory period it reset some targets to be more ambitious compared to these initial targets – we consider this demonstrated a commitment to improving customer value in the current period.
- Central Highlands Water has proposed to double the payable amounts for not meeting two of its existing guaranteed service levels, and also proposed changes to its guaranteed service levels to reflect customer priorities.
- Central Highlands Water's engagement methods supported inclusion and effective participation in its engagement process, including customers experiencing vulnerability and its First Nations customers.
- It has deferred almost \$144 million in capital expenditure from the current period, and accepted risk that these may need to be brought forward.
- Central Highlands Water's efforts to tailor methods and materials to the circumstances of its customers, which had the result of ensuring customers experiencing vulnerability had a reasonable and fair opportunity to influence the issues that affected them.

### 7.1.1 Management

As shown in Table 7.1 above, Central Highlands Water rated its price submission as 'Standard' for the Management element of PREMO, but we rated it 'Basic' in our draft decision. Among the reasons for our rating was that we found Central Highlands Water's financial model (lodged with its

PREMO rating

price submission) included changes to some formulas that we embedded in the model, and substantive corrections were required to its financial model.

Central Highlands Water's response to our draft decision disagreed with our draft decision rating of 'Basic' for the Management element of PREMO, because it did not believe it had changed any formulas in any cells in the model without permission. It also considered the commission did not provide it with reasonable notice that we had such concerns during the assessment period and that such a comment was being considered to be published.<sup>80</sup>

We consider there were changes to formulas and format changes in the financial model. We acknowledge that there were very few changes and they did not have a material impact on prices. And as noted in Central Highlands Water's response to our draft decision, the business was working collaboratively with us to complete a complex financial model. However, even very few or minor changes to formulas or the format of the financial model can impede our review process.<sup>81</sup>

There were multiple resubmissions of the model and a more extensive list of model adjustments required than for other businesses. There were also issues associated with the regulatory accounts that required us to investigate and verify figures during the price review.<sup>82</sup>

For the reasons set out above, we consider that a rating of Central Highlands Water's price submission as 'Basic' for the Management element of PREMO is appropriate.

### 7.1.2 Outcomes

As discussed in Section 3.2 we required Central Highlands Water, in response to our draft decision, to demonstrate how its outcomes proposal reflects 'Advanced' customer value.

Following release of our draft decision, we have worked with Central Highlands Water to expand its outcome set to include measures and targets that reflect both core business performance, as well as measures that reflect customer preferences. This includes the addition of a fourth outcome 'Core services' comprising of key performance measures which continue from the current regulatory period. More detail is provided in Section 3.2.

We consider the re-inclusion of these key measures is consistent with an 'Advanced' rating because it will provide a broad representation of the underlying value received by all customers according to the business's performance in any given year. Accordingly, our final decision is to rate the Outcomes element of PREMO as 'Advanced'.

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<sup>80</sup> Central Highlands Water, *submission in response to the Essential Services Commission 'Central Highlands Water draft decision: 2023 water price review'*, 12 May 2023, p. 4.

<sup>81</sup> Our guidance specified our requirements relating to financial models. See Essential Services Commission, *2023 water price review: Guidance paper*, pp. 61-62.

<sup>82</sup> Our guidance specified our expectations in terms of the accuracy of financial models as they relate to PREMO ratings. See Essential Services Commission, *2023 water price review: Guidance paper*, p. 83.

## Appendix A – Submissions received on draft decision

Name or organisation	Date received
Consumer Action Law Centre	5 May 2023
Anonymous	12 May 2023
Integra	12 May 2023
Central Highlands Water	12 May 2023
Registered Accommodation Association of Victoria	26 May 2023
Luke Kirk	31 May 2023



## Appendix B – Commission’s consideration of legal requirements

Clause 11 of the Water Industry Regulatory Order 2014 (WIRO) specifies the mandatory factors we must have regard to when making a price determination. The WIRO covers matters that are included in the *Water Industry Act 1994* (WI Act) and the *Essential Services Commission Act 2001* (ESC Act).

Below, we describe how we apply the mandatory factors and where we have done so in our final decision for Central Highlands Water.

The WIRO requires the Commission to place particular emphasis on the promotion of efficient use of prescribed services by customers, the promotion of efficiency in water businesses as well as efficiency in, and the financial viability of, the regulated water industry and the provision to regulated entities of incentives to pursue efficiency improvements.

In addition to the mandatory factors set out below, clause 11 of the WIRO requires the commission to have regard to the matters specified in the commission’s guidance.<sup>83</sup> Our draft and final decisions provide further information on where we have considered our guidance, and Central Highlands Water’s compliance with our guidance, in making our price determination.<sup>84</sup>

Note: all chapter and section numbers referenced below refer to our final decision for Central Highlands Water.

### **Economic efficiency and viability matters**

#### **WIRO clause 8(b)(i) requires us to have regard to the ‘promotion of efficient use of prescribed services by customers’.**

We consider that the efficient use of prescribed services by customers is promoted when a tariff is applied to customers benefiting from the service covered by the tariff, and tariffs send appropriate signals about efficient costs.

The following chapters and sections of our final decision involved consideration of this factor:

- Our consideration of customer engagement (Section 3.1).
- Our assessment of the revenue requirement (Chapter 4).

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<sup>83</sup> Essential Services Commission, *2023 water price review: Guidance paper*, 26 October 2021.

<sup>84</sup> Essential Services Commission, *Central Highlands Water draft decision: 2023 water price review*, 12 April 2023; Essential Services Commission, *Central Highlands Water Determination: 1 July 2023 – 30 June 2028*, 23 June 2023.

- Our assessment of efficient operating expenditure (Section 4.1) and capital expenditure (Section 4.2).
- Our assessment of tariffs (Section 5.3).

**WIRO clause 8(b)(ii) requires us to have regard to the ‘promotion of efficiency in regulated entities as well as efficiency in, and financial viability of, the regulated water industry’.**

We consider that the delivery of outcomes which reflect customer service priorities at an efficient cost promotes efficiency in regulated entities and the water industry. Our final decision has therefore had regard to the extent that Central Highlands Water has demonstrated its proposed outcomes reflect customer service priorities, and whether its tariffs and forecast costs reflect efficient levels of expenditure.

The following chapters and sections of our final decision involved consideration of this factor:

- Our consideration of customer engagement (Section 3.1).
- Our assessment of the revenue requirement (Chapter 4).
- Our assessment of efficient operating expenditure (Section 4.1) and capital expenditure (Section 4.2).
- Our assessment of tariffs (Section 5.3).
- Our assessment of financial viability (Chapter 6).

**WIRO clause 8(b)(iii) requires us to have regard to the ‘provision to regulated entities of incentives to pursue efficiency improvements’.**

We consider that the delivery of outcomes which reflect customer service priorities at an efficient cost provides regulated entities incentives to pursue efficiency improvements. The following chapters and sections of our final decision involved consideration of this factor:

- Our consideration of customer engagement (Section 3.1).
- Our consideration of outcomes (Section 3.2).
- Our assessment of the revenue requirement (Chapter 4).
- Our assessment of efficient operating expenditure (Section 4.1) and capital expenditure (Section 4.2).
- Our assessment of tariffs (Section 5.3).

Additionally, our pricing approach allows a water business to retain the benefits of any cost efficiencies it generates until the end of its regulatory period. In other words, a water business has an incentive to outperform the operating and capital expenditure benchmarks we accept for the purpose of estimating its revenue requirement and prices. This is consistent with providing incentives for water businesses to pursue efficiency improvements.

**ESC Act section 8A(1)(a) requires us to have regard to ‘efficiency in the industry and incentives for long term investment’.**

We consider that adopting forecasts of efficient expenditure that reflect the service priorities of the customers of each water business promotes efficiency in the water industry.

The following chapters and sections of our final decision involved consideration of this factor:

- Our consideration of customer engagement (Section 3.1).
- Our consideration of outcomes (Section 3.2).
- Our assessment of the revenue requirement (Chapter 4).
- Our assessment of efficient operating expenditure (Section 4.1) and capital expenditure (Section 4.2).
- Our assessment of tariffs (Section 5.3).

We have had regard to incentives for long term investment by adopting:

- A 10-year trailing average approach to estimating the benchmark cost of debt (see Section 4.4.1).
- A regulatory rate of return that we consider will enable Central Highlands Water to recover borrowing costs associated with its investment in services, and generate a return on assets.<sup>85</sup>

**ESC Act section 8A(1)(b) requires us to have regard to the ‘financial viability of the industry’.**

We consider that the financial viability of the industry is secured by approving prices that provide a high degree of certainty that each water business can maintain an investment grade credit rating. Further, prices should enable each business to generate cash flow to service financing costs arising from investments to meet service expectations.

We have had regard to this matter in Chapter 6.

**ESC Act section 33(3)(b) requires us to have regard to the ‘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’.**

In preparing our final decision, we have had regard to the extent Central Highlands Water has demonstrated its forecasts reflect efficient costs to deliver services valued by customers, and to deliver on relevant legislation and relevant health, safety, environmental and social obligations.

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<sup>85</sup> The regulatory rate of return is comprised of the cost of debt and the return on equity.

The following chapters and sections of our final decision involved consideration of this factor:

- Our consideration of customer engagement (Section 3.1).
- Our assessment of the revenue requirement (Chapter 4).
- Our assessment of efficient operating expenditure (Section 4.1) and capital expenditure (Section 4.2).
- Our assessment of tariffs (Section 5.3).

## **Industry specific matters**

**ESC Act section 33(3)(a) requires us to have regard to the ‘particular circumstances of the regulated industry and the prescribed goods and services for which the determination is being made’.**

Our pricing approach allows each water business to propose outcomes, tariff structures and expenditure that reflect its particular circumstances. We consider that taking into account the particular circumstances of each water business is consistent with taking into account the particular circumstances of the water industry.

The following chapters and sections of our final decision involved consideration of this factor:

- Our consideration of customer engagement (Section 3.1).
- Our consideration of outcomes (Section 3.2).
- Our assessment of the revenue requirement (Chapter 4).
- Our assessment of efficient operating expenditure (Section 4.1) and capital expenditure (Section 4.2).
- Our assessment of tariffs (Section 5.3).

We have had regard to the prescribed services listed in the WIRO in making our final decision. This includes adopting operating and capital expenditure benchmarks that we consider will allow Central Highlands Water to deliver services that are covered by the prescribed services listed in the WIRO.

**ESC Act section 33(3)(c) requires us to have regard to the ‘return on assets in the regulated industry’.**

Our final decision provides for Central Highlands Water to generate a return on assets through:

- Our consideration of the regulatory asset base (Section 4.3).
- Our consideration of the cost of debt (Section 4.4.1).
- Our consideration of the return on equity (Section 4.4.2).

**ESC Act Section 33(3)(d) requires us to have regard to ‘any relevant interstate and international benchmarks for prices, costs and return on assets in comparable industries’.**

In assessing costs, prices and return on assets we have had regard to relevant interstate benchmarks:

- indicative bills paid by customers in other jurisdictions in Australia<sup>86</sup>
- operating and capital expenditure costs per connection throughout Australia<sup>87</sup>
- tariff structures applied by water businesses throughout Australia<sup>88</sup>
- the regulatory rate of return set by other regulators.<sup>89</sup>

We are not aware of any international benchmarks that are relevant to our final decision.

**WI Act section 4C(b) requires us to ‘ensure that regulatory decision making and regulatory processes have regard to any differences between the operating environments of regulated entities’.**

Our pricing approach allows each water business to propose outcomes, a revenue requirement, expenditure and tariffs that reflect its particular circumstances and operating environment.

The following chapters and sections of our final decision involved consideration of this factor:

- Our consideration of customer engagement (Section 3.1).
- Our consideration of outcomes (Section 3.2).
- Our assessment of the revenue requirement (Chapter 4).
- Our assessment of efficient operating expenditure (Section 4.1) and capital expenditure (Section 4.2).
- Our assessment of tariffs (Section 5.3).

Our price review also considers the views of stakeholders affected by Central Highlands Water’s proposals, including through submissions and public meetings.

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<sup>86</sup> Bureau of Meteorology, *National performance report 2020-21; urban water utilities, part A*, February 2022.

<sup>87</sup> Bureau of Meteorology, *National performance report 2020-21; urban water utilities, part A*.

<sup>88</sup> Includes Icon Water, Sydney Water, Hunter Water, Central Coast Council, Power and Water Corp, Urban Utilities, Unity Water, SA Water and TasWater.

<sup>89</sup> Independent Pricing and Regulatory Tribunal NSW, *Final Report - Review of WaterNSW's rural bulk water prices*, 9 September 2021; Independent Pricing and Regulatory Tribunal NSW, *Final Report - Review of prices for Sydney Water*, June 2020; Essential Services Commission of South Australia, *SA Water's water and sewerage retail services: 1 July 2020 - 30 June 2024*, Price Determination, 1 July 2020; Queensland Competition Authority, *Final report - Seqwater bulk water price review 2022–26*, March 2022; Queensland Competition Authority (QCA), *Final report - Rural irrigation price review 2020–24, Part A: Overview*, January 2020; Office of the Tasmanian Economic Regulator, *Final report - Investigation into TasWater's prices and services for the period 1 July 2022 to 30 June 2026*, May 2022.

## **Customer matters**

**ESC Act section 8(1) requires us to have regard to the fact that the ‘objective of the Commission is to promote the long term interests of Victorian consumers’.**

We consider that promoting efficiency in delivering outcomes that align to service priorities of customers is consistent with promoting the long-term interests of Victorian consumers.

The following chapters and sections of our final decision involved consideration of this factor:

- Our consideration of customer engagement (Section 3.1).
- Our consideration of outcomes (Section 3.2).
- Our assessment of the revenue requirement (Chapter 4).
- Our assessment of efficient operating expenditure (Section 4.1) and capital expenditure (Section 4.2).
- Our assessment of tariffs (Section 5.3).
- Our assessment of financial viability (Chapter 6).

**ESC Act Section 8(2) requires us to ‘have regard to the price, quality and reliability of essential services’ in seeking to achieve the objective in section 8(1) of the ESC Act.**

We consider that promoting efficiency in delivering outcomes that align to service priorities of customers, and allowing businesses to meet regulatory and policy obligations is consistent with this objective.

In terms of prices, the following chapters and sections of our final decision involved consideration of this factor:

- Our consideration of the revenue requirement (Chapter 4).
- Our assessment of efficient operating expenditure (Section 4.1) and capital expenditure (Section 4.2).
- Our consideration of demand (Section 5.1).
- Our consideration of tariffs (Section 5.3).

In terms of the quality and reliability of services, the following sections of our final decision involved consideration of this factor:

- Our consideration of customer engagement (Section 3.1).
- Our consideration of outcomes (Section 3.2).

**WIRO Clause 11(d)(i) requires us to have regard to whether Central Highlands Water’s prices ‘enable customers or potential customers of the regulated entity to easily understand prices charged by the regulated entity for prescribed services or the manner in which such prices are calculated, determined or otherwise regulated’.**

We consider that the following matters are relevant when considering whether Central Highlands Water’s prices enable customers or potential customers to easily understand prices, or the manner in which prices are calculated, determined or otherwise regulated:

- feedback from customers during a water business’s engagement
- the structure of individual tariffs
- the proposed form of price control
- any changes to tariffs and how water businesses explain them to customers.

The following sections of our final decision involved consideration of this factor:

- Our consideration of tariffs and the form of price control (Section 5.2 and Section 5.3).

**WIRO Clause 11(d)(ii) requires us to have regard to whether Central Highlands Water’s prices ‘provide signals about the efficient costs of providing prescribed services to customers while avoiding price shocks where possible’.**

We consider prices can provide signals about efficient costs when a tariff is applied to customers benefiting from the service covered by the tariff, and tariffs send appropriate signals about efficient costs.

The following chapters and sections of our final decision involved consideration of this factor:

- Our consideration of customer engagement (Section 3.1).
- Our assessment of the revenue requirement (Chapter 4).
- Our assessment of efficient operating expenditure (Section 4.1) and capital expenditure (Section 4.2).
- Our assessment of tariffs (Section 5.3).

**WIRO Clause 11(d)(iii) requires us to have regard to whether Central Highlands Water’s prices ‘take into account the interests of customers of the regulated entity, including low income and vulnerable customers’.**

We consider that customer value established through prices and customer outcomes, as well as tariff structures, and assistance available to customers having difficulty paying bills is relevant to this objective.

The following chapters and sections of our final decision involved consideration of this factor:

- Our consideration of customer engagement (Section 3.1)
- Our consideration of outcomes (Section 3.2)

Appendix B – Commission’s consideration of legal requirements

- Our consideration of guaranteed service levels (Section 3.4)
- Our consideration of tariff structures and prices (Chapter 5)

## **Health, safety, environmental and social obligations**

**ESC Act Section 8A(1)(d) requires us to have regard to ‘the relevant health, safety, environmental and social legislation applying to the industry’.**

Our final decision proposes to approve a revenue requirement that will enable Central Highlands Water to deliver the outcomes valued by customers, and on its legal and regulatory obligations.

The following chapters and sections of our final decision involved consideration of this factor:

- Our assessment of the revenue requirement (Chapter 4).
- Our assessment of efficient operating expenditure (Section 4.1) and capital expenditure (Section 4.2).
- Our assessment of the form of price control (Section 5.2).

**WI Act section 4C(c) requires us to ‘ensure that regulatory decision making has regard to the health, safety, environmental sustainability (including water conservation) and social obligations of regulated entities’.**

Our final decision proposes to approve a revenue requirement that will enable Central Highlands Water to deliver the outcomes valued by customers, and on its health, safety, environmental sustainability and social obligations.

The following chapters and sections of our final decision involved consideration of this factor:

- Our assessment of the revenue requirement (Chapter 4).
- Our assessment of efficient operating expenditure (Section 4.1) and capital expenditure (Section 4.2).
- Our assessment of tariffs (Section 5.3).

## **Other matters**

**ESC Act section 8A(1)(c) requires us to have regard to ‘the degree of, and scope for, competition within the industry, including countervailing market power and information asymmetries’.**

In relation to the above, Central Highlands Water does not face any competition in the delivery of its prescribed services within its region. Our final decision takes this into account through our consideration of forecast efficient costs, and considering the service priorities of customers as revealed through a business’s customer engagement.



The following sections of our final decision involved consideration of this factor:

- Our assessment of engagement (Section 3.1)
- Our assessment of outcomes (Section 3.2)
- Our assessment of efficient operating expenditure (Section 4.1) and capital expenditure (Section 4.2).

We consider that our pricing approach helps to address market power and information asymmetries relating to the water businesses. Our PREMO water pricing approach provides incentives for a water business to provide its “best offer” to customers in its price submission. This is described in further detail in a report we released in 2016.<sup>90</sup>

**ESC Act section 8A(1)(e) requires us to have regard to the ‘benefits and costs of regulation (including externalities and gains from competition and efficiency) for: (i) consumers and users of products or services (including low income and vulnerable consumers); and (ii) regulated entities’.**

We have had regard to benefits and costs of regulation by:

- Implementing a price review process so that water businesses may receive streamlined price reviews if they submit a high quality price submission. This reduces the costs of regulation for water businesses and the commission.
- Focusing our assessments of price submissions on the materiality of proposals to customer interests (including low income and vulnerable services), including in terms of price, bill and service impacts.
- Designing our guidance so we minimise the compliance costs for water businesses. Our guidance noted that much of the information required in price submissions should be readily available to water businesses as it would be relevant for other purposes such as corporate planning and project prioritisation and justification.<sup>91</sup>

**ESC Act section 8A(1)(f) requires us to have regard to ‘consistency in regulation between States and on a national basis’.**

Similar to other state and national regulators, our economic regulatory approach:

- uses the building block method to estimate a water business’s revenue requirement
- allows water businesses to implement various forms of price control, including price caps and revenue caps

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<sup>90</sup> Essential Services Commission 2016, Water Pricing Framework and Approach, Implementing PREMO from 2018, October, pp. 11–13.

<sup>91</sup> Essential Services Commission, *2023 water price review: Guidance paper*, 26 October 2021, p. 2.

- allows for consultation with key stakeholders during a price review, including through the release of a draft decision.

**WI Act section 4C(a) requires us to ‘ensure that the costs of regulation do not exceed the benefits’.**

We have sought to ensure that the costs of regulation do not exceed the benefits by:

- Implementing a price review process so that water businesses may receive streamlined price reviews if they submit a high quality price submission. This reduces the costs of regulation for water businesses and the commission.
- Focusing our assessments of price submissions on the materiality of proposals to customer interests (including low income and vulnerable services), including in terms of price, bill and service impacts.
- Designing our guidance so we minimise the compliance costs for water businesses. Our guidance noted that much of the information required in price submissions should be readily available to water businesses as it would be relevant for other purposes such as corporate planning and project prioritisation and justification.<sup>92</sup>

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<sup>92</sup> Essential Services Commission, 2023 water price review: *Guidance paper*, 26 October 2021, p. 2.

## Appendix C – Service standards

We have accepted the following standards, and conditions of service and supply, and associated targets for Central Highlands Water. Service standards are set out in our Service standards are set out in our Water Industry Standard – Urban Customer Service (Urban Water Industry Standard). Accordingly, in early 2023-24, we will update the Urban Water Industry Standard to adopt these service standards and targets.

### Water service standards

	2023-24	2024-25	2025-26	2026-27	2027-28
Minimum water flow rate a customer should receive (L/min)	10	10	10	10	10
Maximum number of unplanned water supply interruptions a customer should experience in any 12 month period	5	5	5	5	5
Average time taken to attend bursts and leaks (priority 1) (minutes)	40	40	40	40	40
Average time taken to attend bursts and leaks (priority 2) (minutes)	65	65	65	65	65
Average time taken to attend bursts and leaks (priority 3) (minutes)	450	450	450	450	450
Average duration of unplanned water supply interruptions (minutes)	120	120	120	120	120
Average duration of planned water supply interruptions (minutes)	175	175	175	175	175

## Sewerage service standards

	2023-24	2024-25	2025-26	2026-27	2027-28
Maximum number of sewer blockages a customer should experience in any 12-month period	3	3	3	3	3
Average time to attend sewer spills and blockages (minutes)	40	40	40	40	40
Average time to rectify a sewer blockage (minutes)	120	120	120	120	120
Maximum time taken to contain a sewer spill (minutes)	300	300	300	300	300

## Appendix D – Guaranteed service level scheme

We have accepted the following service level obligations and corresponding payment amounts for failure to attain the stated obligation as the guaranteed service level scheme for Central Highlands Water. Guaranteed service levels are approved in the Water Industry Standard – Urban Customer Service (Urban Water Industry Standard). Accordingly, in early 2023-24, we will update the Urban Water Industry Standard to reflect the guaranteed service levels set out below.

In accordance with clause 20(b) of the Urban Water Industry Standard, Central Highlands Water must ensure that any payment is made to a customer as soon as practicable after a customer becomes entitled to the guaranteed service level payment.

Central Highlands Water is not required to make a payment where the failure to meet the service level is due to the action or inaction of the customer or a third party. For the avoidance of doubt, a third party does not include any person or firm acting on behalf of Central Highlands Water.

### Central Highlands Water’s guaranteed service level scheme

Service level obligation	Payment (\$)
Failure to provide clean drinking water with the presence of dirty water (more than 5 turbidity units) as the result of a Central Highlands Water fault not restored within 8 hours	200
Failure to rectify an unplanned interruption to a customer’s water supply within 4 hours of becoming aware of the interruption	150
Exceeding 3 water supply interruptions to a customer in any 12-month period	150
Failure to repair leaking water service within 3 business days of becoming aware of the leak	200
In the event of a sewer spill within customer’s house, which is caused by Central Highlands Water, the annual wastewater service fee will be refunded as a rebate	1,125
Failure to rectify sewer interruption within 3 hours of becoming aware of the interruption	150
Exceeding 1 sewer supply interruption in any 12-month period	150
Restricting the water supply of, or taking legal action against a residential customer prior to taking reasonable endeavours to contact the customer and provide information about help that is available if the customer is experiencing difficulties paying	450

Note: These are nominal amounts, that is, the amount of payment will not be impacted by inflation.

# Appendix E – Inputs to calculation of long-term inflation

**Inflation – annual estimates (per cent)**

	2023-24	2024-25	2025-26	2026-27	2027-28	Average
RBA geometric mean	7.0	4.1	3.1	2.5	2.5	3.8
Bond breakeven	7.0	2.3	2.3	2.3	2.3	3.3