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2008 WATER PRICE REVIEW

GUIDANCE ON WATER PLANS

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HOW TO RESPOND TO THIS PAPER

We encourage as many stakeholders as possible to provide comment on the Water Plan Guidance.

The responses received will assist the Commission in finalising its guidance to the water businesses.

Written submissions or comments are due by **6 October 2006**.

We would prefer to receive them by email at water@esc.vic.gov.au.

You can also send comments by fax (03) 9651 3688 or by mail to:

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Our normal practice is to make all submissions publicly available on our website. If you do not have access to the website, you can contact Commission staff to make alternative arrangements to view copies of the submissions.

We may choose not to publish a submission where it contains confidential or commercially sensitive information. If there is information that you do not wish to be disclosed publicly on the basis that it is confidential or commercially sensitive, you should discuss the matter first with Commission staff.

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1.1 The 2008 water price review

The Commission will commence reviewing the prices to apply to water and sewerage services provided by Victoria's 20 water businesses for the second regulatory period in 2007. This will be the first time that proposed prices for the rural and regional urban businesses will be reviewed at the same time.

As a part of the review the Commission expects that businesses will be required to submit draft Water Plans in May 2007. The Commission is required to assess the Water Plans against certain principles outlined in the Water Industry Regulatory Order (WIRO) and decide whether to approve or specify the prices or the manner in which prices are to be determined for the services provided by these businesses over the regulatory period.

In deciding whether to approve a business's proposed prices, the Commission must be satisfied that they provide the business with sufficient revenue over the regulatory period to meet its obligations and deliver the level of service required by customers.

The Commission is required to assess the detailed assumptions underpinning the businesses' proposed revenue requirements for the regulatory period. The businesses' expenditure forecasts must reflect efficient costs of supply and the program of work proposed by each business must be deliverable over the period. The businesses' forecasts of demand and supply (which affect both expenditure and prices) must also be reasonable and reflect the best available information. Customer service standards proposed by each business must also be clear, appropriate and reflect the needs and interests of customers.

The Commission must also be satisfied that prices provide appropriate signals about the costs of providing services and incentives for sustainable water use.

The Commission's approach to assessing proposed prices is characterised by three steps. The first step involves establishing the service standards and other outcomes that a business proposes to deliver over the regulatory period. This includes expectations about the water delivery and supply factors that are likely to underpin the delivery of services. These standards and outcomes reflect both obligations imposed by the Minister for Water through the Statement of Obligations, the Environment Protection Authority (EPA), the Department of Human Services (DHS) and Department of Sustainability and Environment (DSE) and customer preferences for service improvements.

Step two involves the Commission assessing each of the key revenue components and proposals against the WIRO principles. The Commission's assumptions are used solely to assess whether prices will result in the business earning sufficient

revenue to deliver services. They do not represent amounts businesses are required to spend or to direct to particular activities or projects. In consultation with customers, businesses are free to determine their own expenditure priorities in light of changing circumstances and to pursue innovation and efficiencies that enable them to outperform the cost assumptions.

The third step in the process involves determining the prices needed to meet that revenue requirement.

Urban prices were previously reviewed in 2005 and rural prices in 2006. An important aspect of these reviews was to establish a firm foundation for economic regulation in the future. The Commission intends to consult with businesses and other stakeholders on aspects of its framework and approach in advance of the businesses submitting their draft Water Plans in May.

1.2 The role of Water Plans

Each water business is required to submit a Water Plan covering each year of the regulatory period commencing 1 July 2008. The key role of the Water Plan is to clearly articulate and commit to a set of outcomes and prices to be delivered over the regulatory period. The Water Plan also provides a mechanism for businesses to resolve tradeoffs with customers, regulators and the Minister for Water.

Therefore it is important that the Water Plans contain sufficient detail about the outcomes that businesses intend to deliver, supporting information and evidence of consultation with customers. The plans should be largely forward looking, that is they should focus on the outcomes to be delivered for the second regulatory period and the expenditure and prices needed to deliver those outcomes.

Standardised Water Plans would assist customers and the Commission with clarity and understanding of the businesses' proposals. Standard Water Plans would also increase transparency and facilitate comparisons across businesses where appropriate. Therefore this paper aims to encourage standardisation of Water Plans across businesses by providing guidance on the content and structure of the plans.

The Water Plan ultimately forms the basis for businesses seeking Commission approval of their proposed prices for the regulatory period. Therefore it is possible that the Commission will require additional information to allow it to fully understand the businesses' proposals. This guidance and the financial templates have been developed with the aim of minimising duplication and the need to seek additional information from businesses.

At a general level the 2008 Water Plans should set out:

- the consultation that the business has undertaken in developing its proposals
- the outcomes the business proposes to deliver over the five year regulatory period to meet demands for its services and the requirements placed on it by government and regulators

- how the business proposes to achieve those outcomes — including the key projects and expenditure drivers for the period
- how much revenue the business requires to be able to deliver its proposed outcomes — as built up by the Commission's financial template
- the proposed prices and tariff structures for all prescribed services

1.3 The Water Plan and financial templates

The Commission has developed standardised templates to be completed by each of the businesses as part of their Water Plan. The Commission will be consulting on the financial templates with businesses.

The templates are generally consistent with those used in the previous price reviews and the requirements of regulatory accounting templates and facilitate the provision of expenditure and pricing information on a consistent basis.

The primary role of the templates is to assist the Commission in building up the revenue requirements and to ensure that the prices proposed by the businesses deliver that revenue requirement. The templates will not necessarily contain all of the detailed cost information required by the Commission. This should be included as supporting information (possibly as an appendix) in the Water Plan.

The Water Plans, information templates and other supporting information will provide the basis for the assessment of proposed prices and service levels by the Commission, customers, and other interested parties during the review process.

Therefore it is important that the information included in the financial templates is consistent with the Water Plans. The Water Plans should draw on the financial templates and include summary tables from templates. Draft financial templates have been issued to the businesses for comment and the Commission will work with the businesses to further refine them.

The completed financial templates should also be included as Appendix A to the Water Plan.

1.4 Consultation on approach

There are a number of key issues related to the application of the regulatory framework, process and approach the Commission will take in assessing Water Plans. A number of these issues will need to be resolved before the businesses submit their Water Plans. Other issues will need to be resolved as part of the price review process itself. In order to give the businesses sufficient guidance before they need to develop and submit their Water plans the Commission intends to consult on these issues over the following months through a series of consultation papers. The outcomes from the consultation process will be reflected in further guidance to be provided to the businesses in December.

The Commission has identified a number of issues for consultation including:

- the length of the regulatory period

- the scope for better alignment of service standards across the State
- guaranteed service levels
- tariff structures
- new customer contributions
- miscellaneous charges
- the form of price control
- dealing with unforeseen events
- incentive mechanisms (such as, efficiency carryover and s factor) and
- classification of prescribed and non-prescribed services

The Commission is seeking feedback from businesses and other stakeholders on the issues that it will be consulting on in the lead up to the next price review.

The comments received in response to this paper will assist the Commission in developing its consultation timetable as well as highlighting any other issues that need to be addressed.

1.5 Purpose and structure of this guidance paper

This paper provides high level guidance on the structure and content of Water Plans for the second regulatory period. The Commission is seeking feedback from the businesses and other stakeholders on whether there is other information they would like to see included in the Water Plans. This paper is structured to provide the following guidance:

- chapter 2 — what should be included in the Water Plan executive summary
- chapter 3 — how the Water Plan should reflect the delivery of outcomes committed to for first regulatory period
- chapter 4 — how the Water Plan should reflect the service outcomes businesses plan to deliver over the regulatory period, including legislative obligations, service standards and customer consultation.
- chapter 5 — how the Water Plan should reflect the revenue requirement for the regulatory period. This chapter outlines requirements related to operating expenditure, capital expenditure, and the financing of capital investments.
- chapter 6 — how the Water Plan should reflect demand forecasts and provides a general overview of the factors impacting on the demand for key services.
- chapter 7 — how the Water Plan should outline proposed prices and tariff structures for the regulatory period.
- chapter 8 — how the Water Plan should reflect the provision of non-prescribed services.

The key role of the Water Plan is to clearly articulate to customers and the Commission the set of outcomes and prices to be delivered over the regulatory period. The executive summary should therefore provide a brief overview of the main proposals contained within the Water Plan.

Specifically, the executive summary should clearly summarise the proposed revenue requirement and annual price change, the key outcomes expected to be delivered over the regulatory period; capital and operating expenditure forecasts; the key drivers and components of expenditure; an overview of tariff structure proposals and a summary of customer consultation undertaken for the purposes of the Water Plan.

2.1 Overview of revenue requirement and proposed annual price change

This section should provide an overview of the revenue required by the business to meet its obligations and deliver services over the regulatory period. It should bring together the business's assumptions about its expenditure requirements, demand and capital financing assumptions. This section should also identify the key drivers of changes in revenue requirement and prices over the regulatory period

2.2 Overview of key outcomes for the period

The service standards and other outcomes that the businesses commit to deliver over the regulatory period underpin their expenditure proposals for the regulatory period and thus prices.

This section should provide an overview of the service standards and obligations that the business intends to deliver over the regulatory period, including any service improvements and new obligations. It should also identify links between key outcomes and forecast expenditure levels.

2.3 Overview of expenditure forecasts

Operating and capital expenditure are key drivers of prices. This section should provide an overview of the business's expenditure forecasts for the regulatory period, including an explanation of the key drivers of expenditure. It should also identify the key capital projects for the period and explain how forecast expenditure levels are related to the delivery of outcomes.

2.4 Overview of proposed tariff structures

This section of the Water Plan should provide an overview of proposed tariff structures for each service provided. It should also identify any changes to tariff structures and include information on what those changes are aimed at achieving.

2.5 Overview of customer consultation

Finally, the executive summary should include a section that presents the type of customer consultation undertaken by the business. This section should summarise the issues consulted on, which customers were consulted and how the outcomes of the consultation have been reflected in the Water Plan.

3 OUTCOMES FOR FIRST REGULATORY PERIOD

As part of the reviews of urban prices in 2005 and rural prices in 2006, the businesses developed Water Plans which identified a set of outcomes and prices that would be delivered over the first regulatory period. This section of the Water Plan should outline the businesses' progress in delivering those outcomes.

3.1 Service standards and other outcomes

As part of the Water Plans for the first regulatory period, the businesses providing urban services committed to meet approved targets for a core set of service standards. A number of businesses also committed to meeting targets for a number of additional service standards that reflect business specific services and localised issues.

The Commission is currently consulting on a performance monitoring framework to apply to the rural businesses which includes a core set of service standards. These businesses will be expected to propose targets for the core set of standards for the second regulatory period. Goulburn-Murray Water and Southern Rural Water also committed to meet targets for a number of service standards for the first regulatory period.

The businesses also committed to the delivery of other outcomes over the first regulatory period such as recycling and renewals targets.

This section of the Water Plan should outline the business's progress in the delivery of the outcomes it committed to for the first regulatory period. In particular the Water Plan should indicate where outcomes have not been delivered and provide information explaining why outcomes have not been delivered. For example, agreed outcomes may not have been delivered because of changed priorities or the delay of key capital projects.

3.2 Delivery of key capital projects

The Water Plans for the first regulatory period also identified a number of key capital projects that the businesses proposed to deliver in the first regulatory period. This section of the Water Plan should outline the business's progress in the delivery of those capital projects. Where capital projects have been delayed or replaced with other projects to deliver the outcomes committed to the Water Plan should explain why the project has been delayed or replaced and identify how and when the business now expects to deliver the project.

3.3 Actual capital expenditure associated with the delivery of outcomes

As part of their Water Plans for the first regulatory period the businesses forecast the capital expenditure that they required to deliver services and meet obligations over the regulatory period. These forecasts were used to update the initial regulatory asset value set by the Minister for Water. As outlined in section 5.4.1, the opening value for the regulatory asset base for the second regulatory period needs to be updated to reflect the value of actual efficient and prudent capital expenditure.

This section of the Water Plan should outline the actual capital expenditure incurred in delivering outcomes for the first regulatory period and provide information to support that expenditure.

3.4 Changes in legislative obligations

In its previous urban and rural determinations the Commission indicated that it intends to take into account changes in legislative obligations that occur in the first regulatory period (2005-06 to 2007-08 for the urban businesses and 2006-07 to 2007-08 for the rural businesses) in determining the prices for the second regulatory period. For the urban businesses (reviewed as part of the 2005 review) such costs will only be taken into account where the net impact is 2.5 per cent of a business's total revenue over the regulatory period or \$1 million, whichever is higher.

For the rural businesses reviewed as part of the 2006 review there is no threshold. GWMWater and Lower Murray Water are still subject to the 2.5 per cent threshold with respect to obligations related to the provision of urban services.

For all businesses the costs that will be taken into consideration include additional net operating costs or any financing costs associated with capital expenditure which are associated with meeting changes to all primary Acts and legislative instruments, any licence issued pursuant to a primary Act, taxes and Statements of Obligations.

This section of the Water Plan should provide information on any additional and changed legislative obligations imposed during the first regulatory period. The plan should identify:

- the nature of the additional or changed obligation
- the date on which the addition or change took place
- any outcomes delivered
- the net operating and financing costs associated with the addition or change
- any decrease in the net operating costs associated with the addition or change.

The Water Plan should also include information to show that any additional expenditure was efficient, that the change was unforeseen and not already included in the expenditure forecasts and that the business was not already meeting any required higher standards.

3.5 Over or under recovery of revenue

For the first regulatory period the rural businesses are being regulated under a 'revenue cap' approach. This means that if revenue is different from that forecast in the final determination (due to differences in demand for services) then this may be taken into account in determining the amount of revenue for the second regulatory period.

This section of the Water Plan should therefore set out the proposed amount of over/under recovered revenue to be returned to or recouped from customers in the second regulatory period.

4 | SERVICE OUTCOMES

The first step in assessing proposed prices involves establishing the service standards and other related outcomes that are to be delivered over the regulatory period. Service standards and other outcomes underpin the businesses' expenditure proposals for the regulatory period and thus prices.

These standards and outcomes reflect both obligations imposed by the Minister for Water through the Statement of Obligations, the Environment Protection Authority (EPA), the Department of Human Services (DHS) and the Department of Sustainability and Environment (DSE).

The Water Plan needs to set out the service standards and obligations that the business intends to deliver over the regulatory period. It should clearly identify any service improvements and new obligations to be delivered over the regulatory period.

The Commission also expects that the Water Plan will clearly identify the link between service outcomes and forecast expenditure levels such that the Commission or customers can clearly identify that proposed increases in expenditure levels and hence prices are reflected in improved service outcomes or the delivery of additional obligations.

4.1 Customer consultation

Customer consultation on outcomes and proposals for the regulatory period provides an opportunity for businesses to understand the concerns of customers and to obtain their views and support for particular proposals.

4.1.1 Overview of customer consultation

This section of the Water plan should provide an overview of how the business has consulted with its customers. There are a number of forms that this consultation can take and the Commission would expect businesses to use a mix of consultation approaches to provide customers with sufficient opportunities to be involved in the process.

Options for customer consultation include:

- market research
- satisfaction surveys
- willingness to pay surveys
- customer committees
- meeting with interest and community groups

- customer focus groups
- meetings with large customers
- project specific consultation with customers and local community groups
- inviting customer comment on proposals
- public meetings, information sessions and workshops
- newsletters and media releases

The Water Plan should indicate what forms of consultation were undertaken, with which customers and on what issues.

4.1.2 Overview of key issues identified by customers

This section of the Water Plan should provide an overview of the key issues identified by customers for the regulatory period. Where possible it should cross reference to other sections of the Water Plan that explain how these concerns are being dealt with.

For example, if customers have raised concerns about service reliability this section should include a cross reference to the discussion on the particular projects or expenditure aimed at addressing service reliability.

Businesses should use the views expressed by customers as evidence of customer support for particular proposals or outcomes outlined in the Water Plan.

4.2 Regulatory and government obligations

A number of the service outcomes that businesses will deliver over the regulatory period are driven by obligations placed on them by regulatory agencies and the government. The Water Plan should clearly identify what these are, the expenditure and projects aimed at meeting them and the outcomes of delivering them.

The Commission also needs to understand the obligations being placed on businesses and the implications for the revenue required to deliver those obligations. However, it is not responsible for deciding on the environmental, water quality and other obligations or priorities placed on businesses. Nor is it responsible for deciding when or how businesses meet those obligations. These priorities will need to be decided by the business in consultation with regulators and the government, whilst having regard for potential customer impacts.

Separate guidance on these obligations has been provided by the EPA and DSE has stated an intention to provide additional guidance regarding the Government's expected outcomes (such as, water conservation, sustainability and dam safety).

Where a business is proposing to deliver an outcome that goes beyond the minimum obligation or target imposed by regulators or the Minister for Water the Commission expects the business to include evidence that it has consulted with and has the support of customers. In particular it expects that customers will have been consulted on and support the proposed targets, the impact on prices and have expressed a willingness to pay.

As a general principle the Commission would expect to see greater justification in terms of consultation with customers where proposals to deliver these outcomes represent a significant level of expenditure over the regulatory period and/or will have a significant impact on prices.

Separately identifying new obligations and customer preferences for service improvements is an important part of the framework. It allows customers, government and regulators to clearly identify the cost of new obligations and the potential impact on prices.

4.2.1 Statement of obligations

This section of the Water Plan should identify the obligations imposed on the business by the Minister for Water through the Statement of Obligations. It should separately identify:

- business as usual obligations — obligations in place prior to 1 July 2008
- new obligations — those obligations that take effect (or are reasonably anticipated to take effect) on or after 1 July 2008.

For each type of obligation the Water Plan should clearly identify:

- the obligation, including any targets that have been imposed on the business
- the outcomes that will be delivered over the regulatory period
- the expenditure or projects aimed at meeting the obligations
- any consultation undertaken

4.2.2 Environmental obligations

This section of the Water Plan should identify the obligations imposed on the business by the EPA. The Commission notes that the EPA has released its own high level guidance on the issues that it expects businesses to address for the regulatory period. This section should also outline other environmental obligations that the business is required to meet. The Water Plan should identify

- business as usual obligations — obligations in place prior to 1 July 2008
- new obligations — those obligations that take effect (or are reasonably anticipated to take effect) on or after 1 July 2008.

For each type of obligation the Water Plan should clearly identify:

- the obligation, including any targets that have been imposed on the business
- the outcomes that will be delivered over the regulatory period
- the expenditure or projects aimed at meeting the obligations
- any consultation undertaken

4.2.3 Water quality obligations

This section of the Water Plan should identify the obligations imposed on the business by the DHS with regards to the delivery of water quality outcomes. The Water Plan should identify

- business as usual obligations — obligations in place prior to 1 July 2008
- new obligations — those obligations that take effect (or are reasonably anticipated to take effect) from 1 July 2008.

For each type of obligation the Water Plan should clearly identify:

- the obligation, including any targets that have been imposed on the business
- the outcomes that will be delivered over the regulatory period
- the expenditure or projects aimed at meeting the obligations
- any consultation undertaken

4.2.4 Other obligations

The Water Plan should identify

- business as usual obligations — obligations in place prior to 1 July 2008
- new obligations — those obligations that take effect (or are reasonably anticipated to take effect) from 1 July 2008.

For each type of obligation the Water Plan should clearly identify:

- the obligation, including any targets that have been imposed on the business
- the outcomes that will be delivered over the regulatory period
- the expenditure or projects aimed at meeting the obligations
- any consultation undertaken

4.3 Service standards

4.3.1 Commission's approach to assessing service standards

The Commission is responsible for regulating standards and conditions of supply for prescribed services. It is required to approve or specify the service standards that businesses propose to deliver over the regulatory period. The Water Plans need to specify the service standard targets that the businesses intend to achieve over the regulatory period. These targets need to have been developed in consultation with customers.

The Commission expects businesses to have consulted with their customers on appropriate service standard targets for the regulatory period. In particular businesses should consult on:

- whether proposed service levels are appropriate given historical performance
- performance relative to other businesses
- customer complaint issues
- failure rates of assets
- the cost implications of improvements or reductions in service standard performance
- the willingness of customers to pay for service improvements

4.3.2 Core service standards

This section of the Water Plan should outline the service standards businesses intend to deliver over the regulatory period for the core set of service standards. Separate core sets have been established for urban and rural services respectively as part of the previous urban and rural price reviews (see Boxes 4.1 and 4.2). GWMWater and Lower Murray Water need to propose targets for both sets of standards. Where a business does not provide a service it does not need to propose a target for that service standard.

Box 4.1 Core service standards — urban services

Water

- rate of unplanned water supply interruptions
- average time taken to attend unplanned water supply interruptions
- proportion of water supply interruptions restored within specified timeframes
- average customer minutes off water supply (planned and unplanned)
- average frequency of water supply interruptions (planned and unplanned)
- average duration of water supply interruptions (planned and unplanned)
- number of customers experiencing a specified number of multiple unplanned water supply interruptions
- level of unaccounted for water
- minimum flow rate

Sewerage

- rate of sewerage blockages
- average time to attend sewer spills and blockages
- average time to rectify a sewer blockage
- proportion of spills contained within a specified time
- number of customers experiencing a specified number of multiple sewer blockages
- odour complaints

Melbourne Water

- aggregated compliance with key aspects of bulk service arrangements at interface points, such as water quality and pressure
- rate of sewer spills and overflows
- proportion of sewer spills contained within a specified time
- level of unaccounted for water
- number of new properties at risk of flooding from specified rainfall events

Customer service

- complaints to EWOV
- frequency of telephone calls answered within 30 seconds
- restrictions and legal action for non payment
- number of customers assisted under hardship schemes

Box 4.2. Core service standards — rural services

Gravity supply (by district/supply system)

- irrigation water orders delivered on day requested (per cent)
- stock and domestic deliveries within [X] days of the initial target delivery period (per cent)
- number of channel burst and leaks (per 100 km of channel)
- unaccounted for water (per cent)

Pumped supply (by district/supply system)

- irrigation water orders delivered on day requested (per cent)
- unavailability of stock and domestic supply systems for continuous periods in excess of [X] hours (per cent)
- number of pipeline bursts and leaks (per 100 km of pipeline)
- unaccounted for water (per cent)

Irrigation drainage (by district/supply system)

- availability of surface drainage schemes (per cent)
- availability of sub-surface drainage schemes (per cent)

Bulk Water

- annual compliance with storage operator obligations (per cent)

Licensing/administration

- applications for surface diversion, groundwater or supply-by-agreement licences determined within [X] days (per cent)
- processing permanent transfer of surface diversion or groundwater licences within [X] days (per cent)
- processing temporary transfer of water entitlement volumes within [X] days (per cent)
- processing permanent transfer of water entitlement volumes within [X] days (per cent)
- number of diversion licences metered or assessed for metering at 30 June (per cent)
- volume of total surface water and groundwater entitlements metered at 30 June (per cent)

Customer service

- complaints to EWOV (number)
- telephone calls answered within 30 seconds (per cent)

The cores service standards for Melbourne Water are set out in box 4.3.

Box 4.3 Core service standards — Melbourne Water

Water

- aggregated water pressure compliance with bulk service arrangements at interface points (per cent)
- aggregated water quality compliance with bulk service arrangements at interface points
 - micro-biological standards (E.coli) (per cent)
 - disinfection by-products (Trihalomethanes and chloroacetic acids) (per cent)
 - aesthetic standards (turbidity) (per cent)
 - aesthetic standards (aluminium) (per cent)
- level of leakage

Sewerage

- sewerage spills and overflows
 - hydraulic deficiency (number)
 - system failure (number)
 - extreme wet weather (number)
- blockages (number)
- odour complaints (number)

Drainage

- new properties meeting new flood protection standard (per cent)
- cumulative reductions in nitrogen loads to Port Philip Bay from wetlands (tonnes)
- drainage development applications processed within specified timeframes (per cent)
- regional River Health Strategy (key outputs)

Customer service

- complaints to EWOV

The Water Plan should outline the targets that the business proposes to deliver for each year of the regulatory period. In proposing targets the Commission expects performance to be at least consistent with average performance over the previous three years for which actual data is available (2003-04 to 2005-06).

The Water Plan should clearly:

- outline the basis used for setting proposed service standards and the reasons for adopting such a basis
- identify where proposed service standard targets are above or below current levels

- identify the cost implications of proposing service levels that are above (or below) current levels. In some cases service outcomes may be improved without a significant change in costs.
- set out how they propose to meet the specified service standards, including identifying the expenditure or projects that are targeted at improving service levels over the regulatory period
- provide evidence of consultation with customers and evidence of their support and willingness to pay for the proposed service standards
- indicate how the business proposes to address and mitigate against the occurrence of outlier events.

4.3.3 Additional service standards

Beyond the core set of service standards, businesses may choose to nominate additional service standards and outputs that they intend to deliver over the regulatory period. These additional service standards are intended to reflect business specific services and localised issues. For example, in the case of urban services sewer odour or aesthetic water quality may be major issues and cost drivers for some businesses. In the case of rural services, response times to leakages or the number of unplanned supply failures may be significant issues for particular districts. It may be useful to identify specific targets for these aspects of service delivery.

This section should outline any additional service standards and targets for the regulatory period. The Water Plan should:

- outline the basis used for setting proposed service standards and the reasons for adopting such a basis
- identify whether proposed service standard targets are above or below current levels
- identify the cost implications of proposing service levels that are above (or below) current levels
- set out how they propose to meet the specified service standards, including identifying the expenditure or projects that are targeted at improving service levels over the regulatory period
- outline evidence of consultation with customers and evidence of their support and willingness to pay for the proposed service standards

The Commission would expect consistency in any additional standards proposed with those proposed in the first regulatory period.

There are a number of additional service outputs set by other regulators that impact on the capital and operating expenditure of businesses and the quality of service received by customers. Water plans should contain outputs for:

- drinking water quality
- environmental discharge requirements
- water reuse
- number of sewer backlog (or small town sewerage scheme) properties serviced.

4.4 Guaranteed service levels

Once the service levels for the regulatory period are approved, it is important to ensure that regulated businesses have sufficient incentives to deliver the desired level of service over the regulatory period.

One approach to enhancing incentives for businesses to meet service standard for all customers is to adopt a guaranteed service level (GSL) scheme. This involves businesses providing rebates to customers who receive a level of service that is significantly worse than the average level of performance expected by most customers. The cost of an assumed level of payments is reflected in a business's revenue requirement and so it has an incentive to minimise the number of events that give rise to payments.

GSL schemes involve businesses making payments to customers who receive services that do not meet defined levels of performance. The primary purpose is to provide an *incentive* for businesses to improve key aspects of service rather than to provide *compensation* to affected customers. GSL schemes also complement other regulatory incentives in the sense that they deal with service levels experienced by the most poorly served customers

In relation to the coverage of a GSL scheme it is desirable for the proposed GSLs to reflect the service standards that are of greatest concern to customers (for example, sewer spills) and where setting service standards may mask the impact on more adversely affected customers of high frequency and duration water and sewerage interruptions.

The Commission expects that those businesses with GSLs in place will continue to offer them in the second regulatory period. As part of the Urban Price Review the Commission indicated that it would review performance data and consider whether all urban businesses should be required to provide GSLs. The Commission will be doing this as part of its consultation in the lead up to the 2008 Price Review. It will also consult on the suitability of GSLs for rural customers.

Where a water business proposes GSLs as part of its 2008 Water Plan, it will be necessary for the business to identify:

- the nature of GSLs that will entitle a customer to a payment, including any exclusions to apply
- the basis for including particular events as GSLs. For example, discussed with customer committees to identify issues of most concern to customers, historical performance, market research and discussions with other businesses
- the threshold at which the business will make payments to customers
- the size or nature of the proposed payment to be made to customers, including any exclusions
- the likely cost of the scheme over the regulatory period, including the forecast cost of actual payments that would be made (based on historic performance data) and other costs associated with implementing the scheme.

The Water Plan should also outline how the business has consulted with customers and outline customer views on the proposed GSLs. In particular the

Water Plan should outline how customers have been consulted and their views on the GSL events and payment levels being proposed. Businesses should also draw on recent performance data in support their argument for particular GSL events.

5.1 Overview of revenue requirement

The Commission's framework uses the 'building block' approach to derive forward looking estimates of the revenue that the businesses require to deliver proposed service standards and other outcomes over the regulatory period. Under this approach the revenue requirement reflects operating expenditure and a return on and of the regulatory asset base (RAB) updated each year to reflect any additional capital expenditure net of contributions, asset disposals and regulatory depreciation.

This section of the Water Plan should provide an overview of the revenue required by the business to meet its obligations and deliver services over the regulatory period. It should bring together the business's assumptions about its expenditure requirements, demand and capital financing assumptions.

The revenue requirement table from the financial template should be included in this section of the Water Plan. The table includes:

- operating expenditure
- return on assets to 30 June 2008
- regulatory depreciation of assets to 30 June 2008
- return on assets constructed during the period
- regulatory depreciation of assets constructed during the period
- renewals annuity
- adjustments from last period
- benchmark tax liability

This section of the Water Plan should clearly identify the key drivers of the revenue requirement and link these to the delivery of particular outcomes. The following sections of the Water Plan should provide a detailed explanation of the components making up the revenue requirement.

5.2 Operating expenditure

Operating expenditure is a key component of the revenue requirement and is included in the year in which it is incurred.

In assessing the expenditure forecasts put forward by each of the businesses, the WIRO requires that the Commission be satisfied that the expenditure forecasts reflected in Water Plans are efficient and that the forecasts take into account a planning horizon that extends beyond the regulatory period. Another principle is

that regulatory arrangements provide incentives for the water businesses to spend efficiently over the regulatory period.

The Water Plan should clearly outline a business's forecasts of operating expenditure for each year of the regulatory period, the key drivers of expenditure, justification of forecast expenditure levels and evidence of productivity improvements (including targets). The Water Plan also needs to outline the relationship between expenditure and the delivery of obligations and service outcomes over the period.

The Water Plan should also clearly distinguish between operating expenditure related to business as usual activities and new obligations. The purpose of this is to provide transparency to the Commission, customers, Government and other regulators of the approximate cost of new obligations and hence the impact on prices. Expenditure associated with new obligations includes any operating expenditure associated with the introduction of new obligations imposed by the government and regulators or increased service standards required by customers which take effect (or are reasonably anticipated to take effect) on 1 July 2008 or later.

5.2.1 Overview of operating expenditure

This section of the Water Plan should outline the business's forecasts of operating expenditure for each year of the regulatory period. This section of the Water plan should include the business as usual operating expenditure forecast summary table from the financial template and separately identify operating expenditure related to new obligations.

Businesses should also include detail on forecast expenditure for the different categories identified in the financial templates (see boxes 5.1 and 5.2).

**Box 5.1 Business as usual operating expenditure categories
— urban services**

- Water, sewerage, bulk water, bulk sewerage and drainage
 - operations and maintenance
 - bulk charges
 - treatment
 - customer service and billing
 - GSL payments
 - licence fees
 - corporate
 - other operating expenditure
 - Recycled water
 - Rural water
 - Licence fees
 - Essential Services Commission
 - Department of Human Services
- Environment Protection Authority

**Box 5.2 Business as usual operating expenditure categories
— rural services**

- Headworks and bulk
 - bulk water charges - Vic
 - bulk water charges - non-Vic
 - storage — operations
 - storage — maintenance
 - bulk carriers — operations
 - bulk carriers — maintenance
 - corporate
- Distribution
 - channel network — operations
 - channel network — maintenance
 - pipeline network — operations
 - pipeline network — maintenance
 - corporate
- Licensing
 - surface water
 - ground water
 - drainage diversion
 - corporate
- Drainage
 - tile drainage
 - groundwater pump operations
 - pipeline collection network
 - surface drainage network
 - saline disposal/salt interception schemes
 - corporate
- Miscellaneous
- Retail
- Licence fees
 - Essential Services Commission
 - Department of Human Services
 - Environment Protection Authority

5.2.2 Key drivers of operating expenditure

This section of the Water Plan should outline the key drivers for both business as usual expenditure and expenditure related to the delivery of new obligations (including meeting customer requirements). The Water Plan should clearly identify how expenditure over the regulatory period is related to the delivery of the outcomes identified earlier in the Water Plan. For example, an increase in expenditure on maintenance could be related to the delivery of reduced failure rates or deferment of asset replacement.

5.2.3 Justification of forecast expenditure levels

This section of the Water Plan should provide information and argument in support of the proposed operating expenditure forecasts. The Water Plan should discuss:

- historical expenditure levels
- benchmarking
- demand forecasts
- introduction of new obligations
- consultation with government, regulators and customers

Where businesses draw on supporting information such as benchmarking studies in support of their forecasts, this section should provide an overview of that information. The detailed information should be included as appendixes. The detailed information underpinning all forecasts should be kept and made available to the Commission on request.

As a general principle the Commission would expect a higher level of justification where a business is proposing a significant departure from historical levels or where expenditure relates to delivering outcomes that are above and beyond what customers have sought or regulators have mandated.

5.2.4 Productivity improvements over the period

The WIRO requires the Commission to be satisfied that the businesses' proposed prices provide for a sustainable revenue stream that does not reflect monopoly rents or inefficient expenditure. The Commission must also be satisfied that the proposed prices will provide the businesses with continuing incentives to pursue efficiency improvements. The Commission considers that it is reasonable to expect that businesses would be able to deliver efficiency improvements with respect to business as usual expenditure.

This section of the Water Plan should outline the productivity improvements that the business intends to deliver over the regulatory period and demonstrate how these are reflected in its business as usual forecasts of operating expenditure.

5.3 Capital expenditure

Capital expenditure is a key component of the revenue requirement. Net capital expenditure is recovered by being added to the regulatory asset base (RAB) and is

reflected in prices through a return on the RAB (that is the WACC multiplied by the RAB) and a return of the RAB (through regulatory depreciation).

In assessing the expenditure forecasts put forward by each of the businesses, the WIRO requires that the Commission be satisfied that the expenditure forecasts reflected in Water Plans are efficient and that the forecasts take into account a planning horizon that extends beyond the regulatory period. Another principle is that regulatory arrangements provide incentives for the water businesses to spend efficiently over the regulatory period.

The Water Plan should clearly outline a business's forecasts of capital expenditure for each year of the regulatory period, the key drivers of expenditure and information to show that the expected levels of expenditure are prudent and efficient.

The Water Plan should also clearly distinguish between capital expenditure related to business as usual activities and new obligations. The purpose of this is to provide transparency to the Commission, customers, Government and other regulators of the approximate cost of new obligations and hence the impact on prices. Expenditure associated with new obligations includes any capital expenditure associated with the introduction of new obligations imposed by the government and regulators or increased service standards required by customers which take effect (or are reasonably anticipated to take effect) on 1 July 2008 or later.

5.3.1 Overview of capital expenditure

This section of the Water Plan should outline the business's forecasts of capital expenditure for each year of the regulatory period. This section of the Water plan should include the capital expenditure forecast by cost driver summary table from the financial template and separately identify capital expenditure related to new obligations. Business as usual cost drivers identified in the financial template include:

- renewals
- growth/augmentation
- improved service
- compliance
- government contributions
- customer contributions.

The Commission is aware that businesses are developing demand-supply strategies and Sustainable Water Strategies (as required under the Water Act). The capital expenditure forecasts proposed in the Water Plan should be consistent with these strategies.

5.3.2 Key drivers of capital expenditure

This section of the Water Plan should outline the key drivers for both business as usual expenditure and expenditure related to the delivery on new obligations

(including meeting customer requirements). The Water Plan should clearly identify how expenditure over the regulatory period is related to the delivery of the outcomes identified in section 3 of the Water Plan.

This section of the Water Plan should include a table which identifies:

- the top ten projects/programs to be delivered over the regulatory period
- the drivers of each project/program
- the outcomes that will be delivered by each project
- the expected delivery date for the project/program
- the cost of the project/program for each year of the period

5.3.3 Prudent and efficient capital expenditure levels

This section of the Water Plan should provide information and argument in support of the proposed capital expenditure forecasts. The Water Plan should present information to show that the expected levels of expenditure are prudent and efficient. That is, they are appropriate given the outcomes that a business is expected to deliver and any risks the business may have to manage over the period. Prudent and efficient capital expenditure is rolled into the asset base (see sections 5.4.1 and 5.4.2). Information that might be used in support includes:

- evidence that asset management plans and processes are in place and have been followed
- benchmarking
- demand forecasts
- introduction of new obligations
- consultation with government, regulators and customers

Where businesses are drawing on supporting information such as benchmarking studies or asset management practices in support of their forecasts, this section should provide an overview of that information. The detailed information should be included as appendixes. The detailed information underpinning all forecasts should be kept and made available to the Commission on request.

As a general principle the Commission would expect a higher level of justification where a business is proposing a significant increase or decrease in expenditure or where expenditure relates to delivering outcomes that are above and beyond what customers and regulators have mandated.

5.4 Financing capital investments

Under the provisions of the WIRO businesses may recover the cost of financing existing and new investments through:

- earning a return on the value of the RAB (ie the weighted average cost of capital multiplied by the RAB) plus
- a return of the value of the RAB (ie regulatory depreciation)

In relation to expenditure on existing assets, three businesses (FMIT, Southern Rural Water and Lower Murray's rural activities) currently recover costs through a renewals annuity. Under this approach the annualised value of forecast long term expenditure is calculated and recovered through prices each year.

5.4.1 Updating the regulatory asset base

The value of the initial RAB (at 1 July 2004) has been set by the Minister for Water. An initial asset value was provided for all businesses, although the value for Southern Rural Water, FMIT and the rural activities of Lower Murray Water was set at zero.

Prices for the first regulatory period were based on these initial values adjusted annually in the following manner:

Opening RAB

Plus forecast gross capital expenditure

Less forecast customer and government and contributions

Less forecast proceeds from disposal of assets

Less regulatory depreciation

Equals closing RAB

The value of the RAB at the start of the second regulatory period needs to be updated to reflect the value of actual efficient and prudent capital expenditure, customer and government contributions and disposals.

The Water Plan should therefore include a table which shows the calculation of the value of the RAB across the regulatory period and at 1 July 2008, based on actual outcomes where available, bearing in mind that:

- at the time the draft Water Plans are prepared businesses will have two years of actual data (2004-05 and 2005-06) and two years of forecasts (2006-07 and 2007-08)
- when the final Water Plans are submitted all businesses will have three years of actual data and one year of forecasts

For years where actual data is not available, the Water Plans should show the capital expenditure, contributions and proceeds value assumed in the initial pricing determinations. For all years the value of regulatory depreciation shown should be that contained in the initial pricing determinations.

5.4.2 Rolling forward the RAB

The Water Plan also needs to show the forecast value of the RAB for each year of the second regulatory period. This should be set out in a table of similar format to that which shows the RAB in the first regulatory period.

The forecast RAB will need to reflect the business's estimate of capital expenditure (as discussed in section 5.3.3) as well as its forecast of capital contributions, disposals and regulatory depreciation.

This section of the Water Plan should therefore set out:

- forecast level of contributions from both customers and government, and the assumptions underpinning those forecasts
- an estimate of the proceeds from asset disposals, and the nature and type of assets anticipated to be sold

The Water Plan should set out a business's proposed regulatory depreciation for each year of the regulatory period. Consistent with the approach adopted by most businesses in the first regulatory period, the Commission would generally expect fixed assets to be depreciated using a straight line approach across the economic life of the assets. Where this is not the case, or where a business proposes to adopt different depreciation assumptions (eg in relation to asset lives) from those adopted in the first regulatory period, the Water Plan should set out the new assumptions and the reasons for the change in approach.

5.4.3 Weighted average cost of capital

The weighted average cost of capital (WACC) is the return that businesses seek to earn on their RAB.

This section of the Water Plan should set out:

- the proposed rate of return sought for the second regulatory period
- the basis for the proposed rate of return. Where the capital asset pricing model (CAPM) is being used to calculate the WACC, businesses should identify and justify the individual parameters adopted.

In early 2007 the Commission intends to release an indicative WACC which businesses may wish to use when preparing their Draft Water Plans. It also intends to release an updated WACC for use in the Final Water Plans. This is intended to assist businesses that do not wish to devote resources to a detailed examination of the WACC. It should also ensure a degree of consistency across the industry.

However there is no obligation for a business to use the indicative WACCs and each business is free to calculate and propose a different WACC figure. The Commission also wishes to make clear that the indicative WACCs (and the parameter values used in deriving them) will not in any way bind the Commission in its determination for the second regulatory period.

5.4.4 Renewals annuity

Three rural businesses currently adopt a renewals annuity approach to financing the renewal and rehabilitation of existing rural assets. For those businesses proposing to continue with a renewals annuity this section of the Water Plan needs to set out the proposed renewals amount and the assumptions used to calculate it. These will include:

- the nature of the assets that are included in the annuities calculation (and those which are not)
- the basis of the long term capital expenditure forecasts that support the calculation — ie when and on what basis were the forecasts made
- the service levels that underpin the capital expenditure forecasts
- the term of the annuity
- the discount rate used to calculate the annuity
- the forecast balance of the renewals annuity provision across the regulatory period

This section of the Water Plan should also include information in support of the renewals annuity approach and discuss why it is appropriate that current customers fund the requirements of future customers. The outcomes of any customer consultation undertaken in relation to the renewals annuity should also be provided.

Where a business proposes to move away from a renewals approach to a RAB approach this section of the Water Plan will need to explain how it proposes to manage the change. This is particularly important where a business has a positive balance in its renewals reserve, implying that customers have already made a contribution to costs that will be incurred in the future. In such circumstances the Water Plan should set out the balance of the renewals reserve(s) each year and a detailed explanation of the manner in which the funds are to be returned to customers – for example via immediate offsets to prices in the second regulatory period, or alternatively through assumed offsets to future capital expenditure. The Commission expects that the options for return of renewals reserves will have been the subject of consultation with customers.

5.5 Taxation

Under the Commission's approach to determining the revenue requirement businesses are able to directly recoup the cost of company tax (payments under the National Tax Equivalents Regime (NTER)) during the regulatory period.

The Commission understands that most businesses will not be required to make NTER payments during the second regulatory period. However, those businesses that anticipate doing so should set out details of the payments in this section of the Water Plan.

6.1 Overview of demand forecasts

The cost and revenue forecasts contained in the Water Plan will be dependent upon, amongst other things, the forecasts of demand for a water business's services.

The Commission is required to be satisfied that the demand forecasts are reasonable, particularly where a price cap form of price control is to be adopted. While rigorous demand forecasts are somewhat less important in the case of a revenue cap, accurate forecasts will reduce price volatility for customers and the risk of short term mis-match between revenues and costs for the business.

The Commission has previously indicated that in reviewing demand forecasts it will examine whether they:

- are statistically unbiased
- recognise and reflect key drivers of demand and supply
- are based on reasonable assumptions using the best available information
- are consistent with other existing forecasts and methodologies
- use the most recent data available, as well as historic data that can identify trends in demand
- take account of relevant trends in economic conditions, and reasonable prospects for future market development

This section of the Water Plan should summarise the demand forecasts and the key assumptions adopted in arriving at those forecasts. The Commission expects this will include:

- written information which describes the methodological approach taken to the various demand forecasts, identifies the key demand forecasting issues and lists the key assumptions adopted in generating the forecasts, and
- tabular information that summarises the forecasts and provides relevant historical information on demand.

Businesses will need to exercise their own discretion and match the level of detail contained in their demand forecast with the materiality of the demand information (and hence revenue impacts) captured.

Government has required businesses to develop demand-supply strategies and Sustainable Water Strategies. A material aspect of these strategies is the generation of robust demand forecasts. Where appropriate, the Commission expects the forecasts proposed in the Water Plan to be consistent with these strategies.

Businesses are encouraged to provide all relevant information which supports their demand forecasts – such as reports from consultants and other third parties, historical records, results of storage modelling and sensitivity analyses. These should be included in appendixes to the Water Plan rather than the main body of the document.

6.2 Summary of demand forecasts

This section of the Water Plan should summarise the forecasts and provide a general overview of the factors impacting on the demand for the key services. These include storage and allocation levels, regional growth prospects, the impact of demand management initiatives including restrictions and tariff changes, and prospects in the rural sector.

An overview of the differences between forecast and actual demand for key services in the first regulatory period, and the reason for those differences, should also be provided.

6.3 Individual demand forecasts

This section of the Water Plan should set out the demand forecasts for each of the services provided and the pricing parameters for those services. These include:

- urban water volumes
- rural water delivery volumes
- rural water rights
- bulk water and sewerage
- customer numbers
- recycled water volumes
- trade waste volumes and strength parameters
- miscellaneous services
- licence applications
- number of developer charges
- diversions volumes

For the key demand parameters, including at a minimum water supply volumes, level of water rights, customer numbers, volumetric sewerage volumes, bulk water and sewerage volumes, and developer lot numbers the Water Plans should:

- describe the key issues impacting upon the forecasts for the second regulatory period
- explain the methodology used to prepare the forecasts, including the key assumptions adopted and the basis of those assumptions
- summarise actual demand for the period 2002-03 to 2006-07, estimated demand for 2007-08 and forecast demand for the second regulatory period
- comment on the differences between the benchmarks adopted for the first regulatory period, and the actual/estimated outcomes

Where relevant (ie at a minimum, where separate tariffs are levied) information should be provided separately for the residential and non-residential sectors.

Where tariff structures for particular services are proposed to change materially at the start or during the regulatory period, the Water Plan should also provide specific information on the demand forecasts have been developed, including details of any assumptions made regarding elasticity of demand.

In the rural sector, as well as certain parts of the urban sector, supply constraints have a material impact on the volume of water that may be sold. For example, a number of businesses have storages which are at low levels and will take a number of years to recover to more typical supply levels. Where these constraints are likely to result in ongoing restrictions or low levels of water allocations, the Water Plan should provide information on:

- current and historic storage levels
- assumptions about storage levels during the regulatory period, including assumed levels of rainfall and inflows
- the relationship between storage levels and restriction/allocation levels and the forecast level of restrictions/allocations, and
- the impact of the restrictions/allocation levels on water usage.

Businesses should provide an overview of their activities in the recycled water market, including actual and projected progress on meeting any Government targets. Separate details of forecasts should be provided in relation to volumes of water sold to third pipe customers and sales negotiated on commercial terms.

Some rural businesses have argued that under a revenue cap approach prices should be based on forecasts of demand (notably the amount of sales water) that are deliberately conservative (ie biased downwards). This, it has been argued, is desirable to protect their revenue position and also reduce the risk of future price increases for customers. Where rural businesses propose to adopt such an approach for the second regulatory period it is essential that they:

- articulate why such an approach should be adopted
- provide both the unbiased and conservative forecasts
- calculate the difference in price that results from the two approaches
- demonstrate the level of customer consultation that has been undertaken, including evidence that the impact of the conservative forecasts has been carefully explained to customers, and
- provide evidence of the level of customer support for the conservative forecasts.

6.4 Issues for specific forecasting parameters

This section of the Water Plan should also include the following information in relation to specific demand forecasts.

6.4.1 Urban water use

The Water Plan should set out details of:

- assumptions made regarding average water use, including a comparison with historic levels of average demand
- the way in which demand has been allocated into tariff bands
- in cases where real prices or tariff structures are forecast to change materially, any assumptions made regarding elasticity of demand
- details of weather normalisation analyses undertaken, including regression analysis
- the nature and impact of any demand management measures.

6.4.2 Customer (fixed charge) numbers

The Commission expects the Water Plan to detail the assumed customer growth rate and the basis of that assumption. Where forecast growth is materially different from historic levels or other independent forecasts of population/household growth (eg the *Victoria in Future* forecasts) justification for the differences should be provided.

6.4.3 Volumetric sewerage forecasts

The Water Plan should compare forecast versus historic sewerage volumes expressed as a percentage of water volumes, and discuss the reasons for any differences.

6.4.4 Miscellaneous services

Businesses are encouraged to provide separate forecasts and historic information on demand for each individual miscellaneous service, and particularly for those which are material to the revenue forecasts — ie where an individual miscellaneous service generates more than, say, 1 per cent of total business revenue. However, the Commission recognises that not all businesses will possess detailed demand information for each miscellaneous service.

In such circumstances it may be appropriate for the Water Plan simply to forecast and justify a total amount of revenue from all miscellaneous services.

6.4.5 Developer charges

Where the number of anticipated developer charges is different from the expected increase in customer numbers, the Water Plan should set out the reasons for the variation. Details of external inputs and forecasts adopted (eg municipal development plans) should be provided where relevant.

6.4.6 Major customer water and wastewater forecasts

The Commission expects the Water Plan to summarise the forecast demand from major users, including providing details of customer numbers, customer type,

potential customer additions and losses, and customers consulted in preparing the forecasts.

The Commission recognises that there may be privacy issues surrounding the provision of information regarding major customers. Water businesses may wish to provide major user information to the Commission on an aggregated or confidential basis, in order to protect the commercial interests of individual customers.

6.4.7 Trade waste forecasts

The Commission's preference is that where scheduled prices for individual trade waste parameters exist, forecasts of demand for each of those parameters should be provided and discussed in the Water Plan.

Information should also be provided on the methodology by which the trade waste forecast has been developed, including assumptions regarding new trade waste customers, as well as details of those trade customers who were directly consulted regarding forecast demand.

As with the major customer forecasts, businesses may wish to provide trade waste forecast information to the Commission on a confidential or aggregated basis.

6.4.8 Rural water sales

Rural businesses should provide a detailed discussion of the manner in which their sales volumes have been estimated, including:

- assumed allocation levels
- changes in on-farm water use patterns
- the economic outlook for different agricultural sectors, and
- the use of historic sales levels as the basis for forward forecasts.

6.4.9 Rural water rights

Businesses should explain the basis for their forecasts of rural water rights, including assumptions about the impact of permanent and temporary trading.

This section of the Water Plan should identify the prices and tariff structures that businesses are proposing to implement over the regulatory period and provide a broad overview of the subsequent pricing sections. Businesses should identify material changes to prices being proposed and provide clear links between the proposed price changes and their drivers, such as new government obligations or material changes in revenue requirement.

7.1 Tariff structures

This section of the Water Plan provides a detailed discussion of the reasoning underlying the pricing proposals. Businesses should clearly articulate what the proposal is, why they are proposing it and how they believe it will influence customer behaviour. The following is relevant both for businesses that propose to continue current tariffs and those that propose to introduce changes during the regulatory period. For example, businesses may wish to propose to adopt variable sewerage charges. In this instance, they should outline:

- the proposed price and tariff structure
- the reasoning behind the proposal, which may be to either reinforce the sustainability signals of variable water prices, or alternatively, to provide better signals to customers regarding the costs associated with the collection or treatment of sewerage
- the ability of customers to adjust their behaviour in response to such a charge
- the impact the proposal will have on customers — such as changes to customers' bills.

Discussion of the ability of proposed tariff structures to change customer behaviour, such that customers are encouraged to better use water resources, will require businesses to have a good understanding of demand elasticities and the ability of customers to change their behaviour in response to price signals.

Having justified a particular tariff structure on the basis of underlying costs and/or on the basis that it will encourage changes in customer behaviour, businesses will also need to consider a number of implementation and customer impact issues. For example, businesses will need to take into account the costs of introducing new metering or billing arrangements and consider the impact of tariff structures on vulnerable and low income customers.

7.1.1 Underlying cost justification

Where appropriate, the proposals should be accompanied by supporting evidence regarding cost drivers. For example, where there is a proposal to significantly

increase a variable charge on the basis of better signalling future capital expenditures incurred by a business in maintaining its demand/supply balance, the proposal should be accompanied by estimates of long run costs and the drivers behind these costs. If businesses wish to support their proposals with estimates of long run marginal cost they will need to include the following:

- the cost estimate
- the validity of the estimate
- the drivers behind the estimate, ie any associated demand supply balance issues that need to be addressed in the future.
- an appendix containing a working version of the model used to generate the estimate

7.1.2 Changes in customer behaviour

Although prices send signals to customers, the extent to which customers respond to those signals will depend on the price elasticity of demand. Price elasticity measures the responsiveness of demand to price changes. Demand elasticities may vary across customer classes, types of water use or at different times of the year. Businesses will need to consider demand elasticities and how responsive customers will be to changes in price under different tariff structures. In some cases, the costs of implementing a particular tariff structure may outweigh the benefits flowing from changes in behaviour, particularly if demand is relatively inelastic. For example, seasonal tariffs (higher summer charges) could be costly to implement, and where summer demand is relatively inelastic changes in price will be unlikely to have a significant impact on consumer behaviour and consumption to justify the costs.

For customers to change their behaviour in response to tariff structures they need to have an understanding of those tariff structures and how they interact with their consumption and investment decisions to influence their overall bills.

Complicated or sophisticated tariff structures that are not readily understood by customers may not deliver the desired changes in customer behaviour. For example, an inclining block tariff structure may not encourage customers to reduce their discretionary consumption unless they clearly understand when each block takes effect and the price relativities between blocks. This may be more of an issue where there are a large number of blocks in place.

7.1.3 Customer impact issues

In considering alternative tariff structures, businesses will need to take into account the costs associated with implementing new tariff structures. For example, businesses may need to install new meters, introduce new meter reading arrangements or change their billing practices and systems to accommodate new tariff structures.

Businesses will also need to take into account any costs they might incur when informing customers about new tariff structures. This is likely to be more of an issue where businesses intend to significantly change or implement overly complex tariff structures.

Any change in tariff structures will have an impact on customers and in some cases that impact may be adverse. Such customer impacts are likely to vary across different customer types or classes. The potential for adverse customer impacts is likely to be greater where customers are unable to change their consumption in response to tariff structures. Businesses will be required to show that they have taken into account the customer impacts of proposed tariff structures and in particular how low income or vulnerable customers will be affected. For example, businesses may need to adjust their hardship policies to better reflect the impacts of tariff structures.

Businesses will also need to consider how they intend to implement any revisions to tariff structures. For example, staged introductions of new tariff structures may have less of an adverse impact on customers but are also less likely to be successful in influencing behaviour. On the other hand, the rapid introduction of a new tariff structure might have an immediate impact on customer behaviour but might also be associated with a price shock.

In some cases, businesses will be serving a number of regions or towns with different costs of service. Businesses will need to consider whether they introduce common tariffs across towns or regions or whether they implement separate tariffs, which may be more cost reflective. They will also need to consider the impacts on customers and the practicalities and costs associated with administering a number of tariff structures.

7.1.4 Tariff proposals

Tariffs proposed in the water plan should be done so on the basis of major service provision. Where appropriate, this section should include the following subsections:

- bulk water
- bulk sewerage
- retail water (residential and non-residential)
- retail sewerage (residential and non-residential)
- tradewaste
- irrigation
- stock and domestic
- recycled water
- customer contributions
- urban drainage
- irrigation drainage
- diversions

Each subsection should follow the same broad structure. Generally, each service subsection should contain the following discussion:

- Relevant background information about the service and recent pricing history.

- a table outlining the current and proposed tariff structure. Prices should be reported in real terms and each price proposed in the body of the water plan should directly correspond with a price in the Water Plan information template.
- The manner in which the tariff is to be applied or implemented — for example, billing period, customer class, the application of prices via connection or meter size, etc.
- The reasoning behind the proposed tariff schedule, including a clear identification of the principles underlying the proposal.
- The relationship of the proposal to its associated long run marginal cost.
- Customers' responsiveness to proposed tariff structures.
- The proposal's ability to deliver incentives for sustainable water use.
- The impacts of the proposal on customers
- Discussion on the consultation the business has undertaken in developing the proposal.

It is particularly important for businesses to address these issues where they are proposing to introduce new tariff structures or are proposing tariffs that will have significant impacts on customers.

While the underlying structure of each subsection is similar, there are service specific issues that should be addressed in the Water Plan. For example, Water Plans should reference the method of cost allocation across customers underlying proposed bulk water and bulk sewerage prices.

Other service specific issues include variable sewerage charges. If businesses intend to propose variable sewerage prices for retail residential and/or non-residential customers, the Water Plan should include a discussion on the manner in which businesses intend estimating the volume of sewerage discharged by customers. This discussion should include any seasonal indices being applied by businesses.

In regard to tradewaste proposals, each proposed tradewaste parameter should be separately identified and accompanied with the discussion outlined in Box 7.1. In addition the Water Plan should discuss how the proposal relates to bulk sewerage charges.

The Water Plan should also outline the manner in which recycled water prices are proposed to be regulated (price caps or principles). In addition, proposals relating to recycled water should include an overview of the relevant proposed recycling projects and the nature of proposed recycling projects — specified, least cost, discretionary. If the project is a discretionary project which generates a funding shortfall, businesses will need to evidence that they have assessed the costs and benefits, clearly identified the basis on which the shortfall is to be recovered, and that there has been consultation with customers about their willingness to pay for the benefits of increased recycling.

7.2 Miscellaneous charges

In addition to providing water, sewerage and irrigation, water businesses also provide other secondary services in connection with these primary prescribed services. These are known as miscellaneous services and are also prescribed services under the WIRO. Some common miscellaneous services provided by most businesses include:

- connections, tapping services and meter installations
- water quality, flow rate and meter accuracy tests
- transfer of water entitlements/diversions licence
- property service plans and information statements.

Like the prices for primary prescribed services, each business should ensure that it includes every miscellaneous charge that it intends to charge during the regulatory period in its Water Plan. As with other tariff proposals businesses should outline:

- the proposed miscellaneous price and tariff structure
- the reasoning behind the proposal
- the ability of customers to adjust their behaviour in response to such a charge
- the impact the proposal will have on customers — such as, changes to customers' bills.

The Commission recognises that there may be instances where it is unclear whether services are prescribed or not. Where this is the case, businesses should err on the side of caution and include the services in their Water Plans. It is preferable to remove non-prescribed tariffs once a proposal has been either approved or determined than it is to amend the determination to included omitted tariffs.

During the 2005 urban water price review, the Commission observed some inconsistency in the miscellaneous charges proposed by businesses. Prices for a number of miscellaneous services were proposed by all businesses. However, in some instances the range of prices proposed by the different businesses for similar services was quite large. Further, prices for other miscellaneous services were proposed by some businesses but not others. The Commission considers that there may be scope to adopt a standard approach to miscellaneous charges and will consult on this matter.

Under the current water price determinations, a business may apply to the Commission to introduce a new miscellaneous charge during the regulatory period. The Commission will approve a new miscellaneous charge where it is satisfied that it applies to a new service that a business did not reasonably expect to provide before the regulatory period and that the associated expenditure was not accounted for during the last price review. The Commission expects to take a similar approach for the next period and will consult on this matter shortly.

7.3 Form of price control

This section of the Water Plan outlines the form of price control businesses are proposing to adopt over the regulatory period. The proposal should include both the form of price control proposed and the reasoning underlying the proposal.

There are a number of options, these include a price or revenue cap, whereby a specified price path or level of revenue is fixed for the term of the regulatory period. Under this approach, businesses have an incentive to minimise costs as they are able to retain any benefits for the regulatory period, after which these benefits are passed on to customers in the form of lower prices.

The form of price control will also provide other incentives for the business when considering how to implement its pricing strategy. The following are among the different forms of price controls that may be adopted, namely:

- individual price caps
- tariff basket
- revenue yield
- revenue cap
- combination of the above

A full discussion of these alternatives can be found in the Commission discussion paper *Economic Regulation of the Victorian Water Sector, Approach to Pricing* (April 2004).

7.4 Adjusting prices

The Commission acknowledges that there may be instances where it may be appropriate to adjust prices to account for certain events that are outside the control of the business. In providing some flexibility to adjust prices during and after a regulatory period in such cases, it is also important that incentives to properly manage and mitigate against such events are not reduced and the administrative costs of adjusting prices do not outweigh the benefits. Businesses should also consider how appropriate the proposal is given the length of the regulatory period.

7.4.1 Changes in legislative obligations

The water price determinations that are currently in effect allow businesses to recover material increases in expenditure incurred during the current regulatory period due to changes in legislative obligations in the next regulatory period. Businesses can apply for a pass through of increased expenditure due to changes during the regulatory period of these instruments:

- changes to all primary Acts and legislative instruments, including regulations
- changes in taxes (or fees or similar charges) excluding income tax, penalties and interest on taxes, stamp duty, financial institutions duty or similar taxes and levies
- changes to EPA licence requirements, and
- changes to the Statement of Obligations.

If a business believes that it has incurred additional expenditure during the regulatory period due a change in legislative obligations and is eligible to recover this amount in the next regulatory period, it should clearly articulate this in its Water Plan. In doing so, the business should demonstrate that:

- the change in legislative obligations was unforeseen and not already reflected in expenditure forecasts during the last price review
- the business was not already meeting any required higher standards
- the business had taken appropriate steps to plan for or manage the impact of the change in legislative obligation where relevant
- the expenditure incurred to deal with the change in legislative obligations was efficient
- the impact on costs is greater than 5 per cent of the business's total revenue.

Businesses should also outline their preferred approach to recovering unforeseen expenditure due to changes in legislative obligations during the next regulatory period as a pass through in the following period.

7.4.2 Unforeseen events

The Commission currently has flexibility to amend a price determination if it considers it desirable or necessary to avoid an unintended consequence of the determination.

The Commission believes that this approach provides incentives for businesses to take appropriate steps to minimise the impact of a major event and to ensure that expenditure to manage the event is efficient. At the same time, it provides flexibility for the Commission to amend the determination if the water business demonstrates that it had taken all reasonable steps to manage an unforeseen event yet would not be financially viable under the determination.

The Commission will consult with businesses shortly on mechanisms for adjusting prices during the regulatory period to account for unforeseen events. In their Water Plans, businesses should outline their proposed approach for accounting for unforeseen events in accordance with further guidance provided by the Commission.

8 NON-PRESCRIBED SERVICES

The correct classification of services as prescribed or non-prescribed is important because, under the WIRO, the Commission has the power to regulate only the prices of those services that are prescribed. While the Commission has no role in regulating prices for non-prescribed services, it needs to be satisfied that these services are correctly classified and not related to prescribed services, and that the costs of these services are accurately identified and excluded from the regulated cost base. Failing to adequately account for these non-prescribed services may lead to regulated costs being under or overstated and customers of prescribed services paying either too much or too little.

As mentioned earlier, the Commission will consult on the classification of prescribed and non-prescribed services prior to the submission of Draft Water Plans in May 2007. Water Plans should be consistent with the outcomes of the consultation.

8.1 Classification of services as non-prescribed

Under the WIRO, the following services provided by the businesses are explicitly specified as prescribed services:

- (i) retail water services
- (ii) retail recycled water services
- (iii) retail sewerage services
- (iv) storage operator and bulk water services
- (v) bulk sewerage services
- (vi) bulk recycled water services
- (vii) metropolitan drainage services
- (viii) irrigation drainage services
- (ix) connection services
- (x) services to which developer charges apply and
- (xi) diversion services.

The WIRO also provides that services provided 'in connection with' the above services are prescribed services.

Non-prescribed services are not provided 'in connection with' prescribed services and are often provided in a competitive market. The Commission considers that services such as property rental or leasing, farming activities on sewage treatment plant sites, boating and recreation services are clearly non-prescribed.

There are also a number of other non-prescribed services undertaken by businesses which are often unique to a particular business and relatively large in size. These include works associated with salinity management undertaken under government services contracts, storage operation and land management services provided under contract to the Murray Darling Basin Commission (MDBC).

This section of the Water Plan should clearly identify each service provided by the business that has been treated as non-prescribed. Where a business is proposing to treat a particular service as non-prescribed the Water Plan needs to demonstrate that either the service is not a prescribed service or that it is not provided in connection with a prescribed service.

8.2 Expenditure and revenue associated with non-prescribed services

This section should provide an overview of the expenditure and revenue forecasts associated with non-prescribed services for the regulatory period.

The non-prescribed services summary table from the financial template should be included in this section of the Water Plan.

The Water Plan should also explain how shared costs have been allocated between prescribed and non-prescribed services. For example, how are corporate costs allocated between the two groups of services?