



# Goulburn-Murray Water price review 2020

Guidance on price submission under the WCIR

October 2018



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# 1. Introduction

The Essential Services Commission of Victoria (the commission) will undertake a review of the prices that Goulburn-Murray Water may charge for their regulated services for the regulatory period from 1 July 2020 (next regulatory period).

Goulburn-Murray Water's prices are regulated under two regulatory frameworks:

- infrastructure-related services are regulated under the Commonwealth Government's *Water Charge (Infrastructure) Rules 2010* (WCIR). These rules cover approximately 95 per cent of Goulburn-Murray Water's total regulated costs.
- groundwater, unregulated surface water and some miscellaneous services are not infrastructure related, and are regulated under the *Water Industry Regulatory Order 2014* (WIRO).<sup>1</sup>

Under the Murray-Darling Basin Agreement, the Commonwealth is responsible for the regulation of the prices charged by Goulburn-Murray Water for its infrastructure-related services.<sup>2</sup>

The Australian Competition and Consumer Commission (ACCC) is responsible under the WCIR for approving or determining the regulated charges of water entities in the Murray-Darling Basin. Part 9 of the WCIR allows for the accreditation of arrangements whereby a state agency would be responsible for approving regulated charges under the WCIR rather than the ACCC.

We successfully applied to the ACCC for accreditation to regulate Goulburn-Murray Water's charges in 2012 for ten years from 17 February 2012.<sup>3</sup> A condition of accreditation was that we must apply the pricing principles published by the ACCC for any price approvals and determinations under the WCIR (see Box 2.1).

This paper explains the requirements of the WCIR in the context of Goulburn-Murray Water's next price review.<sup>4</sup>

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<sup>1</sup> The remaining five per cent of Goulburn-Murray Water's total regulated costs are regulated under the WIRO.

<sup>2</sup> In Victoria, the referral of pricing powers to the Commonwealth is achieved by the *Water (Commonwealth Powers) Act 2008* (Vic).

<sup>3</sup> Australian Competition and Consumer Commission 2012, *Application by Essential Services Commission Victoria for Accreditation Final Decision*, 17 February.

<sup>4</sup> The basis of this paper is Rule 25 and Schedule 1 of the WCIR which sets out Goulburn-Murray Water's minimum information requirements.

## 1.1. Review of the water charge infrastructure rules

In response to recommendation 11 of the Independent Review of the *Water Act 2007*, the ACCC has undertaken a review of the WCIR. The ACCC has provided advice to the Commonwealth Government which included a number of recommendations that seek to:<sup>5</sup>

- ensure a consistent approach to application of the WCIR across Basin states
- improve pricing transparency and customer engagement
- ensure ACCC charge approvals and determinations apply only where necessary
- address charging arrangements that unreasonably favour some customers over others
- facilitate the efficient functioning of water markets, and
- improve the interaction of the water charge rules with other relevant legislation.

**This guidance has been prepared under the current WCIR.** Depending on the outcomes of the Commonwealth Review, we may need to issue further guidance to Goulburn-Murray Water.<sup>6</sup>

## 1.2. Connections project

The \$2 billion Connections project to modernise Goulburn-Murray Water's irrigation network began with the Northern Victoria Irrigation Renewal Project. Goulburn-Murray Water is now in the final stages of delivering the project with the forecast completion date to occur during 2020.

Goulburn-Murray Water will need to explain how its expenditure forecasts have taken into account the completion of the project and achieved cost savings. Its price submission must reflect the impacts of the project on its proposed service levels and prices.

Later chapters of the guidance indicate where Goulburn-Murray Water should provide us with information on the impacts of the project on its proposals.

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<sup>5</sup> ACCC, 2016 *Review of the Water Charge Rules Final Advice*, September.

<sup>6</sup> The Commonwealth Government has responded to one of the ACCC's recommendations on repealing requirements relating to Network Service Plans. This does not impact on Goulburn-Murray Water.

## 2. Assessing Goulburn-Murray Water's price submission

### 2.1. Introduction

We must approve the price arrangements proposed by Goulburn-Murray Water if it is satisfied the prices comply with the Water Charge (Infrastructure) Rules (WCIR) for part 6 operators and the Australian Competition and Consumer Commission's (ACCC) pricing principles. The tariff objectives of the ACCC's pricing principles are given in Box 2.1.

#### **Box 2.1 Australian Competition and Consumer Commission pricing principles**

The ACCC requires the commission to regulate according to the pricing principles made under the WCIR, which require tariffs to be set:

- to promote the economically efficient use of water infrastructure assets
- to ensure sufficient revenue for the efficient delivery of the required services
- to give effect to the principles of user pays for water storage and delivery in irrigation systems
- to achieve pricing transparency
- to facilitate efficient water use and trade in water entitlements.

*Source: ACCC 2012, Application by Essential Services Commission Victoria for Accreditation Final Decision, 17 February.*

The pricing of Goulburn-Murray Water's groundwater, unregulated surface water and non-infrastructure related miscellaneous services, which make up a small percentage of Goulburn-Murray Water's overall revenue, is assessed against the Water Industry Regulatory Order (WIRO).<sup>7</sup>

Under Rule 3 of the WCIR, the regulatory period is defined as four years in duration, which will commence on 1 July 2020 and conclude on 30 June 2024.

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<sup>7</sup> We issued a separate guidance paper in October 2018 to cover Goulburn-Murray Water's services assessed against the WIRO, at the same time we issued the 2020 WCIR guidance.

## 2.2. The commission’s high level requirements

### 2.2.1. Final price submission

Goulburn-Murray Water’s price submission needs to explain, justify and document its proposed prices for regulated services it provides. The submission should provide sufficient and accurate information for us to make a decision in accordance with the WCIR. Goulburn-Murray Water should give careful consideration to the information requirements outlined at the end of each chapter (from Chapter 3).

Goulburn-Murray Water should consider the needs of different stakeholders that are likely to have an interest in its submission. In particular, we expect Goulburn-Murray Water’s price submission will demonstrate that customer engagement has informed and influenced its proposals. We anticipate that Goulburn-Murray Water’s existing customer advisory committees will form part of this engagement.

### 2.2.2. Financial model

Goulburn-Murray Water must complete the financial model prepared by us to accompany its price submission. The financial model enables Goulburn-Murray Water and us to estimate prices, and provides detailed information that allows us (with the assistance of consultants where appropriate) to evaluate assumptions used to estimate prices. The financial model will clearly identify the cells for which Goulburn-Murray Water must provide data. Goulburn-Murray Water must not amend any other cells in the financial model — this includes adding rows, columns, or information not requested by us.

Goulburn-Murray Water’s written price submission must be consistent with the data provided in its financial model.<sup>8</sup> Further, any changes made by Goulburn-Murray Water to its proposals during the price review process must also be reflected by Goulburn-Murray Water in its financial model. All financial values in Goulburn-Murray Water’s price submission and financial model must be in real 2019-20 dollars (with the March quarter 2019 Consumer Price Index as the base).

Goulburn-Murray Water’s submitted prices and financial model will be made public on our website.

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<sup>8</sup> The financial model requires Goulburn-Murray Water to provide detailed information on key assumptions underpinning its prices (such as expenditure estimates) so we can assess Goulburn-Murray Water’s proposal. The model also provides a mechanism for Goulburn-Murray Water to estimate its revenue allowance and prices. The model will require both historic and forecast data. Historic data should be consistent with Goulburn-Murray Water’s regulatory accounting statements.



The Commission expects that Goulburn-Murray Water will draw specific attention to any changes in quantity or timing of costs that become evident during the assessment process.

### 2.3. Assessing prices

We will continue to use the building block approach to assess Goulburn-Murray Water's prices as required by the WCIR and the ACCC's pricing principles.<sup>9</sup> The building block approach has three steps, which are set out in Figure 2.1.

Step one involves confirming the service outcomes that Goulburn-Murray Water proposes to deliver during the next regulatory period. These outcomes should reflect obligations imposed by the Minister for Water through the Statement of Obligations, and reflect the priorities of customers identified by Goulburn-Murray Water through its customer engagement process.

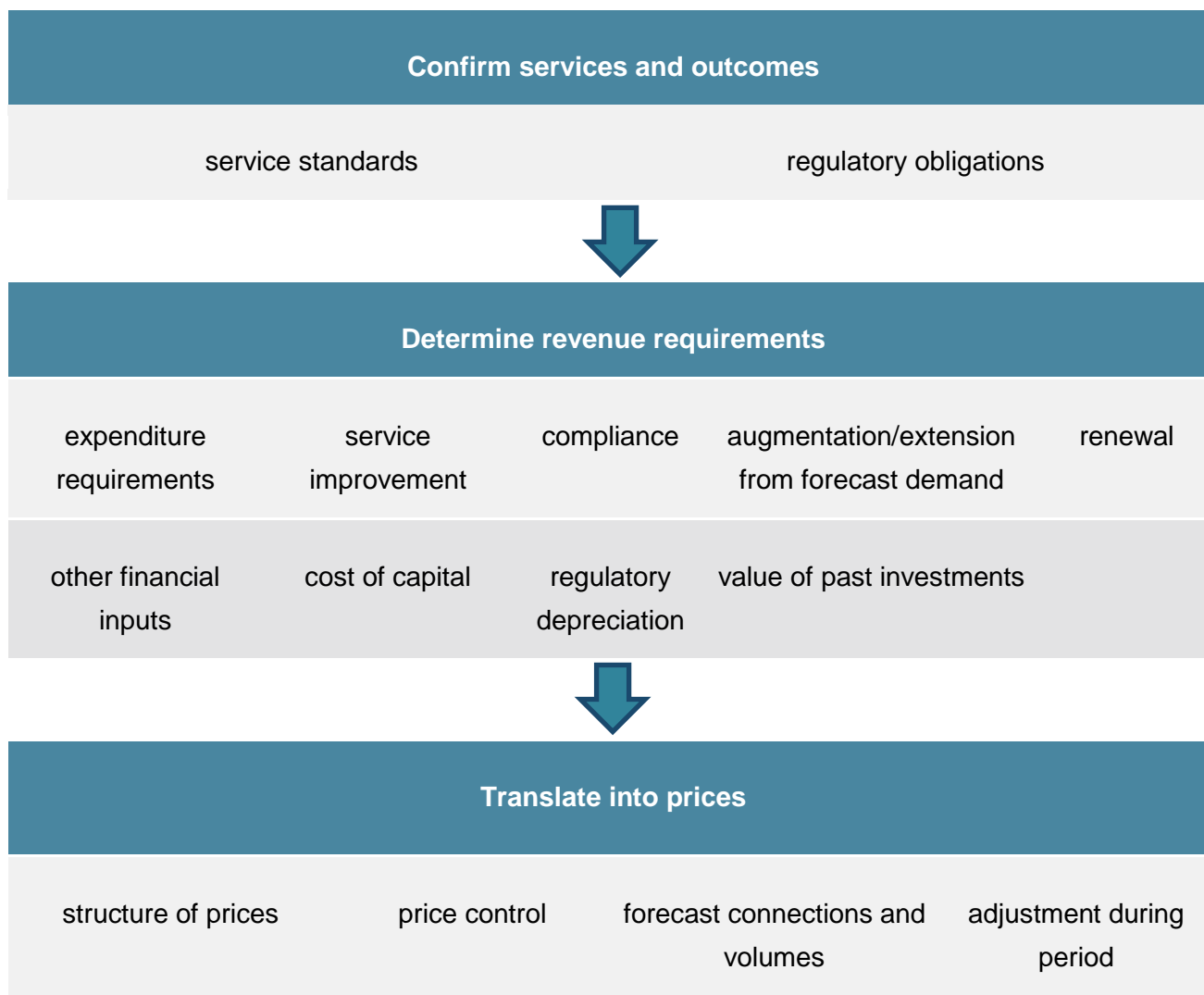
In the second step, we assess the revenue Goulburn-Murray Water claims that it requires to meet the service outcomes identified in step one. We make assumptions about efficient expenditure to assess whether the claimed revenue will be sufficient for Goulburn-Murray Water to deliver the identified services.

Step three is to assess the prices that Goulburn-Murray Water is seeking to apply. We must ensure that prices will generate Goulburn-Murray Water's revenue requirement by considering demand forecasts.

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<sup>9</sup> ACCC 2011, *Pricing Principles for Price Approvals & Determinations Under the Water Charge Infrastructure Rules*, July.

**Figure 2.1 Steps in assessing and approving prices**



## 2.4. Consultation by the commission

We will tailor our consultation to reflect stakeholder comments and work already undertaken by Goulburn-Murray Water.

As in past price reviews, we will invite submissions from interested parties on the proposals contained in Goulburn-Murray Water’s price submission prior to making a draft decision.

Following the release of our draft decision, we will invite submissions and intend to hold public meetings before we make a final decision and issue a price determination. We would prefer to receive written comments via [water@esc.vic.gov.au](mailto:water@esc.vic.gov.au)

We will make our papers and Goulburn-Murray Water’s submissions (including Goulburn-Murray Water’s submitted financial model) available on our website ([www.esc.vic.gov.au](http://www.esc.vic.gov.au)). If there is information that Goulburn-Murray Water or a customer does not want disclosed publicly, because it is confidential or commercially sensitive, the matter should be discussed with our staff before lodging the submission.

## 2.5. Indicative timelines

An indicative timetable for the price review is set out in Table 2.1.<sup>10</sup>

**Table 2.1 Indicative Consultation Timetable**

Indicative Dates	Activity
October 2018	commission releases both draft WIRO and WCIR guidance
December 2018	final WIRO guidance released
15 November 2019	final price submission submitted to the commission
November 2019 to February 2020	commission assesses the price submission and Goulburn-Murray Water responds to commission and consultant queries
March 2020	commission releases draft decision
March 2020 to April 2020	commission consultation on draft decision
12 June 2020	commission releases final decision

<sup>10</sup> The timetable is based on Rule 30 of the WCIR which requires us to approve prices within thirteen months of receiving a business’s price submission.



## 3. Customer engagement

### 3.1. Introduction

We require Goulburn-Murray Water to engage with its customers to inform its price submission. It is in the interests of its customers that Goulburn-Murray Water develops its proposals informed by an understanding of its customers' priorities and preferences. We anticipate that Goulburn-Murray Water engages with its existing rural customer advisory committees, recently established working groups and wider customer base in the development of its price submission.

We will assess Goulburn-Murray Water's consultation process consistent with the requirements of the Australian Competition and Consumer Commission's (ACCC) pricing principles for infrastructure-related services<sup>11</sup> and the requirements of the Water Charge (Infrastructure) Rules (WCIR) (see Box 3.1).

#### **Box 3.1 Consultation Requirements**

Schedule 1 of the WCIR states that water businesses must provide the regulator with:

*details of the extent and nature of the consultation processes including matters consulted on and customer feedback received.*

*Source: WCIR 2010.*

We understand that Goulburn-Murray Water is engaging with its customers in a manner consistent with the principles of good customer engagement. These are:

- The form of customer engagement undertaken by a water business should be tailored to suit the content on which it is seeking to engage, and to the circumstances facing the water business and its customers.
- A water business must provide customers with appropriate information, given the purpose, form and the content of the customer engagement, and a reasonable and fair opportunity to participate as part of the process.
- A water business's customer engagement should give priority to matters that have a significant influence on the services provided and prices charged by the business.
- A water business should start customer engagement early in its planning. The engagement should be ongoing, to keep testing proposals with customers.

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<sup>11</sup> ACCC 2012, op. cit.

- A water business should demonstrate in its price submission how it has taken into account the views of its customers.

### **3.2. Information required in the price submission**

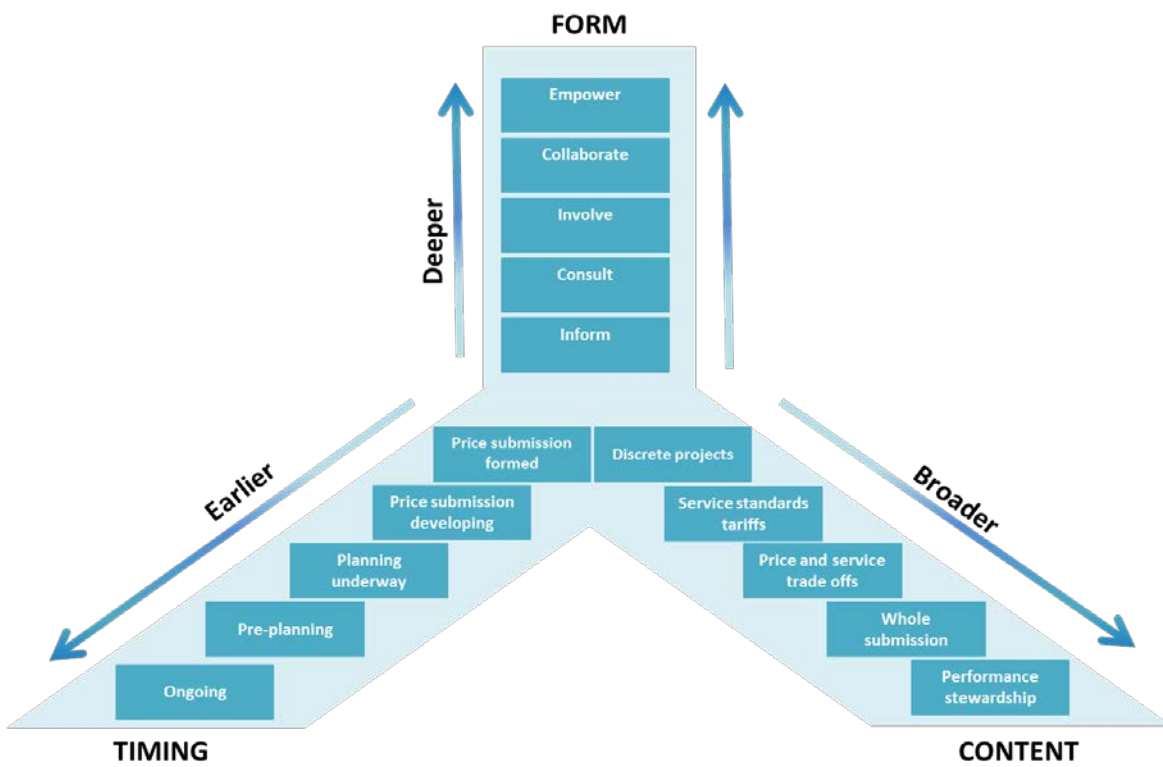
We require Goulburn-Murray Water's price submission to outline:

- the consultation undertaken with customer committees, customers and other stakeholders in preparing the price submission
- the objectives of the consultation, identifying the key areas where customer input was sought
- the steps involved in the consultation process
- a summary of feedback received from customer committees, customers and other stakeholders during consultation processes
- an explanation of how comments received during consultation have been addressed in the pricing submission
- significant issues of customer interest we should be aware of in its consideration of the price submission – particularly where Goulburn-Murray Water has not sought to address these concerns.

Goulburn-Murray Water may use the customer engagement diagram (Figure 3.1) as a descriptive tool of its overall program, or of individual activities. It was developed by us to help businesses describe the extent of their customer engagement programs across three axes of form, timing and content. It is a medium for describing the different types of customer engagement, without prescribing how that engagement is to be conducted.

An expansive engagement program leads to a large triangle overlaid across the three axes. Not all engagement activities need to be expansive, however a wide ranging rather than narrow engagement provides Goulburn-Murray Water the opportunity to test its understanding with customers and to ensure it has properly captured expectations.

Figure 3.1 Customer Engagement Diagram



Source: Essential Services Commission 2016, *Water Pricing Framework and Approach: Implementing PREMO from 2018*, October.





## 4. Service standards and targets

### 4.1. Introduction

The service standards and targets proposed by Goulburn-Murray Water should reflect customers' priorities and expectations in relation to service delivery and should underpin Goulburn-Murray Water's expenditure plans.

The Water Charge (Infrastructure) Rules (WCIR) does not cover Goulburn-Murray Water's service standards, which are regulated under Victoria's legal framework. Under section 4F of the Victorian *Water Industry Act 1994*, we established rural Customer Service Codes to regulate the standards and conditions of supply of declared services.

Our starting point for assessing service standards will be the average levels of service provided in the 2016–2020 regulatory period. Any proposed changes to service standards and/or targets should be explained to us. Goulburn-Murray Water's price submission must explain how its services standards and targets have been impacted by the completion of modernisation by the Connections Project.

We will approve Goulburn-Murray Water's proposed service standards and targets if it demonstrates they relate to verified obligations or customer preferences, as revealed through Goulburn-Murray Water's customer engagement. Once service standards and targets are established through the price review, Goulburn-Murray Water will be required to report annually to customers on their performance against the targets.

## 4.2. Information required in the price submission

We require that Goulburn-Murray Water's price submission:

- outlines all proposed service standards and their corresponding targets for each year of 1 July 2020 – 30 June 2024
- explains how the standards and targets were informed by the business's customer engagement program and evidence of their support and willingness to pay for the proposed service target
- specify, for each standard, whether it reflects an obligation imposed by government policy and regulatory obligations or is an expectation of customers
- outline the basis for setting the proposed service target and the reasons for adopting the target
- where applicable, provide historical performance for each service standard
- identify any proposed changes to service standards and the rationale for changes (such as willingness-to-pay studies or other indicators of customer preferences)
- identify the cost and price implications of proposing a target that is above or below current levels
- set out how Goulburn-Murray Water proposes to meet the specified target, including projects targeted at meeting service levels over 1 July 2020 – 30 June 2024, or areas where a lower target will reduce costs
- specifies the changes to service standards and targets as a result modernisation of infrastructure by the Connections Project.

## 5. Forecast operating expenditure

### 5.1. Introduction

Operating expenditure is a key input into customer prices. The price review is taking place at a time when Goulburn-Murray Water is in the final stages of modernising its irrigation infrastructure network. This will mean some of Goulburn-Murray Water's future operating cost requirements (in terms of the nature and magnitude of expenditure) are likely to differ from past costs.

Goulburn-Murray Water's price submission must explain how it has taken into account the impact of the completion of the Connections project on its forecast operating expenditure.

### 5.2. Commission's approach to assessing operating expenditure

We regulate Goulburn-Murray Water's infrastructure-related services according to the Australian Competition and Consumer Commission's (ACCC) pricing principles for price approvals and determinations made under the *Water Charge (Infrastructure) Rules 2010* (WCIR) — see Box 5.1 for the pricing principles relating to the assessment of operating costs. Our undertaking to apply these pricing principles was a condition of our accreditation to regulate prices for Goulburn-Murray Water's infrastructure services.

### **Box 5.1 ACCC's pricing principles for assessing operating expenditure**

In making an assessment of the prudent and efficient operating expenditure for the next regulatory period, the regulator must assess:

- the prudence and efficiency of operating expenditure in the previous regulatory period
- the reasons and evidence supporting changes to service standards in the next regulatory period
- the reasons and evidence supporting changes to operating expenditure in the next regulatory period
- reasonable productivity improvements in providing services over the next regulatory period.

Where relevant, a regulator must compare and take into account operating expenditure of similar businesses.

Forecasts must be based on reasonable assumptions of the efficient costs likely to be incurred in this period.

*Source: ACCC, Application by Essential Services Commission Victoria for Accreditation Final Decision, 17 February 2012.*

Under the WCIR we are required to approve prices proposed by Goulburn-Murray Water if it is satisfied they will result in the business recovering no more than the forecast efficient cost of delivering validated service requirements.

Our approach for assessing operating expenditure will be as follows:

- establish a base year operating expenditure by reviewing the actual operating costs from the last full year of actual expenditure data (2018-19), and adjusting to remove any one-off or non-recurring expenditure items and any inefficient costs
- assess Goulburn-Murray Water's proposed changes to annual operating expenditure for each year, including the itemised new costs and new savings arising from modernisation, and assess whether identified adjustments are consistent with efficient expenditure
- adjust the forecast operating expenditure based on our findings.

We will engage expenditure consultants to review Goulburn-Murray Water's operating expenditure. Our consultant reports on Goulburn-Murray Water will be made public during the price review.

### 5.2.1. Productivity improvements

Under the ACCC's pricing principles, we must assess whether Goulburn-Murray Water's forecast costs include reasonable productivity improvements in providing services over 1 July 2020-30 June 2024. We expect Goulburn-Murray Water to present a case to us regarding productivity improvements it expects will arise from its infrastructure network and any internal business reform over 1 July 2020-30 June 2024.

### 5.2.2. Connections project

In our 2016 Goulburn-Murray Water final decision, we included \$6.4 million forecast savings expected from the Connections project over 2016-17 to 2019-20.<sup>12</sup> In Goulburn-Murray Water's 2016 Price Submission it stated<sup>13</sup>:

*"During the current regulatory period GMW has operated and maintained sections of the gravity backbone network which have been modernised and automated as well as sections of the non-backbone network which are still non-automated. This is a transition period that will continue in the Price Review 2016 period. While operating expenditure savings have been realised, operating a hybrid network means the full extent of savings will not be realised until after the next regulatory period. Further, while modernisation will drive efficiencies and cost savings, it also introduces new costs that need to be taken into account. For example, planned and reactive maintenance associated with the automated network including replacement of batteries and sensors"*

In its 2020 price submission we expect Goulburn-Murray Water to outline the impact of the modernisation project on its operations since 2012, and underlying assumptions, including outlining the savings realised from the project since 2012 to 2019-20.

Excerpts from our expenditure consultant's report from the 2016 Goulburn-Murray Water price review<sup>14</sup>

Goulburn-Murray Water provided the following examples of where savings have been achieved however, without estimating the cost impacts:

- labour savings associated with the vacancies
- utilisation of remote system monitoring and alarm management

<sup>12</sup> Essential Services Commission 2016, *Price Review 2016: Goulburn-Murray Water – Final Decision*, June pp. 24.

<sup>13</sup> Goulburn-Murray Water 2015, *Submission to Price Review 2016*, September pp. 39

<sup>14</sup> Indec 2016, *2016-20 Review of Water Prices for Goulburn-Murray Water Productivity and Capex Proposals*, January pp.14-15

- utilisation of the automated backbone network to assist in targeting maintenance requirements and correcting performance issues with the channels, improving customer service outcomes
- annual proactive maintenance programs associated with electronic meters and automated regulators;
- introduction of 'field computing' for operational staff to assist in the capture of data and the reduction of manual data entry processes,
- rationalisation in the Shepparton Irrigation Region of surplus service points, with 44 outlets remove.

### 5.3. Supporting information

Goulburn-Murray Water's price submission must provide sufficient information for us to assess its operating cost forecasts.<sup>15</sup> Goulburn-Murray Water's price submission should:

- provide actual annual operating expenditure for past years and annual forecasts for operating expenditure for the remainder of the current regulatory period and the regulatory periods out until 2028
- demonstrate how the baseline year (2018-19) operating costs represents efficient operations, identifying any adjustments for non-recurring expenditure
- specify and justify expected efficiency savings to apply to baseline operating expenditure
- itemise material cost increases or decreases from the 2018-19 baseline year, in particular the operating cost impacts of the infrastructure modernisation project
- provide estimates of (historic and forecast) operating expenditure by cost category (see **Appendix A**)
- explain the trend in forecast operating expenditure having regard to:
  - historic operating expenditure
  - changes in service obligations and targets
  - scope for productivity improvement (see 5.2.1)
  - changes in operating expenditure by cost category
  - trends in input prices
  - forecast demand
  - proposed capital works

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<sup>15</sup> Our requirements in this chapter are aligned with the information requirements for operating expenditure in Schedule 1 of the *WCIR 2010*.

- include a table and explanation outlining the impact of the modernisation project since 2012, including the savings realised from 2012 to 2019-20 and any forecast savings to be achieved
- any other relevant factors outlining key assumptions underlying the operating expenditure forecasts, any risks to the forecasts and how these uncertainties have been addressed.





## 6. Forecast capital expenditure

### 6.1. Introduction

This chapter focuses on our requirements regarding Goulburn-Murray Water's proposed capital expenditure for the regulatory period commencing 1 July 2020.

Capital expenditure forecasting involves anticipating the scope, timing and costs for a large number of various sized projects, ranging from the replacement of existing assets at the end of their lives to the construction of major new assets and facilities.

### 6.2. Commission's approach to assessing capital expenditure

As required in the Australian Competition and Consumer Commission's (ACCC) decision on our accreditation to regulate Goulburn-Murray Water, we regulate Goulburn-Murray Water's infrastructure related capital expenditure according to the ACCC's pricing principles – see Box 6.1.<sup>16</sup> Under the Water Charge (Infrastructure) Rules (WCIR) we must approve prices that reflect no more than prudent and efficient expenditure.

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<sup>16</sup> Our requirements in this chapter are aligned with the information requirements for capital expenditure in Schedule 1 of the *WCIR 2010*.

### **Box 6.1 ACCC's principles for assessing capital expenditure**

In making an assessment of the prudent and efficient capital expenditure for the next regulatory period, the regulator must assess:

- the prudence and efficiency of capital expenditure in the previous regulatory period (where relevant to proposed capital expenditure in the next regulatory period)
- the reasons and evidence supporting the commencement of new major capital expenditure projects in the next regulatory period, including whether such projects are consistent with efficient long term expenditure on infrastructure services
- the reasons and evidence supporting levels of capital expenditure in the next regulatory period
- whether the timeframe for delivering the proposed capital expenditure program is reasonable, having regard to the operator's delivery of major projects in the past
- whether the asset management and planning framework of the operator reflects best practice.

Forecasts must be based on reasonable assumptions of the efficient costs likely to be incurred in this period.

Subject to confidentiality, external review of an operator's proposed capital expenditure must be made public on the regulator's website.

*Source: ACCC, Application by Essential Services Commission Victoria for Accreditation Final Decision, 17 February 2012.*

Non-infrastructure related capital expenditure on areas such as groundwater, unregulated surface water and some miscellaneous services are regulated in accordance with the *Water Industry Regulatory Order 2014 (WIRO)*.

In preparing capital forecasts, Goulburn-Murray Water should avoid including speculative capital expenditure in its price submission forecasts. Where capital projects are not fully scoped, costed or internally approved (via an approved business case, for example) at the time of preparing the price submission, Goulburn-Murray Water should consider the following options so that customers are not asked to bear the full cost should the project scope or timing change:

1. Include sufficient expenditure to cover only the development costs of the project, with efficient actual construction costs incurred during the period to be rolled into the regulatory asset base (RAB) at the end of the period, along with any accumulated interest. This provides sufficient revenue allowance for the project to proceed during the next regulatory

period, with cost recovery to commence in the following regulatory period at no net loss to the business.

2. Include development costs and a notional allowance for construction, with the balance of efficient construction costs (plus associated interest) to be rolled into the RAB at the end of the period. This allows a reasonable portion of the project, based on the various options and cost estimates at the time of preparing the price submission, to be included in prices.

We consider that forecast prudent and efficient capital expenditure has the following characteristics, which reduce the risk borne by customers:

- required expenditure is based on a P50 estimate, in which there is an equal likelihood of project costs being higher or lower than forecast (noting a P50 estimate may not be appropriate where Goulburn-Murray Water's proposed capital program is dominated by one or two major projects)
- contingency allowances are optimised
- forecast capital expenditure for renewals incorporates expectations for a reasonable rate of improvement in productivity
- risks of project delays and cost overruns are managed through contractual agreements with service providers rather than higher customer prices

Where actual construction costs are found to exceed their efficient level, we will not roll these inefficient expenditures into the regulatory asset base. Inefficient costs will be worn by Goulburn-Murray Water and will not be recovered from customers.

We may engage consultants to review Goulburn-Murray Water's capital expenditures. Our consultant reports on Goulburn-Murray Water will be made public during the price review.

### **6.3. Supporting information**

Goulburn-Murray Water's price submission must include a forecast of total prudent and efficient capital expenditure for the next regulatory period, including forecast capital expenditure for each year of the next regulatory period.

Forecast capital expenditure is to be presented by major service category and by the following cost drivers:

- forecast capital expenditure to maintain service standards — that is, renewals
- forecast capital expenditure to expand or improve services — that is, growth and improvements/compliance (improvements or upgrades to existing services or to comply with existing or changed government or regulator obligations).

Goulburn-Murray Water's financial model must also specify actual capital expenditure for the current regulatory period (including a forecast for 2019-20), categorised in the same way as above.

Capital expenditure will fall into one of three key types:

- Major capital projects — large, discrete capital investment projects (may be completed within a regulatory period, or may span more than one period)
- Capital programs — ongoing programs of capital expenditure allocation, containing multiple works or projects (for example; water main renewals, sewer odour management, ICT equipment upgrades, etc.)
- Other capital expenditure — typically smaller discrete projects and programs.

Goulburn-Murray Water's price submission must present the capital expenditure forecasts set out according to these three key types, as follows:

**Major capital projects** – Under the WCIR, major projects are defined as:

*A major project is considered to be one for which total expenditure on the project over its life is expected to exceed \$2m or 5% of the annual revenue to be recovered through regulated charges – whichever is the lesser amount.<sup>17</sup>*

For each major project, Goulburn-Murray Water must provide:

- the project name and scope, and relevant major service and asset category
- justification for the project, including the cost driver
- start and completion dates
- total capital cost (itemising any government or customer contributions), and expenditure by year
- objectives of the project
- and have available:
  - a business case outlining the options considered for achieving the identified objectives and the approach to identifying the optimal solution<sup>18</sup>
  - risk analysis of the selected option and plans to mitigate the identified risks to ensure the project can be delivered on budget and on time
  - the incentive and penalty payment arrangements with contractors<sup>19</sup>
  - information to identify whether the project has (or will be) the subject of competitive tendering.

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<sup>17</sup> ACCC 2011, *A guide to the Water Charge (Infrastructure) Rules: Pricing application for Part 6 operators*, October.

<sup>18</sup> This should also include an assessment of a 'do nothing' option. Cost comparisons of various options should consider P5, P50 and P95 estimates. Forecasts for capital expenditure must be based on the P50 estimate.

<sup>19</sup> Goulburn-Murray Water's proposed prices must reflect incentive and penalty payment arrangements that are based on a symmetrical sharing of risk for delivery or non-delivery of projects.

**Capital programs** – all key capital expenditure programs or allocations that will be ongoing throughout the regulatory period (excluding any discrete projects separately specified above). For each program, provide:

- the program (or cost allocation) name, and relevant major service category
- the cost driver
- total capital cost (itemising any contributions), and expenditure by year
- objectives of the program, including how the program aligns with customer outcomes proposed
- historical annual costs, and an explanation for significant increases or decreases in the forecast average annual expenditure
- and have available:
  - the list of known projects included within the program or cost allocation for the next regulatory period, and business cases and options analyses
  - a description of the methodology for assessing risk and prioritising projects within the program
  - the cost estimation basis.

**Other capital expenditure** — all other capital expenditure not associated with a defined major project or major capital program should be grouped into one or more programs as appropriate, to be included under the capital programs list, as above.

Consistent with the above capital expenditure breakdowns (by type and major service category) in the price submission or financial model where appropriate, a water business must also:

- for each year of the next regulatory period, and beyond to at least 2027-28, provide annual forecasts for capital expenditure separately identifying (where appropriate) and reconciling:
  - total capital expenditure
  - contributions (government and customer)
  - gifted assets
  - proceeds from asset sales
  - written down value of assets disposed, and
  - net capital expenditure.
- explain the methodology used to estimate forecast capital expenditure
- identify and explain the key assumptions which underpin the capital expenditure forecasts by each major service category, and how any risks or uncertainties have been addressed
- justify the timeframe for delivering the proposed new capital expenditure given the business's delivery of major projects in the past

- explain the reasons for the trend or any major annual variations in forecast capital expenditure (including identifying cost items that are having an upward or downward influence on capital expenditure), compared with historic capital expenditure
- justify the total forecast capital expenditure against the principles in Box 6.1, taking into account:
  - forecast demand
  - any relevant industry or economy-wide benchmarks of expenditure
  - the substitution possibilities between forecast operating expenditure and forecast capital expenditure.

Our financial model sets out the forecast capital expenditure consistent with the breakdowns and methodology described above.<sup>20</sup>

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<sup>20</sup> Most of the requirements set out in this section of our guidance are met by accurately populating the capital expenditure tabs in the financial model.

## 7. Revenue requirement

### 7.1. Introduction

This chapter outlines our approach for calculating the Regulatory Asset Base (RAB) roll forward and the rate of return, as well as how regulatory depreciation is to be considered in forecasts. It also discusses how Goulburn-Murray Water should address revenue and costs relating to non-regulated services in its price submission.

Goulburn-Murray Water's price submission must include the estimated annual revenue requirement to at least 2027-28 from 1 July 2020.

Rule 5 of Schedule 1 of the Water Charge (Infrastructure) Rules (WCIR) outlines the requirements for the regulatory asset base (Box 7.1) and Rule 6 of Schedule 1 of the WCIR outlines the details of the rate of return (Box 7.2).

#### **Box 7.1 Regulatory Asset Base**

Details of the Part 6 operator's assets, and their value, that are used to provide infrastructure services:

**a)** in respect of each year of the initial period or the regulatory period that is set to expire:

- i)** actual contributions from customers and government;
- ii)** actual proceeds from asset disposals and the nature and type of assets sold;
- iii)** the regulatory depreciation of assets and the reasons for the depreciation;
- iv)** from the above, the actual regulatory asset base; and

**b)** in respect of each year of the following regulatory period:

- i)** forecast contributions from customers and government and the assumptions underpinning those forecasts;
- ii)** forecast proceeds from asset disposals and the nature and type of assets anticipated to be sold;
- iii)** the regulatory depreciations of assets and the reasons for the depreciation;
- iv)** from the above, the forecast regulatory asset base.

*Source: ACCC, Application by Essential Services Commission Victoria for Accreditation Final Decision, 17 February 2012.*

## **Box 7.2 Rate of return**

Details of the rate of return:

- a) in respect of each year of the initial period or the regulatory period that is set to expire; and
- b) proposed by the Part 6 operator for each year of the following regulatory period: and the basis for that rate, including the methodology used to determine the rate and the values of all inputs used in the calculation of the rate.

*Source: ACCC, Application by Essential Services Commission Victoria for Accreditation Final Decision, 17 February 2012.*

## **7.2. RAB roll forward**

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

### **7.2.1. Determining the opening value of the RAB**

When assessing Goulburn-Murray Water's price submission, we must establish:

- the closing value for the RAB at 30 June 2019 (using actual data)
- the opening value of the RAB at 1 July 2020
- the forecast value of the RAB for each year of the next regulatory period, and
- the forecast value of the RAB for each year after the next regulatory period until at least 2027-28.

To determine the opening RAB value at 1 July 2020, actual figures will be used for past years, while the forecast figures in the 2016 price determination will be used for incomplete years. An adjustment will be made for any difference between assumed and actual net capital expenditure when the opening RAB is calculated for the first year after the next regulatory period.



To calculate the opening RAB at 1 July 2020 the following formula will be used:

$$\begin{aligned} \text{Opening RAB 1 July 2020} &= \text{RAB at 1 July 2016 (adjusted to reflect 2015-16 actual)}^{21} \\ &+ \text{Actual capital expenditure (gross)}_{2016-17 \text{ to } 2018-19} \\ &+ \text{Forecast capital expenditure (gross)}_{2019-20^*} \\ &- \text{Actual contributions}_{2016-17 \text{ to } 2018-19} \\ &- \text{Forecast contributions}_{2019-20^{**}} \\ &- \text{Forecast regulatory depreciation}_{2016-17 \text{ to } 2018-19^*} \\ &- \text{Proceeds from disposal of assets}_{2016-17 \text{ to } 2018-19} \\ &- \text{Forecast proceeds from disposal of assets}_{2019-20^{**}} \end{aligned}$$

(\*denotes the forecast used in the 2016 price determination)

(\*\* denotes the latest available forecast for 2019-20)

Where the up-to-date 2019-20 gross capital expenditure forecast is lower than the forecast benchmark for that year in the 2016 price determination, then Goulburn-Murray Water must use the lower amount.

The same approach is used to determine the opening value for each subsequent year in the next regulatory period, using the forecasts for capital expenditure, customer and government contributions, regulatory depreciation and disposals.<sup>22</sup> The RAB will also be adjusted for the difference between forecast and actual capex from the previous regulatory period.

### 7.2.2. Demonstrating the prudence and efficiency of past capital expenditure

Capital expenditure over the period from 1 July 2016 to 30 June 2020 (the current regulatory period) must be both prudent and efficient to be included in the roll forward into the opening RAB for the next regulatory period. The price submission must link past (the current regulatory period) spending to verified outcomes and demonstrate that associated projects have been delivered cost-effectively. In particular, we will have regard to:

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<sup>21</sup> We stated that the opening RAB for the 2020 regulatory period would be adjusted for actual 2015-16 capital expenditure in our 2016 final decision. In our 2015-16 final decision we did not approve Goulburn-Murray Water's proposed change to its 2015-16 capital expenditure. We noted that we will recognise actual 2015-16 expenditure in our 2020 price review, which is our usual approach.

<sup>22</sup> Our requirements in this chapter are aligned with the information requirements for the RAB in Schedule 1 of the *WCIR*.

- total capital expenditure compared with the benchmarks allowed in Goulburn-Murray Water's 2016 price determination
- capital expenditure compared with the forecast for each of the major capital projects identified in the 2016 price determination
- expenditure that has been redirected from the major projects which were justified as part of the 2016 price review process.

Goulburn-Murray Water's price submission must:

- explain and reconcile actual capex with forecast capex for the current regulatory period
- reconcile expenditure for major projects identified in Goulburn-Murray Water's submission to the 2016 price review
- explain and quantify capex undertaken in the current regulatory period and sought to be recovered in prices but not planned at the time of the 2016 price review.

### 7.2.3. Contributions

For pricing purposes, capital contributions are removed from the RAB.

The price submission should provide separate data and information on:

- government contributions — federal, state and local government contributions towards the capital cost of a project
- customer contributions — upfront cash payments made by new customers
- the value of gifted assets — assets constructed and then handed over to the water business to operate and maintain.

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

### 7.2.4. Depreciation

Regulatory depreciation allows for a return of Goulburn-Murray Water's investments in regulatory assets. As the components of the RAB – including depreciation – are adjusted for inflation over time, depreciation will reflect the return of the real cost of the asset.

The depreciation allowance included in the 2016 price determination will be used to adjust the RAB for each year of the current regulatory period to determine the opening RAB for 1 July 2020. This allowance will not be adjusted to reflect actual expenditure profiles across the period to avoid providing an undue incentive to increase capital expenditure spending above benchmarks during the regulatory period.

The approach taken by Goulburn-Murray Water to estimate regulatory depreciation should reflect reasonable assumptions about asset life and utilisation. We recognise a return of capital

expenditure (regulatory depreciation), commencing when the asset enters service. Consistent with the WCIR, we prefer a straight line depreciation profile.

Goulburn-Murray Water can propose an alternative approach to straight line depreciation having regard to the following assessment principles:

- the depreciation rate should account for technological change, projected future demand and any other factors that may affect the value of the assets in the future
- the technical lives of assets, and
- impact on prices over the long-term.

#### **7.2.5. Taxation**

The WCIR requires that we set the tax to be paid by Goulburn-Murray Water by estimating its annual actual corporate income tax less the imputation credits that would be received by a hypothetical private investor in Goulburn-Murray Water. We do not anticipate that Goulburn-Murray Water will be in a tax paying position over the next regulatory period.

#### **7.2.6. Disposals**

Goulburn-Murray Water's price submission must include and justify estimates of revenue expected from disposal of assets for each year of the next regulatory period, to be deducted from the RAB roll forward.

We must include estimates of disposals when calculating Goulburn-Murray Water's RAB. We will adjust the regulatory value of assets to reflect the proceeds of disposals, rather than some form of regulatory book or written down value.

#### **7.2.7. Adjusting the RAB for inflation**

The existing tariffs were designed to deliver a real (rather than nominal) return on assets as described in Section 2.2.2. The opening RAB must be adjusted to compensate investors for inflation over the current regulatory period and to reflect inflation when projecting revenue for the next regulatory period.

### **7.3. Rate of return**

The rate of return is used to calculate a return on a business's investments in regulated assets. We will decide what rate of return is used for Goulburn-Murray Water for the next regulatory period,

based on the approach specified by the ACCC and consistent with our approach in the 2016 final decision.<sup>23</sup>

### 7.3.1. The commission's assessment of cost of capital

We will set the rate of return for Goulburn-Murray Water consistent with the approach required by the Australian Competition and Consumer Commission (ACCC) under the terms of our accreditation to regulate Goulburn-Murray Water. We will set the Weighted Average Cost of Capital (WACC) within the following parameters as required by the ACCC's pricing principles:

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

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

Where:            Re = cost of equity

                      Rd = cost of debt

                      E = market value of the business's equity

                      D = market value of the business's debt

                      V = E + D = firm value

                      E/V = percentage of financing that is equity

                      D/V = percentage of financing that is debt.

- the cost of equity is to be calculated using a market risk premium of six per cent
- the risk free rate is to be based on the yield of a 10 year Commonwealth Government Security bond. We propose to use an averaging period of 40 business days commencing as close as practically possible to the start of the regulatory period
- the cost of equity is to be calculated using an equity beta of 0.7, and
- the benchmark debt risk premium is to be estimated on the basis of a benchmark gearing level of 60:40 debt to equity on the yields of BBB+ rated corporate bonds with 10 year maturity.<sup>24</sup>

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<sup>23</sup> Essential Services Commission 2016, *Goulburn-Murray Water Price Review 2016— final decision*, June.

<sup>24</sup> These parameters have been set out in the ACCC's 2011 *Pricing principles for price approvals and determinations under the Water Charge (Infrastructure) Rules 2010*, July, Section 5.3, p. 63.

We will include a WACC estimate in the financial model that we will provide to Goulburn-Murray Water for preparing its price submission. This WACC estimate will be updated prior to the final decision to reflect a risk free rate that is calculated using an averaging period of 40 business days just prior to the final decision.

#### **7.4. Treatment of costs relating to non-regulated services**

In order to calculate Goulburn-Murray Water's revenue requirement, we must exclude costs related to non-regulated services. We have the power to regulate only the prices of those services defined as infrastructure services in the WCIR. The WCIR defines infrastructure service as *access, or a service provided in relation to access, to water service infrastructure and includes the storage, delivery, drainage and taking of water.*<sup>25</sup>

While we have no role in regulating prices for non-regulated services, we need to be satisfied that these services are correctly classified and not related to regulated services, and that the costs of these services are accurately identified and excluded from the regulated cost base.

There are also some services that are non-regulated which are assessed under our *Water Industry Regulatory Order 2014* (WIRO) guidance. Non-regulated rural services do not fall within the definition of a regulated charge in paragraph 91(1)(a), (b) or (d) of the *Water Act 2007 (Cth)* or under the WIRO. We consider that services such as property rental or leasing are non-regulated.

There are also a number of other non-regulated services undertaken by businesses which are often unique to a particular business. The price submission should clearly identify each service provided by the business that has been treated as non-regulated, and demonstrate that either the service is not a regulated service or that it is not provided in connection with a regulated service.

The price submission should also provide an overview of the expenditure and revenue forecasts (for at least 8 years from 1 July 2020) associated with non-regulated services for the regulatory period and explain how shared costs (such as corporate costs) have been allocated between regulated and non-regulated services.

Our financial template will require further information on the costs and revenue of non-regulated services. The template will also allow Goulburn-Murray Water to lower customer prices by using revenue from these activities to offset its regulated revenue requirement.

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<sup>25</sup> WCIR 2010, p.7.



## 8. Demand

### 8.1. Introduction

Changes in demand can arise from changes in consumption by existing customers, or changes in the number of customers. Demand forecasts are a key input into the determination of prices and are relevant to the assessment of past and forecast capital expenditure and operating expenditure.

Goulburn-Murray Water's price submission must explain how it has taken into account the impact of the completion of the Connections Project on its forecast demand.

### 8.2. Commission's assessment of demand forecasts

We must ensure that Goulburn-Murray Water's proposed demand forecasts meet the requirements of the WCIR and the Australian Competition and Consumer Commission's (ACCC) pricing principles for rural infrastructure related services. Rule 11 of Schedule 1 of the Water Charge (Infrastructure) Rules (WCIR) outlines the requirements of demand forecasts (Box 8.1).

#### **Box 8.1 WCIR requirements of demand forecasts**

The commission will assess whether Goulburn-Murray Water's proposed forecasts:

- are based on an appropriate and unbiased forecasting methodology
- are based on reasonable assumptions about the key drivers of demand, including:
  - supply restrictions
  - environmental conditions, including water inflows and the availability of water
  - commodities, including the treatment of water as a derived demand
  - any elasticity assumptions
  - demographic impacts, where appropriate
- utilise the best available information, including historical data that can identify trends in demand
- take account of current demand and economic conditions.

*Source: WCIR 2010.*

### 8.3. Information required in the price submission

Goulburn-Murray Water's price submission should summarise its demand forecasts.

Goulburn-Murray Water should use at least an eight year horizon for demand forecasting and scenario work, and reflect this in its price submission. Goulburn-Murray Water should also provide information that enables us to assess its proposals against the WCIR requirements provided in Box 8.1.

We also expect Goulburn-Murray Water's price submission to include:

- tabular information that summarises the demand forecasts adopted for eight years for each service and region, and provides comparable historical information on demand
- information that describes the methodology used, identifies the key demand forecasting issues and lists and justifies the key assumptions adopted in generating the forecasts, including any assumptions about the modernised network reflected in the forecast for the eight years
- an explanation of how the Connections project is incorporated into forecast demand.

If Goulburn-Murray Water proposes to continue with a revenue cap form of price control we would expect less detailed information as volumes are corrected for in the annual price adjustments.

Goulburn-Murray Water will need to exercise discretion and match the level of detail contained in its demand forecasts with the materiality of the demand information (and hence revenue impacts) captured.

Our financial templates will require Goulburn-Murray Water to provide detailed data on actual demand numbers and demand forecasts for every tariff and tariff category. The detail in these templates does not need to be reproduced in the price submission.



## 9. Form of price control

### 9.1. Introduction

From the current regulatory period, Goulburn-Murray Water has a revenue cap form of price control. The form of control can be an important means of managing risk for water businesses and also has implications for how price changes will affect water customers.

We anticipate Goulburn-Murray Water will continue with a revenue cap form of price control for the next regulatory period. If Goulburn-Murray Water wishes to propose a new form of price control, we expect it to discuss this with customers and us before submitting its pricing submission.

### 9.2. Rebalancing constraint

Goulburn-Murray Water has a rebalancing constraint of  $\pm 10$  per cent. We anticipate Goulburn-Murray Water will continue with a rebalancing constraint of  $\pm 10$  per cent for the next regulatory period. Following our 2018 price review for the urban water businesses, and for consistency with the rebalancing constraints applied in the 2018 final determinations, we note that rebalancing constraints apply:

- on the weighted average price movement
- on tariffs and not on bills
- on real price changes, not nominal price changes.

This means that if Goulburn-Murray Water proposes to continue with its current rebalancing constraint of  $\pm 10$  per cent, it must limit the weighted average price change to plus or minus 10 per cent (real) in any single year (beyond the first year), unless the tariff is exempt from the rebalancing constraint. Goulburn-Murray Water must identify in its price submission any tariffs that it proposes to exempt from the rebalancing constraint.

### 9.3. Our assessment framework

The Australian Competition and Consumer Commission's (ACCC) approval of our application for accreditation means that we regulate Goulburn-Murray Water's infrastructure-related services according to the pricing principles in the ACCC's Final Decision on our accreditation.

In its Final Decision, the ACCC states that a water business may apply for any form of price control subject to meeting the requirements of the WCIR.<sup>26</sup> The ACCC also states that pricing principles allow for flexibility in choosing the form of price control. Water businesses are required to submit the form of price control they would like to apply and the reasons for making the proposal.<sup>27</sup>

#### **9.4. Information required in the price submission**

If Goulburn-Murray Water proposes to continue with its current form of price control, it only needs to state this in its submission. If it proposes to change its form of control, we require Goulburn-Murray Water to identify and justify the changes against the WCIR requirements. Also Goulburn-Murray Water must:

- explain how the proposed form of control would operate, the formulas to be used and services affected
- demonstrate it has consulted with potentially affected customers, and explain how the feedback from customers informed its proposals if it is to change its prices or tariffs
- explain how a transition to a new form of price control may impact customers and Goulburn-Murray Water's approach to minimising any adverse effects.
- identify any charges it proposes to pass through and detail how they will interact with Goulburn-Murray Water's form of price control.

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<sup>26</sup> ACCC 2012, op. cit.

<sup>27</sup> ACCC 2011, *A guide to the Water Charge (Infrastructure) Rules: Pricing application for Part 6 operators*, October, p. 27.

## 10. Tariff levels and structures

### 10.1. Introduction

In approving or determining regulated charges we must have regard to the Australian Competition and Consumer Commission's (ACCC) pricing principles under the *Water Charge (Infrastructure) Rules 2010* (WCIR). As part of the 2016 price review, we approved tariff reform for Goulburn-Murray Water's gravity irrigation, surface water and groundwater services. The tariffs for these services have been transitioning over the current regulatory period to full implementation in 2019-20.

Goulburn-Murray Water has indicated it is engaging with its customer consultative committees and customers on its tariff structures to inform its 2020 price submission. Goulburn-Murray Water's price submission must explain how feedback from engagement has influenced its proposed prices and any proposed tariff reform.

### 10.2. Tariff assessment criteria

We will consider Goulburn-Murray Water's tariff proposals against two sets of criteria:

- the ACCC's pricing principles, which apply to Goulburn-Murray Water's infrastructure-related services such as irrigation and bulk water supplies (Box 10.1)
- the *Water Industry Regulatory Order 2014* (WIRO), which applies to Goulburn-Murray Water's groundwater services, unregulated surface water services and some miscellaneous services (refer to our guidelines for services regulated under the WIRO)

#### Box 10.1 ACCC's Pricing Principles for Tariffs

The ACCC's pricing principles for tariffs say that tariff structures should:

- promote the economically efficient use of water infrastructure assets
- ensure sufficient revenue streams to allow efficient delivery of the required services
- give effect to the principles of user pays in respect of water storage and delivery in irrigation systems
- achieve pricing transparency
- facilitate efficient water use and trade in water entitlements.

*Source: ACCC, Application by Essential Services Commission Victoria for Accreditation Final Decision, 17 February 2012.*

The ACCC's pricing principles require that the regulator must have regard to consultation undertaken by an operator in approving or determining regulated charges.

### **10.3. Tariff structure and design issues**

Our view is that Goulburn-Murray Water, in consultation with its customer consultative committees and customers, is best placed to design tariffs and tariff structures that meet its customers' needs, and manage its risk and deliver its desired business outcomes. Goulburn-Murray Water must have regard to the ACCC pricing principles in designing and explaining its tariffs. It is also best able to coordinate and integrate its tariff structures with its broader risk management policies (which include the form of control and management of service standards, among others).

#### **10.3.1. Efficiency**

The ACCC's pricing principles require consideration of efficiency. This could be realised by moving towards cost reflectivity in pricing. We will analyse the extent to which Goulburn-Murray Water's tariffs and charges recover the actual costs incurred in the delivery of specific services. In practice, this may be best achieved where the fixed and variable components of a charge recover the fixed and variable costs of providing services. Goulburn-Murray Water may need to consider transitioning tariffs into efficient cost structures.

#### **10.3.2. Clarity of and alignment with long term strategy**

We note that Goulburn-Murray Water is in the final stages of a long process of modernisation with its Connections Project.

We will consider the clarity and robustness of Goulburn-Murray Water's proposed tariff strategy. In our view, tariff reform should proceed according to a publicised and planned sequence to provide for customer certainty. Ideally Goulburn-Murray Water's tariff strategy should:

- anticipate and deal with customer impacts, and any indirect effects of change. We expect to see evidence of substantial customer engagement and consideration of transition strategies in Goulburn-Murray Water's tariff proposals
- consider price constraints to limit the movement of tariffs in a year to ensure that customers do not face substantial price shock in any one year.

#### **10.3.3. Time frames**

Goulburn-Murray Water should consider timeframes for planning and cost projection beyond the limits of 1 July 2020 – 30 June 2024 when designing tariff structures to cover its costs.

For all tariff proposals, Goulburn-Murray Water should identify the prices and tariff structures it is proposing to implement over 1 July 2020 – 30 June 2024, and 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 the revenue requirement.

We expect Goulburn-Murray Water to clearly articulate the basis for any differences in tariffs and charges for its customers with regards to differences in costs.

#### 10.3.4. Miscellaneous services

Goulburn-Murray Water's prices for miscellaneous services must be set according to actual costs calculated on the basis of the aggregate of:

- direct third party or contractor invoice cost
- direct marginal internal costs, including labour, materials and transport costs and
- a fair contribution to overheads.

For bank dishonour, debt collection and legal fees, the third party costs must be charged directly to the customer with no contribution for internal costs or a contribution to overheads.

The price submission must contain sufficient information to justify prices and tariff proposals. Goulburn-Murray Water must articulate its tariff strategy and highlight any major changes during the regulatory period commencing 1 July 2020. It should show evidence of engagement with customers and how this has been taken into account, analysis of customer impacts of proposed changes and any strategies to address the proposed changes.

The price submission should specify and justify each tariff it proposes to apply for the next regulatory period. It should also include estimates of likely prices until at least 2027-28. Estimates beyond the next regulatory period could be a range of prices, within reasonable bounds.

- In each of the relevant areas above, the price submission should outline:
  - relevant background information about the underlying service and recent pricing history
  - include a tariff schedule listing each tariff and the price (or principles) proposed structure, including each element of a multi-part tariff structure. Prices must be reported in real terms (consistent with our financial template).
  - Include a schedule listing each proposed regulated miscellaneous tariff and the price (or principles)
- Each price proposed in the price submission must directly correspond with a price in the financial template and the following information must be provided:
  - how the tariff is to be applied; for example, billing period, customer class, applying prices through connection or meter size
  - the reasons for the proposed tariff schedule, including clearly identified principles underlying the proposal

- provide data and supporting information that describes how proposed tariffs are consistent with providing signals about the efficient cost of delivering services
  - justify how any proposed change delivers better signals to customers about the efficient costs of service provision
  - the impacts of the proposal on small, medium and large customer bills (including the attributes applying to each customer size) and strategies to address impacts. Goulburn-Murray Water must make the modelling of customer impacts available to us and customers
  - a summary of the business’s approach to consultation and how the views of customers informed the price submission. This information is particularly important if Goulburn-Murray Water proposes new tariff structures or tariffs that will significantly affect customers.
- Provide estimated tariffs for each service for each year beyond the next regulatory period up until at least 2027-28, in the financial model.
  - Separately list its top 10 miscellaneous services (by forecast revenue) for the next regulatory period and the following period up until at least 2027-28, in the financial model.

# 11.Varying the determination

## 11.1. Introduction

Under Rule 40 of the *Water Charge (Infrastructure) Rules 2010* (WCIR), Goulburn-Murray Water may apply in writing to us to vary its regulated charges resulting from unforeseen events that have a material impact on its operations.

## 11.2. Varying the determination

If Goulburn-Murray Water would like to apply to make an adjustment to its determination during the period, it would need to do so according to Rule 40 of the WCIR set out in Box 11.1.

### **Box 11.1 Vary approval or determination**

Regulator may vary approval or determination in certain circumstances

- 1) A Part 6 operator may apply in writing to the Regulator for a variation of the approval or determination under Division 2 or 3 (or, if previously varied under this Division, as so varied) of its regulated charges in respect of a regulatory period if:
  - a. an event occurs during the regulatory period that materially and adversely affects the operator's water service infrastructure or otherwise materially and adversely affects the operator's business; and
  - b. the operator could not reasonably have foreseen the event.
- 2) An application under subrule (1):
  - a. must set out details of the event; and
  - b. must state the Part 6 operator's proposals for rectifying the material and adverse effects of the event; and
  - c. must state—
    - (i) the total amount that the Part 6 operator anticipates will be required during the remainder of the regulatory period to rectify those material and adverse effects;
    - (ii) whether that amount is likely to exceed \$15 million or 5% of the value of the operator's regulatory asset base as at the beginning of the regulatory period whichever is the lesser amount; and
    - (iii) whether it is reasonably likely (in the absence of any reduction of any other expenditure) that the total expenditure during the remaining part of the regulatory period will exceed the total forecast expenditure for that remaining part; and
  - d. must demonstrate that the Part 6 operator is not able to reduce its expenditure to avoid the consequences referred to in subparagraphs (c) (ii) and (iii) without materially and adversely affecting the reliability and safety of the operator's water service infrastructure or the operator's ability to comply with any relevant regulatory or legislative obligations; and
  - e. must set out details of the variation of its regulated charges sought by the Part 6 operator.

*Source: WCIR 2010.*



## 12. Financial viability

We have financial viability objectives set out in *the Essential Services Commission Act 2001*<sup>28</sup> and the principles in the WIRO.<sup>29</sup> There are no financial viability objectives under the WCIR. We propose to continue with our approach for WIRO regulated services for all of Goulburn-Murray Water's operations and will undertake a financial viability test before we approve prices.

Financial viability tests consider whether a business meets an investment grade credit rating and whether the business will be able to pay its cash obligations in its next pricing period. We base these tests on outcomes for the four indicators and associated benchmarks in Table 12.1.

The four quantitative indicators in Table 12.1 focus mainly on cash flow, which we believe provides the best indication of a business's underlying financial position. To calculate these indicators, we will use historic and forecast actual data (as opposed to notional data). We will also rank the importance of indicators – 'FFO interest cover' ranked highest; 'gearing' ranked second highest; 'FFO / net debt', 'internal financing ratio', and 'Proportion of Discretionary Revenue' indicators ranked lowest. The financial viability ratios will be included in the financial template.

If a viability test suggests a viability adjustment to increase prices is necessary and is requested by Goulburn-Murray Water, we will make adjustments on a net present value neutral basis. This ensures that if a business gets a price increase to maintain its viability in the next price period, we will balance out the price increase with price reduction(s) in subsequent pricing periods to ensure the business recovers no more than efficient costs from customers. Although price increases for financial viability usually occur over one pricing period, we would likely smooth the commensurate price reductions to customers over a number of years to ensure a business does not re-enter a financially vulnerable position.

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<sup>28</sup> S8(A)(b) of the *Essential Services Commission Act 2001*.

<sup>29</sup> 8(b) (ii) of the *Water Industry Regulatory Order 2014*.

**Table 12.1 Financial indicators**

Indicator	Calculation	Benchmark Range	Description
<b>Primary indicator – used to determine size of adjustments</b>			
FFO interest cover	$(\text{FFO} + \text{net interest}) / \text{net interest}$	> 1.5 times < 1.8 times <sup>30</sup>	Measures the extent of the cash flow buffer a business has to meet its debt obligations.
<b>Secondary indicators – used as contextual information to determine whether an adjustment is necessary</b>			
Net Debt / Regulatory Asset Value (%) (Gearing)	$(\text{Interest bearing liabilities} - \text{cash}) / \text{RAV}$	< 70 per cent	Measures the debt component of the regulatory capital structure.
FFO / Net debt (%)	$\text{FFO} / (\text{Interest bearing liabilities} - \text{cash})$	> 10 per cent	Measures the extent to which the serviceability of debt is improving, remaining stable, or declining.
Internal financing ratio (%)	$(\text{FFO} - \text{dividends}) / \text{net capital expenditure}$	> 35 per cent	Measures the extent to which an entity has cash remaining to finance a prudent portion of capital expenditure after making dividends.

Notes: FFO refers to 'funds from operations', and RAV refers to the 'regulatory asset value'.

<sup>30</sup> We would not consider intervention if the indicator was greater than 1.5, however, we would monitor and expect caution from the business if the indicator was below 1.8.

## Appendix A: Cost categories

The price submission should outline expenditure by cost category, and discuss major cost items and any substantial divergence in individual cost categories from past trends. The information should be consistent with the following categories:

- irrigation
- drainage
- water districts (domestic and stock)<sup>31</sup>
- regulated surface water diversions
- unregulated surface water diversions (WIRO)
- groundwater diversions (WIRO)
- bulk water services
- external temporary water purchases
- licence fees
- environmental contribution
- fully funded government or customer programs/projects
- Murray Darling basin fees

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<sup>31</sup> Water districts cover (Normanville, Tungamah, East Loddon, East Loddon North and West Loddon).