

City West Water final decision

2018 Water Price Review

19 June 2018

An appropriate citation for this paper is:

Essential Services Commission 2018, City West Water final decision: 2018 Water Price Review, 19 June

Copyright notice

© Essential Services Commission, 2018



This work, City West Water final decision, is licensed under a Creative Commons Attribution 4.0 licence [creativecommons.org/licenses/by/4.0/]. You are free to re-use the work under that licence, on the condition that you credit the Essential Services Commission as author, indicate if changes were made and comply with the other licence terms.

The licence does not apply to any brand logo, images or photographs within the publication.

Contents

Summary	iv
1. Our role and approach to water pricing	1
2. Our assessment of City West Water's price submission	5
Regulatory period	5
Customer engagement	6
Outcomes	6
Service Standards	7
Guaranteed service levels	8
Revenue requirement	8
Operating expenditure	10
Regulatory asset base	14
Closing regulatory asset base	14
Forecast regulatory asset base	15
Capital expenditure	16
Customer contributions	18
Cost of debt	18
Return on equity – PREMO rating	19
Regulatory depreciation	20
Tax allowance	21
Demand	21
Form of price control	21
Tariff structures and prices	22
Adjusting prices	24
New customer contributions	25
Financial position	26
3. PREMO rating	27
Our review of City West Water's PREMO rating	27
Appendix A – submissions received on draft decision	30
Appendix B – approved service standards	31
Appendix C – approved GSL schemes	32
Appendix D – rate of return	33

Summary

In September 2017, City West Water provided a submission to us proposing prices for a five year period starting 1 July 2018

In March 2018, we released our draft decision on City West Water's price submission.¹ The draft decision set out our preliminary views on City West Water's proposals, and invited interested parties to make further submissions. We also held a public meeting in April 2018. In addition to City West Water's response, we received six written submissions on our draft decision, which are available on our website. A list of these submissions is included in Appendix A to this final decision.

After considering feedback, we have made a price determination for City West Water.² The price determination sets out the maximum prices City West Water may charge for prescribed services (or the manner in which its prices are to be calculated, determined, or otherwise regulated) for the five year period from 1 July 2018 (2018-23). This final decision paper sets out our supporting reasons and analysis for the price determination.

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

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

Our final decision has updated the revenue to be collected by City West Water

Our final decision approves a revenue requirement of \$3,191.2 million over the five year period starting 1 July 2018.³ This is \$4.2 million or 0.1 per cent lower than our draft decision, and mainly reflects our updates to the cost of debt (see pages 18 to 19), foreshadowed in our draft decision.

¹ Clause 16 of the Water Industry Regulatory Order 2014 requires us to issue a draft decision. City West Water's price submission and our draft decision are available at www.esc.vic.gov.au/waterpricereview.

² Before the commencement of a regulatory period, clause 10 of the Water Industry Regulatory Order 2014 requires us to make a price determination which determines the maximum prices a water corporation may charge, or the manner in which its prices are to be calculated, determined or otherwise regulated during the regulatory period. See Essential Services Commission 2018, *City West Water Determination: 1 July 2018 – 30 June 2023*, June.

³ The revenue requirement is the forecast amount a water corporation needs to deliver on customer outcomes, government policy, and obligations monitored by technical regulators including the Environment Protection Authority

A summary of approved maximum prices for major services delivered by City West Water is set out on page 24. The estimated typical bills for residential customer groups under City West Water’s proposal and our final decision are provided in Table A. In 2018-19 the estimated annual typical bill for a residential owner occupier will fall by around \$26, while decreasing by around \$17 for a residential tenant (in constant price \$2018-19 terms).

Table A **Estimated typical water and sewerage bills**
\$ 2018-19

Customer group	Average consumption (kL p.a.)	2017-18 annual bill	2018-19 annual bill	2022-23 annual bill
Residential (Owner occupier)	150	\$981 ^a	\$955	\$955
Residential (Tenant)	150	\$484 ^a	\$467	\$467

^a Following a \$100 rebate paid to customers from a government efficiency review

Note: Numbers have been rounded

City West Water will improve services

Our final decision approves prices that will allow City West Water to deliver on its customer service commitments, government policy, and obligations monitored by the Environment Protection Authority Victoria and the Department of Health and Human Services.

Some of the ways City West Water plans to improve outcomes for customers are by:

- reducing maximum prices for residential and non-residential customers
- providing live updates on works or service interruptions
- extending the opening hours of its customer service centre
- increasing support for customers experiencing financial hardship.

Some tariff structures will change

Our final decision approves City West Water’s proposed tariff structures.

For residential water tariffs, our final decision approves City West Water’s proposed fixed service charge, and a variable component that depends on water use. For the variable component, we have approved City West Water’s proposal to reduce the inclining block from three steps to two.

Victoria and the Department of Health and Human Services. Along with forecast demand, it is an input to calculating the prices to be charged by a water corporation.



We accept its proposal as it balances affordability for large households, makes charges simpler, and continues to provide customers with some reward for saving water.

For residential sewerage, our final decision approves City West Water's proposed fixed service charge and a variable sewage disposal charge. City West Water will reduce the variable sewage disposal charge as a step towards phasing this charge out.

Our final decision also approves City West Water's proposed price cap form of price control. This means its maximum prices are fixed subject to updates for inflation, and any other price adjustments we approve in our price determination. City West Water currently uses a price cap.

More detail on tariffs and the form of price control are available from page 21.

City West Water's price submission is rated as 'Advanced' under PREMO

Our final decision accepts City West Water's PREMO self-rating of its price submission as 'Advanced'. City West Water has demonstrated that its proposals will deliver better value to its customers. This is reflected in City West Water's proposals to reduce prices, and to improve services in areas that are the highest priority among its customers.

Figures A and B summarise our final decision on PREMO. More detail on our assessment of City West Water's PREMO rating is provided in Chapter 3. City West Water is one of nine water businesses for which we have approved an 'Advanced' PREMO price submission rating.

Our PREMO rating is an assessment of the water corporation's price submission. It is not an assessment of the water corporation itself.

Figure A **PREMO Rating – City West Water**

	Overall PREMO rating	Risk	Engagement	Management	Outcomes
City West Water's rating	Advanced	Advanced	Advanced	Advanced	Advanced
Commission's rating	Advanced	Advanced	Advanced	Advanced	Advanced

Figure B **Final decision on PREMO – overall rating**

Leading	Advanced	Standard	Basic	Not rated
Goulburn Valley Water	Barwon Water Central Highlands Water City West Water Coliban Water GWMWater North East Water South East Water Southern Rural Water Yarra Valley Water	East Gippsland Water Gippsland Water Lower Murray Water (urban) Westernport Water	Wannon Water	South Gippsland Water Western Water *

* We have not assessed Western Water under PREMO, as prior to lodging its price submission it notified us of its intention to target a short-term pricing outcome rather than the overall value for money outcome expected under PREMO. Western Water adopted this approach to provide time for it to undertake a review to inform longer-term prices.

1. Our role and approach to water pricing

We are Victoria's independent economic regulator

Our role in the water industry is based on the Water Industry Regulatory Order 2014 (WIRO) which is made under the *Water Industry Act 1994* (Vic) (WI Act) and sits within the broader context of the *Essential Services Commission Act 2001* (Vic) (ESC Act). Our role under the WIRO includes regulating the prices and monitoring service standards of the 19 water corporations operating in Victoria.

We are reviewing the prices 17 water corporations propose to charge customers from 1 July 2018

Our review of the prices proposed by the water corporations covers the prescribed services listed in the WIRO.⁴ The prescribed services include retail water and sewerage services, and bulk water and sewerage services delivered by the water corporations.⁵

Our task is to assess price submissions by water corporations against the legal framework that governs our role, and make a price determination that takes effect from 1 July 2018. We make a price determination after issuing a draft decision, and considering feedback from interested parties.

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

We assess prices against the WIRO and other legal requirements

Clause 11 of the WIRO specifies the mandatory factors we must have regard to when making a price determination, including matters set out in the WIRO, the WI Act and the ESC Act. In making a price determination, we have had regard to each of the matters required by clause 11 of the WIRO, including:

- the objectives and matters specified in clause 8 of the WIRO, which include economic efficiency and viability matters, industry specific matters, customer matters, health, safety, environmental and social matters, and other matters which are specified in sections 8 and 8A of the ESC Act and section 4C of the WI Act

⁴ The review excludes Melbourne Water and Goulburn-Murray Water. In 2016 we approved prices for Melbourne Water to 30 June 2021 and for Goulburn-Murray Water to 30 June 2020.

⁵ The prescribed services are listed at clause 7(b) of the WIRO.

- the matters specified in our guidance⁶
- the principle that prices should be easily understood by customers and provide signals about the efficient costs of providing services, while avoiding price shocks where possible
- the principle that prices should take into account the interests of customers of the regulated entity, including low income and vulnerable customers.

Our consideration of legal requirements document lists the specific objectives and the various matters the commission must have regard to when making a price determination and provides a guide to where we have done so for our final decision for City West Water.⁷

In 2016, we issued guidance to City West Water to inform its price submission. The guidance set out how we will assess City West Water's submission against the matters we must consider under clause 11 of the WIRO.

If we consider the price submission has adequate regard for the matters in clause 11 of the WIRO and complies with our guidance, we must approve City West Water's proposed prices.⁸

If we consider the submission does not have adequate regard for the matters specified in clause 11 of the WIRO or comply with our guidance, we may specify maximum prices, or the manner in which prices are to be calculated, determined or otherwise regulated.⁹

The power for water corporations to impose fees is set out in the *Water Act 1989 (Vic)* (Water Act). Provisions in the Water Act also govern the manner in which water corporations may impose fees, and it is for each water corporation to ensure that it complies with them.¹⁰

The 2018 price review is the first we've undertaken under our new water pricing approach

In 2014, the Victorian Government reviewed and revised the WIRO. The changes allowed us more flexibility to decide on the pricing approach we use in Victoria's water sector. In April 2015 we released a consultation paper to start reviewing our pricing approach.¹¹

⁶ Essential Services Commission 2016, *2018 Water Price Review: Guidance paper*, November.

⁷ Essential Services Commission 2018, *City West Water final decision, 2018 Water Price Review – commission's consideration of legal requirements*, 19 June. This is available at www.esc.vic.gov.au/waterpricereview.

⁸ This is a requirement of the WIRO, clause 14(b).

⁹ This is provided for under the WIRO, clause 14(b)(i).

¹⁰ See Part 13, Division 5 of the *Water Act 1989 (Vic)*.

¹¹ Essential Services Commission 2015, *Review of Water Pricing Approach: Consultation paper*, April.

Over 2015, we held a series of workshops and hosted a conference (in November) to hear from stakeholders and explore alternative ways to approach water pricing.

In May 2016, we released a position paper setting out our proposed new pricing approach, and invited submissions.¹² We met with each water corporation and other interested parties to help inform their submissions. Submissions were supportive of the overall proposal, in particular the greater focus on customer engagement and value.

We finalised our new approach to water pricing in October 2016.¹³

Our new pricing approach builds on many aspects of the previous approach. We continue to use the building blocks to estimate the revenue requirement for a water corporation.¹⁴ Our guidance explains the building blocks and how we use it to estimate the revenue requirement.¹⁵

Among the key changes, the new approach introduces new incentives to help ensure water corporations deliver the outcomes most valued by customers. Our new PREMO framework rewards stronger customer value propositions in price submissions, and an early draft decision is available for price submissions we can assess in a short timeframe.¹⁶ The PREMO incentive is described next.

Our consultation on the pricing approach informed the guidance we issued water corporations in November 2016 to inform price submissions for the 2018 water price review.

PREMO

PREMO stands for **P**erformance, **R**isk, **E**ngagement, **M**anagement, and **O**utcomes. The purpose of PREMO is to provide an incentive for water corporations to deliver outcomes most valued by customers. It includes incentives for a water corporation to engage with customers to understand their priorities and concerns, and take these into account.

PREMO links the return on equity allowed in the revenue requirement to the value delivered by a water corporation to its customers. Under PREMO, a higher level of ambition in terms of delivering customer value results in a higher return on equity.

¹² Essential Services Commission 2016, *A new model for pricing services in Victoria's water sector: Position paper*, May.

¹³ For more detail on the new water pricing approach see: Essential Services Commission 2016, *Water Pricing Framework and Approach: Implementing PREMO from 2018*, October.

¹⁴ The revenue requirement is the forecast amount that a water corporation needs to deliver on customer outcomes, government policy, and obligations monitored by technical regulators including Environment Protection Authority Victoria and the Department of Health and Human Services.

¹⁵ Essential Services Commission 2016, *Guidance Paper*, op. cit., pp. 8–9.

¹⁶ In December 2017 we issued early draft decisions for East Gippsland Water, South East Water, Westernport and Yarra Valley Water.

The 2018 water price review is the first time we've applied our PREMO incentive mechanism.

A water corporation's ambition in terms of delivering customer value is being assessed against four elements of PREMO – Risk, Engagement, Management and Outcomes.¹⁷

A water corporation must self-assess and propose a rating for its price submission as 'Leading', 'Advanced', 'Standard' or 'Basic'. Its proposed return on equity will then reflect its PREMO rating. A 'Leading' submission has the highest return on equity, and a 'Basic' submission the lowest. We assess the justification for the PREMO rating, and also rate the price submission. This process determines the return on equity reflected in the revenue requirement.¹⁸

¹⁷ The Performance element of PREMO will be assessed at the review following the 2018 water price review.

¹⁸ The PREMO process is described in: Essential Services Commission 2016, *Guidance paper*, op. cit., pp. 44–49.

2. Our assessment of City West Water's price submission

We have made our price determination for City West Water after considering: City West Water's price submission, its responses to our queries and our draft decision, and written submissions from interested parties. A list of submissions responding to our draft decision is provided in Appendix A. We also held a public meeting in April on our draft decision to receive feedback.

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

City West Water's price submission and financial model presented clear and comprehensive information to support its proposals. City West Water also provided evidence that its engagement sought to capture the main priorities and concerns of customers, and that it has taken this feedback into account (see customer engagement from page 6).

Our guidance included a number of matters water corporations must address in their price submissions. City West Water's price submission addressed each of these matters, with our preliminary assessment set out in our draft decision. Our final decision is set out below.

Regulatory period

Our draft decision accepted the five year regulatory period proposed by City West Water (1 July 2018 to 30 June 2023) in its price submission. Our guidance proposed to approve a five year regulatory period, subject to any alternative and justified proposal.¹⁹

In response to our draft decision, Consumer Action Law Centre (CALC) recommended the regulatory period should be the same for all water corporations, unless there are special circumstances.²⁰ In support of this, it noted factors such as greater community attention when all price reviews are undertaken at the same time.

Our final decision is to approve the five year regulatory period proposed by City West Water. This is the same period we have approved for all but three water corporations in our current price review.

¹⁹ For detail on the reasons for using five years as the default regulatory period, see: Essential Services Commission 2016, *Guidance paper*, op. cit., p. 21.

²⁰ Consumer Action Law Centre 2018, *Submission on standard draft decisions: 2018 Water Price Review*, 8 May, p. 10.

Customer engagement

Our guidance required City West Water to engage with customers to inform its price submission.

The engagement by City West Water:

- took place between November 2016 and September 2017
- included a range of engagement methods including focus groups, interviews, online discussion forums, surveys, workshops, and pop-up stalls at community festivals and shopping centres
- covered matters such as the service priorities of customers, the structure of residential tariffs, and the corporation's guaranteed service level scheme.

More detail on City West Water's engagement is available in its price submission.²¹

Evidence that City West Water's engagement influenced its proposals includes:

- taking into account customer feedback in proposing a change from a three to two step tariff structure for its residential water usage tariff
- expanding the ways customers may contact the business, including by extending the opening hours of its customer service centre and making greater use of online communications
- proposing four new guaranteed service levels in response to customer feedback about service priorities.

The influence of City West Water's engagement on its proposals supports the objectives in our pricing framework relating to efficiency and the interests of consumers.²²

CALC suggested we could play a greater role to promote best practice customer engagement and identify areas for improvement.²³ We note that following our price review, we will continue to work with water corporations to promote best practice engagement.

Outcomes

The outcomes City West Water proposes to deliver over the five year period starting 1 July 2018 are:

- services to homes and businesses are safe, reliable and efficiently delivered
- customer service is accessible and enquiries are promptly resolved
- billing and payment options are efficient and convenient

²¹ City West Water's price submission is available on our website at www.esc.vic.gov.au. See pages 15 to 22.

²² See for example, WIRO clauses 8(b)(i), 8(b)(ii), 8(b)(iii), 11(d)(iii), and ESC Act Sections 8(1), 8A(1)(a).

²³ Consumer Action Law Centre, *op. cit.*, p. 4.

- customers in hardship are supported
- the whole of the water cycle is managed in an environmentally sustainable way
- City West Water is a valued partner in servicing a growing Melbourne.

City West Water's proposed measures and targets for reporting against these outcomes are set out in appendix B of its price submission. City West Water has committed to reporting to customers against each of these measures. Performance information will be supplied to customers through bill inserts and an annual performance report.

In early 2018-19, we will engage with City West Water to finalise measures, targets and how it will report to customers. Its performance will inform our assessment during future price reviews as part of the Performance element of PREMO assessments.

In response to our draft decision, an anonymous submission raised concerns that City West Water's proposed outcomes did not go far enough to reduce prices for customers.²⁴ In response to this submission, we note that City West Water has sought to address affordability by proposing to reduce prices for tenants, property owners and non-residential customers. It has also proposed to increase hardship support for residential customers experiencing difficulty paying their bill.

Service Standards

City West Water has also provided a list of service standards relating to reliability and attending faults that it will include in its customer charter. These service standards and City West Water's targets until 2023 are set out in Appendix B.

CALC has noted a range of ambitions by water corporations in relation to proposed service standards and commented that water corporations should be encouraged to 'improve service standards over time'.²⁵

We note that City West Water proposed to reduce some targets for reliability and attending faults to align with current performance. City West Water's tested these service targets with its customer committee, an approach that aligns with our expectation that water corporations consider customer preferences when forming service targets.

Approved service standards relating to reliability and attending faults are set out in Appendix B and form part of the manner in which City West Water's services are regulated.

²⁴ Anonymous 2018, *Submission*, 26 April.

²⁵ Consumer Action Law Centre, *op. cit.*, p. 6.

Guaranteed service levels

Guaranteed service levels (GSLs) define a water corporation's commitment to deliver a specified level of service. For each GSL, a water corporation commits to a payment or a rebate on bills to those who have received a level of service below the guaranteed level. We expect water corporations to include GSLs in its customer charter.

City West Water's proposed GSLs are set out on pages 45 and 46 of its price submission. It has proposed to increase rebate amounts for existing GSLs and introduce four new GSLs relating to interruptions in water and sewerage services.²⁶ In our draft decision we provided an overview of City West Water's proposed GSLs.

CALC supported GSL payments increasing over time.²⁷ Another (anonymous) submission commented on the importance of GSLs promoting the rapid repair of leaks in public areas.

We note City West Water reviewed its GSL scheme in consultation with its customers. City West Water took into account feedback and proposed to expand its GSL scheme, including by introducing new GSLs (related to areas of service most important to customers) and increasing rebate amounts. For these reasons, our final decision approves City West Water's proposed GSLs.

City West Water's GSLs are set out in Appendix C.

City West Water's commitment to GSL payments should these service levels not be met, forms part of the manner in which City West Water's services are regulated.

Revenue requirement

The revenue requirement is the forecast amount a water corporation needs to deliver on customer outcomes, government policy, and obligations monitored by technical regulators including Environment Protection Authority Victoria and the Department of Health and Human Services.²⁸ Along with forecast demand, it is an input to calculating prices.

Our draft decision accepted City West Water's proposed revenue requirement of \$3,195.4 million over a five year period starting 1 July 2018. Our final decision approves a slightly lower revenue

²⁶ City West Water's proposed GSLs are set out in its price submission from page 45 – its price submission is available at www.esc.vic.gov.au.

²⁷ Consumer Action Law Centre, *op. cit.*, p. 1.

²⁸ We met with officers of the Department of Environment, Land, Water and Planning, Department of Health and Human Services, and Environment Protection Authority Victoria, to discuss their expectations of City West Water in the regulatory period from 1 July 2018. We had regard to their views in our draft decision.

requirement of \$3,191.2 million. This reflects our final decision on each element of the revenue requirement, as set out in Table 2.1.

The reduction in the revenue requirement since our draft decision is mainly due to updates we made to City West Water’s cost of debt, reducing its return on assets. This reduction was partly offset by an upward adjustment to non-controllable operating expenditure, mainly reflecting updated forecast bulk water charges. Adjustments to the revenue requirement since our draft decision are set out at Table 2.2, with the reasons set out in the following sections.

Table 2.1 Final decision – Revenue requirement
\$ million 2017-18

	2018-19	2019-20	2020-21	2021-22	2022-23	Total
Operating expenditure	478.6	474.6	466.5	467.1	467.7	2,354.6
Return on assets	77.8	78.7	79.1	78.9	78.6	393.1
Regulatory depreciation	76.8	75.6	76.2	78.6	65.1	372.5
Tax allowance	16.3	15.3	14.6	14.2	10.8	71.1
Revenue requirement	649.5	644.2	636.4	638.8	622.3	3,191.2

Note: Numbers have been rounded

Table 2.2 Adjustments to draft decision revenue requirement

\$ million 2017-18

	2018-19	2019-20	2020-21	2021-22	2022-23	Total
Draft decision – revenue requirement	648.1	645.6	637.8	640.2	623.7	3,195.4
Operating expenditure	2.9	0.1	0.1	0.1	0.1	3.3
Return on assets	-1.3	-1.3	-1.3	-1.3	-1.3	-6.7
Tax allowance	-0.2	-0.2	-0.2	-0.2	-0.2	-0.8
Total adjustments	1.4	-1.4	-1.4	-1.4	-1.4	-4.2
Final decision – revenue requirement	649.5	644.2	636.4	638.8	622.3	3,191.2

Note: Numbers have been rounded

Operating expenditure

Operating expenditure is an input to the revenue requirement. Our draft decision proposed to adopt a \$531.6 million benchmark for City West Water’s forecast controllable operating costs for the 2018–23 period. This was \$3.5 million lower than proposed by City West Water, and we set out our reasoning for this adjustment in our draft decision (pages 9 to 16). In summary, we found:

- Evidence indicating its baseline controllable operating expenditure reflects an efficient benchmark.²⁹
- City West Water’s proposed efficiency improvement rate on controllable operating costs is 2.0 per cent per annum, which is greater than its past performance (where it met our mandated 1.0 per cent efficiency rate).
- The proposed electricity price forecast was high in the later years of the period, and City West Water identified lower operating costs for the production of recycled water from its new West Werribee salt reduction plant, resulting in a \$3.06 million reduction to the forecast.

In addition, City West Water advised us of a correction to its financial model due to a calculation error. City West Water proposed to reduce its forecast by \$0.46 million to correct this error, and we adjusted its controllable operating expenditure accordingly.

²⁹ Controllable costs are those that can be directly or indirectly influenced by a water corporation’s decisions.

Our draft decision also requested an updated forecast for electricity costs based on new contract prices, given the electricity contract was currently under negotiation.

We forecasted \$1,819.7 million for City West Water's non-controllable operating costs for the 2018–23 period.³⁰ We note that for metropolitan water corporations, which purchase bulk water and sewerage services from Melbourne Water, the proportion of non-controllable operating expenditure is large relative to the regional water corporations which harvest their own water supply and operate their own sewerage treatment plants.³¹ We noted in our draft decision that we would update this forecast for our final decision, and also adjust for the latest inflation and external bulk charges data.

City West Water's response to our draft decision proposed to accept the commission's adjustments, including for electricity costs.³² City West Water advised it will join the Victorian Government electricity procurement contract, but it doesn't yet have updated rates. City West Water estimated revised costs for the regulatory period based on ASX futures data, which were higher overall than our draft decision, but lower than its original price submission forecast. We accept City West Water's proposal to accept our draft decision electricity forecast and manage its exposure to the energy market in the later years of the period.

CALC's submission to our draft decision supported our approach of adjusting forecast electricity costs above the baseline.³³ No other new considerations were presented in submissions received following the draft decision that caused us to change our views on controllable operating expenditure.

Accordingly, our final decision for controllable operating expenditure is unchanged from our draft decision.

For non-controllable operating expenditure, we have revised our draft decision forecasts where required based on the latest March 2018 inflation and external bulk charges information. We have

³⁰ Non-controllable costs are those that cannot be directly or indirectly influenced by a water corporation's decisions.

³¹ Bulk services are considered non-controllable costs because the commission approves the bulk water and sewerage prices, and these cannot be negotiated by the water retailers.

³² We requested our expenditure consultant, Deloitte Access Economics, to review the updated electricity price forecasts and compare against the information received for our draft decision. Deloitte did not recommend any adjustments for our final decision.

³³ Consumer Action Law Centre, *op. cit.*

revised our forecast environmental contribution from our draft decision, and made no changes to forecast licence fees.³⁴

We have increased our draft decision forecast for City West Water’s non-controllable operating expenditure by \$3.28 million across the 2018–23 period, resulting from the following adjustments:

- increasing 2018-19 external bulk charges by \$2.80 million, based on the recently approved tariffs for Melbourne Water for that year
- increasing the forecast 2018-19 environmental contribution from \$25.86 million to \$25.96 million based on the latest inflation data. We have then declined this value in real terms across the period (a total increase of \$0.48 million).

Table 2.3 sets out our adjustments from our draft decision for non-controllable operating expenditure. Table 2.4 sets out the benchmark operating expenditure we have adopted for our final decision.

Table 2.3 Adjustments to operating expenditure
\$ million 2017-18

	2018-19	2019-20	2020-21	2021-22	2022-23	Total
Draft decision – total operating expenditure	475.7	474.5	466.4	467.0	467.7	2,351.3
Environment contribution	0.10	0.10	0.10	0.09	0.09	0.48
External bulk charges	2.80	0.00	0.00	0.00	0.00	2.80
Total adjustments to non-controllable costs	2.90	0.10	0.10	0.09	0.09	3.28
Final decision – total operating expenditure	478.6	474.6	466.5	467.1	467.7	2,354.6

Note: Numbers have been rounded

We have adopted the benchmark for operating expenditure set out in Table 2.4 for the purpose of making our final decision on City West Water’s revenue requirement (Table 2.1). We consider our

³⁴ For the environmental contribution, we have used the 2018-19 value provided by the Department of Environment, Land, Water and Planning and assumed that this will remain flat in nominal terms (decline in real terms) across the 2018–23 regulatory period.

final decision for City West Water's forecast operating expenditure is consistent with the requirements of the Water Industry Regulatory Order 2014 (WIRO) and the criteria for prudent and efficient expenditure outlined in our guidance.³⁵

Table 2.4 Final decision – operating expenditure

\$ million 2017-18

	2018-19	2019-20	2020-21	2021-22	2022-23	Total
Controllable costs	105.1	105.9	106.3	107.0	107.3	531.6
Non-controllable costs	373.5	368.7	360.2	360.2	360.4	1,822.9
Bulk services ^a	346.9	342.7	334.7	335.3	335.9	1,695.4
Environmental contribution ^b	26.0	25.4	24.8	24.3	23.7	124.1
Licence fees – ESC ^c	0.387	0.387	0.387	0.387	0.581	2.130
Licence fees – DHHS ^c	0.138	0.138	0.138	0.138	0.138	0.691
Licence fees – EPA ^c	0.122	0.122	0.122	0.122	0.122	0.611
Other	0.0	0.0	0.0	0.0	0.0	0.0
Final decision – total operating expenditure	478.6	474.6	466.5	467.1	467.7	2,354.6

^a Bulk services covers the supply of bulk water and sewerage services

^b The Environmental Contribution collects funds from water corporations under the Water Industry Act 1994

^c Licence fees are paid to cover costs incurred by Department of Health and Human Services, Environment Protection Authority Victoria, and the Essential Services Commission in their regulatory activities related to the water corporation

Note: Numbers have been rounded

The benchmark operating expenditure that we have adopted for City West Water does not represent the amount that City West Water is required to spend or allocate to particular operational, maintenance and administrative activities. Rather, it represents assumptions about the

³⁵ Essential Services Commission 2016, *Guidance paper*, op. cit., p. 31.

overall level of operating expenditure (to be recovered through prices) that we consider sufficient to operate the business and to provide services over the regulatory period.

Regulatory asset base

The regulatory asset base is used to estimate the return on assets and regulatory depreciation in the revenue requirement. Our guidance required City West Water to propose its:

- closing regulatory asset base at 30 June 2017
- forecast regulatory asset base for each year of the regulatory period from 1 July 2018.

Closing regulatory asset base

We update the regulatory asset base to reflect actual capital expenditure, government and customer contributions, and asset disposals for the period to 30 June 2017. This helps to ensure prices reflect the actual expenditure of a water corporation.

Our draft decision proposed to approve a closing regulatory asset base for 30 June 2017 of \$1,846.1 million. We proposed to approve this amount as City West Water's actual net capital expenditure was 32.1 per cent lower than the forecast used to approve maximum prices for the period from 1 July 2013.^{36 37} City West Water also calculated its closing regulatory asset base in accordance with the requirements of our guidance.

No other new considerations were raised in submissions on our draft decision that affected our assessment of the closing regulatory asset base. Our final decision approves a closing regulatory asset base at 30 June 2017 of \$1,846.1 million. The calculations are provided at Table 2.5.

³⁶ Net capital expenditure is calculated by deducting government and customer contributions from gross capital expenditure.

³⁷ We take a risk-based approach to including past capital expenditure in the regulatory asset base. We undertake a prudence and efficiency review where a water corporation has exceeded its net capital expenditure forecasts by more than 10 per cent. We believe this approach is reasonable given capital expenditure can be relatively 'lumpy' in nature.

Table 2.5 Final decision – Closing regulatory asset base
\$ million 2017-18

	2012-13	2013-14	2014-15	2015-16	2016-17
Opening RAB 1 July	1,648.6	1,796.2	1,865.2	1,868.8	1,846.1
Plus gross capital expenditure	201.5	130.1	80.9	79.3	92.5
Less government contributions	0.6	1.2	5.0	2.5	1.3
Less customer contributions	17.6	17.0	21.5	27.9	33.1
Less proceeds from disposals	0.4	0.8	0.8	16.6	0.9
Less regulatory depreciation	35.4	42.0	50.1	55.0	57.2
Closing RAB 30 June	1,796.2	1,865.2	1,868.8	1,846.1	1,846.1

Note: Numbers have been rounded

Forecast regulatory asset base

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

Table 2.6 sets out our final decision on City West Water's forecast regulatory asset base from 1 July 2018.³⁸ Each element of the forecast regulatory asset base is discussed in the following sections.

³⁸ Our guidance required water corporations to provide an estimate of the components of its regulatory asset base for 2017-18. This is so we can assess the opening asset base for 1 July 2018. Our guidance noted that where the 2017-18 forecasts for net capital expenditure (gross capital expenditure less government and customer contributions) is lower than the forecast benchmark for that year in its 2013 price determination; the lower amount must be used. The estimates for 2017-18 will be confirmed at the price review following the 2018 water price review.

Table 2.6 Final decision – Forecast regulatory asset base
\$ million 2017-18

	2017-18	2018-19	2019-20	2020-21	2021-22	2022-23
Opening RAB 1 July	1,846.1	1,874.3	1,893.6	1,915.8	1,916.3	1,903.5
Plus gross capital expenditure	109.5	120.9	122.8	101.4	90.6	90.1
Less government contributions	0.0	0.0	0.0	0.0	0.0	0.0
Less customer contributions	21.2	24.3	24.5	24.2	24.2	23.8
Less proceeds from disposals	0.5	0.5	0.5	0.5	0.5	0.5
Less regulatory depreciation	59.6	76.8	75.6	76.2	78.6	65.1
Closing RAB 30 June	1,874.3	1,893.6	1,915.8	1,916.3	1,903.5	1,904.2

Note: Numbers have been rounded

Capital expenditure

Capital expenditure is an input to estimating the regulatory asset base. Our draft decision proposed to adopt a \$525.8 million benchmark for City West Water’s forecast gross capital expenditure for the 2018–23 period. This was \$23.3 million lower than proposed by City West Water, and we set out our reasoning for this adjustment in our draft decision (pages 19 to 22). In summary, we found:

- City West Water’s price submission and business cases demonstrate that it has a reasonable approach for developing project scope, the timing of works and cost estimates.
- The planned capital expenditure program is achievable, given City West Water’s past track record delivering its capital expenditure program.
- City West Water has an appropriate approach for managing expenditure associated with uncertain projects.
- \$23.3 million of capital expenditure for the sewer KPI renewal program was inconsistent with the requirements of our guidance.

City West Water’s response to our draft decision maintained that its sewer KPI renewal program is prudent in the long run, and it proposed a revised allowance of \$45.0 million for the 2018–23 period (compared to \$56.2 million in its price submission, and our draft decision forecast of \$32.9 million). However, the information provided by City West Water did not address our concern that it is proposing to reduce its customers’ level of service (from no more than two sewer

Our assessment

blockages in a year to no more than three) while increasing the budget for sewer renewal.³⁹ We consider that there is insufficient justification for increased costs, and our final decision is unchanged from our draft decision.

CALC's submission reminded the commission and corporations that 'smart energy meters were touted as a game changer...but have so far failed to deliver on this promise'.⁴⁰ It stated that new technology must deliver tangible benefits for water customers and be backed by a comprehensive business case. In its submission, City West Water identified a widespread roll-out of digital metering, which has been excluded from the capital expenditure forecast due to uncertainty in timing, cost, scope or benefits. We share CALC's view and in our draft decision we noted that before proceeding with this program, we would expect City West Water should define the success criteria for any digital metering trials before any broader roll-out could proceed. At a minimum, we expect this would include the requirement that expenditure for a full roll-out would deliver a positive net present value for the water corporation.

In its submission, CALC also recommended the commission sets industry-wide principles to ensure the rollout of smart meters is in the best interest of consumers, including support mechanisms for vulnerable customers.⁴¹ However, our regulatory role does not extend to overseeing the design and delivery of capital projects. We agree with CALC that strong customer engagement and collaboration across the industry is important for achieving an efficient outcome for customers, including vulnerable customers. We also agree water corporations should take into account lessons learnt from the energy smart meter rollout, and from other water corporations further advanced with their digital metering programs.

No other new considerations were presented in submissions received following the draft decision that caused us to change our views on gross capital expenditure.

Accordingly, we have adopted the gross capital expenditure benchmark proposed in our draft decision for the purpose of making our final decision on City West Water's forecast regulatory asset base (Table 2.6) and its revenue requirement (Table 2.1). We consider this benchmark is consistent with our guidance and WIRO principles.⁴²

The benchmark that we adopt for City West Water does not represent the amount that the water corporation is required to spend or allocate to particular projects. Rather, it represents assumptions

³⁹ We requested our expenditure consultant, Deloitte Access Economics, to review City West Water's response and compare against the information received for our draft decision. Deloitte did not recommend any changes from our draft decision.

⁴⁰ Consumer Action Law Centre, *op. cit.*

⁴¹ *ibid.*

⁴² Essential Services Commission 2016, *Guidance Paper*, *op. cit.*, p. 35; WIRO clause 8(b).

about the overall level of expenditure (to be recovered through prices) that we consider sufficient to operate the business and to maintain or improve services over the regulatory period. City West Water determines how to best manage the allocation of its revenue and priority of its expenditure within a regulatory period.

In our draft decision, we accepted City West Water's approach for addressing uncertain capital expenditure. We reiterate that City West Water will need to demonstrate the prudence and efficiency of additional costs incurred during the 2018–23 period if seeking to include them in the regulatory asset base.

Customer contributions

Customer contributions are deducted from gross capital expenditure so they are not included in the regulatory asset base.

Our draft decision considered City West Water's forecast revenue from customer contributions was reasonable, having regard to past trends and its growth forecasts. We proposed to accept City West Water's forecast. No other new considerations were presented in submissions received following the draft decision which caused us to change our views on revenue from customer contributions.

For the reasons set out above, our final decision on revenue from customer contributions is the same as our draft decision. Our final decision adopts the benchmarks set out at Table 2.6.

Cost of debt

Our draft decision proposed to approve the cost of debt proposed by City West Water as it used the cost of debt values we specified in our guidance to calculate its revenue requirement. We also noted that we will update the value of the estimated cost of debt for 2017-18 with our calculation of the actual cost, applying the method outlined in our guidance.⁴³

CALC recommends that we set the benchmark cost of debt at five per cent or around one per cent lower than the amount allowed in our draft decision (6.05 per cent per annum in nominal terms).⁴⁴ CALC submits that government owned water corporations carry less risk than private corporations and as such, the allowed cost of debt and the return on equity should be lowered compared with

⁴³ We received data on the actual trailing average cost of debt for 2017-18 from Treasury Corporation Victoria in April 2018 and we updated the 2017-18 estimates for our final decision.

⁴⁴ Consumer Action Law Centre, *op. cit.*, p. 8.

the rates allowed in our draft decision. These recommendations are based on a report prepared by CME for CALC.⁴⁵

A submission by the Water Services Association of Australia (WSAA) addressed CALC’s submission.⁴⁶ Among other things, WSAA’s submission noted that competitive neutrality principles have been embedded in government policy, including in Victoria via the Financial Accommodation Levy. As a result, water corporations face a cost of debt that reflects the commercial cost of debt.

In keeping with government policy, the approach we take to the cost of debt is to adopt a benchmark rate that applies to all water corporations. The benchmark reflects our estimate of the efficient financing costs for a privately owned business facing a similar degree of economic risk to a regulated water corporation. We consider this is consistent with the requirements of the WIRO.⁴⁷

In our view, adopting the approach recommended by CALC would mean a benchmark efficient water corporation may not have a reasonable opportunity to recover their debt costs.

A more detailed response to the issues raised by CALC is set out at Appendix D.

Our final decision adopts the benchmark cost of debt as set out in Table 2.7.

Table 2.7 Final decision – Trailing average cost of debt

	2008-09	2009-10	2010-11	2011-12	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18
Cost of debt (nominal)	6.9%	7.4%	7.0%	6.3%	5.3%	7.1%	5.4%	5.3%	4.9%	4.5%

Note: Numbers have been rounded

Return on equity – PREMO rating

City West Water rated its price submission as ‘Advanced’. Based on its PREMO self-rating, City West Water proposed a rate of return on equity of 4.9 per cent per annum. This reflects the maximum return rate allowed in our guidance (specified in a PREMO matrix) for a price submission rated as ‘Advanced’.⁴⁸

⁴⁵ *ibid.*, Appendix A.

⁴⁶ Water Services Association of Australia 2018, *Submission*, 15 May.

⁴⁷ Including, in particular, the requirements that our decision have regard to: the promotion of efficiency in regulated industries and the financial viability of the regulated water industry (cl 8(b)(ii) WIRO); efficiency in the industry and incentives for long term investment (s 8A(1)(a) ESC Act); and consistency in regulation between States and on a national basis (s 8A(1)(f) ESC Act).

⁴⁸ Essential Services Commission 2016, *Guidance paper*, *op. cit.*, p. 49.

Our draft decision accepted City West Water's proposed return on equity. This reflected our preliminary review of its PREMO self-rating.

CALC recommended a one per cent reduction to each return on equity value in the PREMO matrix.⁴⁹ CALC's recommendation is based on the findings of a report prepared by CME. The main reason CME proposed the reduction is due to comparisons with returns allowed for UK water entities, and that government owned water corporations carry less risk than private corporations.

The most relevant comparisons for the return on equity are other economic regulators in Australia. We also consider the allowed return on equity should not be adjusted to reflect government ownership, as the exposure of a water corporation to market risk will not be materially affected by government ownership.

A more detailed response to the issues raised by CALC is set out at Appendix D.

We consider our approach to the return on equity is consistent with our requirements under the WIRO, and in particular, that our estimate provides water corporations with an incentive to invest efficiently, and that our approach has regard to the financial viability of the water industry. We have also had regard to the return on equity allowed or estimated by regulators in other Australian jurisdictions recently for the water industry.⁵⁰

Consistent with our draft decision, our final decision accepts City West Water's PREMO self-rating and proposed return on equity of 4.9 per cent per annum, reflecting our reasons above and our final decision on its PREMO rating (see Chapter 3).

Regulatory depreciation

Regulatory depreciation is an input to calculating the regulatory asset base. Our draft decision proposed to accept City West Water's forecast regulatory depreciation, as it was calculated in a manner consistently with the requirements of our guidance.⁵¹ No other new considerations were presented in submissions received following the draft decision which caused us to change our views on depreciation.

For the reasons set out above, our final decision adopts City West Water's forecast for regulatory depreciation, as set out in Table 2.1.

⁴⁹ Consumer Action Law Centre, *op. cit.*, p. 8.

⁵⁰ Essential Services Commission of South Australia 2016, *SA Water regulatory determination 2016, Final determination*, June; Independent Pricing and Regulatory Tribunal 2017, *WACC biannual update*, August.

⁵¹ Essential Services Commission 2016, *Guidance paper*, *op. cit.*, p. 42.

Tax allowance

The tax allowance is an input into the revenue requirement. Our draft decision proposed to accept City West Water's forecast tax allowance⁵²

In its response to our draft decision, City West Water updated its estimates of forecast tax to reflect our updated cost of debt. We consider City West Water's updated estimates were calculated in a manner consistent with our guidance. The revisions lower the forecasts for tax payments by City West Water by around \$0.8 million over the five year regulatory period from 1 July 2018, compared to our draft decision (the adjustments are shown in Table 2.2).

No other new considerations were presented in submissions received following the draft decision which caused us to change our views on City West Water's tax allowance.

For the reasons set out above, our final decision adopts City West Water's tax forecasts as set out in Table 2.1.

Demand

In our draft decision, we proposed to approve City West Water's demand forecasts as we considered they were estimated in a manner consistent with the requirements of our guidance. No new considerations were presented in submissions received following the draft decision which caused us to change our views on demand.

For the reasons set out above, our final decision on demand is the same as our draft decision.

City West Water's price determination includes the benchmark demand forecasts adopted for our final decision.

Form of price control

Our draft decision accepted City West Water's proposal to retain a price cap form of price control. We considered that a price cap provides customers with price certainty, and means a water corporation is managing demand risk on behalf of its customers. We also noted that we consider demand risk is more efficiently managed by a water corporation, rather than its customers.

No other new considerations were presented in submissions received following the draft decision which caused us to change our views on the form of price control.

For the reasons set out above, our final decision confirms our draft decision and approves City West Water's proposed price cap form of price control.⁵³

⁵² Essential Services Commission 2016, *Guidance paper*, op. cit., pp. 50-51.

Tariff structures and prices

Our draft decision accepted City West Water's proposed tariff structures, including its proposals to:

- restructure the residential water variable usage component, reducing it from a three-tier to a two-tier inclining block
- reduce the sewage disposal charge applying to residential customers
- calculate tariffs for recycled water, trade waste and miscellaneous services in accordance with the pricing principles referenced in our guidance
- reduce the trade waste volumetric price for non-residential customers by 18 per cent, as it more closely reflects the long run marginal cost of providing the service.

A submission from Mainstream Aquaculture Group (MAG) responding to our draft decision considered City West Water's proposed trade waste fees excessive, and not reflective of the cost of remediating water that MAG discharges.⁵⁴ MAG contended that its discharges positively impact on City West Water's processes, so they should be charged a significantly lower trade waste price.

In its response to our draft decision, City West Water noted the high salt content of MAG's discharges make it unsuitable for land application so it is discharged to sewer, where it is transported and treated in the same manner as all other trade waste. Accordingly, City West Water has not proposed either an industry-specific or a customer-specific set of fees for MAG.⁵⁵ We agree that MAG's discharge does not warrant special consideration relative to other trade waste customers, and note that City West Water's proposed 18 per cent reduction to trade waste volumetric fees will benefit all its trade waste customers.

City West Water intends to review its trade waste fees, including salt charges, during the next regulatory period (coinciding with Melbourne Water's 2021 price review). We encourage trade waste customers to participate in the consultative processes of this review.

A submission commented that fees charged to owners of multi-residential apartments do not reflect the costs of service delivery.⁵⁶ During the development of its price submission City West Water explored alternative ways of charging residential and non-residential customers, including meter-based charging (which calculates fixed charges based on meter size, instead of the number

⁵³ We note our determinations allow water corporations flexibility to apply to change from a price cap to a weighted average price cap or tariff basket within a regulatory period.

⁵⁴ Mainstream Aquaculture Group 2018, *Submission on City West Water's Trade Waste Fees*, 3 May.

⁵⁵ City West Water 2018, *Response to the ESC's draft decision on City West Water's price submission*, 8 March.

⁵⁶ Anonymous 2018, *Submission*, 16 April.

of connections). In its submission, City West Water noted it did not receive sufficient customer support for meter-based charging and will continue to charge connected properties consistent with the provisions of the *Water Act 1989*. We note City West Water's proposed reduction to the residential sewage disposal tariff will reduce bills for owners of multi-residential apartments.

In its response to our draft decision, City West Water proposed tariffs reflecting our draft decision on its revenue requirement. We consider these proposed tariffs take into account customers' interests, including low income and vulnerable customers, because:

- the proposed tariffs reflect the forecast efficient costs of delivering services
- the proposed two-part structure for water services tariffs will promote efficient water use, and provide customers with a signal regarding the costs of their water use
- the proposed tariffs were informed by an extensive customer engagement program
- the proposed tariffs will allow the corporation to recover revenue sufficient to cover forecast efficient costs
- City West Water has payment options and assistance for customers experiencing difficulty paying bills.

For the reasons set out above, our final decision approves City West Water's proposed tariffs.

Our price determination for City West Water sets out the maximum prices it may charge for the five year period from 1 July 2018 (or the manner in which its prices are to be calculated, determined, or otherwise regulated for each tariff). Approved maximum prices for water and sewerage services applying to most residential and non-residential customers are set out in Tables 2.8 and 2.9 (in \$2018–19).^{57 58}

⁵⁷ On 23 May 2018 (after our consultation period had closed on our draft decision for City West Water), we received a submission from Kingspan Environmental and Urban Water Cycle Solutions under our consultation process for Western Water's draft decision. We have considered the views raised in the submission for our final decision and price determination for City West Water. Our response to the submission is set out in our final decision paper for Western Water.

⁵⁸ On 6 April 2018 we received a submission from Carmel Jacobs a Melton resident, who noted our price review of City West Water. Our response to the submission is set out in our final decision paper for Western Water as Melton is located in Western Water's service area.

Table 2.8 Final decision – water prices
\$ 2018-19

	2018-19	2019-20	2020-21	2021-22	2022-23
Residential					
Variable (\$/kL)					
1st tier	2.4904	2.4904	2.4904	2.4904	2.4904
2nd tier	2.9312	2.9312	2.9312	2.9312	2.9312
Fixed (\$/year)	231.18	231.18	231.18	231.18	231.18
Non-residential					
Variable (\$/kL)	2.5970	2.5970	2.5970	2.5970	2.5970
Fixed (\$/year)	336.74	336.74	336.74	336.74	336.74

Note: Numbers have been rounded down

Table 2.9 Final decision – sewerage charges
\$ 2018-19

	2018-19	2019-20	2020-21	2021-22	2022-23
Residential					
Variable (\$/kL)	0.8348	0.8348	0.8348	0.8348	0.8348
Fixed (\$/year)	256.54	256.54	256.54	256.54	256.54
Non-residential					
Variable (\$/kL)	1.7068	1.7068	1.7068	1.7068	1.7068
Fixed (\$/year)	453.05	453.05	453.05	453.05	453.05

Note: Numbers have been rounded down

Adjusting prices

Our draft decision accepted City West Water’s proposal to continue its existing:

- annual adjustment of prices for prescribed price movements and inflation
- approved desalination cost pass through mechanisms.

Our assessment

We approved these mechanisms as they reflect a continuation of current arrangements, and they are consistent with the efficiency objectives in the WIRO.^{59 60} No submissions responding to our draft decision raised matters that caused us to change our view on these adjustment mechanisms. For these reasons our final decision approves the adjustment mechanisms noted above.

Our draft decision also accepted City West Water's proposal to continue with its current uncertain and unforeseen events mechanism. However, we did not accept its proposal to include a number of additional events under the mechanism, including changes to the environmental contribution. In its response to our draft decision, City West Water agreed with our position that the current mechanism allows for cost pass throughs of this nature.

Our draft decision invited City West Water to resubmit a revised mechanism for passing through changes in the cost of debt to customer prices, specified in real terms (not nominal terms as proposed in its price submission). In its response to our draft decision, City West Water proposed a price adjustment formula that allows for the pass through of changes in the cost of debt in real terms. Our final decision approves City West Water's revised cost of debt adjustment mechanism, as it meets the requirements of our guidance.

New customer contributions

New customer contributions (or developer charges) are levied by water corporations when a new connection is made to its water, sewerage or recycled water networks. New customer contributions can be either standard or negotiated. Standard charges apply to new connections in areas where infrastructure requirements and growth rates are relatively well known, while negotiated charges allow water corporations and developers to negotiate a site-specific arrangement.

Our draft decision proposed to accept City West Water's proposal to maintain its standard water and sewerage new customer contribution charges at the 2017-18 level until 2022-23 (plus annual adjustments for inflation). We also proposed to accept City West Water's proposed increase to the standard recycled water charge covering the West Werribee and Greek Hill zones.⁶¹

Furthermore, our draft decision proposed to approve City West Water's proposal to discontinue the existing standard recycled water charge in the Holden Zone. City West Water stated that land development is yet to proceed and the servicing strategy for the area has not confirmed they should supply the zone with recycled water. City West Water proposed to negotiate recycled water

⁵⁹ WIRO clauses 8(b)(i)(ii) and (iii).

⁶⁰ Essential Services Commission 2016, *Guidance paper*, op. cit., pp. 59–61.

⁶¹ City West Water provided the commission with supporting modelling showing its regard for incremental costs and incremental revenue.

charges in the Holden Zone with any future developers utilising its negotiating framework which incorporates the new customer contribution principles.

For negotiated new customer contributions, our draft decision approved City West Water's proposed method of calculating a charge in accordance with the requirements of our new customer contribution pricing principles.⁶²

No other new considerations were presented in submissions received following the draft decision which caused us to change our views on new customer contributions charges.

Our final decision approves City West Water's proposed new customer contribution charges, including its method of calculating negotiated contribution charges, as they are consistent with the requirements of our guidance.⁶³

Our price determination for City West Water sets out the approved new customer contribution charges for the five year period from 1 July 2018 (or the manner in which its prices are to be calculated, determined, or otherwise regulated).

City West Water should update and publish any development servicing plans and negotiation protocols to assist developers understand the underlying assumptions of its new customer contribution charges.⁶⁴

Financial position

In approving prices, we must have regard to the financial viability of the water industry.⁶⁵ We interpret the financial viability requirements under the *Essential Services Commission Act 2001* (Vic) and the *Water Industry Regulatory Order (2014)* to mean that the prices we approve should provide a level of certainty that each water corporation can generate sufficient cash flow to deliver on service commitments, including financing costs arising from investments to meet service expectations.

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

⁶² Essential Services Commission 2016, *Guidance paper*, op. cit., p. 62.

⁶³ *idid.*, pp. 62-63.

⁶⁴ Essential Services Commission 2013, *New Customer Contributions: Explanatory Note*, December, pp. 9-11.

⁶⁵ WIRO clause 8(b)(ii) and ESC Act section 8A(1)(b).

3. PREMO rating

PREMO is an incentive mechanism that links the return on equity to a water corporation's level of ambition in delivering value to its customers.

For the 2018 price review, a water corporation must rate its price submission as 'Leading', 'Advanced', 'Standard' or 'Basic'. The rating is based on an assessment against the Risk, Engagement, Management and Outcomes elements of PREMO. A 'Leading' price submission is allowed the highest return on equity, and a 'Basic' the lowest.

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

In Chapter 2, we noted our final decision is to accept City West Water's proposed return on equity of 4.9 per cent, based on our PREMO assessment.

Our review of City West Water's PREMO rating

City West Water's proposed PREMO rating, and our draft and final decision are summarised below (Table 3.1).

Table 3.1 PREMO Rating

	Overall PREMO rating	Risk	Engagement	Management	Outcomes
City West Water's rating	Advanced	Advanced	Advanced	Advanced	Advanced
Commission's draft decision rating	Advanced	Advanced	Advanced	Advanced	Advanced
Commission's final decision rating	Advanced	Advanced	Advanced	Advanced	Advanced

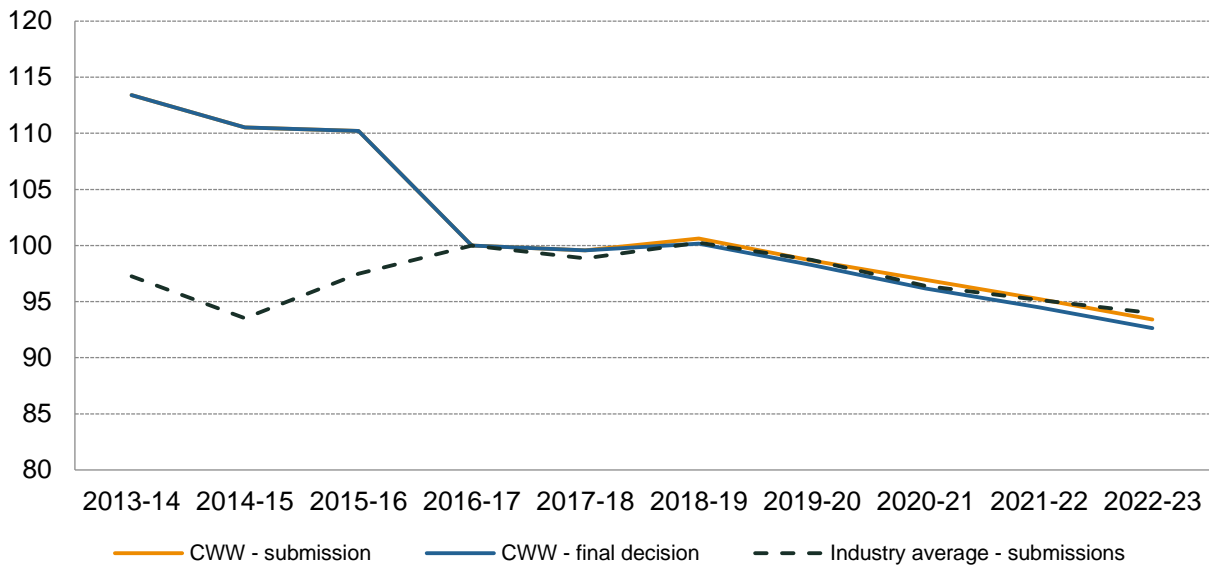
Consistent with our draft decision, we agree with City West Water's proposed overall PREMO self-rating of 'Advanced'. In support of City West Water's PREMO ratings we note:

- City West Water has demonstrated that its proposals will deliver better value to its customers. This is reflected in its proposals to reduce prices, and to improve services in areas of highest importance to its customers. This supports its rating for the Outcomes element of PREMO.
- City West Water's engagement provided a fair opportunity for customers to participate and to influence its proposals. City West Water used a variety of formats for customer engagement, including deliberative approaches to test customer views on complex matters such as tariff structures. The influence of City West Water's engagement is reflected in its consideration of feedback relating to residential tariff reform, and its decision to expand the ways the corporation communicates with customers.
- City West Water has increased the revenue at risk for failing to deliver on its service targets (through increased rebates relating to guaranteed service levels). Our expenditure review proposed relatively minor adjustments to City West Water's forecast expenditure. We found City West Water generally has sound capital management programs in place, and has sound supporting justification for key projects (including through cost benefit analysis). This supports its rating for the Risk element of PREMO.
- The ongoing rate of efficiency improvements reflected in City West Water's forecasts for controllable operating costs (Figure 3.1). This contributes to the price declines proposed by City West Water from 1 July 2018. We also found its price submission and supporting financial model were of a high quality. These factors support City West Water's rating for the Management element of PREMO.

Our final decision to approve a PREMO rating of 'Advanced' is reflected in the return on equity we have approved on pages 19 to 20.

Figure 3.1 Controllable operating expenditure per water connection

Index: 2016-17=100



Submission – based on actual historical and forecast values provided by the water corporation in its price submission.
 Final decision – includes any corrections or adjustments to historical and forecast values arising from our assessment.
 Industry average – drawn from the price submissions for all urban water corporations (excludes rural expenditure).

Appendix A – submissions received on draft decision

Name or organisation	Date received
Kingspan Environmental and Urban Water Cycle Solutions	23 May 2018
Water Services Association of Australia	16 May 2018
Consumer Action Law Centre	8 May 2018
Mainstream Aquaculture Group	3 May 2018
Anonymous	16 April 2018
Carmel Jacobs	6 April 2018

Appendix B – approved service standards

We have approved the following standards and conditions of service and supply and associated targets for City West Water.

City West Water's approved service standards

Service Standard	2018-19	2019-20	2020-21	2021-22	2022-23
Water					
Number of customers experiencing more than 5 unplanned water supply interruptions in the year (number)	0	0	0	0	0
Average time taken to attend bursts and leaks (priority 1) (minutes)	32	32	32	32	32
Average time taken to attend bursts and leaks (priority 2) (minutes)	40	40	40	40	40
Average time taken to attend bursts and leaks (priority 3) (minutes)	252	252	252	252	252
Average duration of unplanned water supply interruptions (minutes)	125	125	125	125	125
Average duration of planned water supply interruptions (minutes)	133	133	133	133	133
Sewerage					
Customers receiving more than 3 sewer blockages in the year (number)	6	6	6	6	6
Average time to attend sewer spills and blockages (minutes)	31	31	31	31	31
Average time to rectify a sewer blockage (minutes)	150	150	150	150	150
Spills contained within 5 hours (per cent)	100	100	100	100	100

Note: Numbers have been rounded

Appendix C – approved GSL schemes

We have approved the following service level obligations and corresponding amounts of payment for failure to attain the stated obligation as the guaranteed service level (GSL) scheme for City West Water.

In accordance with clause 13 of our Customer Service Code: Urban Water Businesses, City West Water must ensure that any payment is made to a customer as soon as practical after a customer becomes entitled to the GSL payment.

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

City West Water's approved GSL scheme

Approved service level obligation	Approved payment (\$)
No more than five unplanned water supply interruptions in a 12 month period.	200
No more than three sewerage service interruptions in a 12 month period.	100
Unplanned Water Supply Outage not restored within 5 Hours of notification.	100
Sewerage interruptions not restored within 5 hours of notification	75
Sewage spill in a house, caused by the business or a failure of the business' system(s), not contained within 1 hour of notification	3,000
Sewage spill not contained within 5 hours of notification	75
Restricting the water supply of, or taking legal action against, a residential customer prior to taking reasonable endeavours (as defined by the ESC) to contact the customer and provide information about help that is available if the customer is experiencing difficulty paying.	300
Failure to give at least 2 business days' notice of a planned water interruption	75
No planned interruptions during peak hours (5am to 9am and 5pm to 11pm)	50
Sewage spill in a house, caused by the business or a failure of the business' system(s)	1,000
No more than 3 unplanned water interruptions within any 12 month period	100

Appendix D – rate of return

A submission from the Consumer Action Law Centre (CALC) recommended we set the benchmark cost of debt at five per cent or around one per cent lower than the amount allowed in our draft decision (6.05 per cent per annum in nominal terms). It also recommended that we reduce each of the equity values in the PREMO matrix by one per cent. CALC submits that government owned water corporations carry less risk than private corporations, and as such, the allowed cost of debt and the return on equity should be lowered, compared with the rates allowed in our draft decision.⁶⁶ These recommendations are based on a report prepared by CME for CALC.⁶⁷

Victoria's water corporations are subject to the competitive neutrality measures the Victorian government agreed to implement as part of the national competition policy agreement and related reforms.⁶⁸ This includes ensuring that borrowing costs reflect an estimate of a water corporation's standalone risk profile and credit rating. We note that:

- Victoria's water corporations do not access debt capital markets directly, but rather, their debt is managed by the state government treasury corporation, through the issuance of government bonds. While the treasury corporation may have access to lower debt funding costs due to government's higher credit rating, the water corporation's borrowing costs do not reflect this. Rather, the water corporations borrow from the state treasury corporation at rates consistent with the risk inherent in the businesses as reflected in their stand-alone credit rating.
- The difference between the government's borrowing costs and the costs faced by water corporations represents consideration for state taxpayers accepting the corporations' credit risk. This is achieved via the Financial Accommodation Levy (FAL), which seeks to ensure the borrowing cost faced by each water corporation reflects the nature of their businesses, not the tax powers of government. If state-owned service providers accessed debt markets directly, then they would face debt financing interest rates that reflected their stand-alone credit ratings.

In keeping with these policy parameters, the approach we take to the cost of debt is to adopt a benchmark rate that applies to all water corporations. The benchmark reflects our estimate of the efficient financing costs for a privately owned business facing a similar degree of economic risk to

⁶⁶ Consumer Action Law Centre, op. cit.

⁶⁷ *ibid.*, Appendix A.

⁶⁸ We note the Water Services Association of Australia supports application of competitive neutrality principles, see Water Services Association of Australia 2016, *Submission to the Essential Services Commission: A new model for pricing services in Victoria's water sector*, July, p. 11.

a regulated water corporation. We consider this is consistent with the requirements of the Water Industry Regulatory Order 2014 (WIRO).⁶⁹

Adopting the approach recommended by CALC would mean the allowed rate for the cost of debt may be lower than the rate faced by a benchmark efficient water corporation. As well as being inconsistent with government policy that water corporations pay an estimate of a commercial equivalent borrowing rate, it would also be inconsistent with the WIRO's viability and efficiency objectives. Our approach is also similar to that adopted by other Australian economic regulators.

CALC's submission also recommended a one per cent reduction to each return on equity value in the PREMO matrix.⁷⁰ CME proposed the reduction mainly based on comparisons with the return allowed for UK water entities, and its view that government-owned water corporations carry less risk than comparable privately owned businesses.

We believe the most relevant comparisons for the return on equity are other economic regulators in Australia. We note the rate for the return on equity (and the overall regulatory rate of return, comprising the cost of debt and the return on equity) approved in our draft decision are within the range of rates estimated by other Australian-based regulators.⁷¹

Also, our current view is that the allowed return on equity should not be adjusted to reflect government ownership. In deriving the values for the return on equity in the PREMO matrix, we had regard to the return on equity we had allowed in the past, and the incentives for water corporations to provide high quality price submissions in the interests of their customers.

CME also argues for a reduction in return on equity to reflect the prevailing revenue cap form of price control. This reflects that a revenue cap provides a water corporation with greater revenue certainty than other forms of price control, such as a price cap. We note however, that only one urban water corporation in Victoria (Yarra Valley Water) has a revenue cap form of price control. As well, a revenue cap does not necessarily change the level of systematic risk faced by a water corporation. For example, it is possible that a water corporation operating under a revenue cap is more exposed to cost risks than corporation operating under a price cap.⁷²

⁶⁹ Including, in particular, the requirements that our decision have regard to: the promotion of efficiency in regulated industries and the financial viability of the regulated water industry (cl 8(b)(ii) WIRO); efficiency in the industry and incentives for long term investment (s 8A(1)(a) ESC Act); and consistency in regulation between States and on a national basis (s 8A(1)(f) ESC Act).

⁷⁰ Consumer Action Law Centre, *op. cit.*

⁷¹ Essential Services Commission of South Australia, *op. cit.*; Independent Pricing and Regulatory Tribunal, *op. cit.*

⁷² For example, increases in water demand can lead to increased costs for a water corporation, which would not be matched by an increase in revenue, under a revenue cap. By contrast, under a price cap increases in water demand would also lead to an increase in revenue.

While our final decision has not agreed with CALC’s recommendations, we will re-consider its arguments as part of any future review of the PREMO framework.