



North East Water draft decision

2018 Water Price Review

28 March 2018



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Summary

In September 2017, North East Water provided a submission to us proposing new prices to apply from 1 July 2018

This draft decision sets out our preliminary views on North East Water's price submission.^{1 2}

We invite interested parties to comment on our preliminary views in this draft decision before we make a final decision and issue a price determination in June 2018. Details on how to make a submission on our draft decision are provided in Chapter 4.

Our draft decision proposes to accept North East Water's prices, over an eight year period from 1 July 2018

We have accepted North East Water's proposal for an eight year regulatory period (page 6). Our draft decision proposes to approve a revenue requirement of \$499.5 million for North East Water over the eight year period starting 1 July 2018.³

After lodging its price submission, North East Water made a correction to the treatment of new customer contribution tariffs. While the corporation could have raised prices as a result of the correction, it decided to maintain its commitment to the prices set out in its original price submission.⁴ In effect, North East Water has decided to forgo revenue it could have earned, under our traditional approach to estimating its revenue requirement (see page 8). Our draft decision therefore, proposes to accept North East Water's proposed prices.

North East Water has proposed improvements to some services

Our draft decision should allow North East Water to deliver on its customer service commitments, government policy, and obligations monitored by Environment Protection Authority Victoria and Department of Health and Human Services.

Some of the ways North East Water plans to improve outcomes for customers are by:

¹ Clause 16 of the Water Industry Regulatory Order 2014 requires us to issue a draft decision.

² North East Water's price submission is available on our website at www.esc.vic.gov.au.

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 Environment Protection Authority 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.

⁴ For more information, see the submission from North East Water on 26 February 2018, available at www.esc.vic.gov.au.

- increasing use of digital communication to better inform and communicate with customers
- planning for growth by investing in wastewater treatment plants in Wodonga and Beechworth
- investing in solar energy to reduce carbon emissions.

Tariff structures will remain the same

Our draft decision approves North East Water's proposed 'price cap' form of price control. This means its maximum prices are fixed subject to updates for inflation and cost of debt, and any other price adjustments we approve in our price determination. It currently uses a price cap form of control.

Our draft decision accepts North East Water's proposed tariff structures, which are the same as its current tariff structures. For water services, North East Water proposed a fixed service charge and a variable component that depends on water used. For sewerage services, North East Water proposed a fixed charge only. See the tariff structures section from page 28 for more information.

North East Water's price submission is rated as 'Advanced' under PREMO

Our draft decision is to accept North East Water's PREMO self-rating of its price submission as 'Advanced' (Table A).

While North East Water proposed a real price increase of 0.45 per cent per annum, this is from a starting point of comparatively low prices. Its forecast operating costs also included a higher rate of improvement in operating cost efficiency, than the industry average. We also note that North East Water has the lowest typical residential customer bill in Australia.⁵

Its PREMO self-rating is also supported by its engagement program, and its acceptance of greater risk during its eight year regulatory period. See page 33 for more information.

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

⁵ See chapter 4 of: Bureau of Meteorology 2018, *National performance report 2016–17: urban water utilities, part A*, March

Table A **PREMO Rating**

	Overall PREMO rating	Risk	Engagement	Management	Outcomes
North East Water's rating	Advanced	Advanced	Leading	Advanced	Advanced
Commission's rating	Advanced	Advanced	Leading	Advanced	Advanced

Among the 15 draft decisions we have released so far, North East Water is one of eight corporations for which we propose to approve an 'Advanced' rating (Table B).

Table B **Draft decision on PREMO – overall rating**

Leading	Advanced	Standard	Basic
Goulburn Valley Water	Barwon Water	Coliban Water	Wannon Water
	Central Highlands Water	East Gippsland Water	
	City West Water	Gippsland Water	
	GWMWater	Lower Murray Water (urban)	
	North East Water	Westernport Water	
	South East Water		
	Southern Rural Water		
	Yarra Valley Water		

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.⁶ The prescribed services include retail water and sewerage services, and bulk water and sewerage services delivered by the water corporations.⁷

In September 2017, North East Water provided a submission to us proposing prices for an eight year period starting 1 July 2018. Our task is to assess the price submission against the legal framework that governs our role, and make a price determination that takes effect from 1 July 2018. The price determination will specify the maximum prices North East Water 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 explains the 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 reaching this draft decision 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

⁶ 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.

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

- the matters specified in our guidance⁸
- 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.

A separate 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 the commission has done so in this draft decision.⁹

In 2016, we issued guidance to North East Water to inform its price submission. The guidance set out how we will assess North East 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 North East Water's proposed prices.¹⁰

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.¹¹

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.¹²

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.¹³ We met with each water corporation and other interested parties to help

⁸ Essential Services Commission 2016, *2018 Water Price Review, Guidance paper*, November.

⁹ Essential Services Commission 2018, *North East Water draft decision, 2018 Water Price Review – commission's consideration of legal requirements*, 28 March. This is located on our website at www.esc.vic.gov.au

¹⁰ This is a requirement of the WIRO, clause 14(b).

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

¹² Essential Services Commission 2015, *Review of Water Pricing Approach, Consultation paper*, April.

¹³ Essential Services Commission 2016, *A new model for pricing services in Victoria's water sector, Position paper*, May.

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 2016.¹⁴

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.¹⁵ Our guidance explains the building blocks and how we use it to estimate the revenue requirement.¹⁶

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.¹⁷ 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.

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

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

¹⁴ For more detail on the new water pricing approach see: Essential Services Commission 2016, *Water Pricing Framework and Approach: Implementing PREMO from 2018*, October.

¹⁵ 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.

¹⁶ Essential Services Commission 2016, *Guidance Paper*, op. cit., pp. 8–9.

¹⁷ In December 2017 we issued early draft decisions for East Gippsland Water, South East Water, Westernport Water and Yarra Valley Water.

For the 2018 water price review, a water corporation's ambition in terms of delivering customer value is being assessed against four elements of PREMO – Risk, Engagement, Management and Outcomes.¹⁸

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.¹⁹

¹⁸ The Performance element of PREMO will be assessed at the review following the 2018 water price review.

¹⁹ Essential Services Commission 2016, *Guidance paper*, op. cit., pp. 45–49.

2. Our assessment of North East Water's price submission

We have made our draft decision on North East Water's price submission after considering: North East Water's price submission, its responses to our queries, and written submissions from interested parties (a list of submissions is provided in Appendix A).

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

Our guidance included a number of matters water corporations must address in their price submissions. North East Water's price submission addressed each of these matters. Our preliminary assessment of these matters is provided in this chapter.

North East Water must submit a response to our draft decision and provide an updated financial model by 8 May 2018 (via email to water@esc.vic.gov.au). The response will be published on our website. We also invite other interested parties to make a submission.

We intend to make a price determination for North East Water in June 2018.

All financial values referred to in this chapter are in \$2017-18.

Regulatory period

North East Water proposed an eight year regulatory period. We propose to accept North East Water's proposal for an eight year regulatory period, for the following reasons:

- North East Water has committed to additional reporting and review mechanisms during the period, providing a transparent way to track its performance. This includes:
 - a six-monthly report card which outlines North East Water's performance against the customer outcomes sought in its price submission, to be published on its website
 - an annual report card outlining performance against its proposed outcomes, for presentation to regulators, stakeholders, industrial customers, developers and its deliberative customer forum group
 - a mid-point review in 2022, the outcomes of which will decide whether North East Water continues its eight year regulatory period, or whether it will need to re-submit proposed prices that would take effect after year five (that is, from 1 July 2023).
- North East Water is in a financial position that provides a basis for it to absorb risks associated with lower demand or higher costs than forecast during the eight year period.
- Its price submission noted that any material under-recovery of revenue (relative to the revenue benchmark in its price determination) would not impact unfavourably on its customers.²⁰

As well, North East Water's proposal for a regulatory period of more than five years was developed in response to customers seeking longer-term price certainty. The benefits and risks of a longer regulatory period were discussed and debated in a deliberative forum. Customers concluded that the benefits of a longer regulatory period outweighed the risks.

We note that if the mid-point review finds that there is uncertainty as to North East Water's performance, customer outcomes, or if there are significant changes due to factors that were not within the corporations' control (such as any changes to government policy), we could require a new price submission from North East Water to re-consider its prices from 1 July 2023 (in effect, shortening the initial eight year regulatory period). We noted in our guidance that a risk associated with a longer regulatory period is that expenditure or revenue outcomes could significantly diverge from the benchmarks used to establish prices.²¹

²⁰ North East Water's price submission is available on our website at www.esc.vic.gov.au. See page 22.

²¹ Essential Services Commission 2016, *Guidance paper*, op. cit., p. 21.

Any re-consideration of prices should be viewed as a last resort measure, for circumstances beyond the water corporation's control. We expect North East Water to accept risks associated with a longer regulatory period, not its customers.

In its response to our draft decision, North East Water must list the matters that would be reported in its six monthly and annual report cards.

Customer engagement

Our guidance required North East Water to engage with customers to inform its price submission.

The engagement by North East Water:

- took place between February 2016 and August 2017
- used a range of methods including a deliberative forum, online survey, social media discussions, pop-up kiosks, workshops and focus groups
- sought views from its stakeholder reference group, councils and government agencies, traditional owners, and future customers (young people under 16)
- covered topics such as service standards, water security and supply, guaranteed service levels, hardship, customer communications, and tariffs.

More detail on North East Water's engagement is available in its price submission.²²

Evidence that North East Water's engagement influenced its proposals includes:

- maintaining the current mix of fixed and variable tariffs, in response to a recommendation from its deliberative forum
- increasing the use of SMS notifications and social media for timely notification of unplanned interruptions, in response to feedback from customers
- the implementation of a partnership project with Traditional Owners and Aboriginal people, in response to feedback from stakeholders.

The influence of North East Water's engagement on its proposals supports the objectives in our pricing framework relating to efficiency and the interests of consumers.²³

Outcomes

The outcomes North East Water proposes to deliver over the eight year period starting 1 July 2018 are:

²² North East Water's price submission is available on our website at www.esc.vic.gov.au.

²³ 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).

- Reliable services: Clean, safe water and more resilient systems
- Responsive services: Timely responses and inclusive decisions
- Affordable prices: Fair prices and increased customer support
- Efficient systems: Improved asset stewardship and continuous improvement
- Local focus: Local people and increased education and awareness
- Sustainable region: Smaller environmental footprint and enhanced liveability.

North East Water proposed measures and activities it will use to report on progress against achieving each outcome. These are set out at pages 12 to 20 of its price submission. To report on its performance North East Water proposes to publish a six monthly 'Report Card' on performance against the Customer Outcomes. This report will be available on its website, and links will be provided through social media and announcements in regional press.

We will engage with North East Water to finalise the measures and targets used to assess performance against its outcomes, and how it will report this publicly. Performance against these measures will inform our assessment during future price reviews.

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.

North East Water's proposed GSLs are set out in Appendix 8 on page 74 of its price submission. It has made no changes to its hardship GSL, and proposed to maintain the other two GSLs with no change to the rebates paid.²⁴

North East Water developed its GSLs in consultation with its customers. On this basis, our draft decision proposes to accept North East Water's proposed GSLs. Final GSLs will be subject to our consideration of any feedback following the release of our draft decision.

Revenue requirement

North East Water's price submission proposed a revenue requirement of \$512.8 million over the eight years from 1 July 2018. During our review, we identified some relatively minor corrections to North East Water's financial model. Our draft decision proposes downward adjustments to forecast expenditure. This results in a 'notional' revenue requirement of \$499.9 million (Table 2.1).

²⁴ Justification for North East Water's proposed GSLs is set out in its price submission at Appendix 8 – its price submission is available at www.esc.vic.gov.au.

This amount reflects North East Water's proposed return on equity of 4.1 per cent. Under PREMO, North East Water could have claimed a return on equity of 4.9 per cent for an 'Advanced' rating. We have estimated a 'PREMO-based revenue requirement' (also included in Table 2.1), reflecting the allowable 4.9 per cent return on equity.

After lodging its price submission, North East Water made a correction to the treatment of new customer contribution tariffs. In its price submission, North East Water incorrectly included income from new customer contributions in its estimate of tariff revenue, which meant the revenue from its other tariffs was lower.²⁵ In order to generate enough tariff revenue to meet its revenue requirement after correcting this, North East Water could have proposed to raise its other tariffs above the amount originally included in its price submission. However, North East Water reaffirmed its commitment to the customer prices set out in its original price submission, thereby absorbing the revenue correction.²⁶

Our draft decision proposes to approve a revenue requirement ('Draft decision revenue requirement' in Table 2.1) of \$499.5 million that reflects North East Water's commitment to the tariffs it proposed in its price submission, and its assumption of a return on equity of 4.1 per cent. We propose to accept this amount as an efficient benchmark for the revenue requirement. We estimate the total revenue North East Water has foregone is around \$9.7 million. The water corporation will not be able to recover this amount in its future regulatory periods.

We have assessed North East Water's financial position (page 31) and consider our draft decision on the revenue requirement will allow North East Water 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.²⁷

Our final decision will be based on the latest available information. Accordingly, as well as responding to our draft decision, North East Water must update its revenue requirement and prices to reflect our April 2018 updates to estimates for the cost of debt and inflation.

There may be changes in laws or government policy before we make a price determination. If any such changes occur between the draft decision and the price determination, and impact on the

²⁵ In our pricing model, revenue from new customer contributions is treated as a reduction to a water corporation's asset base.

²⁶ For more information, see the submission from North East Water on 26 February 2018, available at www.esc.vic.gov.au.

²⁷ 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 North East Water in the regulatory period from 1 July 2018. We had regard to their views in our draft decision.

revenue requirement, North East Water should update its price submission and also provide us with an updated financial model. Any updates will be publicly available on our website.

Table 2.1 Draft decision – revenue requirement

\$ million 2017-18

	2018-19	2019-20	2020-21	2021-22	2022-23	2023-24	2024-25	2025-26	Total
Proposed revenue requirement	63.6	63.9	63.0	63.2	64.4	64.6	65.0	65.2	512.8
Model corrections	-0.02	-0.02	-0.02	-0.02	-0.02	-0.02	-0.02	-0.01	-0.14
Draft decision adjustments to expenditure	-2.0	-2.2	-0.9	-1.1	-1.2	-1.7	-1.8	-1.9	-12.8
Notional revenue requirement – based on assessment of efficient costs	61.6	61.7	62.0	62.1	63.2	62.9	63.2	63.3	499.9
Adjustment to reflect 4.9% return on equity	1.1	1.1	1.1	1.2	1.2	1.2	1.2	1.2	9.3
PREMO-based rev. requirement	62.6	62.8	63.2	63.3	64.4	64.1	64.4	64.5	509.2
Foregone revenue due to 4.1% return on equity	-1.1	-1.1	-1.1	-1.2	-1.2	-1.2	-1.2	-1.2	-9.3
Foregone revenue due to NCC correction	-1.7	-1.1	-0.7	-0.1	-0.4	0.6	1.1	1.8	-0.4
Draft decision revenue requirement	59.9	60.6	61.3	62.0	62.8	63.5	64.3	65.0	499.5

Note: Numbers have been rounded

Our assessment

The following sections outline our assessment of efficient costs and the notional revenue requirement. Table 2.2 shows the components of the notional revenue requirement.

Table 2.2 Calculation of the notional revenue requirement
\$ million 2017-18

	2018-19	2019-20	2020-21	2021-22	2022-23	2023-24	2024-25	2025-26	Total
Operating expenditure	42.2	41.9	41.6	40.9	41.2	40.7	40.8	40.9	330.0
Return on assets	10.1	10.4	10.7	11.2	11.5	11.6	11.7	11.6	88.8
Regulatory depreciation	9.3	9.4	9.7	10.1	10.5	10.6	10.7	10.8	81.1
Notional revenue requirement	61.6	61.7	62.0	62.1	63.2	62.9	63.2	63.3	499.9

Note: Numbers have been rounded

Operating expenditure

Operating expenditure is an input to the notional revenue requirement. North East Water’s price submission provides detail on its forecast operating expenditure from pages 25 to 27, with a cost breakdown shown in table 4 on page 25.

We assess both:

- controllable costs – those that can be directly or indirectly influenced by a water corporation’s decisions
- non-controllable costs – those that cannot be directly or indirectly influenced by a water corporation’s decisions.

For controllable operating expenditure, our assessment process first confirms an efficient baseline, based on the last year of actual costs prior to our price review (that is, 2016-17). We then consider the forecast costs relative to this baseline, including the proposed efficiency improvement rate and forecast growth, and any proposed cost changes relative to the baseline. We engaged Deloitte Access Economics to provide expert advice to inform our assessment of controllable operating

expenditure. Deloitte's report on its assessment of North East Water's expenditure forecast is available on our website.²⁸

For non-controllable expenditure (including bulk water and sewerage services, government charges and licence fees) we confirm the proposed forecasts, and refer with the relevant regulatory body where appropriate.

Table 2.3 sets out our draft decision on North East Water's forecast operating expenditure, for the purpose of establishing the revenue requirement (Table 2.1). Details of our assessment and reasons for our proposed adjustments to North East Water's proposal follow, with a summary of our adjustments shown at Table 2.4.

We consider our proposed operating expenditure in this draft decision better reflects the expenditure that a prudent service provider would incur when acting efficiently to achieve the lowest cost in delivering the outcomes specified in North East Water's price submission.

The benchmark operating expenditure that we propose to adopt for North East Water does not represent the amount that North East Water is required to spend or allocate to particular operational, maintenance and administrative activities. Rather, it represents assumptions about the overall level of operating expenditure (to be recovered through prices) that we consider sufficient to operate the business efficiently and to maintain services over the regulatory period.

²⁸ Deloitte Access Economics 2018, *North East Water – expenditure review for 2018 water price review*, February.

Table 2.3 Draft decision – operating expenditure

\$ million 2017-18

	2018-19	2019-20	2020-21	2021-22	2022-23	2023-24	2024-25	2025-26	Total
Controllable costs	38.6	38.4	38.1	37.3	37.6	37.1	37.2	37.2	301.5
Non-controllable costs	3.5	3.5	3.5	3.5	3.5	3.6	3.6	3.7	28.6
Bulk services ^a	0.9	0.9	1.0	1.0	1.1	1.1	1.2	1.3	8.5
Environmental contribution ^b	2.5	2.4	2.4	2.3	2.3	2.3	2.3	2.3	18.5
Licence fees - ESC ^c	0.034	0.034	0.034	0.034	0.051	0.034	0.034	0.034	0.289
Licence fees - DHHS ^c	0.023	0.023	0.023	0.023	0.023	0.023	0.023	0.023	0.183
Licence fees - EPA ^c	0.130	0.130	0.130	0.130	0.130	0.130	0.130	0.130	1.041
Draft decision – operating expenditure	42.2	41.9	41.6	40.9	41.2	40.7	40.8	40.9	330.0

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

^b The Environmental Contribution collects funds from water corporations under the WI Act

^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

North East Water proposed a total forecast controllable operating expenditure of \$311.8 million over an eight-year regulatory period. For the reasons set out below, we propose to reduce this by \$10.3 million to establish a benchmark controllable operating expenditure of \$301.4 million.

Baseline controllable operating expenditure:

- North East Water has proposed downward adjustments of \$1.82 million to its actual 2016-17 baseline year controllable operating expenditure, producing a starting point for forecast annual operating expenditure. The resultant figure of \$37.89 million is 4 per cent above the benchmark allowance of \$36.29 million allowed for 2016-17 in the previous price determination. Deloitte found this was mainly due to significant increases in full time equivalent (FTE) staff numbers

Our assessment

following two resource reviews. Deloitte considered that despite the increase, North East Water's current labour costs and labour costs per FTE are comparable with other regional urban water corporations.²⁹ We accept Deloitte's assessment and we consider this reflects an efficient baseline cost to forecast annual operating expenditure.

- We note that North East Water advised us of an error in its financial model during our review, however the change to its proposed 2016-17 baseline was immaterial for its controllable operating expenditure forecasts.

Efficiency improvement:

- North East Water's proposed efficiency improvement rate on controllable operating costs is 1.2 per cent per annum. This is higher than the 1 per cent efficiency hurdle that we imposed on all businesses for the last regulatory period. However, it is the second lowest rate proposed by any of the fifteen water corporations in their price submissions. It is the same value as North East Water's forecast connection growth rate of 1.2 per cent per annum, giving a flat annual baseline operating cost.

Proposed cost changes:

- North East Water has sought additional operating expenditure of \$7.44 million above its annual baseline cost across 2018–26. This amount included forecast additional costs of \$15.03 million offset by \$7.59 million of savings.
- North East Water proposed a \$7.33 million increase in baseline operating expenditure for labour.
 - North East Water proposed wage increases above inflation, resulting from its enterprise agreement. Deloitte's assessment of wage increases above inflation is that these should be managed by the water corporation through productivity improvements or through the growth allowance applied to the baseline, as most other water corporations have proposed.
 - Deloitte found North East Water had proposed the fourth highest proportional labour increase for the next regulatory period, with the labour variation representing 1.8 per cent of total controllable operating expenditure.
 - Deloitte's assessment recommended the removal of the \$7.33 million.³⁰ We agree that this adjustment reflects more efficient labour expenditure forecast.
- North East Water has forecast an additional \$1.60 million for asset decommissioning. Deloitte noted North East Water had also adjusted its 2016-17 baseline down \$1.29 million to remove

²⁹ Deloitte Access Economics, op. cit., p. 16.

³⁰ Deloitte Access Economics, op. cit., p. 20.

Our assessment

non-recurring costs for two large decommissioning projects. Deloitte considered the allowance of \$0.20 million per year for decommissioning was a reasonable way to treat this expenditure.³¹ We accept Deloitte's assessment that this decommissioning cost reflects efficient expenditure, as it is effectively a net reduction of \$1.09 million against the baseline year expenditure.

- North East Water has forecast a net increase of \$3.16 million from other expenditure. Deloitte reviewed the digital metering project, which accounts for \$3.00 million of this increase. Deloitte considered there is currently insufficient detail on the project scope and costs to provide a sound cost estimate. It also found limited evidence of customer willingness to incur increases in water bills to fund a digital meter roll-out. However, Deloitte noted there was some support for North East Water to at least undertake further investigations, and potentially roll out digital meters later in the 2018–26 period. Deloitte recommended the removal of \$3.00 million from 2018-19 and 2019-20, with the inclusion of \$1.00 million for 2022–24 to support further investigations and trials.³² We agree with Deloitte's assessment to remove some of these costs due to uncertainty, but we believe any costs associated with a digital meter roll-out or a trial should be included as capital expenditure, and we have therefore moved the \$1.00 million to capital expenditure. We discuss this further in the capital expenditure section.
- North East Water has proposed savings of \$2.11 million for electricity, due to planned capital projects that will reduce its energy demand. Deloitte considers North East Water has taken efficient steps to manage its electricity usage and costs, so it recommends no adjustment.³³ We accept Deloitte's recommendation, however we do acknowledge that there is currently uncertainty in forecasting electricity prices. We request that North East Water proposes a revised electricity forecast based on any updated contract prices in response to our draft decision.

We consider applying our proposed adjustment of \$10.33 million to North East Water's total proposed controllable operating expenditure forecast better meets the requirements of the WIRO and the criteria for prudent and efficient expenditure outlined in our guidance.³⁴ North East Water's controllable operating expenditure per connection decreases (in real terms) relative to the 2016-17 baseline year, at a greater rate than the industry average, as shown in Figure 2.1. Our proposed adjustments will bring about this decrease sooner in the period.

³¹ Deloitte Access Economics, op. cit., p. 24.

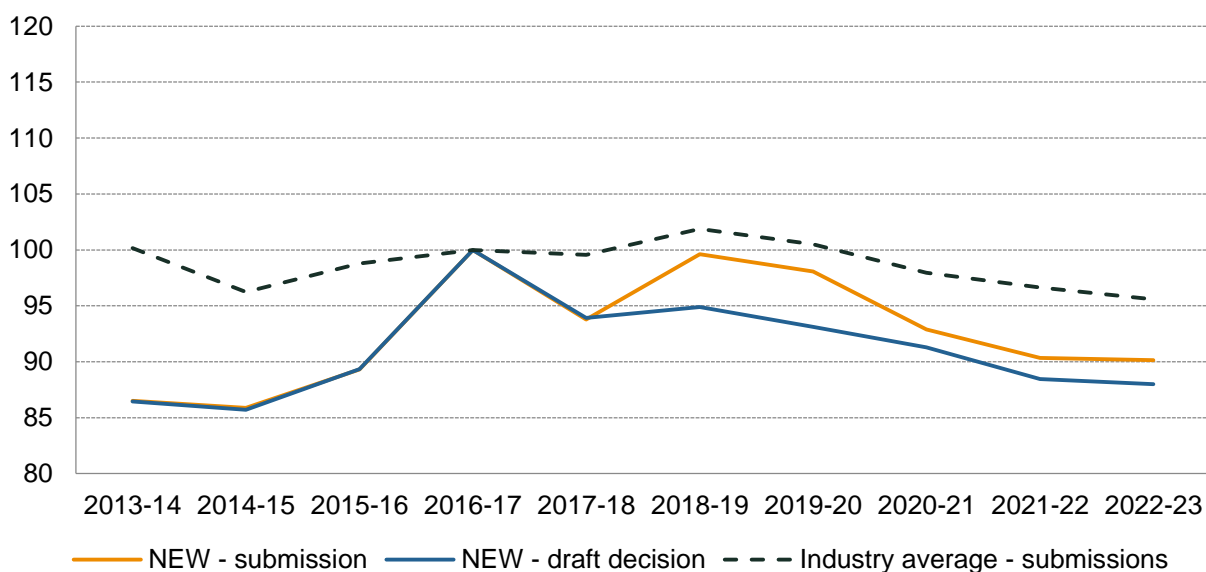
³² Deloitte Access Economics, op. cit., p. 25.

³³ Deloitte Access Economics, op. cit., pp. 21-24.

³⁴ Essential Services Commission 2016, *Guidance paper*, op. cit., p. 31.

Figure 2.1 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.
 Draft 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).

For non-controllable operating expenditure, we have adjusted North East Water’s forecasts where required based on the latest information received from the relevant regulatory authorities on their licence fees and the environmental contribution. The values we have adopted for our draft decision are set out in Table 2.2 above.

For the environment 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 period, and will remain flat in real terms across the 2023-26 period.

We have assumed the licence fees for the Department of Health and Human Services, the Environment Protection Authority Victoria and the Essential Services Commission remain flat in real terms across the period, but with a 50 per cent increase for our commission fee in 2022-23 to align with our regulatory review cycle.³⁵

We have verified North East Water’s forecast external bulk water charges against the current price determination for Goulburn-Murray Water.

³⁵ The Department of Health and Human Services and the EPA Victoria provided their latest 2016-17 licence fees for making our draft decision. We have also based our forecast on our 2016-17 commission licence fee.

We have reduced North East Water's forecast non-controllable operating expenditure by \$0.68 million across the 2018–26 period, resulting from our adjustments to:

- increase our commission licence fee by \$0.02 million in 2022-23
- decrease the environment contribution by average of \$0.23 million per year for 2023-24 to 2025-26 (a total reduction of \$0.69 million).

Overall, non-controllable operating expenditure increases by \$0.41 million from 2017-18 to 2018-19, predominantly due to the increase in the environmental contribution from \$2.08 million to \$2.47 million.

Prior to making our final decision, we will adjust North East Water's forecast non-controllable operating expenditure for the latest inflation and external bulk charges data.

Table 2.4 sets out our proposed adjustments to both controllable and non-controllable operating expenditure.

Table 2.4 Adjustments to operating expenditure

\$ million 2017-18

	2018-19	2019-20	2020-21	2021-22	2022-23	2023-24	2024-25	2025-26	Total
Proposed total operating expenditure	44.1	44.0	42.3	41.7	42.1	42.1	42.3	42.4	341.0
Employees: operations	-0.1	-0.2	-0.2	-0.2	-0.3	-0.3	-0.4	-0.4	-2.2
Employees: admin	-0.4	-0.4	-0.5	-0.6	-0.7	-0.8	-0.9	-0.9	-5.2
Admin: digital metering	-1.5	-1.5	0.0	0.0	0.0	0.0	0.0	0.0	-3.0
Total adjustments to controllable costs	-2.0	-2.1	-0.7	-0.9	-1.0	-1.1	-1.2	-1.4	-10.3
License fees - ESC	0.0	0.0	0.0	0.0	0.017	0.0	0.0	0.0	0.017
Environmental contribution	0.0	0.0	0.0	0.0	0.0	-0.3	-0.2	-0.2	-0.7
Total adjustments to non-controllable costs	0.0	0.0	0.0	0.0	0.0	-0.3	-0.2	-0.2	-0.7
Draft decision - total operating expenditure	0.0	0.0	0.0	0.0	0.017	-0.3	-0.2	-0.2	-0.7

Note: Numbers have been rounded

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 North East 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 gross capital expenditure, less government and customer contributions, and asset disposals for the period to 30 June 2017. This helps to ensure prices reflect the actual net expenditure of a water corporation.³⁶

Table 2.5 sets out North East Water's proposed regulatory asset base at 30 June 2017.

We compared North East Water's actual net capital expenditure for 2012-13 to 2016-17 with the forecast used to approve maximum prices for the period from 1 July 2013. We undertake a prudence and efficiency review where a water corporation's net capital expenditure is more than 10 per cent above the forecast used to approve maximum prices for the period from 1 July 2013. We believe this approach is reasonable given capital expenditure can be relatively 'lumpy' in nature.

In its price submission, North East Water assumed \$105.8 million net capital expenditure over the period from 2012-13 to 2016-17. We identified some minor adjustments to the estimates used by North East Water, which reduced this to \$105.4 million. This figure is 13.9 per cent higher than its 2013 forecast (covering the period from 2012-13 to 2016-17). The majority of this additional capital expenditure was in 2012-13.

We requested information from North East Water in relation to the projects explaining the net capital expenditure above the forecast. We did not receive information to satisfy us that the additional expenditure was prudent and efficient.

We have adopted North East Water's proposed amounts for past net capital expenditure to estimate its closing RAB. However, in response to our draft decision, North East Water must provide us with more information to justify the additional net capital expenditure above its 2013 determination forecast, to have these amounts confirmed in our final decision.

For each major project driving the expenditure above forecast, North East Water must provide:

- a reconciliation between the total approved budget and actual expenditure, for each year from 2008-09 to 2012-13
- details on the drivers of cost increases and supporting data and justification
- information on how costs were managed including how efficiencies were sought in the project
- business cases or internal project reports that describe the costs and need for the project.

³⁶ Net capital expenditure is calculated by deducting government and customer contributions from gross capital expenditure. Customer contributions reflects revenue earned from new connections made to the water corporation's water, sewerage or recycled water networks.

Our draft decision is to approve a closing regulatory asset base at 30 June 2017 of \$264.5 million, as set out in Table 2.5 below.

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

	2012-13	2013-14	2014-15	2015-16	2016-17
Opening RAB 1 July	204.2	238.8	255.1	256.8	262.9
Plus gross capital expenditure	47.3	28.5	13.3	17.1	13.6
Less government contributions	0.0	1.2	1.4	0.2	0.1
Less customer contributions	2.5	2.1	2.0	2.0	2.8
Less proceeds from disposals	1.5	1.5	0.4	0.5	0.4
Less regulatory depreciation	8.7	7.4	7.8	8.3	8.7
Closing RAB 30 June	238.8	255.1	256.8	262.9	264.5

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 draft decision on North East Water's forecast regulatory asset base from 1 July 2018.³⁷ Later sections provide an overview of our assessment of the components of the forecast regulatory asset base.

³⁷ 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 (otherwise the 2013 determination forecast applies). The estimates for 2017-18 will be confirmed at the price review following the 2018 water price review.

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

	2017-18	2018-19	2019-20	2020-21	2021-22	2022-23	2023-24	2024-25	2025-26
Opening RAB 1 July	264.5	264.5	268.7	277.2	287.6	300.6	303.8	306.3	307.4
Plus gross capital expenditure	12.1	15.6	20.2	22.4	25.4	16.1	15.5	14.3	11.0
Less government contributions	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Less customer contributions	2.0	1.7	1.7	1.8	1.8	1.8	1.9	1.9	1.9
Less proceeds from disposals	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.5
Less regulatory depreciation	9.5	9.3	9.4	9.7	10.1	10.5	10.6	10.7	10.8
Closing RAB 30 June	264.5	268.7	277.2	287.6	300.6	303.8	306.3	307.4	305.2

Note: Numbers have been rounded

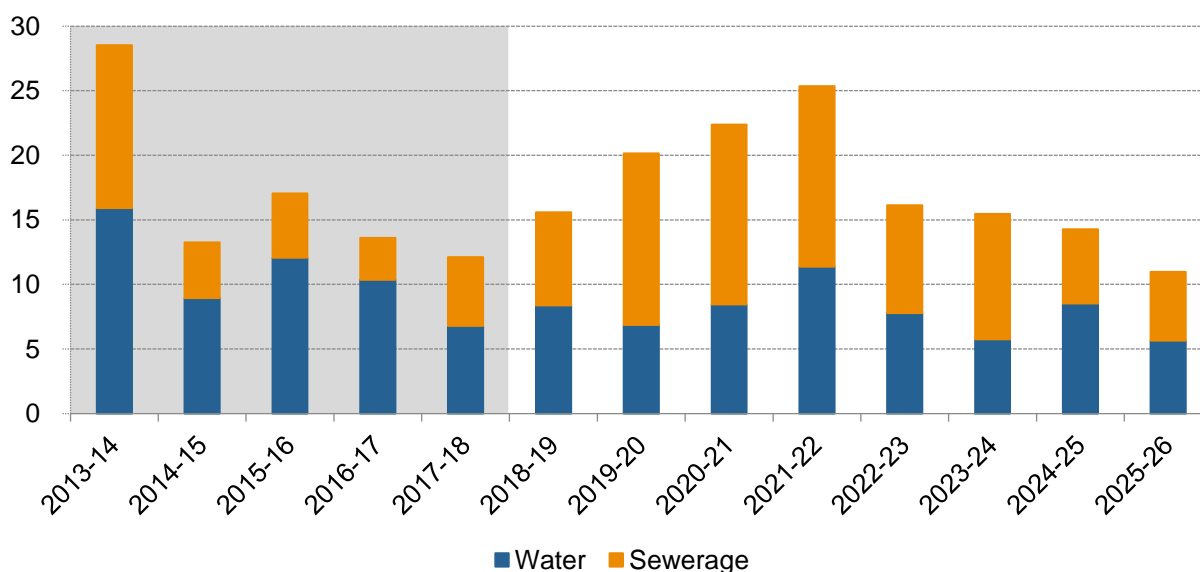
Capital expenditure

Capital expenditure is an input to estimating the regulatory asset base. North East Water's forecast capital expenditure and supporting information is provided at pages 28 to 31 of its price submission. This is summarised in Figure 2.2, for the current 2013–18 period, and as proposed by the water corporation for the 2018–26 period.

We engaged Deloitte Access Economics to provide expert advice to inform our assessment of capital expenditure. Deloitte's report on its assessment of North East Water's expenditure forecast is available on our website.³⁸

³⁸ Deloitte Access Economics, op. cit.

Figure 2.2 Gross capital expenditure by service category
\$ million 2017-18



Note: actuals for 2013-14 to 2016-17 and water corporation forecasts for 2017-18 to 2025-26

North East Water proposed a total gross capital expenditure of \$146.1 million over an eight-year regulatory period. For the reasons set out below, we propose to reduce this by \$5.8 million to establish a benchmark gross capital expenditure of \$140.3 million:

- North East Water’s average annual proposed capital expenditure is \$18.26 million per year, which is 8 per cent higher than the \$16.91 million per annum estimated for the 2013–18 period.³⁹ North East Water’s proposed capital expenditure is predominantly driven by renewals. We also note North East Water has one of the lowest rates of capital expenditure per customer connection amongst the regional water corporations.
- Deloitte requested selected documents from North East Water as a representative sample to demonstrate its asset management processes and justification for its capital expenditure program. Based on the sample of documents reviewed, Deloitte found that overall North East Water had a robust process for developing project scope and estimating costs that supported its price submission, but there was opportunity to improve options analyses and documented justification for major projects.
 - Deloitte reviewed the business cases for Wodonga wastewater treatment plant capacity and emissions reduction, Wodonga wastewater treatment plant major upgrade, Beechworth wastewater system upgrade and Wodonga wastewater treatment plant – solar power, which

³⁹ Excluding capital expenditure associated with uncertain growth projects for the 2013-18 and next regulatory periods.

are four of North East Water's five largest projects for the period. Deloitte also reviewed the business case for renewals expenditure.

- Deloitte found that North East Water had included excessive contingencies in the cost estimate for two of the Wodonga wastewater treatment plant projects. Deloitte recommended a reduction of \$10.5 million (10 per cent) for the capacity upgrade and emission reduction project and a reduction of \$7.65 million (5 per cent) for the major upgrade.⁴⁰
 - Deloitte found that it was unclear why the chosen option for the Beechworth wastewater system upgrade was not the lowest cost option. Deloitte recommended a \$5.05 million reduction for the upgrade, which is consistent with the cost of the lowest cost option.⁴¹
 - North East Water proposed total renewals expenditure of \$37.40 million over the fourth regulatory period, equivalent to a 13 per cent increase over the current annual renewals expenditure. Deloitte considered that North East Water has not provided sufficient information to demonstrate that the proposed additional renewals expenditure is prudent. However, Deloitte also noted that North East Water is carrying a significant renewal backlog. Deloitte recommended that the renewal budget be reduced to the historical level, a reduction of \$4.21 million for a total of \$33.2 million over eight years.⁴²
 - We accept Deloitte's proposed adjustments and we consider these better reflect efficient gross capital expenditure.
- We consider the planned capital expenditure program is achievable, given North East Water's past track record delivering its capital expenditure program. Over the current 2013–18 regulatory period, North East Water is expected to deliver most of its planned major projects, with the Yackandandah reclaimed water management project deferred until 2019-20 to allow time for investigation of an alternative option. Although two of North East Water's seven major projects were completed one or two years late, the delays were due to weather or ministerial requests.⁴³
 - North East Water has 'ring-fenced' or excluded \$47 million of growth-related and small town projects from its expenditure forecasts in its price submission, due to uncertainty about timing, scope and cost. This is consistent with our guidance for managing uncertain expenditure. For our draft decision, we accept North East Water's proposal for addressing uncertainty, noting the following:

⁴⁰ Deloitte Access Economics, op. cit., p. 31.

⁴¹ Deloitte Access Economics, op. cit., pp. 31-32.

⁴² Deloitte Access Economics, op. cit., p. 30.

⁴³ Essential Services Commission 2018, *Status of major projects supplement: Water performance report 2016-17*, March.

- North East Water will need to demonstrate the prudence and efficiency of these costs if they are indeed incurred during the 2018–26 period if seeking to include them in the regulatory asset base.
- We consider costs associated with the proposed digital metering roll-out would be included as capital rather than operating expenditure. We have included \$1.00 million in 2022–24 to support further investigations and trials, consistent with Deloitte’s recommendation, but transferred from operating expenditure. We would expect North East Water define the success criteria for any digital water metering pilot 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.
- Variations in capital expenditure from forecast during the 2018–26 period will form a key part of our assessment of the Performance element of PREMO at the next price review.

Table 2.7 below sets out our proposed adjustments to North East Water’s forecast to establish our draft decision benchmark for gross capital expenditure, consistent with our guidance and WIRO principles.⁴⁴ This benchmark is used to calculate the forecast regulatory asset base (Table 2.6) and the notional revenue requirement (Table 2.2).

⁴⁴ Essential Services Commission 2016, *Guidance paper*, op. cit., p. 35.

Table 2.7 Draft decision – gross capital expenditure

\$ million 2017-18

	2018-19	2019-20	2020-21	2021-22	2022-23	2023-24	2024-25	2025-26	Total
Proposed gross capital expenditure	16.7	21.6	23.4	25.5	16.5	16.2	14.8	11.4	146.1
Wastewater above ground asset renewal	-0.2	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.9
Wastewater below ground asset renewal	-0.1	-0.1	-0.1	-0.1	-0.4	-0.1	-0.1	-0.1	-1.1
Water above ground asset renewal	-0.2	-0.1	-0.02	-0.2	-0.2	-0.1	-0.1	-0.1	-1.1
Water below ground asset renewal	-0.2	-0.1	-0.2	-0.2	-0.1	-0.1	-0.1	-0.1	-1.1
Wodonga WWTP capacity upgrade and emissions reduction	-0.1	-0.4	-0.6	-0.1	0.0	0.0	0.0	0.0	-1.2
Wodonga WWTP major upgrades	0.0	0.0	0.0	0.0	-0.02	-0.3	-0.1	0.0	-0.4
Beechworth wastewater system upgrade	-0.4	-0.6	0.0	0.0	0.0	0.0	0.0	0.0	-1.0
Digital meter trial	0.0	0.0	0.0	0.5	0.5	0.0	0.0	0.0	1.0
Total adjustments to gross capital expenditure	-1.2	-1.5	-1.0	-0.1	-0.4	-0.8	-0.5	-0.4	-5.8
Draft decision – gross capital expenditure	15.6	20.2	22.4	25.4	16.1	15.5	14.3	11.0	140.3

Note: Numbers have been rounded

Our assessment

The benchmark that we adopt for North East Water does not represent the amount that the water corporation is required to spend or allocate to particular projects. Where we have made an adjustment to exclude a project’s capital expenditure from North East Water’s revenue requirement, we are not requiring the corporation to remove that project. Rather, it represents assumptions about the overall level of expenditure (to be recovered through prices) that we consider sufficient to operate the business and to maintain or improve services over the regulatory period. North East Water determines how to best manage the allocation of its revenue and priority of its expenditure within a regulatory period.

Revenue from customer contributions

Revenue from customer contributions is deducted from gross capital expenditure so it is not included in the regulatory asset base.⁴⁵

We compared North East Water’s forecast for customer contributions with past outcomes, and its forecasts for growth in customer connections.⁴⁶ We consider North East Water’s forecast contributions are reasonable, having regard to past trends and its growth forecasts.

Our draft decision proposes to accept North East Water’s forecasts for customer contributions.

Cost of debt

Our guidance required North East Water to use estimates of the cost of debt provided by the commission to estimate its revenue requirement. North East Water used the cost of debt values we specified to calculate its revenue requirement. For this reason, our draft decision accepts the cost of debt proposed by North East Water, as set out in Table 2.8.

Table 2.8 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%	4.9%*

* Estimated cost of debt – we will update the 2017-18 figure before the final decision and price determination.

Note: Numbers have been rounded

From 2016, we accepted a ten-year trailing average approach to estimating the benchmark cost of debt, changing from an on-the-day approach. The trailing average approach better aligns the

⁴⁵ Revenue from new customer contributions reflects revenue earned from new connections made to a water corporation’s water, sewerage or recycled water networks.

⁴⁶ Growth in customer connections can be used as an indicator of growth in customer contributions.

actual cost of debt for an efficient business to the regulated benchmark, compared with an on-the-day approach.⁴⁷ We consider the ten year trailing average approach helps to minimise risk to water corporations and provides better incentives for long-term investment.

Return on equity – PREMO rating

North East Water rated its price submission as ‘Advanced’. Based on its PREMO self-rating, North East Water could have proposed a rate of return on equity of 4.9 per cent per annum. This reflects the maximum return rate allowed in our guidance for a price submission rated as ‘Advanced’.⁴⁸

This return on equity is similar to the range of rates we have approved in past reviews for 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.⁴⁹

As outlined at Chapter 3, our draft decision accepts North East Water’s proposed PREMO rating of ‘Advanced’. North East Water proposed a lower return on equity than the maximum allowed for an ‘Advanced’ PREMO self-rating. It proposed a return on equity of 4.1 per cent per annum, rather than the 4.9 per cent allowed given its PREMO self-rating.

Our draft decision is to accept North East Water’s proposed return on equity of 4.1 per cent, as this is lower than the maximum allowed for an ‘Advanced’ PREMO rating.

Regulatory depreciation

Regulatory depreciation is an input to calculating the regulatory asset base. North East Water’s forecast regulatory depreciation⁵⁰ was calculated using a straight line depreciation profile. We noted in our guidance that we prefer this approach.⁵¹

Our draft decision on regulatory depreciation differs from North East Water’s proposal due to our proposed adjustments to capital expenditure. Our final decision will confirm the regulatory depreciation to be reflected in the forecast regulatory asset base.

Our draft decision on regulatory depreciation is shown in Table 2.2.

⁴⁷ For more detail on the trailing average and on the day approaches to the cost of debt, see Essential Services Commission 2016, *Water pricing framework*, op. cit., p.27.

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

⁴⁹ 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.

⁵⁰ For the period from 2018-19 to 2022-23, North East Water proposed a regulatory depreciation of \$49.4 million.

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

Tax allowance

The tax allowance is an input into the revenue requirement. North East Water has proposed no allowance for tax in its revenue requirement. Our draft decision is to accept the forecast as it was calculated consistently with the method required by our guidance.⁵²

Demand

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

North East Water's demand forecasts are set out at pages 32 to 33 of its price submission, and are also included in its financial model. Our draft decision proposes to accept North East Water's demand forecasts for the purpose of approving maximum prices as we consider they were estimated in a manner that is consistent with the requirements of our guidance. This includes basing demand forecasts on the latest *Victoria In Future* population growth forecasts issued by the Victorian Government.

Form of price control

North East Water proposed to continue with a price cap form of price control as set out on page 35 of its price submission.

Our draft decision is to approve North East Water's proposed form of price control as it allows for the recovery of sufficient revenue to cover the forecast efficient costs of providing services, and for it to deliver on any health, safety, social and environmental obligations.

A price cap also provides customers with price certainty, and means a water corporation is managing demand risk on behalf of its customers. We consider demand risk is more efficiently managed by a water corporation, rather than its customers.⁵³

Tariff structures

North East Water's proposed tariffs are set out at pages 33 to 34 and 60 to 65 of its price submission.⁵⁴ North East Water proposed to maintain its existing tariff structures:

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

⁵³ We note our determinations will 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 North East Water also provided the commission with a full list of its tariffs in response to a request for information. This list can be seen with North East Water's submission on our website www.esc.vic.gov.au.

- For residential and non-residential water services, North East Water proposed a two-part tariff with a fixed service charge and a variable usage component that depends on water use.
- For residential and non-residential sewerage services, North East Water proposed a fixed charge only. North East Water also proposes to maintain the current level of cost recovery tariff loadings for higher cost towns in its service area.

As outlined in our guidance, we have provided the water corporations with a large degree of discretion to decide on individual tariff structures.⁵⁵ This recognises water corporations are often best placed to consider the interests of customers in designing tariffs, and that existing tariff structures have been developed over time to deal with a variety of local circumstances. We note North East Water's finding that customers generally supported its existing tariff structures.

Two-part tariffs

We consider the two-part structure proposed by North East Water for its residential and non-residential water service tariffs will promote efficient use of services. The two-part structure for water tariffs sends customers a signal about costs of their water use, and is an approach that is commonly applied in other states and territories.⁵⁶ We also consider two-part tariff structures are easy to understand.

We consider a single fixed charge for residential sewerage customers sends signals about the efficient costs of sewerage services.

Price levels

North East Water proposed a price increase of 0.45 per cent per annum (from 1 July 2018) across all tariffs.⁵⁷

Submissions by Gerald Mallon and the Consumer Action Law Centre highlighted the impact price changes may have on some customers, particularly those with low or fixed incomes.⁵⁸ North East Water proposed to increase its annual contributions to a customer hardship fund, and to continue enhancing its customer support program and provide assistance to those in financial distress.

⁵⁵ Essential Services Commission 2016, *Guidance paper*, op. cit., p. 55.

⁵⁶ Includes the tariffs of Icon Water, Sydney Water, Hunter Water, Gosford City Council, Wyong Shire Council, Power and Water Corp, Urban Utilities, Unity Water, SA Water and TasWater.

⁵⁷ During the third regulatory period North East Water passed on the government's efficiency savings through lower prices, not a rebate. The proposed increase in prices is in reference to their actual 2017-18 price which incorporates the efficiency savings.

⁵⁸ Gerald Mallon 2017, *Submission*, 7 November; Consumer Action Law Centre 2017, *Initial Feedback: 2018 Water Price Review*, 15 November.

Given North East Water has proposed prices that will generate revenue below the amount we consider they may recover under our pricing framework, our draft decision proposes to accept North East Water's proposed prices. Our intention is that North East Water will not be able to claim any revenue foregone in future regulatory periods.

Unique services

North East Water has confirmed its proposed tariffs for recycled water, trade waste and miscellaneous services are calculated in accordance with the pricing principles referenced in our guidance.

Draft decision

For the reasons set out above, our draft decision accepts North East Water's proposed tariffs, as set out at pages 33 to 34 and 60 to 65 of its price submission.

Prior to our final decision and price determination, North East Water must submit updated prices to reflect our updates to cost of debt and inflation estimates, which we will provide in late April 2018.

Adjusting prices

North East Water did not propose any price adjustment mechanisms in its price submission, but provided further detail in response to our queries. It proposed:

- to continue with its existing uncertain and unforeseen events mechanism
- to accept a cost of debt adjustment mechanism determined by the commission

Our draft decision accepts North East Water's proposal to continue the existing uncertain and unforeseen events mechanism. We noted in our guidance that we propose that the mechanism continues in its current form.

North East Water has not included adjustments to reflect movements in the cost of debt, as set out in our guidance. We require North East Water to work with the commission on a revised price adjustment formula, allowing for adjustments to reflect movements in the cost of debt.

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 businesses and developers to negotiate a site-specific arrangement.

Our assessment

North East Water's proposed charges for new customer contributions are set out at page 36 of its price submission. For standard water and sewerage charges, North East Water proposed an annual increase of 0.45 per cent on the 2017-18 charge until 2025-26.

For negotiated new customer contributions, North East Water proposes to continue to calculate a charge in accordance with the requirements of our NCC principles.⁵⁹

We have reviewed North East Water's proposed charges and consider them consistent with the requirements of our guidance and the NCC pricing principles.⁶⁰ For this reason, our draft decision proposes to accept North East Water's proposed new customer contribution charges.

Financial position

In approving prices, we must have regard to the financial viability of the water industry.⁶¹ 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 high 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.

North East Water's price submission and the supporting financial model provided estimates for key indicators of financial performance. These estimates were based on North East Water's assumptions about revenue and expenditure. We have reviewed the key indicators of financial performance based on our draft decision. Under our draft decision, we consider North East Water will generate sufficient cash flow to deliver on service commitments, including financing costs arising from investments to meet service expectations.

⁵⁹ Essential Services Commission 2016, *Guidance paper, op. cit.*, p. 62.

⁶⁰ In response to a request for information, North East Water provided supporting modelling showing its regard for incremental costs and incremental revenue.

⁶¹ WIRO clause 8(b)(ii) and ESC Act s.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 draft decision is to accept North East Water's proposed return on equity of 4.1 per cent. Below, we set out our preliminary assessment of North East Water's proposed PREMO rating.

Our review of North East Water's PREMO self-rating

North East Water's proposed PREMO rating, and our draft decision is summarised below.

Table 3.1 PREMO Rating

	Overall PREMO rating	Risk	Engagement	Management	Outcomes
North East Water's rating	Advanced	Advanced	Leading	Advanced	Advanced
Commission's rating	Advanced	Advanced	Leading	Advanced	Advanced

We agree with North East Water's proposed overall PREMO self-rating of 'Advanced', and its proposed rating for each element of PREMO. In support of its self-ratings we note:

- While North East Water proposed a price increase of 0.45 per cent per annum, this is from a starting point of relatively low prices. North East Water has the lowest typical residential

customer bill in Australia.⁶² Its forecast operating costs included higher than industry average improvements in controllable operating costs per customer (a measure of efficiency). These factors support North East Water's self-rating of 'Advanced' for the Management element of PREMO.

- North East Water's engagement was inclusive and provided customers multiple ways to contribute to, and influence proposals. Early in the engagement program customers were able to influence the format, timing and content of North East Water's engagement program. It engaged with a variety of customers through surveys, social media, focus groups, workshops and stakeholder reference groups. It held pop-up kiosks across its service area to ensure that all customers had an opportunity to participate. It was one of the few water corporations to use a deliberative forum, which provided a representative group of customers six days to deliberate on matters and make recommendations to North East Water. Matters explored by the deliberative forum included the length of the regulatory period, service standards and priorities, the guaranteed service level scheme, and tariffs. These factors support North East Water's self-rating of 'Leading' for the Outcome element of PREMO.
- The influence of the findings of North East Water's engagement on its proposals. North East Water adopted a large majority of the deliberative forum recommendations. The corporation also provided feedback to participants on why any recommendations were not accepted or the reasons for varying the recommendations provided by the panel. These factors support North East Water's self-rating of 'Advanced' for the Outcome element of PREMO.
- North East Water's management of risk on behalf of its customers, including through absorbing risks (such as demand and expenditure forecasting risk) over its proposed eight year regulatory period. It has also sought to proactively manage its approach to electricity consumption, including investments in renewals to help manage its costs and minimise customer prices.

While there were some aspects of its capital forecast which were not well justified (particularly 2012-13 actual expenditure and the inclusion of contingencies for several large wastewater projects), in general North East Water's price submission was underpinned by reasonable estimates.

In assessing whether to accept North East Water's self-rating of 'Advanced' for Management, we also took into account the correction it made to the treatment of new customer contributions revenue, after we received its initial price submission.

While North East Water could have responded by raising customer prices (to generate revenue to recover forecasts of its efficient costs), it decided to maintain the prices set out in its price

⁶² Bureau of Meteorology 2018, op. cit.

submission. North East Water has demonstrated accountability to customers, by committing to deliver on the prices it originally proposed.

Given these factors, on balance we have accepted North East Water's self-rating of 'Advanced' for the Management element of PREMO.

4. We invite feedback on our draft decision

We invite feedback from stakeholders on our draft decision before we make a final decision and price determination. Our final decision and price determination will be made in June 2018.

Stakeholders may comment on any aspect of our draft decision, including the information we have relied upon in our assessment (such as North East Water's price submission). Feedback may also cover:

- additional matters or issues we should consider before making our final decision
- whether our draft decision on North East Water's price submission has adequate regard to the matters in clause 11 of the WIRO and our guidance.

How to provide feedback:

Attend a public forum

We will hold a public forum in April or May 2018. Forums provide an opportunity for interested parties to discuss key features of our draft decisions. We will publish details of public forums at www.esc.vic.gov.au/waterpricereview.

Provide written comments or submissions

Written comments or submissions in response to this draft decision will be due in early May 2018.

We require submissions by this date so we have time to fully consider submissions for our final decision. Comments or submissions received after this date may not be afforded the same weight as submissions received by the due date.

We would prefer to receive comments and submissions via our website at www.esc.vic.gov.au/waterpricereview.

Alternatively, you may send comments and submissions by mail to:

2018 Water Price Review
Essential Services Commission
Level 37, 2 Lonsdale Street
Melbourne VIC 3000

We usually make all comments and submissions publicly available in the interests of transparency. If you wish part or all of your submission to be private, please discuss with commission staff.

We invite feedback

If you cannot access documents related to our price review, please contact us to make alternative arrangements (phone (03) 9032 1300).

Next steps

Indicative dates are provided below. To keep up-to-date, visit our website at www.esc.vic.gov.au/waterpricereview.

- April or May 2018 – public forum.
- 8 May 2018 – closing date for submissions on our draft decision.
- June 2018 – release date for final decision and price determination.

APPENDIX A – submissions received

Name or organisation	Date received
Environment Protection Authority Victoria	12 December 2017
Consumer Action Law Centre	15 November 2017
Mr G Mallon	7 November 2017