

North East Water final decision

2018 Water Price Review

19 June 2018

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Summary

In September 2017, North East Water provided a submission to us proposing prices for an eight year period starting 1 July 2018

In March 2017, we released our draft decision on North East Water's price submission.¹ The draft decision set out our preliminary views on North East Water's proposals, and invited interested parties to make further submissions. We also held a public meeting in April 2018. In addition to a response from North East Water, we received three 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 North East Water.² The price determination sets out the maximum prices North East Water may charge for prescribed services (or the manner in which its prices are to be calculated, determined, or otherwise regulated) for the eight year period from 1 July 2018 (2018–26). This final decision paper sets out our supporting reasons and analysis.

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 approves a revenue requirement of \$499.5 million over the eight year period starting 1 July 2018.³ This is the same as our draft decision.

A summary of approved maximum prices for major services delivered by North East Water is set out on page 27. The estimated typical bill impacts of North East Water's proposal and our final

¹ Clause 16 of the Water Industry Regulatory Order 2014 requires us to issue a draft decision. North East 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, *North East Water Determination: 1 July 2018 – 30 June 2026*, 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 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.

decision on residential customers are provided in Table A. Typical bills for an owner occupier will rise by around \$4 in 2018-19 and by around \$2 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	2025-26 annual bill
Residential (Owner occupier)	190	\$871	\$875	\$903
Residential (Tenant)	190	\$426	\$428	\$442

Note: Numbers have been rounded

North East Water will improve services

Our final decision approves prices that will allow North East 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 North East Water plans to improve outcomes for customers are by:

- 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.

In addition to its guaranteed service level scheme, if it does not meet certain service targets, North East Water will provide a rebate to its customers. The rebate is payable in 2023-24, with the amount varying depending on the number of service targets missed during the 2018-23 period.

Tariff structures are the same

Our final decision approves North East Water’s proposed tariff structures, which reflect a continuation of its current approach. For water services, we have approved North East Water’s proposal for a fixed service charge and a variable component that depends on water use. For sewerage services, we have approved North East Water’s proposal for a fixed charge only.

Our final decision also 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 any other price adjustments we approve in our price determination. North East Water currently uses a price cap.

For more detail on tariffs and the form of price control, see pages 25 to 28.

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

Consistent with our draft decision, our final decision accepts North East Water’s PREMO self-rating of its price submission as ‘Advanced’. 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. North East Water has the lowest typical residential customer bill in Australia.⁴ Its forecast operating costs also included a relatively high rate of improvement in cost efficiency. We also consider North East Water provided customers multiple ways to contribute to and influence proposals, consistent with a ‘Leading’ engagement program. These factors support North East Water’s PREMO ratings.

Figures A and B summarise our final decision on PREMO. More detail on our assessment of Barwon Water’s PREMO rating is provided in Chapter 3. North East 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

	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

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

Figure B Final decision on PREMO – overall rating

Leading	Advanced	Standard	Basic	Not rated
Goulburn Valley Water	Barwon Water	East Gippsland Water	Wannon Water	South Gippsland Water
	Central Highlands Water	Gippsland Water		Western Water *
	City West Water	Lower Murray Water (urban)		
	Coliban Water	Westernport Water		
	GWMWater			
	North East Water			
	South East Water			
	Southern Rural Water			
	Yarra Valley 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.⁵ The prescribed services include retail water and sewerage services, and bulk water and sewerage services delivered by the water corporations.⁶

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

⁵ 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.

⁶ The prescribed services are listed at clause 7(b) of the WIRO.

- the matters specified in our guidance⁷
- 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 we have done so for our final decision for North East Water.⁸

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.⁹

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.¹⁰

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.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

⁷ Essential Services Commission 2016, *2018 Water Price Review: Guidance paper*, November.

⁸ Essential Services Commission 2018, *North East 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.

⁹ This is a requirement of the WIRO, clause 14(b).

¹⁰ This is provided for under the WIRO, clause 14(b)(i).

¹¹ See Part 13, Division 5 of the *Water Act 1989 (Vic)*.

¹² 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.¹³ 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 2016.¹⁴

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.

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

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.

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

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

We have made our price determination for North East Water after considering: North East 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 North East Water's price submission are available on our website (to the extent the content 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, with our preliminary assessment set out in our draft decision. Our final decision is set out below.

Regulatory period

Our draft decision accepted the eight year regulatory period (1 July 2018 to 30 June 2026) proposed by North East Water in its price submission for a number of reasons, including:

- 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
- North East Water committed to reporting and reviewing mechanisms (including publicly available report cards) during the period, providing a transparent way to track its performance.

Our draft decision noted that a mid-point review in 2022 would 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).

In response to our draft decision, the 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.

We acknowledge there are advantages and disadvantages of allowing a different regulatory period for each water corporation. Given the diversity of the sector, we believe allowing flexibility is in the

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

interests of customers, where it is sufficiently justified by a water corporation. We note that North East Water's engagement found that its customers sought longer-term price certainty. Other potential benefits of a relatively long regulatory period include reduced regulatory costs. We also prefer flexibility to approve a relatively short regulatory period where we consider a water corporation has not sufficiently justified its proposals.

Our final decision approves an eight year regulatory period from 1 July 2018 for North East Water, for the same reasons set out in our draft decision.

There will be 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).

Reporting during the eight year regulatory period

We required North East Water's response to our draft decision to list the matters its report cards would use to track business performance over its proposed eight year period.

North East Water's response indicated that matters covered would include service quality and reliability, compliance with water quality standards, and customer satisfaction. North East Water noted it will undertake further work to design specific measures for the report cards, in consultation with customers and stakeholders.

North East Water must engage with us as it undertakes this work. In addition to measuring service outcomes, our expectation is the report cards will include measures covering North East Water's financial performance and outlook (based on the indicators used by the commission to assess financial viability), comparisons of revenue and costs against the benchmarks adopted in our price determination, and progress delivering major projects. This should draw on existing reporting requirements, such as regulatory accounts, to minimise costs.

The reporting will inform the mid-point review in 2022.

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.²¹

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.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 customer engagement.

Outcomes

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

- 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.

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

- 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.

²¹ North East Water's price submission is available on our website at www.esc.vic.gov.au. See pages 6 to 11.

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.

North East Water's proposed measures and targets for reporting against these outcomes are set out on pages 12 to 20 of its price submission. North East Water has committed to reporting to customers against each of these measures. Performance information will be available on its website, and links will be provided through social media and announcements in regional press.

In early 2018-19, we will engage with North East Water to finalise the set of measures, targets, and how it will report on its achievement against outcomes to customers. Its performance will inform our assessment during future price reviews as part of the Performance element of PREMO assessments.

CALC commented on the need for additional funding for regional water corporations to strengthen existing hardship programs or adopt new practices to assist vulnerable customers.²⁴ CALC cited our 2013 price review where we provided an additional allowance for metropolitan water corporations to expend existing hardship programs or introduce new hardship programs.

We have not adopted CALC's recommendation in our final decision. We note that the additional allowance in our 2013 price review was provided in recognition of the large one-off price increases approved for the metropolitan corporations during the review.²⁵ Further, water corporations already allocate funds to programs aimed to deliver payment options and hardship support required by our customer service codes. North East Water has responded to its customers' views on affordability by proposing to increase its customer hardship fund and continue to develop programs to support customers in financial difficulty.

Service Standards

North East 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 North East Water's targets until 2023 are set out in Appendix B.

In a submission on our draft decision CALC noted a range of ambitions by water corporations when it comes to proposed service standards and that water corporations should be encouraged to 'improve service standards over time'.²⁶

North East Water proposed reducing some targets for reliability and attending faults noting previous targets required performance levels far higher than other rural water corporations.

²⁴ *ibid*, p. 3.

²⁵ The increase in prices approved in 2013 for metropolitan Melbourne was around 20 to 25 per cent. We note for most water corporations in our 2018 price review, generally prices are remaining relatively steady, or falling.

²⁶ Consumer Action Law Centre, *op. cit.*, p. 6.

We accept there are arguments for maintaining or decreasing service levels over time particularly where engagement identifies customers are satisfied with the existing level of service or do not support increasing expenditure to deliver improved service. We note that North East Water's proposed targets for reliability and attending faults were informed by customers during its deliberative forum. This aligns with our expectation that water corporations consider customer preferences and use appropriate engagement methods when asking customers to consider complex trade-offs.

Approved service standards relating to reliability and attending faults are set out in Appendix B of this final decision and form part of the manner in which North East Water's services are regulated.

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.

North East Water's proposed GSLs are set out in appendix 8 of its price submission. It proposed to maintain existing GSLs on the advice of its deliberative forum.²⁷ In our draft decision we provided an overview of North East Water's proposed GSLs. In a submission responding to our draft decisions, Consumer Action Law Action Centre supported GSL payments increasing over time.²⁸ We note North East Water has proposed no change to the payment amounts for its GSLs.

North East Water's proposed GSLs were informed by recommendations from its deliberative forum to reflect the aspects of service delivery most important to customers. For this reason, our final decision approves North East Water's proposed GSLs.

North East Water's GSLs are set out in Appendix C to this final decision.

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

²⁷ 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.

²⁸ Consumer Action Law Centre, *op. cit.*, p. 1.

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 the Environment Protection Authority Victoria and the Department of Health and Human Services.²⁹

Our draft decision proposed to approve a revenue requirement of \$499.5 million over an eight year period starting 1 July 2018, which reflected the demand forecast and prices proposed by North East Water. We note our building block method produced a 'notional' allowable revenue requirement of \$509.2 million, which was higher than that sought by North East Water.³⁰

Our final decision also approves a revenue requirement of \$499.5 million. The final decision revenue requirement is still below our updated notional allowable revenue requirement of \$500.9 million (Table 2.1). Adjustments to the notional allowable revenue requirement from our draft decision are set out in Table 2.2, and described later in this Chapter.

Our final decision approves the revenue requirement figure of \$499.5 million over an eight year period starting 1 July 2018, consistent with the reasons in our draft decision.

We also consider our final decision approves prices and a revenue requirement that enables North East Water to deliver on customer outcomes, government policy, and obligations.

²⁹ 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 Barwon Water in the regulatory period from 1 July 2018. We had regard to their views in our draft decision

³⁰ We called this a PREMO based revenue requirement in our draft decision.

Table 2.1 Final decision – Revenue requirement

\$ million 2017-18

	2018-19	2019-20	2020-21	2021-22	2022-23	2023-24	2024-25	2025-26	Total
Operating expenditure	40.8	40.8	40.3	39.7	40.6	40.1	40.2	40.4	322.9
Return on assets *	11.0	11.3	11.7	12.2	12.5	12.6	12.7	12.7	96.7
Regulatory depreciation	9.3	9.4	9.7	10.1	10.6	10.7	10.7	10.8	81.3
Tax allowance	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Max allowable revenue requirement *	61.1	61.5	61.7	62.0	63.6	63.4	63.7	63.8	500.9
Foregone revenue due to NCC error	-1.2	-0.9	-0.4	0.1	-0.9	0.1	0.6	1.2	-1.4
Final 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

* Assumes a return on equity of 4.9 per cent, consistent with the maximum rate allowed for an 'Advanced' PREMO price submission rating.

Table 2.2 Notional allowable revenue requirement

\$ million 2017-18

	2018-19	2019-20	2020-21	2021-22	2022-23	2023-24	2024-25	2025-26	Total
Draft decision – notional revenue requirement *	62.6	62.8	63.2	63.3	64.4	64.1	64.4	64.5	509.2
Operating expenditure	-1.3	-1.1	-1.3	-1.2	-0.6	-0.6	-0.6	-0.5	-7.1
Return on assets	-0.2	-0.2	-0.2	-0.2	-0.2	-0.2	-0.2	-0.2	-1.4
Regulatory depreciation	0.00	0.01	0.03	0.03	0.03	0.03	0.03	0.03	0.20
Total adjustments	-1.5	-1.2	-1.4	-1.3	-0.7	-0.7	-0.7	-0.7	-8.3
Final decision – notional revenue requirement *	61.1	61.5	61.7	62.0	63.6	63.4	63.7	63.8	500.9

* Assumes a return on equity of 4.9 per cent, consistent with the maximum rate allowed for an ‘Advanced’ PREMO price submission rating.

Operating expenditure

Operating expenditure is an input to the revenue requirement. Our draft decision proposed to adopt a \$301.4 million benchmark for North East Water’s forecast controllable operating costs for the 2018–26 period. This was \$10.3 million lower than proposed by North East Water, and we set out our reasoning for this adjustment in our draft decision (pages 12 to 19). In summary, we found:

- Evidence indicating its baseline controllable operating expenditure reflects an efficient benchmark.³¹
- \$7.33 million for wage increases above inflation should be managed by the corporation within productivity improvements or its customer connection growth allowance.
- \$3.00 million for a digital metering project should be excluded from operating expenditure, but we allowed \$1.00 million within forecast capital expenditure for further investigations and trials.

Our draft decision also requested an updated forecast for electricity costs based on any new contract prices, given the uncertainty around electricity prices at the time of the price submission.

³¹ Controllable costs are those that can be directly or indirectly influenced by a water corporation’s decisions.

We forecasted \$28.6 million for North East Water's non-controllable operating costs for the 2018–26 period.³² We noted in our draft decision that we would update this forecast for our final decision, and adjust for the latest inflation and external bulk charges data.

North East Water's response to our draft decision provided new information for labour, a payroll tax adjustment, and an updated forecast for electricity, and accepted the commission's other adjustments to its price submission proposal:

- The 2017-18 payroll tax reduced from 4.85 per cent to 3.65 per cent for regional corporations. In addition, the 2018-19 Victorian budget cut the payroll tax from 3.65 per cent to 2.425 per cent for regional corporations from 1 July 2018. As a result, North East Water has advised a reduction of \$3.32 million across the 2018–26 period compared to its baseline year. This is consistent with our draft decision requirement to be provided with updated forecasts if there is a change in legislation or government policy, and we have reduced the forecast accordingly.
- In its response, North East Water re-argued for its wage increases above inflation to be included as additional costs and requested, as a minimum, an additional 0.67 per cent of its wage costs above the baseline.³³ North East Water's controllable operating expenditure, including the wages component, increases by 1.23 per cent per year through the customer connection growth allowance. With no forecast increase in the number of FTE positions across the period, the growth allowance should adequately cover the difference between inflation and the 3.0 per cent wage increase provided by the enterprise bargaining agreement. Therefore, our final decision on labour costs remains unchanged from our draft decision.
- North East Water provided an updated forecast based on the updated VicWater electricity price forecast report, as it doesn't have updated contract prices available.³⁴ North East Water used the 'Status Quo' (high price) scenario for the first five years of 2018–26, and assumed that prices then remain constant in real terms across the final three years. We note the report states the NEG (medium) scenario is now looking much more likely than the other scenarios, and we consider this scenario provides a more reasonable basis for forecasting a benchmark electricity

³² Non-controllable costs are those that cannot be directly or indirectly influenced by a water corporation's decisions.

³³ Our pricing approach does not necessarily allow for the direct pass through of costs incurred (or forecast to be incurred) by a water corporation. This approach is commonly adopted by economic regulators, and is consistent with efficiency objectives in the WIRO. For example, in the Australian Energy Regulator's 2015 decision for the SA Power Networks (SAPN) 2015-20 regulatory period, it rejected SAPN's proposed annual wage increase because it considered them above the efficient market rate. SAPN's proposal had reflected its future actual wage costs, arising from an enterprise agreement it had entered into with its employees. The AER's approach in relation to labour costs was affirmed as reasonable by both the Tribunal and the Full Federal Court.

³⁴ The VicWater Supply Chain Excellence Program 5 Year Electricity Price Forecast May 2018 sets out three scenarios; 'Status Quo', 'National Energy Guarantee' (NEG) and 'Luddite' (broadly corresponding to high, medium and low). The prices in the report are expressed in nominal terms, and must be converted to 2017-18 real terms for use in our financial models.

cost.³⁵ We have calculated a revised forecast in real terms based on the medium scenario, and accordingly we have reduced our draft decision on North East Water's electricity costs by \$3.90 million across the 2018–26 period.

Following our draft decision, North East Water advised us it did not intend that forecast electricity cost savings would be included in addition to its targeted 1.2 per cent annual cost efficiency improvement rate set out in its price submission. It asked that our pricing model be adjusted for this, noting its view that the unintended outcome of the draft decision was to double count forecast reductions in electricity costs. We consider our draft decision correctly assessed North East Water's submission, as presented by the business. We also note that North East Water's proposed adjustment has no effect on customer prices because of its commitment to a specified price path. For these reasons, we have not adjusted our pricing model as requested by North East Water.³⁶

CALC's submission to our draft decision supported our approach of adjusting forecast electricity costs and limiting wage increases in operating expenditure above the baseline.³⁷ 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 costs is \$7.22 million lower than 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 revised our forecast environmental contribution from our draft decision, and made no changes to forecast licence fees or external bulk charges.³⁸

Based on the latest inflation data, we have revised the forecast 2018-19 environmental contribution from \$2.47 million to \$2.48 million, which results in a total increase of \$0.08 million across the 2018–26 period.

Accordingly, we have increased our draft decision forecast for North East Water's non-controllable operating expenditure by \$0.08 million to \$28.66 million across the 2018–26 period.

³⁵ 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 recommended a \$3.90 million for our final decision.

³⁶ North East Water raised concerns about the impact of the efficiency assumptions on future cost benchmarking. We will take our final decision approach into account in future price reviews.

³⁷ Consumer Action Law Centre, op. cit.

³⁸ 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 2018–26 regulatory period.

Table 2.3 sets out our adjustments from our draft decision for controllable and 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	2023-24	2024-25	2025-26	Total
Draft decision – total operating expenditure	42.2	41.9	41.6	40.9	41.2	40.7	40.8	40.9	330.0
Payroll tax	-0.40	-0.41	-0.41	-0.41	-0.42	-0.42	-0.42	-0.42	-3.32
Electricity	-0.93	-0.68	-0.91	-0.76	-0.19	-0.18	-0.15	-0.09	-3.90
Total adjustments to controllable costs	-1.33	-1.09	-1.33	-1.18	-0.61	-0.60	-0.57	-0.52	-7.22
Environment contribution	0.010	0.010	0.010	0.010	0.010	0.009	0.009	0.009	0.076
Total adjustments to non-controllable costs	0.010	0.010	0.010	0.010	0.010	0.009	0.009	0.009	0.076
Final decision – total operating expenditure	40.8	40.8	40.3	39.7	40.6	40.1	40.2	40.4	322.9

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 North East Water’s revenue requirement (Table 2.1). We consider our final decision for North East 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.³⁹

Table 2.4 Final 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	37.3	37.3	36.7	36.2	37.0	36.5	36.6	36.7	294.2
Non-controllable costs	3.6	3.5	3.5	3.5	3.6	3.6	3.6	3.7	28.7
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	18.6
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
Other	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Final decision – total operating expenditure	40.8	40.8	40.3	39.7	40.6	40.1	40.2	40.4	322.9

^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* (Vic)

^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 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

³⁹ 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 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 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 adopted North East Water's proposed amounts for past net capital expenditure to estimate its closing regulatory asset base.⁴⁰ However, we required North East Water to 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.⁴¹

Following our draft decision, North East Water provided additional information in support of its proposed closing regulatory asset base. This showed that most of the net capital expenditure above its 2013 determination forecast related to its regional head office, the Bright offstream storage project, small town sewer projects, and the Bundalong water supply augmentation.

For these projects, North East Water provided additional material explaining the increases above the 2013 determination forecasts, including changes to initial project assumptions impacting the scope of works and costs. After reviewing the information provided by North East Water, we are satisfied that the additional net capital expenditure incurred in 2012-13 was prudent and efficient.

No other new considerations were raised in submissions on our draft decision that affected our assessment of the closing regulatory asset base.

For the reasons set out above, our final decision approves a closing regulatory asset base at 30 June 2017 of \$264.5 million. The calculations are provided at Table 2.5.

⁴⁰ Net capital expenditure is calculated by deducting government and customer contributions from gross capital expenditure.

⁴¹ 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	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 final decision on North East Water's forecast regulatory asset base from 1 July 2018.⁴² Our assessment of each component of the regulatory asset base is discussed below.

⁴² 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	2023-24	2024-25	2025-26
Opening RAB 1 July	264.5	264.5	269.1	278.1	288.5	301.5	304.7	307.1	308.2
Plus gross capital expenditure	12.1	16.0	20.7	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	10.6	10.7	10.7	10.8
Closing RAB 30 June	264.5	269.1	278.1	288.5	301.5	304.7	307.1	308.2	306.0

Note: Numbers have been rounded

Capital expenditure

Capital expenditure is an input to estimating the regulatory asset base. In our draft decision (pages 22 to 27), we proposed a gross capital expenditure forecast of \$140.3 million for North East Water for the 2018–26 period. In summary, we found:

- North East Water’s price submission and business cases provided evidence it has a robust approach for developing project scope and estimating costs.
- The planned capital expenditure program is achievable, given North East Water’s past track record delivering its capital expenditure program.
- North East Water has an appropriate approach for managing expenditure associated with uncertain projects.
- \$1.57 million of capital expenditure for major upgrades to the Wodonga wastewater treatment plant (WWTP) included excessive contingencies.
- \$0.98 million of capital expenditure for the Beechworth wastewater system upgrade should be removed to be consistent with the lowest cost option.

Our assessment

- \$4.22 million of capital expenditure above historical asset renewal levels was not justified.

North East Water's response to our draft decision proposed to:

- accept our \$4.2 million reduction for water and wastewater asset renewals
- accept our transfer of \$1.0 million from operating expenditure for a digital metering trial
- reinstate \$1.2 million for the Wodonga WWTP capacity upgrade and emissions reduction project
- reinstate \$0.4 million for the Wodonga WWTP major upgrades
- reinstate \$1.0 million for the Beechworth wastewater system upgrade.

For the Wodonga WWTP projects, North East Water's response proposed the re-inclusion of its original contingency amounts for the two projects. It did not consider the project management costs on top of the base project costs were contingency or risk costs, and therefore the additional contingency allowances were reasonable.⁴³ We do not consider that North East Water's response provided new justification to the additional contingency components that we removed for our draft decision. As a result, our final decision remains unchanged from our draft decision.

For our draft decision on the Beechworth system upgrade, it was unclear why North East Water did not choose the lowest cost option, so we removed \$0.98 million to be consistent with the lowest cost. In its response, North East Water highlighted its use of a multiple criteria analysis and its consultation with the Beechworth community, the Department of Environment Land Water and Planning, Parks Victoria and Indigo Shire. The community and stakeholders agreed an alternative solution to the lowest cost option, which requires major works through the Beechworth Historic Park, is required for this upgrade. We accept North East Water's proposal to include \$0.98 million above our draft decision for this project because we consider it better reflects prudent expenditure and the expectations of its customers.

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'. It stated that new technology must deliver tangible benefits for water customers and be backed by a comprehensive business case. North East Water has \$1.00 million of capital expenditure for a smart water meter trial. Its customers requested smart water meters to enable them to better monitor and manage their water consumption. This will be made possible with planned future improvements to North East Water's information management systems. We consider that North East Water's digital metering costs reflected in our draft and final decision are consistent with our guidance and CALC's view.

⁴³ We requested our expenditure consultant, Deloitte Access Economics, to review North East Water's response and compare against the information received for our draft decision. Deloitte did not recommend any adjustments for our final decision.

In its submission, CALC also recommended the commission sets industry-wide principles to ensure the rollout of smart meters is in the long-term interest of consumers, including support mechanisms for vulnerable customers.⁴⁴ 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 North East Water’s proposed increase for the Beechworth system upgrade in addition to the gross capital expenditure benchmark proposed in our draft decision for our final decision (Table 2.7). We consider this benchmark is consistent with our guidance and WIRO principles, and is used to calculate our final decision on North East Water’s forecast regulatory asset base (Table 2.6) and its revenue requirement (Table 2.1).⁴⁵

Table 2.7 Final decision – Gross capital expenditure
\$ million 2017-18

	2018-19	2019-20	2020-21	2021-22	2022-23	2023-24	2024-25	2025-26	Total
Draft decision – gross capital expenditure	15.6	20.2	22.4	25.4	16.1	15.5	14.3	11.0	140.3
Beechworth Wastewater System Upgrade	0.39	0.59	0.00	0.00	0.00	0.00	0.00	0.00	0.98
Total adjustments to gross capital expenditure	0.39	0.59	0.00	0.00	0.00	0.00	0.00	0.00	0.98
Final decision – gross capital expenditure	16.0	20.7	22.4	25.4	16.1	15.5	14.3	11.0	141.3

Note: Numbers have been rounded

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. Rather, it represents assumptions

⁴⁴ Consumer Action Law Centre, op. cit.

⁴⁵ 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. North East 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 North East Water's approach for addressing uncertain capital expenditure. We reiterate that North East Water will need to demonstrate the prudence and efficiency of additional costs incurred during the 2018–26 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 North East Water's forecast revenue from customer contributions was reasonable, having regard to past trends and its growth forecasts. We proposed to accept North East 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 confirms our draft decision. Our final decision benchmark for customer contributions is set out in Table 2.6.

Cost of debt

In our draft decision we proposed to approve the cost of debt proposed by North East 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.⁴⁶

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).⁴⁷ 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

⁴⁶ We received data on the actual trailing average cost of debt for 2017-18 from Treasury Corporation Victoria in April 2018.

⁴⁷ 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.⁴⁸

A submission by the Water Services Association of Australia (WSAA) addressed CALC’s submission.⁴⁹ 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.⁵⁰

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 2.8.⁵¹

Table 2.8 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

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’.⁵² It

⁴⁸ Consumer Action Law Centre, op. cit.

⁴⁹ Water Services Association of Australia 2018, *Submission*, May.

⁵⁰ 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).

⁵¹ 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.

⁵² Essential Services Commission 2016, *Guidance paper*, op. cit., p. 49.

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 accepted 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.

CALC recommended a one per cent reduction to each return on equity value in the PREMO matrix.⁵³ 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. The rate for the return on equity (and the regulatory rate of return, comprising the cost of debt and the return on equity) approved in our draft decision are similar to rates recently estimated by other Australian-based regulators of the water sector.⁵⁴ 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.

Our final decision estimate of the revenue requirement (page 11) includes an assumption for a return on equity of 4.9 per cent, reflecting the rate North East Water could have claimed under the PREMO framework (see Chapter 3). We note that for the purposes of establishing a rate of return for its price determination, we have accepted North East Water's proposed return on equity of 4.1 per cent per annum, noting this is lower than what it could have claimed.

Regulatory depreciation

Regulatory depreciation is an input to calculating the regulatory asset base. Our draft decision proposed to accept North East Water's forecast regulatory depreciation, as it was calculated in a manner consistent with the requirements of our guidance.⁵⁵

Our final decision on regulatory depreciation is slightly higher than our draft decision due to final decision adjustments to forecast capital expenditure, as set out in Table 2.7.

⁵³ Consumer Action Law Centre, *op. cit.*, p. 8.

⁵⁴ Essential Services Commission of South Australia 2016, *SA Water regulatory determination 2016*, Final Determination, June; Independent Pricing and Regulatory Tribunal 2017, *WACC biannual update*, February.

⁵⁵ Essential Services Commission 2016, *Guidance paper*, *op. cit.*, p. 42.

No new considerations for depreciation were raised in submissions on our draft decision.

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

Tax allowance

The tax allowance is an input into the revenue requirement. Our draft decision accepted North East Water's forecasts for zero tax payments, as it was calculated consistently with the method required by our guidance.⁵⁶ No new considerations were presented in submissions received following the draft decision which caused us to change our views on the tax allowance.

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

Demand

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

For these reasons, we consider it appropriate to maintain the views we expressed in our draft decision. Our final decision accepts the position in our draft decision for the same reasons, and accepts North East Water's demand forecasts.

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

Form of price control

Our draft decision accepted North East 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 new considerations were presented in submissions received following the draft decision which caused us to change our views on the form of price control.

⁵⁶ Essential Services Commission 2016, *Guidance paper*, op. cit., pp. 50-51.

For the reasons set out above, we consider it appropriate to maintain the views we expressed in our draft decision. Our final decision accepts the position in our draft decision for the same reasons, and approves North East Water's proposed price cap form of price control.⁵⁷

Tariff structures and prices

Our draft decision accepted North East Water's proposal to maintain its existing tariff structures, including:

- for residential and non-residential water services – a two-part tariff structure with a fixed service charge and a variable component that depends on water use
- for residential and non-residential sewerage services – a fixed service charge only.

We considered the two-part structure for water services will promote efficient use. It also provides customers a signal about their water use costs, and is an approach that is commonly applied in other states and territories.⁵⁸ We also considered two-part tariff structures are easy to understand.

We noted in our draft decision that North East Water found that customers generally supported its existing tariff structures. We provide water corporations with a large degree of discretion to decide on individual tariff structures.⁵⁹ This recognises water corporations are often best placed to consider the interests of customers in designing tariffs.

Our draft decision also accepted North East Water's proposal to continue its existing cost recovery tariff loadings for higher cost towns in its service area.

In its response to our draft decision, North East Water noted that our draft decision accepted its proposal to increase prices by 0.45 per cent (annual). The draft decision accepted North East Water's proposal to absorb the impact of a correction made to its treatment of new customer contributions revenue, meaning that its proposed prices would generate forecast revenue below the amount we consider they may recover under our usual approach to estimating the revenue requirement (based on an assessment of efficient costs).

Consistent with our draft decision, our final decision approves an average increase in prices of 0.45 per cent per year. North East Water will not be able to claim revenue foregone due to its decision to set prices below an amount that we would normally approve under our pricing approach, in future regulatory periods.

⁵⁷ 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.

⁵⁸ 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.

⁵⁹ Essential Services Commission 2016, *Guidance paper*, op. cit., p. 55.

No other new considerations were presented in submissions received following the draft decision which caused us to change our views on North East Water's proposed tariff structures and prices.⁶⁰

We consider the tariffs approved in our final decision take into account customers' interests, including low income and vulnerable customers, because:

- the proposed two-part structure for water services tariffs will promote efficient water use, and provide customers a signal about the costs of their water use
- the proposed tariffs were informed by an extensive customer engagement program
- the proposed tariffs would allow the corporation to recover revenue to support its financial viability (see pages 29 to 30)
- North East Water has payment options and assistance for customers experiencing difficulty paying bills.

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

Our price determination for North East Water sets out the maximum prices it may charge for the eight 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 2.9 and 2.10 (in \$2018–19).

⁶⁰ On 23 May 2018 (after our consultation period had closed on our draft decision for North East 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 North East Water. Our response to the submission is set out in our final decision paper for Western Water.

Table 2.9 Final decision – water prices
\$ 2018-19

	2018-19	2019-20	2020-21	2021-22	2022-23	2023-24	2024-25	2025-26
Residential								
Variable (\$/kL)	2.2547	2.2649	2.2751	2.2853	2.2956	2.3059	2.3163	2.3267
Fixed (\$/year)	207.12	208.05	208.99	209.93	210.87	211.82	212.77	213.73
Non-residential								
Variable (\$/kL)	2.2547	2.2649	2.2751	2.2853	2.2956	2.3059	2.3163	2.3267
Fixed (\$/year)	207.12	208.05	208.99	209.93	210.87	211.82	212.77	213.73

Note: Numbers have been rounded down

Table 2.10 Final decision – sewerage charges
\$ 2018-19

	2018-19	2019-20	2020-21	2021-22	2022-23	2023-24	2024-25	2025-26
Residential								
Fixed (\$/year)	239.16	240.23	241.31	242.40	243.49	244.59	245.69	246.79
Non-residential								
Fixed (\$/year)	239.16	240.23	241.31	242.40	243.49	244.59	245.69	246.79

Note: Numbers have been rounded down

Adjusting prices

In our draft decision we:

- proposed to approve North East Water’s proposal to continue the existing uncertain and unforeseen events mechanism
- proposed to work with North East Water on price adjustment formulas that allowed prices to adjust to changes in the cost of debt.

North East Water’s worked with the commission to establish a cost of debt adjustment formula that was consistent across the industry. Our approved cost of debt adjustment formula is set out in our determination for North East Water.

Our final decision approves North East Water’s uncertain and unforeseen events mechanism and updated price adjustment mechanisms as they satisfy the requirements of our guidance.

Our assessment

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 draft decision proposed to accept North East Water's proposed charges for new customer contributions, which included an annual real increase of 0.45 per cent on its standard water and sewerage new customer contribution charges until 2025-26.

For negotiated new customer contributions, we proposed to accept North East Water proposal to continue to calculate charges in accordance with the requirements of our new customer contribution pricing principles.

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.

For the reasons set out above, we consider it appropriate to maintain the views expressed in our draft decision. Our final decision accepts the position in our draft decision for the same reasons, and accepts North East 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.⁶¹

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

North East 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.⁶²

Financial position

In approving prices, we must have regard to the financial viability of the water industry.⁶³ We interpret the financial viability requirements under the *Essential Services Commission Act 2001*

⁶¹ Essential Services Commission 2016, *Guidance paper, op. cit.*, pp. 62-63.

⁶² Essential Services Commission 2013, *New Customer Contributions: Explanatory Note, December*, pp. 9-11.

⁶³ WIRO clause 8(b)(ii) and ESC Act section 8A(1)(b).

(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 North East Water's prices. We have assessed that, under our final decision, North East Water will generate sufficient cash flow to deliver on service commitments, including financing costs arising from investments to meet service expectations.

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 North East Water’s proposed return on equity of 4.1 per cent, based on our PREMO review.

Our review of North East Water’s PREMO rating

North East 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
North East Water’s rating	Advanced	Advanced	Leading	Advanced	Advanced
Commission’s draft decision rating	Advanced	Advanced	Leading	Advanced	Advanced
Commission’s final decision rating	Advanced	Advanced	Leading	Advanced	Advanced

Consistent with our draft decision, our final decision accepts North East Water’s proposed rating for each element of PREMO. In support of its PREMO ratings we note:

- While North East Water’s proposed a price increase (of 0.45 per cent per annum, as outlined in its price submission), this was from a starting point of relatively low prices. North East Water has

the lowest typical residential customer bill in Australia.⁶⁴ Its forecast operating costs included higher than industry average improvements in controllable operating costs per customer (a measure of efficiency) (Figure 3.1). These factors support North East Water's self-rating of 'Advanced' for 'Management'.

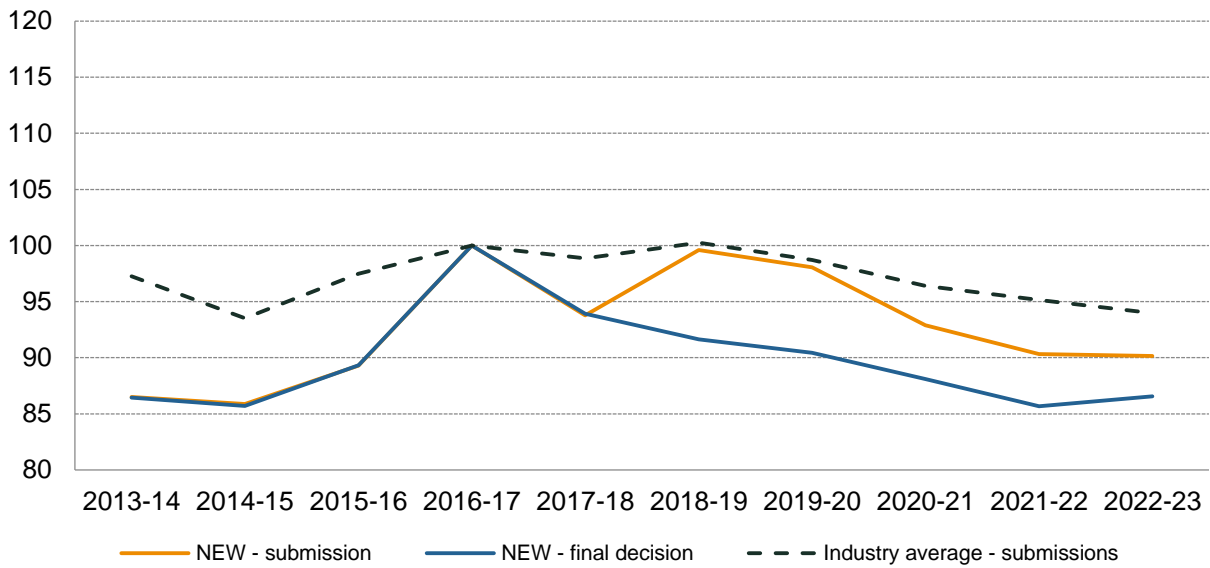
- North East Water's engagement was inclusive and provided customers multiple ways to contribute to, and influence proposals. Early in the engagement program customers were able to influence the format, timing and content of North East Water's engagement. It engaged with customers through surveys, social 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 a rating of 'Leading' for Engagement.
- The influence of North East Water's engagement on its proposals. North East Water adopted a large majority of the deliberative forum's 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.

Consistent with our draft decision, we agree with North East Water's proposed overall PREMO self-rating of 'Advanced'. This is reflected in the return on equity we have approved at pages 23 to 24.

⁶⁴ Bureau of Meteorology 2018, op. cit.

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	15 May 2018
Consumer Action Law Centre	8 May 2018

Appendix B – approved service standards

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

North East Water's approved service standards

Service Standard	2018-19	2019-20	2020-21	2021-22	2022-23	2023-24	2024-25	2025-26
Water								
Number of customers experiencing more than 5 unplanned water supply interruptions in the year (number)	375	375	375	375	375	375	375	375
Average time taken to attend bursts and leaks (priority 1) (minutes)	30	30	30	30	30	30	30	30
Average time taken to attend bursts and leaks (priority 2) (minutes)	30	30	30	30	30	30	30	30
Average time taken to attend bursts and leaks (priority 3) (minutes)	240	240	240	240	240	240	240	240
Average duration of unplanned water supply interruptions (minutes)	100	100	100	100	100	100	100	100
Average duration of planned water supply interruptions (minutes)	95	95	95	95	95	95	95	95
Sewerage								
Customers receiving more than 3 sewer blockages in the year (number)	14	14	14	14	14	14	14	14
Average time to attend sewer spills and blockages (minutes)	30	30	30	30	30	30	30	30
Average time to rectify a sewer blockage (minutes)	140	140	140	140	140	140	140	140
Spills contained within 5 hours (per cent)	100	100	100	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 North East Water.

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

North East 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 North East Water.

North East Water’s approved GSL scheme

Approved service level obligation	Approved payment (\$)
Unplanned water interruptions within any 12 month period	50
Sewer spills in a house not contained within 1 hour	1,000
Restriction of water - inappropriately	300

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.⁶⁵ These recommendations are based on a report prepared by CME for CALC.⁶⁶

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.⁶⁷ 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

⁶⁵ Consumer Action Law Centre, op. cit.

⁶⁶ *ibid.*, Appendix A.

⁶⁷ 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.

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.⁶⁸

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.⁶⁹ 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.⁷⁰

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.⁷¹

⁶⁸ 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).

⁶⁹ Consumer Action Law Centre, op. cit.

⁷⁰ Essential Services Commission of South Australia, op. cit.; Independent Pricing and Regulatory Tribunal, op. cit.

⁷¹ 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.