



Wannon Water draft decision

2018 Water Price Review

28 March 2018



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Summary

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

This draft decision sets out our preliminary views on Wannon 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.

Wannon Water has committed to improving services in key areas

Our draft decision proposes to approve a revenue requirement that will allow Wannon 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 Wannon Water plans to improve outcomes for customers are by:

- expanding the ways customers can contact the corporation
- improving the taste and smell of drinking water
- upgrading Warrnambool's sewerage infrastructure to support growth.

Our draft decision approves a lower revenue requirement than proposed by Wannon Water, reflecting our review of efficient costs

Our draft decision proposes to approve a revenue requirement of \$331.5 million for Wannon Water over the five year period starting 1 July 2018.³ This is \$23.8 million or 6.7 per cent lower than proposed by Wannon Water.

The main reasons relate to our review of Wannon Water's expenditure forecasts, and in particular different assumptions for:

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

² Wannon 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.

- Operating expenditure, particularly our lower assumptions for forecast labour costs. Our view is that the increase in labour costs above inflation (as forecast by Wannon Water) should instead be managed through efficiency improvements, or via increased revenue from customer growth.
- Capital expenditure, mainly reflecting our lower assumptions for asset renewals expenditure. The large increase in asset renewals proposed by Wannon Water (compared with previous years) was not justified by the supporting material provided to us by the water corporation.

Compared to Wannon Water's original proposal, our draft decision results in lower prices (on average) for customers. Based on our draft decision, on average Wannon Water's prices over 2018-19 to 2022-23 will be about 6.7 per cent lower than Wannon Water's original proposal.⁴

Wannon Water must respond to our draft decision and propose individual tariffs that reflect our initial views on the revenue requirement. Wannon Water's response will determine the price and bill impact of our draft decision on individual tariffs and customer groups.

We accept Wannon Water's proposed tariff structures

Our draft decision accepts Wannon Water's proposed tariff structures, which are the same as its current tariff structures. For water services, Wannon Water proposed a fixed service charge and a variable component that depends on water used. For residential customers, the variable component includes an inclining block structure where prices increase as higher amounts of water are used. For residential sewerage, Wannon Water proposed a fixed service charge only. For non-residential sewerage services, it proposed a fixed service charge and a variable component.

Our draft decision approves Wannon 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.

Our draft decision rates Wannon Water's price submission as 'Basic' under PREMO

Our draft decision proposes to rate Wannon Water's price submission as 'Basic', compared to the 'Standard' proposed by Wannon Water (Table A). This mainly reflects our review of Wannon Water's self-ratings for the Management and Risk elements of PREMO; both of which we have rated as 'Basic', compared to the 'Standard' proposed by Wannon Water.

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

⁴ This is an indicative percentage change on prices based on the percentage change in draft decision revenue requirement compared to the proposed revenue requirement.

Table A **PREMO Rating**

	Overall PREMO rating	Risk	Engagement	Management	Outcomes
Wannon Water's rating	Standard	Standard	Advanced	Standard	Standard
Commission's rating	Basic	Basic	Advanced	Basic	Standard

In proposing this overall PREMO rating we have given weight to the 'cost-plus' approach adopted by Wannon Water in its price submission. We found little evidence the corporation has sought to minimise costs or prices on behalf of its customers. On this, we note:

- Wannon Water's operating cost forecasts included expectations for efficiency improvement (measured on the basis of controllable operating costs per connection) that were the lowest of any water corporation in our price review.
- Our draft decision proposes relatively large reductions to the corporation's operating and capital expenditure forecasts. In percentage terms, our proposed reductions are the largest of any water corporation in our price review. This indicates Wannon Water's proposed prices were not based on reasonable assumptions about prudent and efficient expenditure.

Among the 15 draft decisions we have released so far, Wannon Water is the only corporation for which we propose to approve a 'Basic' 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.⁵ The prescribed services include retail water and sewerage services, and bulk water and sewerage services delivered by the water corporations.⁶

In September 2017, Wannon Water provided a submission to us proposing prices for a five 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 Wannon 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

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 the commission has done so in this draft decision.⁸

In 2016, we issued guidance to Wannon Water to inform its price submission. The guidance set out how we will assess Wannon 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 Wannon 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 2018 price review is the first we've undertaken under our new water pricing approach

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

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

In May 2016, we released a position paper setting out our proposed new pricing approach, and invited submissions.¹² We met with each water corporation and other interested parties to help

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

⁸ Essential Services Commission 2018, *Wannon 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

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

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

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

¹² 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 2016.¹³

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

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

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

PREMO

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

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

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.

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

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

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

¹⁶ In December 2017 we issued early draft decisions for East Gippsland Water, South East Water, Westernport 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.¹⁷

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

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

¹⁸ Essential Services Commission 2016, *Guidance paper*, op. cit., pp. 45–49.

2. Our assessment of Wannon Water's price submission

We have made our draft decision on Wannon Water's price submission after considering: Wannon 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 Wannon 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. Wannon Water's price submission addressed each of these matters. Our preliminary assessment of these matters is provided in this chapter.

Wannon 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 Wannon Water in June 2018.

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

Regulatory period

Wannon Water proposed a five year regulatory period. Our draft decision accepts Wannon Water's proposal as it is consistent with our guidance. Our guidance proposed to approve a five year regulatory period, subject to any alternative and justified proposal.¹⁹

Customer engagement

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

The engagement by Wannon Water:

- took place between December 2015 and September 2017
- used a range of methods including face to face and phone interviews, surveys, focus groups, community events and a deliberative forum
- sought views from a range of customer groups including residential, small business and major business, environmental, community and its stakeholder reference group
- covered topics such as prices, tariffs, service levels, the taste of water and the environment.

More detail on Wannon Water's engagement is available in its price submission.²⁰

Evidence that Wannon Water's engagement influenced its proposals includes:

- its approach to service levels, with customers indicating they are satisfied with current outcomes
- introducing customer SMS and email alerts in response to feedback that customers like timely notification of service outages
- partnering with the community to develop investment plans to improve water quality, in response to feedback from customers about water quality issues.

The influence of Wannon Water's engagement on its proposals supports the objectives in our pricing framework relating to efficiency and the interests of consumers.²¹

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

²⁰ Wannon Water's price submission is available on our website at www.esc.vic.gov.au.

²¹ 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).

Outcomes

Wannon Water proposed to deliver a number of outcomes over the five year period starting 1 July 2018. It has proposed to customers that it will:

- provide safe and reliable water supplies
- provide sewerage services that protect public health and the environment
- ensure the long-term resilience of services
- be responsive and willing to adapt as customer needs change
- protect and enhance the environment in line with community expectations
- partner with communities and help its region flourish
- ensure it provides great value.²²

Wannon Water proposed measures and activities it will use to report on progress against achieving each outcome. These are set out at pages 21 to 52 of its price submission. To report on its performance Wannon Water proposed to issue annual progress reports on its website, via email and social media.

We will engage with Wannon 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.

Wannon Water's proposed GSLs are set out on page 52 of its price submission.

Wannon Water proposed to tighten its service level for unplanned interruptions to water supply, by doubling the rebate from \$50 to \$100, after two interruptions within a 12 month period (rather than five). A new GSL relating to a sewage spill on a customer's property will attract a GSL rebate of \$100. It has made no changes to its hardship GSL.

Wannon Water developed its GSLs in consultation with customers and any payments will not be funded through revenue collected from customers. On this basis, our draft decision proposes to accept Wannon Water's proposed GSLs. Final GSLs will be subject to our consideration of any feedback following the release of our draft decision.

²² Wannon Water's price submission is available on our website at www.esc.vic.gov.au. See page 5.

Revenue requirement

The revenue requirement is the forecast amount a water corporation needs to deliver on customer outcomes, government policy, and obligations monitored by technical regulators including Environment Protection Authority Victoria and the Department of Health and Human Services. Along with forecast demand, it is an input to calculating prices.²³

Wannon Water proposed a revenue requirement of \$355.3 million over a five year period starting 1 July 2018. Our draft decision proposes to reject the revenue requirement in Wannon Water's submission and instead approve a revenue requirement of \$331.5 million, 6.7 per cent lower than proposed by Wannon Water. This reflects our assessment of each element that comprises the revenue requirement, including forecast expenditure.

Our draft decision on the revenue requirement is set out at Table 2.1.

Table 2.1 Draft decision – revenue requirement
\$ million 2017-18

	2018-19	2019-20	2020-21	2021-22	2022-23	Total
Operating expenditure	42.1	42.5	40.2	39.6	39.2	203.5
Return on assets	12.7	13.4	14.5	15.2	15.4	71.1
Regulatory depreciation	9.9	10.5	11.1	12.2	12.5	56.1
Adjustments from last period	0.1	0.1	0.1	0.1	0.1	0.7
Draft decision – revenue requirement	64.8	66.4	65.9	67.1	67.2	331.5

Note: Numbers have been rounded

The main adjustments we've proposed in our draft decision on the revenue requirement relate to our review of Wannon Water's expenditure forecasts. Table 2.2 summarises proposed changes to the revenue requirement.

²³ 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 Wannon Water in the regulatory period from 1 July 2018. We had regard to their views in our draft decision.

Our final decision will be based on the latest available information. Accordingly, as well as responding to our draft decision and providing an updated price schedule, Wannon 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 revenue requirement, Wannon 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 2.2 Adjustments to revenue requirement
\$ million 2017-18

	2018-19	2019-20	2020-21	2021-22	2022-23	Total
Proposed revenue requirement	67.8	69.8	71.1	73.0	73.6	355.3
Operating expenditure	-2.3	-2.4	-3.9	-4.1	-4.5	-17.1
Return on assets	-0.7	-1.0	-1.2	-1.4	-1.5	-5.7
Regulatory depreciation	-0.001	-0.001	-0.2	-0.4	-0.4	-1.0
Total adjustments	-3.0	-3.4	-5.2	-5.9	-6.4	-23.8
Draft decision revenue requirement	64.8	66.4	65.9	67.1	67.2	331.5

Note: Numbers have been rounded

Operating expenditure

Operating expenditure is an input to the revenue requirement. Wannon Water's price submission provides detail on its forecast operating expenditure from pages 55 to 60.

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.

Our assessment

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 Wannon Water's expenditure forecast is available on our website.²⁴

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

Table 2.3 sets out our draft decision on Wannon 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 Wannon 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 reflects the expenditure that a prudent service provider would incur when acting efficiently to achieve the lowest cost in delivering the outcomes specified in Wannon Water's price submission.

The benchmark operating expenditure that we propose to adopt for Wannon Water does not represent the amount that Wannon 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.

²⁴ Deloitte Access Economics 2018, *Wannon 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	Total
Controllable costs	38.3	38.7	36.6	36.0	35.7	185.3
Non-controllable costs	3.8	3.7	3.6	3.6	3.5	18.2
Bulk services ^a	0.3	0.3	0.3	0.3	0.3	1.7
Environmental contribution ^b	3.2	3.2	3.1	3.0	3.0	15.4
Licence fees - ESC ^c	0.040	0.040	0.040	0.040	0.061	0.221
Licence fees - DHHS ^c	0.020	0.020	0.020	0.020	0.020	0.100
Licence fees - EPA ^c	0.158	0.158	0.158	0.158	0.158	0.789
Draft decision – operating expenditure	42.1	42.5	40.2	39.6	39.2	203.5

^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

Wannon Water proposed a total forecast controllable operating expenditure of \$201.8 million over a five-year regulatory period. For the reasons set out below, we propose to reduce this by \$16.5 million to establish a benchmark controllable operating expenditure of \$185.3 million.

Baseline controllable operating expenditure:

- Wannon Water has proposed downward adjustments of \$0.70 million to its actual 2016-17 baseline year controllable operating expenditure, producing a starting point for forecast annual operating expenditure. The resultant figure of \$35.61 million is 18 per cent below the benchmark of \$43.62 million allowed for 2016-17 in the previous price determination. This demonstrates significant efficiency gains made by Wannon Water during the 2013-18 period, and we consider this reflects an efficient baseline cost to forecast annual operating expenditure.

Our assessment

Efficiency improvement:

- Wannon Water's proposed efficiency improvement rate on controllable operating costs is 1.0 per cent per annum. This is equivalent to our mandated 1 per cent efficiency rate from the last price review, and is the equal lowest improvement rate posted across all water corporations in their price submissions. It exceeds Wannon Water's forecast connection growth rate of only 0.8 per cent per annum, which results in a slightly declining annual baseline operating cost.

Proposed cost changes:

- Wannon Water has sought additional operating expenditure of \$25.41 million (14 per cent) above the growth-adjusted baseline, the highest of all regional water corporations, and second highest statewide. This results in a net increase of 1.8 per cent per year in controllable operating cost per customer connection, the larger of only two water corporations proposing increases. Controllable operating expenditure per connection will rise by 7 per cent across the period from the 2016-17 baseline year.
- The largest component of this proposed increase was for labour costs:
 - \$2.67 million for filling positions that were vacant in 2016-17, which we accept as a reasonable variation to the baseline.
 - \$9.18 million for 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. We agree with Deloitte's view, and do not accept this as prudent additional operating expenditure.
- Wannon Water sought additional net expenditure of \$5.08 million for electricity and its carbon neutrality plan. We propose adjustments to some of these costs:
 - Deloitte considered small increases in electricity consumption due to small capital projects should be covered by the baseline growth allowance, however the larger consumption increase resulting from the Warrnambool Water Reclamation Plant augmentation project was a prudent new cost above the baseline. We agree that this reflects a more efficient electricity cost forecast and we have removed the proposed \$0.09 million associated with the smaller projects.
 - Deloitte compared the forecast electricity costs above the baseline with its latest forecasts for electricity prices, and recommended an indicative reduction of \$3.21 million as it did not agree with Wannon Water's forecasted higher electricity prices continuing beyond 2019-20

Our assessment

through to 2022-23.²⁵ We accept Deloitte’s recommendation as we consider it reflects a more accurate forecast of efficient electricity costs during the 2018–23 regulatory period. However we do acknowledge that there is currently uncertainty in forecasting electricity prices and Wannon Water’s electricity contract expires on 30 June 2018. We request that Wannon Water proposes a revised electricity forecast based on its new contract prices in response to our draft decision.

- Consistent with its revised electricity price forecast, Deloitte has reduced the forecast cost savings Wannon Water expects to achieve through its Carbon Neutrality Action Plan which involves solar and wind renewable energy projects. This results in an increase of \$0.36 million to forecast operating expenditure. We accept this increase due to lower savings as a result of our adopting Deloitte’s more efficient electricity price forecast.
- Wannon Water proposed to include \$1.64 million to fund a new Water for the Community program, which is effectively a rebate on water bills for relevant community-based customers. We don’t consider this to be an actual cost incurred by Wannon Water – rather, it represents revenue not collected, and we have therefore removed this amount from operating expenditure and transferred it to the appropriate location in the financial template. Likewise, funding of the proposed two-year phase out of the Government efficiency rebate to tenant customers (\$0.27 million) is also not an operating cost, and we have also removed this amount from the forecast.
- Deloitte assessed the remaining proposed new costs above the baseline and has recommended removing some of these costs (\$2.49 million in total) as they were not considered new obligations on the business. Rather, they should be absorbed within the growth-adjusted baseline or funded through efficiency gains resulting from the new initiatives. This includes:
 - \$0.29 million for one-off operating expenditure items Wannon Water calls operating projects
 - \$1.02 million in small scale operating cost increases resulting from new minor capital projects
 - \$0.89 million of proposed IT costs, including a correction of \$0.61 million for an error Wannon Water identified in its IT forecast
 - \$0.29 million for a proactive maintenance program and for insurance premium increases.

We consider applying our proposed adjustment of \$16.52 million to Wannon 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.²⁶ This will bring

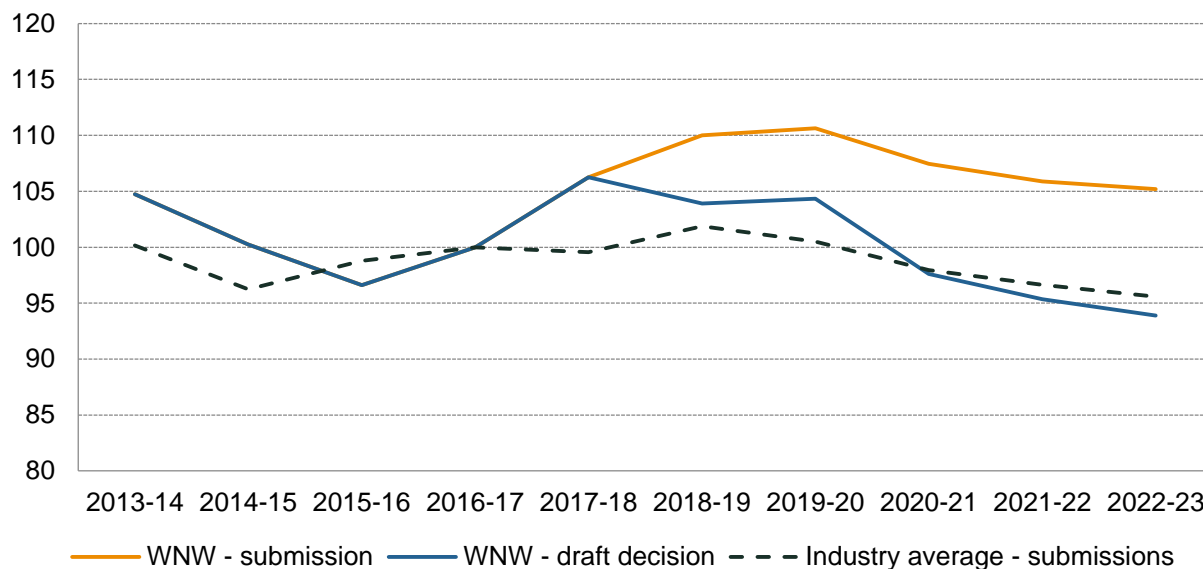
²⁵ Deloitte Access Economics, op. cit., pp.17–21.

²⁶ Essential Services Commission 2016, *Guidance paper*, op. cit., p. 31.

about a decrease (in real terms) in controllable operating expenditure per connection relative to the baseline year, on par with the industry average, as shown in Figure 2.1.

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 Wannon 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 2.3 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 regulatory 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.²⁷

²⁷ 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 verified Wannon Water's forecast external bulk water charges against those proposed by GMMWater in its price submission.

We have reduced Wannon Water's forecast non-controllable operating expenditure by \$0.60 million across the 2018–23 period, resulting from our adjustments to:

- increase our commission licence fee by \$0.02 million in 2022-23
- decrease the environment contribution from \$3.29 million to \$3.23 million for 2018-19 and decline this value across the period (a total decrease of \$0.66 million)
- increase the Environment Protection Authority licence fee by \$0.008 per year (a total increase of \$0.04 million).

Overall, non-controllable operating expenditure will increase by \$0.64 million from 2017-18 to 2018-19, due to the increase in the environment contribution from \$2.56 million to \$3.23 million offsetting licence fee and bulk charge reductions.

Prior to making our final decision, we will adjust Wannon Water's forecast non-controllable operating expenditure for the latest inflation data, including any concurrent changes we make to GMMWater's bulk charges in our final decision and price determination.

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	Total
Proposed total operating expenditure	44.4	44.8	44.1	43.7	43.7	220.7
Labour	-1.3	-1.6	-1.9	-2.1	-2.3	-9.2
Electricity (prices above CPI)	0.0	0.0	-1.1	-1.1	-1.1	-3.2
Electricity (usage increase)	0.0	0.0	-0.02	-0.03	-0.04	-0.1
Carbon neutrality (adjustment for electricity prices)	0.0	0.0	0.1	0.1	0.1	0.4
Water for Community	-0.3	-0.3	-0.3	-0.3	-0.3	-1.6
Tenant rebate	-0.3	0.0	0.0	0.0	0.0	-0.3
Operating projects	-0.1	-0.1	-0.1	0.0	0.0	-0.3
Opex from new capex	-0.04	-0.1	-0.2	-0.3	-0.4	-1.0
IT licence costs	-0.2	-0.2	-0.2	-0.2	-0.2	-0.9
Other opex items	-0.1	-0.1	-0.1	-0.1	-0.1	-0.3
Total adjustments to controllable costs	-2.2	-2.3	-3.7	-4.0	-4.3	-16.5
Licence fees	0.008	0.008	0.008	0.008	0.029	0.1
Environmental contributions	-0.054	-0.053	-0.187	-0.186	-0.183	-0.7
Total adjustments to non-controllable costs	-0.05	-0.05	-0.2	-0.2	-0.2	-0.6
Draft decision – total operating expenditure	42.1	42.5	40.2	39.6	39.2	203.5

Note: Numbers have been rounded

Our assessment

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 Wannon 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.²⁸

Table 2.5 sets out our draft decision on Wannon Water's closing regulatory asset base at 30 June 2017.

We compared Wannon 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, Wannon Water assumed \$101.43 million net capital expenditure over the period from 2012-13 to 2016-17. We identified some very minor adjustments were required, which reduced this to \$101.41 million. This figure is 17.6 per cent lower than the forecast used to approve maximum prices for the period from 1 July 2013. This is well below the 10 per cent threshold identified above, so we have not undertaken a prudence and efficiency review of its past net capital expenditure.

Other than this adjustment for past net capital expenditure, Wannon Water calculated its closing regulatory asset base in accordance with the requirements of our guidance. For these reasons, our draft decision proposes to approve a closing regulatory asset base for 30 June 2017 of \$320.2 million.

Table 2.5 sets out our draft decision on Wannon Water's regulatory asset base at 30 June 2017.

²⁸ 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.

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

	2012-13	2013-14	2014-15	2015-16	2016-17
Opening RAB 1 July	264.3	285.8	296.8	303.0	310.0
Plus gross capital expenditure	30.2	20.5	17.4	17.6	21.5
Less government contributions	0.0	0.1	0.1	0.1	0.2
Less customer contributions	1.0	0.7	2.0	0.6	1.0
Less proceeds from disposals	1.1	0.5	0.4	0.5	0.5
Less regulatory depreciation	6.6	8.2	8.8	9.3	9.6
Closing RAB 30 June	285.8	296.8	303.0	310.0	320.2

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 Wannon Water's proposed forecast regulatory asset base from 1 July 2018.²⁹ Our assessment of the components of the forecast regulatory asset base is set out below.

²⁹ 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.

Our assessment

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

	2017-18	2018-19	2019-20	2020-21	2021-22	2022-23
Opening RAB 1 July	320.2	329.6	339.1	364.4	396.3	404.7
Plus gross capital expenditure	20.4	20.9	37.3	44.6	22.1	13.3
Less government contributions	0.1	0.02	0.2	0.2	0.1	0.0
Less customer contributions	1.0	1.0	0.9	0.9	0.9	0.9
Less proceeds from disposals	0.5	0.5	0.5	0.5	0.5	0.5
Less regulatory depreciation	9.4	9.9	10.5	11.1	12.2	12.5
Closing RAB 30 June	329.6	339.1	364.4	396.3	404.7	404.1

Note: Numbers have been rounded

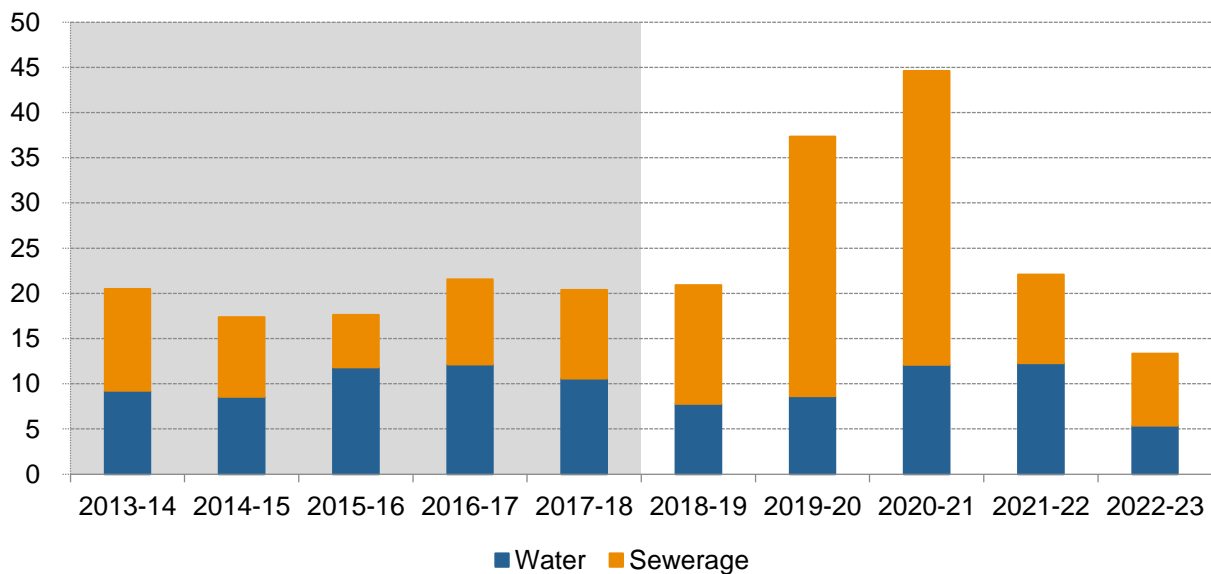
Capital expenditure

Capital expenditure is an input to estimating the regulatory asset base. Wannon Water's forecast capital expenditure and supporting information is provided at pages 60 to 69 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 2018–23 period.

We engaged Deloitte Access Economics to provide expert advice to inform our assessment of capital expenditure. Deloitte's report on its assessment of Wannon Water's expenditure forecast is available on our website.³⁰

³⁰ Deloitte Access Economics 2018, 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 2022-23

Wannon Water proposed a total gross capital expenditure of \$156.5 million over a five-year regulatory period. For the reasons set out below, we propose to reject this and instead approve a benchmark gross capital expenditure of 138.3 million (a reduction of \$18.2 million):

- Wannon Water’s proposed forecast for gross capital expenditure is \$59.1 million (61 per cent) higher than for the current regulatory period. The increase is mainly driven by:
 - a major upgrade to the Warrnambool Water Reclamation Plant (WRP) to accommodate residential and industrial growth (\$38.0 million)
 - a large increase (57 per cent) in renewals expenditure against the historical average.
- Deloitte requested selected documents from Wannon Water as a representative sample to demonstrate its asset management processes and justification for its capital expenditure program. Deloitte found that overall, Wannon Water’s capital planning approach and processes were generally in line with similar businesses, and would benefit from further work on asset condition data collection. However, Deloitte expressed concern about the level of unspecified projects within the capital allocations, with over half of the increased renewals expenditure allocated to unspecified projects.³¹

³¹ Deloitte Access Economics, op. cit., p.27.

- Renewals expenditure makes up over half of the total capital forecast when the Warrnambool WRP is excluded. The forecast shows a peak in the fourth regulatory period, before dropping off again in the fifth period. Deloitte considered the large increase in renewals in Wannon Water's price submission for the fourth regulatory period was not appropriate, and Wannon Water was unable to justify the increase. Deloitte recommended Wannon Water smooth its renewals spending across the current and future regulatory periods. Deloitte has also recommended reducing the renewals expenditure by \$11.69 million, which represents a lower increase of 25 per cent above the historical value. This will still allow Wannon Water to address some age profile related renewals and backlog renewals items. We agree with Deloitte's recommendation on the basis that the large increase was not well justified, and therefore did not represent prudent expenditure.
- Deloitte assessed the following major capital projects:
 - The major upgrade of the Warrnambool WRP – whilst the business case for this major project is not yet formally approved, the driver for the project is clear, the options analysis is robust and a detailed cost estimate has been prepared for the preferred option. Given this, Deloitte has not recommended any adjustments to the proposed amount or timing of the expenditure for this project.
 - Two water supply projects to provide for Warrnambool growth corridors, the Wollaston Road water tower and the Wangoom Road water tower projects. Both of these projects had been included in the current pricing period, and both were deferred to the next period because sufficient urban growth had not yet occurred in these areas. Deloitte found that the business cases put forward for both projects were not strong, and were largely updates of previous assessments and reports undertaken in 2010 and 2012 respectively. In both cases, there was not a clear justification for the timing of the project or a clear trigger for when the works were required. The Wangoom Road tower also had inconsistent project costs in different documents provided by Wannon Water. Deloitte has recommended that 5 per cent of the proposed expenditure be retained for developing a robust business case and the remainder be removed from the forecast. We agree with Deloitte's assessment – considering we have previously allowed for this expenditure in the current period pricing, and our guidance required clear justification for including capital expenditure in the forecast, we would have expected Wannon Water to provide a strong justification for the timing of expenditure. We have removed \$2.43 million and \$4.12 million respectively for these projects. Should either of these projects be required to commence during the period, Wannon Water may seek to recover the associated costs at the end of the period, consistent with our guidance for managing costs of uncertain capital projects.
- Wannon Water states that while the quantum of the expenditure program is larger than for previous periods, the number of projects is similar, and it expects to deliver the program in full.

We note that of Wannon Water's seven major projects in the current 2013–18 regulatory period, four were completed late, two were deferred (the water towers mentioned above), with the remaining project expected to be completed on schedule.³²

- Where there is uncertainty in timing of capital expenditure, Wannon Water says it has excluded these projects from its price submission. An example of this is growth related infrastructure for new housing developments in Warrnambool, where it has not included costs for all identified projects, moving some to the first years of the following regulatory period. This approach is consistent with our guidance for managing uncertain expenditure, but we note Deloitte identified two growth projects with sufficient uncertainty to recommend removing most of their expenditure. For our draft decision, we accept Wannon Water's proposal for addressing uncertainty, noting the following:
 - Wannon Water will need to demonstrate the prudence and efficiency of these costs if they are indeed incurred during the 2018–23 period, when updating the regulatory asset base for the fifth regulatory period.
 - Variations in capital expenditure from forecast during the 2018–23 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 Wannon Water's forecast to establish our draft decision benchmark for gross capital expenditure, consistent with our guidance and WIRO principles.³³ This benchmark is used to calculate the forecast regulatory asset base (Table 2.6) and the revenue requirement (Table 2.1).

³² Essential Services Commission 2018, *Status of major projects supplement: Water performance report 2016-17*, 1 March, pp. 23-24.

³³ 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	Total
Proposed gross capital expenditure	24.8	42.5	48.4	25.4	15.4	156.5
Warrnambool – Wollaston Road water tower	0.1	-0.4	-2.1	0.0	0.0	-2.4
Warrnambool – Wangoom Road water tower	0.0	-0.5	-1.7	-1.9	0.0	-4.1
Renewals program (excluding corporate renewals)	-4.0	-4.3	0.04	-1.4	-2.1	-11.7
Total adjustments to gross capital expenditure	-3.9	-5.2	-3.8	-3.3	-2.1	-18.2
Draft decision – gross capital expenditure	20.9	37.3	44.6	22.1	13.3	138.3

Note: Numbers have been rounded

The benchmark that we adopt for Wannon 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 Wannon 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. Wannon Water determines how to best manage the allocation of its revenue and priority of its expenditure within a regulatory period.

Customer contributions

Revenue from customer contributions is deducted from gross capital expenditure so it is not included in the regulatory asset base.³⁴

We compared Wannon Water's forecast for customer contributions with past outcomes, and its forecasts for growth in customer connections.³⁵ We consider Wannon Water's forecast contributions are reasonable, having regard to past trends and its growth forecasts.

Our draft decision proposes to accept Wannon Water's forecasts for customer contributions.

Cost of debt

Our guidance required Wannon Water to use estimates of the cost of debt provided in our guidance to estimate its revenue requirement. Wannon 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 Wannon 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 actual cost of debt for an efficient business to the regulated benchmark, compared with an on-the-day approach.³⁶ We consider the ten year trailing average approach helps to minimise risk to water corporations and provides better incentives for long-term investment.

³⁴ Revenue from new customer contributions reflects revenue earned from new connections made to a water corporation's water, sewerage or recycled water networks.

³⁵ Growth in customer connections can be used as an indicator of growth in customer contributions.

³⁶ 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.

Return on equity – PREMO rating

Wannon Water rated its price submission as ‘Standard’. Based on its PREMO self-rating, Wannon Water proposed a rate of return on equity of 4.5 per cent per annum. This reflects the maximum return rate allowed in our guidance for a price submission rated as ‘Standard’.³⁷

Our draft decision proposes not to accept Wannon Water’s PREMO self-rating and proposed return on equity of 4.5 per cent per annum. This reflects our assessment of Wannon Water’s price submission as ‘Basic’. This means our draft decision proposes to approve a return on equity of 3.9 per cent per annum. Our assessment of Wannon Water’s proposed PREMO rating is set out in Chapter 3.

Our draft decision on the return on equity is consistent with the approach set out in our guidance. The range for the return on equity set out in our guidance had regard to the return on equity allowed or estimated by regulators in other Australian jurisdictions recently for the water industry.³⁸

Regulatory depreciation

Regulatory depreciation is an input to calculating the regulatory asset base. Wannon Water’s forecast regulatory depreciation was calculated using a straight line depreciation profile.³⁹ We noted in our guidance that we prefer this approach.⁴⁰

Our draft decision on regulatory depreciation differs from Wannon 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 2.6.

Tax allowance

The tax allowance is an input into the revenue requirement. Wannon 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.⁴¹

³⁷ Essential Services Commission 2016, *Guidance paper*, op. cit., p. 49.

³⁸ 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.

³⁹ For the period from 2018-19 to 2022-23, Wannon Water proposed a regulatory depreciation of \$57.1 million.

⁴⁰ Essential Services Commission 2016, *Guidance paper*, op. cit., p. 42.

⁴¹ Essential Services Commission 2016, *Guidance paper*, op. cit., pp. 50-51.

Demand

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

Wannon Water's demand forecasts are set out at pages 73 to 74 of its price submission, and are also included in its financial model. Our draft decision proposes to accept Wannon Water's demand forecasts for the purpose of approving maximum prices. We have accepted the forecasts based on *Victoria in Future 2015* as we consider they were estimated in a manner that is consistent with the requirements of our guidance.

Form of price control

Wannon Water proposed a price cap form of price control. It currently uses a price cap.

Our draft decision is to accept Wannon Water's proposed form of price control. A price cap will allow Wannon Water to recover sufficient revenue to cover the forecast efficient costs of providing services. 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.⁴²

Tariff structures

Wannon Water's proposed tariffs are set out at page 75 and Appendix A of its price submission. Wannon Water proposed flat prices for most customers over 2018-19 to 2022-23. However, due to the end of a residential customer bill rebate after 2017-18, the typical bills for Wannon Water will increase, as outlined in its price submission.

We propose to reject the revenue requirement in Wannon Water's submission. Our draft decision is to approve a revenue requirement that is 6.7 per cent lower than Wannon Water's proposed revenue requirement. On average this will result in a further reduction in prices from 2018-19 to 2022-23 by approximately the same amount, compared with Wannon Water's original proposal.

Wannon Water must respond to our draft decision with updated prices, which will reflect its response to our initial views on its revenue requirement. Because of this, our draft decision does not approve maximum prices for each tariff. We will provide final prices in our final decision.

⁴² 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.

However, our draft decision considers Wannon Water's proposals relating to changes in tariff structures, and any submissions relating to the level of prices or bills.⁴³

As outlined in our guidance, we have provided the water corporations with a large degree of discretion to decide on individual tariff structures.⁴⁴ 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.

Wannon Water proposed to maintain its existing tariff structures. For water services, it proposed a two-part tariff with a fixed service charge and a variable usage component that depends on water use. For residential customers, the variable component includes a three-tier inclining block, where the price increases with each higher tier. For residential sewerage services, Wannon Water proposed a fixed service charge only while for non-residential sewerage services it proposed a two-part tariff.

Two part tariffs

We consider the two-part structure proposed by Wannon Water for its 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.⁴⁵ We also consider two-part tariff structures are easy to understand.

For sewerage tariffs, we consider a fixed charge only for residential customers and a two-part tariff for non-residential tariffs sends customers signals about the efficient costs.⁴⁶

Inclining block tariffs

Inclining block tariffs are structured so that volumetric prices increase with higher water consumption, in blocks determined by consumption levels.

Consumer Action Law Centre's submission referred to research concluding that inclining block structures are not effective on social equity grounds, as they fail to account for household size, and

⁴³ Tariff structure refers to the way in which prices are grouped and the manner of charging, for example, water and sewerage charges, fixed and variable charges.

⁴⁴ Essential Services Commission 2016, *Guidance paper*, op. cit., p. 55.

⁴⁵ 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.

⁴⁶ Our reasons are outlined in our 2013 draft decisions on price review 2012-13 to 2017-18.

essential versus discretionary use.⁴⁷ The submission also noted inclining blocks can confuse households.

A number of Victorian water corporations and interstate water businesses have removed inclining block structures in recent years. We have previously noted our preference for a single volumetric charge for water services on efficiency grounds.⁴⁸ We generally consider a simple two-part tariff with a single variable charge may be a more efficient approach to pricing and reduce complexity for customers. However, given there is no clear evidence that Wannon Water's customers want to reduce the steps from three to two our draft decision proposes to accept Wannon Water's proposal to retain the three-tier inclining block tariff.

Tariff groups

Wannon Water is proposing to reduce its water tariffs from four to two groups and its sewerage service tariff from three groups to a single consistent tariff across the region. The simplification of Wannon Water's tariff groups began in the third regulatory period and was supported by customers. We consider these reforms promote ease of understanding and provide signals about the efficient costs of providing services to customers.

Unique services

Wannon 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.

Price levels

From 2014-15, Wannon Water's residential customers receiving a bill including water usage charges received an annual rebate. The rebate reflects the outcomes of a government efficiency review, and ends after 2017-18. While Wannon Water has proposed reduced prices for most tariffs, the removal of the rebate means the bill impact of price changes on customer groups may vary. In particular, for some customers such as relatively low water users (including some residential tenants), bills may rise as a result of the rebate being removed. Submissions by Carmel Blackman, 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.⁴⁹

⁴⁷ Consumer Action Law Centre 2017, Initial Feedback: 2018 Water Price Review, 15 November.

⁴⁸ Essential Services Commission 2011, *2013 Water Price Review – Tariff Issues Paper*, July, p. 26.

⁴⁹ Carmel Blackman 2017, *Submission*, 28 October; Gerald Mallon 2017, *Submission*, 7 November; Consumer Action Law Centre 2017, op. cit.

Wannon Water has sought to address the impact of the rebate removal on its customers by:

- proposing a \$35 rebate to tenant customers in the first quarter of the 2018-19 year
- committing to maintaining its current level of support to those in financial hardship
- developing a Financial Inclusion Action Plan as part of its response to the needs of low income and vulnerable customers.

As noted on page 13, Wannon Water proposed that the rebate for tenants would be funded via higher operating expenditure and therefore would be reflected in higher prices for other (non-tenant) customers. This is different to the approach taken by other water businesses seeking to mitigate the impact of the removal of the rebate, as it introduces a cross subsidy between customer classes, removing signals to customers about the efficient costs of providing services. For this reason, our draft decision proposes not to accept Wannon Water's funding method for its proposed transitional tenant rebate.

We note Wannon Water has proposed to use its current support framework for customers experiencing payment difficulty and has partnered with Good Shepherd Microfinance to develop a Financial Inclusion Action Plan as part of its response to the needs of low income and vulnerable customers. Combined with our draft decision to reduce Wannon Water's revenue requirement, which will provide some bill relief, we consider these measures will help to mitigate the impact of the removal of the rebate after 2017-18.

Draft decision

For the reasons set out above, our draft decision accepts Wannon Water's proposed tariff structures as set out on page 75 and on Appendix A of its price submission.

Prior to our final decision and price determination, Wannon Water must submit updated prices to reflect our draft decision on the revenue requirement, and our updates to cost of debt and inflation estimates, which we will provide in late April 2018.

Adjusting prices

Wannon Water's proposed price adjustment mechanism is set out at page 72 of its price submission. It proposes to continue with its existing uncertain and unforeseen events mechanism. Our draft decision accepts Wannon Water's proposal to continue the existing uncertain and unforeseen mechanism. We noted in our guidance that we propose that the mechanism continue its current form.

Wannon Water has not included adjustments to reflect movements in the cost of debt, as set out in our guidance. We invite Wannon Water to respond to our draft decision with revised price adjustment formulas allowing for adjustments to reflect movements in the cost of debt.

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.

Wannon Water's proposed charges for new customer contributions are set out at page 82 of its price submission. For Warrnambool growth areas, Warrnambool roof harvesting areas, Warrnambool infill, Dennington, Koroit, Allansford & Port Fairy and small towns, Wannon Water proposed that sewerage and water charges from 2017-18 be maintained.

Wannon Water also proposed that Hamilton and Portland, two areas previously charged a separate sewerage charge, be included in the standard sewerage charge. This proposal represents a 50 per cent decrease on 2017-18 area specific charge.

For negotiated new customer contributions, Wannon Water proposes to continue to calculate a charge in accordance with the requirements of our new customer contribution principles.⁵⁰

We have reviewed Wannon Water's proposed charges and consider them consistent with the requirements of our guidance and NCC principles.⁵¹ For this reason, our draft decision proposes to accept Wannon Water's proposed new customer contribution charges.

Financial position

In approving prices, we must have regard to the financial viability of the water industry.⁵² 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.

Wannon Water's price submission and the supporting financial model provided estimates for key indicators of financial performance. These estimates were based on Wannon Water's assumptions

⁵⁰ Essential Services Commission 2016, *Guidance paper*, op. cit., p. 62. Wannon Water confirmed negotiated charges are calculated in accordance with our principles in response to a request for information.

⁵¹ In response to a request for information, Wannon Water provided supporting modelling showing its regard for incremental costs and incremental revenue.

⁵² WIRO clause 8(b)(ii) and ESC Act s.8A(1)(b).

about revenue and expenditure. Our draft decision proposes adjustments to revenue and expenditure. We have reviewed the key indicators of financial performance based on our draft decision. Under our draft decision, we consider Wannon 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 draft decision is not to accept Wannon Water's proposed return on equity of 4.5 per cent, based on the justification provided for the level of ambition in its price submission. Below, we set out our preliminary assessment of Wannon Water's proposed PREMO rating.

Our review of Wannon Water's PREMO self-rating

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

Table 3.1 PREMO Rating

	Overall PREMO rating	Risk	Engagement	Management	Outcomes
Wannon Water's rating	Standard	Standard	Advanced	Standard	Standard
Commission's rating	Basic	Basic	Advanced	Basic	Standard

Our draft decision is not to accept Wannon Water's proposed overall PREMO self-rating of 'Standard'. We have rated Wannon Water's price submission as 'Basic'. This is reflected in the return on equity we propose to approve for Wannon Water at page 25.

We agree with Wannon Water's self-rating for the Engagement and Outcomes elements of PREMO. In support of its self-ratings we note:

- Wannon Water's engagement started early relative to other corporations and feedback was used to develop and shape themes that were carried through its program. Wannon Water's

customer engagement was inclusive, and covered all parts of its service area. It engaged using a deliberative forum which in our view was well suited to the complexity of the content it engaged on, namely tariff structures and the taste of water. Feedback from participants showed high levels of satisfaction with the corporation's approach.

- While customers report a high degree of satisfaction with existing service levels, Wannon Water has proposed targeted improvements to deliver better outcomes to its customers. This is demonstrated by its focus on improving water taste and smell, and providing more timely notification to customers of service disruptions, in response to customer feedback.

Our draft decision proposes to approve a rating of 'Basic' for Management. The Management element of PREMO includes a focus on a water corporation's management of its costs. As part of our review of Management, we look at the direction of controllable costs, a water corporation's commitment to improve efficiency, and whether any proposed increases in costs are justified.

On Wannon Water's Management rating, we note:

- Wannon Water's operating cost forecasts included expectations for efficiency improvement (measured on the basis of controllable operating costs per connection) that were the lowest of any water corporation in our price review.
- Our draft decision proposes relatively large reductions to the corporation's operating and capital expenditure forecasts. In percentage terms, our proposed reductions are the largest of any water corporation in our price review. This indicates Wannon Water's proposed prices were not based on reasonable assumptions about prudent and efficient expenditure.

For these reasons, our draft decision rates the Management element of PREMO as 'Basic', compared to the 'Standard' proposed by Wannon Water.

Our draft decision also proposes to approve a rating of 'Basic' for the Risk element of PREMO, compared to the 'Standard' proposed by Wannon Water.

While Wannon Water has proposed changes to its guaranteed service level program, including increasing the revenue at risk, we note that the water corporation proposed a relatively large increase in its renewals capital expenditure, including a large amount for unspecified renewals. The consultant assisting in our expenditure review (Deloitte) considered that the relatively high amounts for unspecified renewals could represent a high level of uncertainty in renewals planning, and a lack of actual site based condition assessments.⁵³ We consider this transfers risk to customers – and potentially results in customers paying more than they need to.

⁵³ Deloitte Access Economics, op. cit., p.33.

We consider that given the (average) customer bill increases, that Wannon Water could have better managed its asset program to mitigate bill impacts for customers. This may have involved smoothing its asset renewals program over time, and making greater use of condition-based assessments of assets, to better inform its renewals program.

In our view, the consequences for customers of the Risk and Management elements of PREMO of the price submission outweighed the benefits of the Engagement and Outcome elements and were sufficient to justify our proposal to rate Wannon Water's overall price submission as 'Basic'.

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 Wannon 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 Wannon 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
Ms C Blackman	28 October 2017