ESSENTIAL SERVICES COMMISSION

GOULBURN-MURRAY WATER PRICE REVIEW 2016

Guideline on Price Submission

August 2014

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GLOSSARY

Baseline expenditure	The baseline level of operating expenditure is based on the last full year of data. This expenditure excludes once-off or temporary costs associated with major projects.
Capital expenditure (CAPEX)	Capital expenditure is incurred when a business spends money either to buy fixed assets or to add to the value of an existing fixed asset. This includes expenditure on new works, renewals or replacements, and other expenditure that would otherwise be referred to as capital.
Long run marginal cost (LRMC)	The change in total cost resulting from a one unit change in output, over a long enough timeframe such that no inputs are 'fixed'. It is the sum of short run marginal operating and long run marginal capital costs.
Operating expenditure	Ongoing cost of running a product, business, or system.
Regulatory depreciation	An amount set to allow the regulated water businesses to recover the cost of capital investment over time. Also known as Return of Assets.
Revenue requirement	The revenue needed by a water business to cover operating costs and taxes, and provide a

	return on assets and a return of assets (depreciation).
Tariff schedules	A list of prices arranged or organised in a particular order.
Tariff structure	The way prices are organised, which can provide different incentives and signals to customers.
Water Charge (Infrastructure) Rules (WCIR)	The Rules which apply to the regulation of entities in the Murray-Darling Basin.
Weighted average cost of capital (WACC)	The rate that a company is expected to pay on average to all its security holders to finance its assets.

ACRONYMS

ACCC	Australian Competition and Consumer Commission
CAPEX	Capital Expenditure
G-MW	Goulburn-Murray Water
RAB	Regulatory Asset Base
WACC	Weighted Average Cost of Capital
WCIR	Water Charge (Infrastructure) Rules
WIRO	Water Industry Regulator Order

CONTENTS

1 INTRODUCTION

The purpose of this Guideline is to set out the Commission's minimum requirements for the information that should be provided in Goulburn-Murray Water's (G-MW) final price submission for the regulatory period 1 July 2016 – 30 June 2020.

G-MW's final price submission must provide sufficient information for the Commission to assess G-MW's proposals for services, expenditure, revenue, and tariffs. A significant amount of the information we require should be readily available to G-MW, and should be relevant for other purposes such as corporate planning or project justification and prioritisation. Consequently the price review process seeks to minimise the costs of our review for G-MW.

Customer consultation by G-MW is an integral part of the price review. As with past reviews, the Commission requires G-MW to publicly release information that provides a basis for consultation with its customer committees, customers and other stakeholders, which should inform its final price submission. In the past, some businesses have released a single document outlining proposals; others have summarised information relevant to customers in information notes or fact sheets. Consultation on its price submission should build on the consultation process already undertaken by G-MW in relation to its proposed prices and its program of reform of its irrigation network.

1.1 CONTEXT FOR G-MW

G-MW is undergoing a period of substantial change within its business which will impact on its service and price proposals for the period of 1 July 2016 – 30 June 2020. Major investments in infrastructure to modernise G-MW's irrigation network began with the Northern Victoria Irrigation Renewal Project which was integrated into G-MW's business in 2012, and will continue as the "Connections Project". In addition, G-MW has committed to cost reductions and the reorganisation of its business structure, as well as to altering its tariff structure to better reflect infrastructure costs. The shifting focus of G-MW's business and the changes to its network should be reflected in the service and price proposals G-MW develops.

1.2 CONTEXT FOR THE COMMISSION

The Commonwealth is responsible for the regulation of G-MW's water charges following the Murray-Darling Basin Agreement among Basin states to manage the Basin's shared water uniformly across jurisdictions. In Victoria, the referral of powers is achieved by the *Water (Commonwealth Powers) Act 2008* (Vic).

The Australian Competition and Consumer Commission (ACCC) is responsible under the *Water Charge (Infrastructure) Rules 2010 (Cth)* (WCIR) for approving or determining the regulated charges of water entities in the Murray-Darling Basin. Part 9 of the WCIR allows for the accreditation of arrangements whereby a State agency would be responsible for approving regulated charges under the WCIR rather than the ACCC.

The Commission successfully applied to the ACCC for accreditation to regulate G-MW's and Lower Murray Water's (rural) charges in 2012. The Commission was accredited for ten years from 17 February 2012.[1] A condition of the accreditation was that the Commission apply pricing principles developed by the ACCC when approving regulated charges under the WCIR.

This paper explains the requirements of the WCIR in the context of G-MW's next price review.[2]

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1 Water Charge (Infrastructure) Rules, Application by Essential Services Commission of Victoria for accreditation, Final Decision, 17 February 2012.

2 The basis of this paper is Rule 25 and Schedule 1 of the Water Charge (Infrastructure) Rules which sets out G-MW's minimum information requirements

2 ASSESSING G-MW'S PRICE SUBMISSION

2.1 INTRODUCTION

Goulburn-Murray Water's (G-MW) infrastructure-related services (the majority of its services) are regulated under the *Water Charge (Infrastructure) Rules 2010* (WCIR) and Australian Competition and Consumer Commission's (ACCC) pricing principles.[3] G-MW's infrastructure services covered by the WCIR account for 95 per cent of G-MW's total regulated costs. This Guideline will focus on G-MW's pricing proposal as it relates to the WCIR and the ACCC pricing principles.

The Commission must approve the price arrangements proposed by G-MW if it is satisfied the prices comply with the WCIR and the ACCC's pricing principles. The tariff objectives of the ACCC's pricing principles are given in box 2.1.

BOX 2.1 ACCC PRICING PRINCIPLES

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

- to promote the economically efficient use of water infrastructure assets
- to ensure sufficient revenue for the efficient delivery of the required services
- to give effect to the principles of user pays for water storage and delivery in

[3] Australian Competition and Consumer Commission, *Application by Essential Services Commission Victoria for Accreditation Final Decision,* 17 February 2012.

irrigation systems

- to achieve pricing transparency
- to facilitate efficient water use and trade in water entitlements.

The Commission must be satisfied the expenditure forecasts contained in the price submission reflect the efficient delivery of the proposed outcomes and account for a planning horizon that extends beyond the term of the price submission.

The Commission must account for the interests of customers of the regulated entity, including low income and vulnerable customers.

Source: ACCC pricing principles.

The pricing of G-MW's groundwater and non-infrastructure related miscellaneous services, which make up a small percentage of G-MW's overall revenue, are assessed against the Water Industry Regulatory Order (WIRO).[4]

Under Rule 3 of the WCIR the regulatory period is defined as 4 years in duration which will commence on 1 July 2016 and conclude on 30 June 2020.

2.2 THE COMMISSION'S HIGH LEVEL REQUIREMENTS

2.2.1 FINAL PRICE SUBMISSION

G-MW's price submission needs to explain, justify and document its proposed prices for regulated services it provides. The submission should provide stakeholders with a clear understanding of G-MW's price proposals and provide sufficient information for the Commission to analyse and review its proposals. G-MW should consider the needs of different stakeholders that are likely to have an interest in its submission. For

[4] The Commission expects a change to the WIRO after the current Independent Review of regulation in Victoria – this should however, only impact a small number of G-MW's tariffs.

example, customer committees and customers must be consulted on issues such as prices and levels of service.

The Commission needs a well-argued submission that will allow it to review G-MW's proposals in a timely way. G-MW should submit sufficient and accurate information for the Commission to make a decision in accordance with the WCIR. G-MW should give careful consideration to the information requirements outlined at the end of each chapter (from chapter 3).

2.2.2 FINANCIAL MODEL

The Commission will provide G-MW with a financial model template that it must populate and submit with its price submission. The financial model enables G-MW and the Commission to estimate prices, and provides detailed information that allows us (with the assistance of consultants where appropriate) to evaluate the assumptions used to estimate prices. The model will be based on the one used at the last price review.

The Commission will work with G-MW on its financial model in order to streamline information requirements where possible. The Commission will also provide any training or assistance the business needs to complete its model.

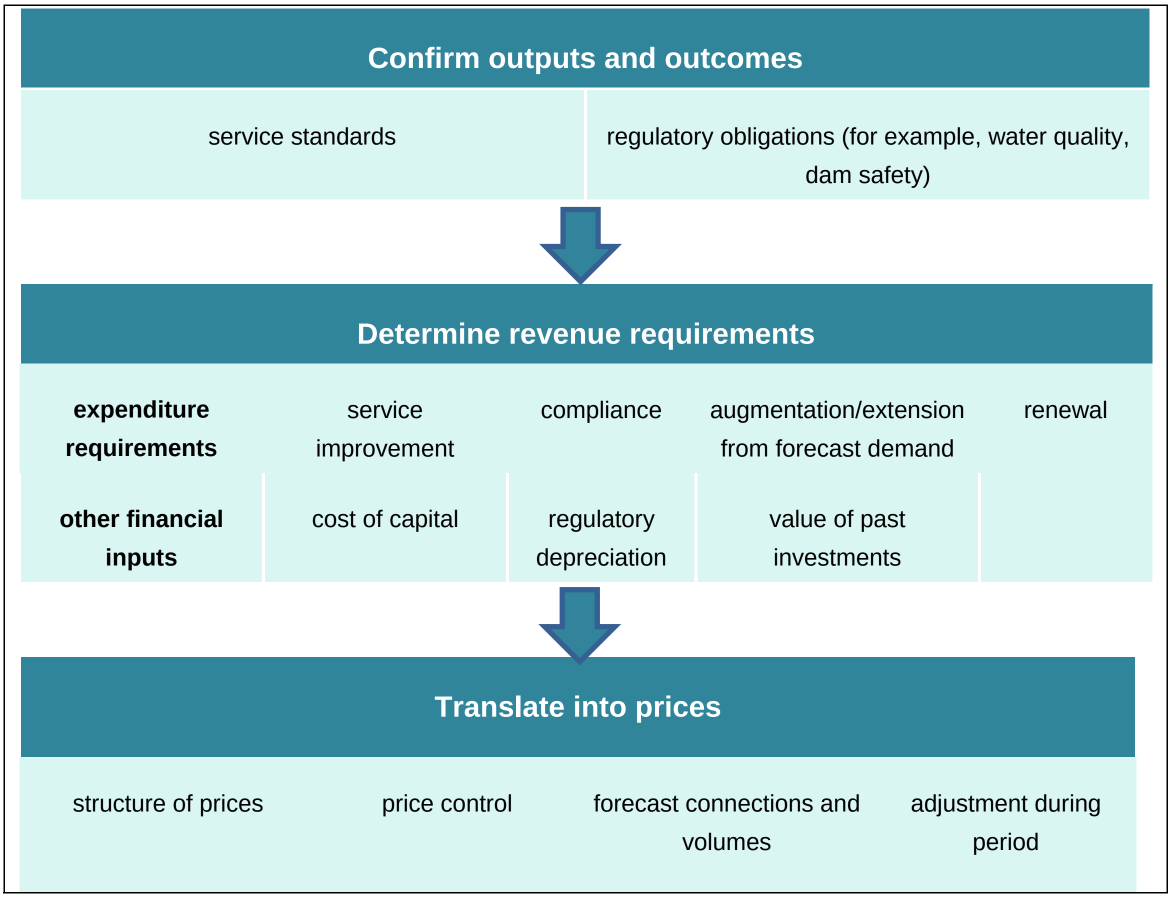
G-MW's written submission and its financial model must be consistent. Further, any changes made by G-MW to its proposals during the price review process must also be reflected by G-MW in its financial model. All financial values in G-MW's price submission and financial model must be in real 2015-16 dollars (with the March quarter 2015 CPI as the base).

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

2.3 ASSESSING PRICES

The Commission will continue to use the 'building block' approach to assess G-MW's prices as specified by the WCIR and the ACCC's pricing principles. The building block approach has three steps which are set out in figure 2.1.

FIGURE 2.1 STEPS IN ASSESSING AND APPROVING PRICES



Step one involves confirming the service outcomes that G-MW proposes to deliver over 1 July 2016 – 30 June 2020. These outcomes should reflect verified obligations imposed by the Minister for Water (through the Statement of Obligations), the Department of Health, the Department of Environment and Primary Industries, the Commission and other agencies. Service proposals should also reflect documented customer preferences established through consultation.

In the second step, the Commission assesses the revenue G-MW claims that it requires to meet the service obligations and expected outcomes identified in step one. The Commission makes assumptions about efficient expenditure to assess whether the claimed revenue will be sufficient for G-MW to deliver the identified services.

Step three is to assess the prices that G-MW is seeking to apply. The Commission must ensure that prices will generate G-MW's revenue requirement by considering demand forecasts. The Commission will assess whether G-MW's demand forecasts are reasonable and reflect the best available information.

2.4 CONSULTATION BY THE COMMISSION

The Commission will undertake its own consultation in order to test G-MW's proposals. We will aim to engage G-MW's water customers as broadly as practicable. The Commission will tailor its consultation to reflect stakeholder comments and work already undertaken by G-MW.

We will make our papers and G-MW's submissions available on our website (www.esc.vic.gov.au). If the price submission contains information that G-MW wishes not to be published because it is commercially sensitive or confidential, then it should provide confidential and public versions to the Commission.

The Commission will also consult with agencies such as the Department of Environment and Primary Industries, the Department of Health and the Energy and Water Ombudsman (Victoria).

2.5 INDICATIVE TIMELINES

An indicative timetable for the price review consultation process is set out in table 2.1. The timetable is based on Rule 30 of the WCIR which requires that the Commission approve prices within thirteen months of receiving a business's price submission.

TABLE 2.1 INDICATIVE CONSULTATION TIMETABLE

Indicative Dates	*Activity*
August 2014	ESC releases Guideline
August 2014 to April 2015	G-MW consultation with public on draft price submission
End April 2015	Final price submission submitted to ESC
May 2015 to October 2015	ESC assesses the price submission and G-MW responds to Commission and consultant queries
November 2015	ESC releases Draft Decision
November to April 2016	ESC consultation on Draft Decision
May 2016	ESC releases Final Decision

3 CUSTOMER CONSULTATION

3.1 INTRODUCTION

Goulburn-Murray Water (G-MW) has consulted extensively with customers in recent years as it has undergone changes to its service delivery model as a result of its Connections Project. The Commission requires G-MW to continue to consult with its customer committees and customers during the development of its price submission. G-MW must detail the extent and nature of the consultation processes including matters on which it has consulted and customer feedback in response (as required by the WCIR).

3.2 COMMISSION'S EXPECTATIONS OF G-MW'S CONSULTATION WITH CUSTOMERS

The Commission will assess G-MW's consultation process consistent with the requirements of the ACCC's pricing principles for infrastructure-related services[5] and the requirements of the WCIR (see box 3.1).

5 Australian Competition and Consumer Commission, *Application by Essential Services Commission Victoria for Accreditation Final Decision,* 17 February 2012.

BOX 3.1 CONSULTATION REQUIREMENTS

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

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

Source: *Water Charge (Infrastructure) Rules 2010.*

The Commission will assess whether G-MW has sought and considered input from its customer committees and customers on matters in its price submission such as:

- price and service trade-offs
- investment decisions
- proposed tariffs.

The Commission suggests providing customers with fact sheets or summary sheets outlining the key issues and proposals to be included in the pricing submission. Other consultation methods that could be used are:

- public meetings
- website surveys
- newsletters
- media releases.

3.3 INFORMATION REQUIRED IN THE PRICE SUBMISSION

The Commission requires G-MW's price submission to include the following information:

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

4 SERVICE STANDARDS AND TARGETS

4.1 INTRODUCTION

Service standards and targets should reflect customers' priorities and expectations in relation to service delivery and should underpin Goulburn-Murray Water's (G-MW) expenditure plans.

G-MW has historically reported service standards on an individual district basis. More recently, it has moved towards unified service standards, to reflect more common levels of service received by its customers resulting from its Connections Project. G-MW's existing set of service standards and targets reflect customer preferences in relation to (but not limited to):

- administration of licensing
- customer service
- water delivery
- response to bursts and leaks

4.2 APPROACH TO ASSESSING SERVICE STANDARDS

The WCIR do not cover G-MW's service standards which are regulated under Victoria's legal framework. Under section 4F of the Victorian *Water Industry Act 1994*, the Commission has established rural Customer Service Codes to regulate the standards and conditions of supply of declared services. Service standards and associated targets were approved under these Codes at the last price review. Under these Codes, the Commission can:

- approve standards set out in a water business's price submission, and/or
- specify those standards in a code.

The Commission will approve G-MW's service standards and targets if it demonstrates the service standards relate to verified obligations or service expectations of customers. G-MW should demonstrate that customer committees and customers have been consulted on their service expectations and that their views have been taken into account.

The Commission's starting point for assessing service standards will be the average levels of service provided in the 2013-2016 regulatory period. Any proposed changes to service standards and/or targets should be explained to the Commission. The Commission expects G-MW to provide evidence of consultation with customer committees and customers on service and price trade-offs if changes to service standards and/or targets are proposed.

4.3 INFORMATION REQUIRED IN THE PRICE SUBMISSION

The Commission requires that G-MW's price submission:

- outlines all proposed service standards and their corresponding targets for each year of 1 July 2016 – 30 June 2020
- specify, for each standard, whether it reflects an obligation imposed by government policy and regulatory obligations or is an expectation of customers
- outline the basis for setting the proposed service target and the reasons for adopting the target
- where applicable, provide historical performance for each service standard
- identify any proposed changes to service standards and the rationale for changes (such as willingness to pay studies or other indicators of customer preferences)
- identify the cost and price implications of proposing a target that is above or below current levels

- set out how G-MW proposes to meet the specified target, including projects targeted at meeting service levels over 1 July 2016 – 30 June 2020, or areas where a lower target will reduce costs
- provide evidence of consultation with customer committees and customers and evidence of their support and willingness to pay for the proposed service target.

5 OPERATING EXPENDITURE

5.1 INTRODUCTION

Operating expenditure is a key input into customer prices. The price review is taking place at a time when Goulburn-Murray Water (G-MW) is undergoing substantial change within its business, mainly due to major investments to modernise its infrastructure network. This investment will mean some of G-MW's future operating cost requirements (in terms of the nature and magnitude of expenditure) are likely to differ from past costs. The Commission will examine past operating expenditure and establish a baseline of costs to use as a starting point for its analysis, and examine G-MW's proposals for changes from this baseline.

In the last review G-MW put forward a well-explained operating expenditure proposal with reasonably flat operating costs and significant savings stemming from its infrastructure modernisation program. The Commission made only minor adjustments to G-MW's proposed operating expenditure. If G-MW put forward a proposal of similar quality again, with flat or declining operating expenditure, it is likely that we would also only make minimal adjustments for 1 July 2016 – 30 June 2020.

5.2 COMMISSION'S APPROACH

The Commission regulates G-MW's infrastructure-related services according to the ACCC's pricing principles for price approvals and determinations made under the *Water Charge (Infrastructure) Rules 2010* (WCIR) — see box 5.1 for the pricing principles relating to the assessment of operating costs. The Commission's undertaking to apply these pricing principles was a condition of the Commission's accreditation to regulate G-MW.

BOX 5.1 ACCC'S PRICING PRINCIPLES FOR ASSESSING OPERATING EXPENDITURE

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

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

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

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

Source: Australian Competition and Consumer Commission, *Application by Essential Services Commission Victoria for Accreditation Final Decision,* 17 February 2012.

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

The Commission's approach for assessing operating expenditure will be as follows:

- establish a baseline operating expenditure by reviewing the actual operating costs from the last full year of actual expenditure data, and adjusting to remove any one-off or non-recurring expenditure items and any inefficient costs
- assess G-MW's proposed changes to annual operating expenditure for each year, including the itemised new costs and new savings arising from the modernisation

program, and assess whether identified adjustments are consistent with efficient expenditure

- adjust the baseline forecast operating expenditure to reflect the recommended adjustments.

5.2.1 PRODUCTIVITY IMPROVEMENTS

Under the ACCC's pricing principles, the Commission must assess whether G-MW's forecast costs include reasonable productivity improvements in providing services over 1 July 2016 – 30 June 2020. The Commission expects G-MW to present a case to the Commission regarding productivity improvements it expects will arise from its infrastructure network and internal business reform program over 1 July 2016 – 30 June 2020.

5.3 INFORMATION REQUIRED IN THE PRICE SUBMISSION

G-MW's price submission must provide sufficient information for the Commission to assess G-MW's operating cost forecasts.[6] G-MW's price submission should:

- provide actual annual operating expenditure for past years and annual forecasts for operating expenditure for the remainder of the third regulatory period and the regulatory periods out until 2024.
- justify the operating cost estimate for the baseline year, identifying any adjustments for non-recurring expenditure
- quantify and justify the operating cost impact of the infrastructure modernisation program, itemising any cost increases or decreases from the baseline year
- specify and justify expected efficiency savings to apply to baseline operating expenditure

[6] The Commission's requirements in this chapter are aligned with the information requirements for operating expenditure in Schedule 1 of the *Water Charge (Infrastructure) Rules 2010*.

- provide estimates of (historic and forecast) operating expenditure by cost category (see appendix A)
- explain the trend in forecast operating expenditure having regard to:
  - historic operating expenditure
  - changes in service obligations and targets
  - scope for efficiency improvement (see 5.2.1)
  - changes in operating expenditure by cost category
  - trends in input prices
  - forecast demand
  - proposed capital works
- any other relevant factors outlining key assumptions underlying the operating expenditure forecasts, any risks to the forecasts and how these uncertainties have been addressed.

6 CAPITAL EXPENDITURE

6.1 INTRODUCTION

This chapter focuses on the Commission's requirements relating to justification by Goulburn-Murray Water (G-MW) of its proposed capital expenditure for 1 July 2016 – 30 June 2020. G-MW is currently undertaking a large program of capital spending funded by government, called the "Connections Program" which will not directly impact on prices paid by customers. The remainder of its capital program, which in the past has been relatively small, will be assessed by the Commission using the approach adopted at the 2013 review.

6.2 COMMISSION'S APPROACH TO ASSESSING CAPITAL EXPENDITURE

As required in the ACCC's decision on the accreditation of the Commission to regulate G-MW, the Commission regulates G-MW's infrastructure related capital expenditure according to the ACCC's pricing principles – see box 6.1.[7] Under the WCIR the Commission must approve prices that reflect no more than prudent and efficient expenditure.

[7] The Commission's requirements in this chapter are aligned with the information requirements for capital expenditure in Schedule 1 of the *Water Charge (Infrastructure) Rules 2010*.

BOX 6.1 ACCC'S PRINCIPLES FOR ASSESSING CAPITAL EXPENDITURE

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

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

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

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

Source: Australian Competition and Consumer Commission, *Application by Essential Services Commission Victoria for Accreditation Final Decision,* 17 February 2012.

Non-infrastructure related capital expenditure on areas such as groundwater or miscellaneous services are regulated in accordance with the WIRO.

The Commission will assess G-MW's proposed capital expenditure by considering:

- proposed investment in existing infrastructure —expenditure to maintain existing service standards (renewals)
- proposed new investment — expenditure to provide new or improved service outcomes (growth, service improvement), improve business efficiency, or to meet new government obligations (compliance).

6.2.1 MAINTENANCE CAPITAL EXPENDITURE

The Commission will assess G-MW's proposed maintenance capital expenditure by scrutinising its overall strategy for asset renewals, with a focus on the business's approach to prioritisation and timing of works. In order to test the efficiency of proposed renewals capital expenditure, the Commission may select a random sample of renewals projects and assess the efficiency of forecast costs for each project.

6.2.2 NEW CAPITAL EXPENDITURE

Capital expenditure driven by growth, service improvement, efficiency improvement, or new government obligations is usually related to discrete projects to deliver clearly defined outcomes. The Commission will assess whether proposed capital projects are prudent, efficient and deliverable. Specifically, whether:

- proposed capital expenditure reflects obligations imposed by government (including technical regulators) or customers' service expectations
- proposed new major capital works are consistent with efficient long-term expenditure on infrastructure services (based on a best practice asset management framework which considers risk and system-wide needs)
- changes in operating costs are consistent with the timing of major capital projects
- the timeframe for delivering the proposed new capital expenditure is reasonable, considering G-MW's delivery of major projects in the past
- G-MW's incentive and penalty payment arrangements with its contractors are based on a symmetrical sharing of risk for delivery or non-delivery of projects.

6.3 MAJOR PROJECTS

Under the WCIR, major projects are defined as:

> *A major project is considered to be one for which total expenditure on the project over its life is expected to exceed $2m or 5% of the annual revenue to be recovered through regulated charges – whichever is the lesser amount.*[8]

To assist with the capital expenditure assessment, G-MW's price submission must identify its major projects (by total project cost) to be started, progressed or completed during 1 July 2016 – 30 June 2020, and provide details of the projects.

Major projects should only include discrete projects with clearly defined objectives and outcomes and target completion dates – it should not include large allocations for ongoing expenditure programs (such as renewals) which are assessed separately.

The Commission will assess whether G-MW has justified the need for the projects and its project cost estimation, including whether the proposed timing for delivery of major projects is achievable.

6.4 PROJECT COST ESTIMATES AND TIMELINES

The Commission will assess a selection of the nominated major projects, as well as some randomly selected minor projects, and consider the following in determining the capability to cost and deliver projects:

- the actual performance against previous capital expenditure programs and the business's demonstrated capacity to deliver against capital budgets of the order of those proposed
- the project cost estimation methodology and degree of accuracy (which should include a schedule of quantities using typical industry rates)

[8] Australian Competition and Consumer Commission, *A guide to the Water Charge (Infrastructure) Rules: Pricing application for Part 6 operators October 2011*.

- the internal and external resources available to deliver the identified projects
- timing of proposed capital programs in terms of deliverability, taking into account the proposed capital expenditure across the industry
- opportunity to smooth the business's proposed capital profiles or defer discretionary or non-essential projects from the start of the regulatory period to later in the period
- the business's risk sharing, and incentive and penalty payment arrangements with its contractors. The Commission's view is that incentive payments should be based on a symmetrical sharing of risk for delivery/non-delivery of projects
- the business's project management capability, including evidence to demonstrate that appropriate project management systems and processes are in place.

Systemic findings from the assessment of these selected projects will be considered to apply to all capital expenditure forecasts, and the Commission may apply a blanket adjustment across all or part of the capital expenditure forecast.

The Commission's consultant reports on G-MW will be made public during the price review.

6.5 INFORMATION REQUIRED IN THE PRICE SUBMISSION

G-MW's price submission must provide sufficient information for the Commission to assess G-MW's capital expenditure forecasts. G-MW's price submission must:

- provide annual forecasts for capital expenditure for 1 July 2016 – 30 June 2020 and 1 July 2020 – 30 June 2024 separately identifying and reconciling:
  - total capital expenditure
  - contributions (government and customer)
  - proceeds from asset sales
  - net capital expenditure
- provide a breakdown of (historic and forecast) capital expenditure by maintenance related expenditure and new capital expenditure
- explain and justify the trend in forecast capital expenditure having regard to:
  - historic capital expenditure

- changes in service obligations and targets
- trends in input prices
- forecast demand
- forecast operating costs
- any other relevant factors

- provide estimates of (historic and forecast) capital expenditure by cost driver (see appendix A)
- outline key assumptions underlying the capital expenditure forecasts, any risks to the forecasts and how these uncertainties have been addressed
- identify the major capital expenditure projects proposed for 1 July 2016 – 30 June 2020, for each providing:
  - the project name and scope
  - cost category and cost driver
  - start and completion dates
  - total capital cost (itemising any contributions), and expenditure by year
- for major projects, a completed business case should be available for each project, including:
  - the cost drivers (referring to any specific government or regulatory obligation)
  - the specific outcomes to be delivered
  - a cost-benefit analysis, including a rigorous analysis of options considered for achieving the identified outcomes and preferred approach. This should also include an assessment of a 'do nothing' option. Cost comparisons of various options should consider P5, P50 and P95 estimates
  - a risk analysis of the selected option, with a plan to mitigate the identified risks to ensure the project can be delivered on time
  - the expected commencement and delivery dates, including the expenditure profile across each year of the regulatory period (and beyond if necessary)
- identify proposed expenditure for ongoing major capital programs (for example, channel renewals, access tracks and fencing, storage management) that continue from one regulatory period into the next
- for each capital program, identify the expenditure profile across each year of the regulatory period.

7 REVENUE REQUIREMENT

7.1 INTRODUCTION

The ACCC pricing principles and the WCIR require the Commission to use a building block model when assessing prices. In this model the revenue requirement reflects operating expenditure (see chapter 5) and a return on and of the regulatory asset base (RAB) updated each year to reflect any additional capital expenditure net of contributions, asset disposals and regulatory depreciation.

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

G-MW's price submission must include the estimated annual revenue requirement for at least 8 years (two regulatory periods) from 1 July 2016. A likely range can be provided for the estimated revenue requirement for years beyond 1 July 2016 – 30 June 2020.

Rule 5 of Schedule 1 of the WCIR outlines the requirements for the regulatory asset base (box 7.1) and Rule 6 of Schedule 1 of the WCIR outlines the details of the rate of return (box 7.2).

BOX 7.1 REGULATORY ASSET BASE

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

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

(i) actual contributions from customers and government;

(ii) actual proceeds from asset disposals and the nature and type of assets sold;

(iii) the regulatory depreciation of assets and the reasons for the depreciation;

(iv) from the above, the actual regulatory asset base; and

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

(i) forecast contributions from customers and government and the assumptions underpinning those forecasts;

(ii) forecast proceeds from asset disposals and the nature and type of assets anticipated to be sold;

(iii) the regulatory depreciation of assets and the reasons for the depreciation;

(iv) from the above, the forecast regulatory asset base.

Source: Water Charge (Infrastructure) Rules 2010.

BOX 7.2 RATE OF RETURN

Details of the rate of return:

(a) in respect of each year of the initial period or the regulatory period that is set to expire; and

(b) proposed by the Part 6 operator for each year of the following regulatory period: and the basis for that rate, including the methodology used to determine the rate and the values of all inputs used in the calculation of the rate.

Source: Water Charge (Infrastructure) Rules 2010.

7.2 RAB ROLL FORWARD

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

7.2.1 DETERMINING THE OPENING VALUE OF THE RAB

When assessing G-MW's price submission, the Commission must establish:

- the opening value of the RAB at 1 July 2016, and
- the forecast value of the RAB for each year of 1 July 2016 – 30 June 2020.

To determine the opening RAB value at 1 July 2016, actual figures will be used for past years, while the forecast figures in the 2013 price determination will be used for incomplete years. An adjustment will be made for any difference between assumed and actual net capital expenditure when the opening RAB is calculated for 1 July 2020.

To calculate the opening RAB at 1 July 2016 the following formula will be used:

Opening RAB 1 July 2016	=	RAB at 1 July 2013
	+	Actual capital expenditure (gross)
	+	Forecast capital expenditure (gross)
	–	Actual contributions
	–	Forecast contributions
	–	Forecast regulatory depreciation
	–	Proceeds from disposal of assets
	–	Forecast proceeds from disposal of assets

The same approach is used to determine the opening value for each subsequent year of 1 July 2016 – 30 June 2020, using the forecasts for capital expenditure, customer and government contributions, regulatory depreciation and disposals.[9] The RAB will also be adjusted for the difference between forecast and actual capex from the previous regulatory period.

7.2.2 DEMONSTRATING THE PRUDENCE AND EFFICIENCY OF PAST CAPITAL EXPENDITURE

Capital expenditure during 1 July 2013 – 30 June 2016 must be both prudent and efficient to be included in the roll forward into the opening RAB for 1 July 2016 – 30 June 2020. The price submission must link past (1 July 2013 – 30 June 2016) spending to verified outcomes and demonstrate that associated projects have been delivered cost-effectively. In particular, the Commission will have regard to:

- total capital expenditure compared with the benchmarks allowed in G-MW's 2013 price determination

[9] The Commission's requirements in this chapter are aligned with the information requirements for the regulatory asset base in Schedule 1 of the *Water Charge (Infrastructure) Rules 2010*.

- capital expenditure compared with the forecast for each of the major capital projects identified in the 2013 price determination
- expenditure that has been redirected from the major projects which were justified as part of the 2013 price review process.

G-MW's price submission must:

- explain and reconcile actual capex with forecast capex for 1 July 2013 – 30 June 2016
- reconcile expenditure for major projects identified in G-MW's submission to the 2013 price review
- explain and quantify capex undertaken in 1 July 2013 – 30 June 2016 and sought to be recovered in prices but not planned at the time of the 2013 price review.

7.2.3 CONTRIBUTIONS

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

The price submission should provide separate data and information on:

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

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

7.2.4 DEPRECIATION

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

The depreciation allowance included in the 2013 price determination will be used to adjust the RAB for each year of 1 July 2013 – 30 June 2016 to determine the opening RAB for 1 July 2016. This allowance will not be adjusted to reflect actual expenditure profiles across the period to avoid providing an undue incentive to increase capital expenditure spending above benchmarks during the regulatory period.

For 1 July 2016 – 30 June 2020, the Commission's principles for assessing G-MW's regulatory depreciation are:

- the regulatory value of G-MW's assets will not be changed in future regulatory reviews
- the approach taken by G-MW to estimate regulatory depreciation should reflect reasonable assumptions about asset life and utilisation.

The Commission's approach is for businesses to only receive depreciation when an asset comes into service, and this approach will apply for the calculation of G-MW's regulatory depreciation. In its price submission G-MW must explain and justify its approach to depreciation.

7.2.5 DISPOSALS

G-MW's price submission must include estimates of revenue expected from disposal of assets for each year of 1 July 2016 – 30 June 2020, to be deducted from the RAB roll forward.

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

7.2.6 ADJUSTING THE RAB FOR INFLATION

The existing tariffs were designed to deliver a real (rather than nominal) return on assets as described in section 2.2.2. The opening RAB must be adjusted to compensate investors for inflation over 1 July 2013 – 30 June 2016 and to reflect inflation when projecting revenue for 1 July 2016 – 30 June 2020.

7.3 RATE OF RETURN

The rate of return is used to calculate a return on a business's investments in regulated assets. The Commission will decide what rate of return is used for G-MW for 1 July 2016 – 30 June 2020, based on the approach specified by the ACCC and consistent with our approach in the 2013 final decision.[10]

7.3.1 THE COMMISSION'S ASSESSMENT OF COST OF CAPITAL

The Commission will set the rate of return for G-MW consistent with the approach required by the ACCC under the terms of the Commission's accreditation to regulate G-MW. The Commission will set the Weighted Average Cost of Capital (WACC) within the following parameters as required by the ACCC's pricing principles:

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

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

Where: Re = cost of equity

Rd = cost of debt

E = market value of the business's equity

D = market value of the business's debt

V = E + D = firm value

E/V = percentage of financing that is equity

D/V = percentage of financing that is debt.

- the cost of equity is to be calculated using a market risk premium of 6 per cent

[10] Essential Services Commission 2013, *Price Review 2013: Rural Water Businesses — final decision*, June.

- the risk free rate is to be based on the yield of a 10 year Commonwealth Government Security bond. The Commission proposes to use an averaging period of 40 business days commencing as close as practically possible to the start of the regulatory period
- the cost of equity is to be calculated using an equity beta of 0.7, and
- the benchmark debt risk premium is to be estimated on the basis of a benchmark gearing level of 60:40 debt to equity on the yields of BBB+ rated corporate bonds with 10 year maturity.[11]

The Commission will determine a WACC that takes into account prevailing market conditions and recent decisions by other regulators.

The Commission will include a WACC estimate in the financial model that it will provide to G-MW for preparing its price submission. This WACC estimate will be updated prior to the final decision to reflect prevailing market conditions.

7.4 TREATMENT OF COSTS RELATING TO NON-REGULATED SERVICES

In order to calculate G-MW's revenue requirement, the Commission must exclude costs related to non-regulated services. The Commission has the power to regulate only the prices of those services defined as infrastructure services in the WCIR. The WCIR defines infrastructure service as *access, or a service provided in relation to access, to water service infrastructure and includes the storage, delivery, drainage and taking of water.*

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

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

Non-regulated services are not provided ‘in connection with’ regulated services and are often provided in a competitive market. The Commission considers that services such as property rental or leasing, and boating and recreation services are non-regulated.

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

The price submission should also provide an overview of the expenditure and revenue forecasts (for at least 8 years from 1 July 2016) associated with non-regulated services for the regulatory period and explain how shared costs (such as corporate costs) have been allocated between regulated and non-regulated services.

The Commission’s financial template will require further information on the costs and revenue of non-regulated services. The template will also allow G-MW to lower customer prices by using revenue from these activities to offset its regulated revenue requirement.

8 DEMAND

8.1 INTRODUCTION

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

8.2 COMMISSION'S ASSESSMENT OF DEMAND FORECASTS

The Commission must ensure that Goulburn-Murray Water's (G-MW) proposed demand forecasts meet the requirements of the WCIR and the ACCC's pricing principles for infrastructure related services. Rule 11 of Schedule 1 of the WCIR outlines the requirements of demand forecasts (box 8.1).

BOX 8.1 WCIR REQUIREMENTS OF DEMAND FORECASTS

The Commission will assess whether G-MW's proposed forecasts:

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

Source: Water Charge (Infrastructure) Rules 2010.

The Commission's consultant reports on G-MW will be made public during the price review.

8.3 INFORMATION REQUIRED IN THE PRICE SUBMISSION

G-MW's price submission should summarise its demand forecasts and the key assumptions adopted to develop those forecasts. G-MW should use at least an 8 year horizon for demand forecasting and scenario analysis and reflect this in its price submission.

The Commission also expects G-MW's price submission to include:

- tabular information that summarises the demand forecasts adopted for 8 years for each service and region, and provides comparable historical information on demand

- information that describes the methodology used, identifies the key demand forecasting issues and lists and justifies the key assumptions adopted in generating the forecasts, including any assumptions about modernisation, connections and buyback reflected in the forecast for the 8 years
- evidence that a range of supply and demand scenarios were modelled, including low, normal and high water inflow scenarios
- an explanation about why the demand forecasts adopted were chosen over other scenarios modelled
- an explanation of where price elasticity was applied, the figures used, and how the measure was translated into G-MW's demand forecasts
- an explanation of where it accounted for changed tariff structures
- an explanation of where water trading has occurred
- an explanation of how demand forecasts are consistent with proposed expenditure (in terms of the level and nature of expenditure).

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

The Commission's financial templates will require G-MW to provide detailed data on actual demand numbers and demand forecasts for every tariff and tariff category. The detail in these templates does not need to be reproduced in the price submission.

9 FORM OF PRICE CONTROL

9.1 INTRODUCTION

From 1 July 2013 – 20 June 2016, Goulburn-Murray Water (G-MW) has a revenue cap form of price control with a rebalancing constraint of ±10 per cent. This means that G-MW may alter its prices to raise the revenue allowed by the Commission at the last Price Review, but that it must limit individual price changes to plus or minus 10 per cent in any single year.

The form of control can be an important means of managing risk for water businesses and also has implications for how price changes will affect water customers.

We anticipate G-MW will continue with a revenue cap form of price control for 1 July 2016 – 30 June 2020. If G-MW wishes to propose a new form of price control, we expect it to discuss this with customers and the Commission before submitting its pricing submission.

9.2 OUR ASSESSMENT FRAMEWORK

The ACCC's approval of the Commission's application for accreditation means the Commission regulates G-MW's infrastructure-related services according to the pricing principles in the ACCC's Final Decision on the Commission's accreditation.

In its Final Decision, the ACCC states that a water business may apply for any form of price control subject to meeting the requirements of the *Water Charge (Infrastructure) Rules 2010*.[12] The ACCC also states that pricing principles allow for flexibility in choosing the form of price control. Water businesses are required to submit the form of price control they would like to apply and the reasons for making the proposal.[13]

9.3 ADJUSTING PRICES

If G-MW would like to apply to make an adjustment to any regulated charges during the period, it would need to do so according to Rule 40 of the WCIR set out in box 9.1.

BOX 9.1 VARY APPROVAL OR DETERMINATION

Regulator may vary approval or determination in certain circumstances

(1) A Part 6 operator may apply in writing to the Regulator for a variation of the approval or determination under Division 2 or 3 (or, if previously varied under this Division, as so varied) of its regulated charges in respect of a regulatory period if:

(a) an event occurs during the regulatory period that materially and adversely affects the operator's water service infrastructure or otherwise materially and adversely affects the operator's business; and

(b) the operator could not reasonably have foreseen the event.

(2) An application under subrule (1):

(a) must set out details of the event; and

(b) must state the Part 6 operator's proposals for rectifying the material and

[12] Australian Competition and Consumer Commission, *Application by Essential Service Commission of Victoria for Accreditation*, Final Decision, 17 February 2012.

[13] Australian Competition and Consumer Commission, *A guide to the Water Charge (Infrastructure) Rules: Pricing application for Part 6 operators,* October 2011, p. 27.

adverse effects of the event; and

(c) must state—

(i) the total amount that the Part 6 operator anticipates will be required during the remainder of the regulatory period to rectify those material and adverse effects;

(ii) whether that amount is likely to exceed $15 million or 5% of the value of the operator’s regulatory asset base as at the beginning of the regulatory period whichever is the lesser amount; and

(iii) whether it is reasonably likely (in the absence of any reduction of any other expenditure) that the total expenditure during the remaining part of the regulatory period will exceed the total forecast expenditure for that remaining part; and

(d) must demonstrate that the Part 6 operator is not able to reduce its expenditure to avoid the consequences referred to in subparagraphs (c) (ii) and (iii) without materially and adversely affecting the reliability and safety of the operator’s water service infrastructure or the operator’s ability to comply with any relevant regulatory or legislative obligations; and

(e) must set out details of the variation of its regulated charges sought by the Part 6 operator.

Source: Water Charge (Infrastructure) Rules 2010.

9.4 INFORMATION REQUIRED IN THE PRICE SUBMISSION

The Commission assumes G-MW will continue to use a revenue cap form of control. If G-MW plans to alter its form of control, the Commission would require G-MW to state the form of price control it is applying for, accompanied by an explanation of how the proposed form of price control meets the WCIR requirements. Also G-MW must:

- explain how the proposed form of control will operate and the specific formula that will be used
- demonstrate it has consulted with customer committees and customers on its proposal
- explain how the form of control may impact customers and how it has addressed those impacts.

10 TARIFF LEVELS AND STRUCTURES

10.1 INTRODUCTION

During the 2013 Price Review, Goulburn-Murray Water (G-MW) indicated it would propose: substantial tariff reform at the next price review to better match its tariffs with its resized irrigation infrastructure; and a tariff structure with greater commonality of charges for irrigators.

10.2 TARIFF ASSESSMENT CRITERIA

The Commission will consider G-MW's tariff proposals against two sets of criteria:

- the ACCC's pricing principles which apply to G-MW's infrastructure-related services such as irrigation and bulk water supplies (box 10.1)
- the WIRO which applies to G-MW's groundwater services and some miscellaneous services.

BOX 10.1 ACCC'S PRICING PRINCIPLES FOR TARIFFS

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

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

Source: ACCC Pricing Principles.

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

10.3 TARIFF STRUCTURE AND DESIGN ISSUES

The Commission's view is that G-MW, in consultation with its customer committees and customers, is best placed to design tariffs and tariff structures that meet its customers' needs, and manage its risk and deliver its desired business outcomes. It is also best able to coordinate and integrate its tariff structures with its broader risk management policies (which include the form of control and management of service standards, among others). The Commission will consider a number of tariff structure issues for 1 July 2016 – 30 June 2020, explained below.

10.3.1 EFFICIENCY

The ACCC's pricing principles require consideration of efficiency. This could be realised by moving towards cost reflectivity in pricing. The Commission will analyse the extent to which G-MW's tariffs and charges recover the actual costs incurred in the delivery of specific services. This includes providing for a two part tariff to reflect fixed and variable costs where applicable.

10.3.2 CLARITY OF AND ALIGNMENT WITH LONG TERM STRATEGY

The Commission notes that G-MW is part way through a long process of modernisation with its connections project. G-MW has consulted well on this project. We expect this consultation to continue.

The Commission will consider the clarity and robustness of G-MW's proposed tariff strategy. In the Commission's view, tariff reform should proceed according to a publicised and planned sequence to provide for customer certainty. Ideally G-MW's tariff strategy should:

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

10.3.3 TIME FRAMES

G-MW should consider timeframes for planning and cost projection beyond the limits of 1 July 2016 – 30 June 2020 when designing tariff structures to cover its costs.

For all tariff proposals, G-MW should identify the prices and tariff structures it is proposing to implement over 1 July 2016 – 30 June 2020, and should identify material changes to prices being proposed and provide clear links between the proposed price changes and their drivers, such as new government obligations or material changes in the revenue requirement.

Locational pricing often reflects a less integrated network with large differences in costs between different water networks. However, in G-MW's case the substantial alterations to its infrastructure will lead to a more inter-connected network which will mean that customers will increasingly have more uniform service. This is likely to lead to streamlined tariffs and charges. Where differences in costs for different customers remain, we expect G-MW to clearly articulate the basis for any differences in tariffs and charges for its customers.

10.3.4 INFORMATION REQUIRED IN THE PRICE SUBMISSION

The price submission must contain sufficient information to justify prices and tariff proposals. G-MW must articulate its tariff strategy and highlight any major changes during 1 July 2013 – 30 June 2016. It should show evidence and analysis of customer impacts of proposed changes and any strategies to address them.

The price submission should specify and justify each tariff it proposes to apply in 1 July 2016 – 30 June 2020. It should also include estimates of likely prices until at least 2023-24. Estimates beyond 1 July 2016 – 30 June 2020 could be a range of prices, within reasonable bounds.

In each of the relevant areas above, the price submission should outline:

- relevant background information about the underlying service and recent pricing history
- a table outlining the current and proposed tariff structure. Prices must be reported in real terms (consistent with the Commission's financial template).

Each price proposed in the price submission must directly correspond with a price in the financial template and the following information must be provided:

- how the tariff is to be applied, for example, billing period, customer class, applying prices through connection or meter size
- the reasons for the proposed tariff schedule, including clearly identified principles underlying the proposal
- the relationship between the proposed price for a service and the associated long run marginal cost
- the impacts of the proposal on customers and strategies to address impacts
- a discussion on the consultation G-MW conducted to develop the proposal. This information is particularly important if G-MW proposes new tariff structures or tariffs that will significantly affect customers.

11 FINANCIAL VIABILITY

The Commission has financial viability objectives set out in the *Essential Services Commission Act 2001* and the principles in the WIRO. To satisfy these objectives and principles, we undertake a financial viability test when we approve prices.

Financial viability tests consider whether a business meets an investment grade credit rating and whether the business will be able to pay its cash obligations in its next pricing period. We base these tests on outcomes for the four indicators and associated benchmarks in table 11.1.

The four quantitative indicators in table 11.1 focus mainly on cash flow, which we believe provides the best indication of a business's underlying financial position. To calculate these indicators, we will use historic and forecast actual data (as opposed to notional data). We will also rank the importance of indicators – 'FFO interest cover' ranked highest; 'gearing' ranked second highest; 'FFO / net debt', 'internal financing ratio', and 'Proportion of Discretionary Revenue' indicators ranked lowest. The financial viability ratios will be included in the financial template.

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

TABLE 11.1 FINANCIAL INDICATORS

Indicator	Calculation	Benchmark Range	Description
Primary indicator – used to determine size of adjustments			
FFO interest cover	(FFO + net interest) / net interest	> 1.5 times < 1.8 times[14]	Measures the extent of the cash flow buffer a business has to meet its debt obligations.
Secondary indicators – used as contextual information to determine whether an adjustment is necessary			
Net Debt / Regulatory Asset Value (%) (Gearing)	(Interest bearing liabilities – cash) / RAV	< 70 per cent	Measures the debt component of the regulatory capital structure.
FFO / Net debt (%)	FFO / (Interest bearing liabilities – cash)	> 10 per cent	Measures the extent to which the serviceability of debt is improving, remaining stable, or declining.
Internal financing ratio (%)	(FFO – dividends) / net capital expenditure	> 35 per cent	Measures the extent to which an entity has cash remaining to finance a prudent portion of capital expenditure after making dividends.

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

[14] The Commission would not consider intervention if the indicator was greater than 1.5, however, the Commission would monitor and expect caution from the business if the indicator was below 1.8.

APPENDIX A: COST CATEGORIES

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

- irrigation
- drainage
- domestic and stock
- surface water diversions
- groundwater diversions
- bulk water services
- external temporary water purchases
- licence fees
- environmental contribution
- fully funded government or customer programs/projects.