

# Western Water draft decision

2020 Water Price Review

11 March 2020



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# Summary

## **In November 2019, Western Water provided a submission to us proposing prices for a three-year period starting 1 July 2020**

This draft decision sets out our views on Western Water's price submission.<sup>1 2</sup> This paper should be read in conjunction with Western Water's price submission.

We invite interested parties to comment on our views in this draft decision before we make a final decision and issue a price determination in June 2020. Details on how to make a submission on our draft decision are provided in Chapter 4.

## **Our draft decision does not accept many of Western Water's proposals**

Our guidance provided to Western Water set out the regulatory price setting process we must follow, including the matters Western Water must address in its price submission.<sup>3</sup>

Our assessment of Western Water's price submission found it did not have adequate regard to the matters specified in clause 11 of the Water Industry Regulatory Order (WIRO), or comply with our guidance in many instances (including in terms of the information we required). We have identified throughout our assessment in Chapter 2 where, in our opinion, Western Water's price submission does not comply with clause 11 of the WIRO or meet the requirements of our guidance.

During our assessment we sought further information from Western Water. We consider the information provided by Western Water in response to our queries was in many instances insufficient and inadequate to meet the information standards required by our guidance or the matters specified in our requests. We found Western Water was unable to provide adequate supporting evidence for many of its claims and proposals, or demonstrate how the proposals met the requirements of the WIRO or our guidance. Our expenditure assessment consultant reported similar difficulties in obtaining adequate supporting evidence from Western Water.

In addition, we found Western Water's price submission contained numerous errors and inconsistencies between the written submission and the financial template. Western Water changed many of its inputs in response to our requests for clarification, and errors were still being identified and amended in mid-February as we were finalising our draft decision assessment.

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

<sup>2</sup> Western Water's price submission is available on our website at [www.esc.vic.gov.au](http://www.esc.vic.gov.au).

<sup>3</sup> Essential Services Commission 2018, Western Water's 2020 water price review, final guidance paper, December.

Taking into account the considerations in the WIRO and our guidance, we have not accepted Western Water's proposals for:

- Expenditure – Western Water's operating and capital expenditure forecasts have been adjusted for our draft decision as a result of our assessment of prudence and efficiency following our review and consideration of our consultant's recommendations.
- Demand – we consider Western Water has not demonstrated it has used the best available estimates derived from an appropriate forecasting methodology, as required by our guidance.
- New customer contributions – Western Water's new customer contributions model included a number of unexplained inconsistencies with its price submission, so we could not verify that its proposed charges meet the requirements of our guidance.
- Cost of debt – Western Water proposed an alternate approach to adjusting for cost of debt to smooth its prices over the three-year period, however we found the corporation did not sufficiently justify its proposed approach against the WIRO requirements.
- Tariff structures – we do not consider some of the proposed tariff structure changes are consistent with the WIRO and the requirements of our guidance, notably Western Water's proposal to change from single fixed water and sewerage charges to different charges depending on customer type.

### **We have lowered the return on equity**

Our water pricing framework incorporates the PREMO incentive mechanism, whereby water corporations are required to rate their price submissions in terms of customer value proposed and the quality of the price submission prepared by the corporation. The PREMO rating informs the return on equity benchmark adopted for pricing.<sup>4</sup>

For the 2018 price review, Western Water sought a shorter two-year period to allow additional time to prepare a price submission better aimed at meeting its large customer growth. We agreed, and provided new guidance which said Western Water was not required to self-assess and give itself a PREMO rating. Instead, we said we would set the return on equity at 4.5 per cent, equivalent to a 'Standard' rated water corporation, provided it met the requirements set out in our guidance – our assessment subsequently found that it had.

Given this approach taken by Western Water in 2018, we did not consider it appropriate for its 2020 price submission to have access to the higher return rates associated with an 'Advanced' or 'Leading' price submission.

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<sup>4</sup> Under the PREMO incentive mechanism, return on equity is linked to a water corporation's level of ambition – 'Leading', 'Advanced', 'Standard' or 'Basic'. More information on the PREMO mechanism is available in Essential Services Commission 2016, 2018 Water Price Review, Guidance paper, November.

Accordingly, our guidance outlined the minimum information requirements for a ‘Standard’ rated corporation under the PREMO incentive mechanism. Western Water was again not required to give itself a PREMO rating but had to be satisfied that it met the requirements of our guidance in order to receive an equity return rate of a ‘Standard’ rated corporation.

We do not consider Western Water’s price submission met the requirements set out in our guidance. For the reasons discussed in Chapter 3, we consider Western Water’s performance on the Management and the Risk elements of PREMO was well below the expectations for a ‘Standard’ price submission. We have not assigned an overall PREMO rating in our draft decision.

Our draft decision proposes to set the return on equity to 3.9 per cent (in real terms, after tax), which is the minimum return on equity for a water corporation established for our 2018 water price review.

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

### **Our draft decision sets a benchmark revenue requirement of \$290.7 million**

Western Water’s price submission proposed a revenue requirement of \$302.3 million over the three-year period. However, Western Water has made subsequent changes to the inputs used to calculate its revenue requirement, including its late request to amend its tax and depreciation forecasts which we have not had sufficient time to consider. In such instances, we have made reasonable assumptions based on the best information available to us. We have also proposed changes to the operating and capital expenditure forecasts, and a lower return on equity.

Given all these changes, our draft decision proposes to approve a benchmark revenue allowance of \$290.7 million, that we consider will allow Western 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.

### **Western Water must respond to our draft decision**

Western Water’s response to our draft decision will need to take into account our proposed changes to its forecasts, as well as updated inflation and cost of debt figures we will provide, to establish a new revenue requirement.

It will also need to address the issues we raise throughout this draft decision, and propose tariff structures and prices that satisfy the requirements set out in the WIRO and in our guidance.





# 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 (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 three water corporations propose to charge customers from 1 July 2020**

We are reviewing prices for two urban water corporations (South Gippsland Water and Western Water) and one rural water corporation (Goulburn-Murray Water).<sup>5</sup>

Our review of the prices proposed by the two urban water corporations covers the prescribed services listed in the WIRO. The prescribed services include retail water and sewerage services, and bulk water and sewerage services delivered by the water corporations.<sup>6</sup>

In November 2019, Western Water provided a submission to us proposing prices for a three-year period starting 1 July 2020. 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 2020. The price determination will specify the maximum prices Western Water may charge for prescribed services, or the manner in which prices are to be calculated, determined or otherwise regulated. We will 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

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<sup>5</sup> Goulburn-Murray Water's price submission is assessed against the Commonwealth Government's Water Charge (Infrastructure) Rules (WICR).

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

- the matters specified in our guidance <sup>7</sup>
- 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.

Appendix B lists the specific objectives and the various matters we must have regard to when making a price determination and provides a guide to where we have done so in this draft decision.

In December 2018, we issued guidance to Western Water to inform its price submission. The guidance set out how we will assess Western 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 Western Water's proposed prices.<sup>8</sup>

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.<sup>9</sup>

### **The 2018 price review was the first 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.<sup>10</sup>

Over 2015, we held a series of workshops and hosted a conference 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.<sup>11</sup> We met with each water corporation and other interested parties to help inform their submissions. Submissions were supportive of the overall proposal, in particular the greater focus on customer engagement and value.

We finalised our new approach to water pricing in October 2016.<sup>12</sup>

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<sup>7</sup> Essential Services Commission 2018, Western Water's 2020 water price review, final guidance paper, December.

<sup>8</sup> This is a requirement of the WIRO, clause 14(b).

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

<sup>10</sup> Essential Services Commission 2015, Review of Water Pricing Approach, Consultation paper, April.

<sup>11</sup> Essential Services Commission 2016, A new model for pricing services in Victoria's water sector, Position paper, May.

<sup>12</sup> For more detail on the new water pricing approach see: Essential Services Commission 2016, Water Pricing Framework and Approach: Implementing PREMIO from 2018, October.

In November 2016, we issued guidance for the 2018 water price review, which set out how price submissions should be prepared in accordance with our new approach, including our new PREMO self-assessment incentive mechanism.<sup>13</sup>

At the 2018 water price review, Western Water did not submit a price decision by the due date of 29 September 2017.

In October 2017, Western Water requested we consider alternative arrangements for its price review.<sup>14</sup> It sought our support for:

- a shorter pricing period of two years
- prices to be held at current levels, plus an allowance for inflation.

Its letter stated this would allow Western Water, including recently appointed board members, to assess its capacity to address the challenge of servicing an unprecedented level of growth across its region, while providing affordable and value-adding services to its customers, before committing to longer term prices. Western Water's letter noted that its engagement highlighted the importance of providing bills that are affordable and equitable, and that its initial modelling showed prices would have to increase to a level that may not be affordable in the medium and longer term.

We accepted Western Water's request, given the unique circumstances it was facing in coming years.

In January 2018, we issued new guidance for Western Water's 2018 price review.<sup>15</sup> The guidance set a two-year regulatory period for Western Water from 1 July 2018 to 30 June 2020. This guidance stated that Western Water was not required to self-assess and give itself a PREMO rating.<sup>16</sup> Rather we said we would set Western Water's return on equity at 4.5 per cent, which reflects the rate of return a 'Standard' corporation would receive under the PREMO incentive mechanism, if it met the requirements of our guidance.<sup>17</sup>

Our decision for Western Water's 2018 price review approved the two-year period, and its proposed tariffs (which remained unchanged) and prices (increase by inflation only).<sup>18 19</sup> We also

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<sup>13</sup> Essential Services Commission 2016, 2018 Water Price Review, Guidance paper, November.

<sup>14</sup> Western Water 2017, Letter, 20 October, available on our website at [www.esc.vic.gov.au](http://www.esc.vic.gov.au)

<sup>15</sup> Essential Services Commission 2018, Guidance – Western Water's 2018 water price review, January.

<sup>16</sup> *ibid.*, p. 26.

<sup>17</sup> Under the PREMO incentive mechanism, return on equity is linked to a water corporation's level of ambition – 'Leading', 'Advanced', 'Standard' or 'Basic'. However, this mechanism did not apply to Western Water in this instance. More information on the PREMO mechanism is available in Essential Services Commission 2016, 2018 Water Price Review, Guidance paper, November.

<sup>18</sup> Essential Services Commission 2018, Western Water final decision: 2018 Water Price Review, 19 June

<sup>19</sup> Essential Services Commission 2018, Western Water Determination: 1 July 2018 – 30 June 2020, 19 June

accepted its proposed customer outcomes, which were informed by its customer engagement. Among other things, we expressed some concerns with Western Water's proposal and how it had derived its revenue requirement, namely:

- its assumptions for operating expenditure efficiency
- its considerably reduced water demand forecasts
- its approach to deferring recovery of depreciation.

However, given Western Water's forecast revenue did not exceed our established notional revenue requirement, we approved Western Water's proposed revenue and committed price path (of inflation only) for the two-year period from 1 July 2018, while it undertook its further business review to better address future costs. We considered Western Water's proposal to effectively extend the current pricing structures for two years while it undertook its review was in the long-term interests of its customers, consistent with the requirements of our guidance.

In December 2018 we issued new guidance to Western Water for its 2020 price review. While still following our new pricing approach, this guidance once again specified that Western Water is not required to self-assess and give itself a PREMO rating.<sup>20</sup> Rather we said we would set Western Water's return on equity at 4.5 per cent, which reflects the rate of return a 'Standard' corporation would receive under the PREMO incentive mechanism, if it met the requirements of our guidance.

Our consultation on the pricing approach informed the guidance we issued Western Water in December 2018, which informs Western Water's price submission for the 2020 water price review.

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<sup>20</sup> Essential Services Commission 2018, Guidance – Western Water 2020, op. cit., p. 2.

## 2. Our assessment of Western Water's price submission

We have made our draft decision on Western Water's price submission after considering: Western 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 Western Water's price submission are available on our website (to the extent the material is not confidential).

This draft decision should be read in conjunction with Western Water's price submission.

Our guidance included a number of matters Western Water must address in its price submission. We formed the opinion that Western Water's price submission did not have adequate regard to the matters specified in clause 11 of the WIRO, or comply with our guidance in many instances (including the information requested to be provided in the guidance). We have identified throughout this chapter where, in our opinion, Western Water's price submission does not comply with clause 11 or meet the requirements of our guidance.

During our assessment we sought further information from Western Water. We consider the information provided by Western Water in response to our queries was in many instances insufficient and inadequate to meet the information standards required by our guidance or the particular matters specified in our follow up requests. Overall, we found Western Water was unable to provide adequate supporting evidence for its various proposals, or demonstrate how they met the requirements of the WIRO or our guidance.

Consequently, for our draft decision we have not accepted many of the proposals in Western Water's price submission, and we have not accepted its proposed tariff structures or prices. We have used the best information available to us at this time to estimate Western Water's revenue requirement. Western Water will need to re-submit its proposed prices, along with appropriate supporting evidence consistent with our guidance and the WIRO.

We will provide Western Water with updated values for cost of debt and inflation in April 2020. These changes will likely impact the revenue requirement proposed by Western Water.

Western Water must submit a response to our draft decision and provide an updated financial model by 30 April 2020 (via email to [water@esc.vic.gov.au](mailto:water@esc.vic.gov.au)). The response will be published on our website.

We also invite other interested parties to make a submission in response to our draft decision up until that date (see Chapter 4 for details on how to provide feedback).

We intend to make a price determination for Western Water in June 2020.

All financial values referred to in this chapter are in \$2019-20.

## Regulatory period

Our guidance set a regulatory period of three years, from 2020-21 to 2022-23. Western Water's price submission is consistent with this requirement. Accordingly, our draft decision sets the term for Western Water's regulatory period as 1 July 2020 to 30 June 2023.<sup>21</sup>

## Customer engagement

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

The engagement by Western Water:

- built on its engagement for the 2018 price submission
- used a range of methods including online and face-to-face surveys, in-depth interviews, workshops with interest groups, focus groups, developer forums and deliberative forums
- sought views from community representatives including advocates of vulnerable customers, business groups, traditional owners, and a community engagement reference group established by the corporation
- covered matters such as residential tariffs, customer willingness to pay for a real price increase, customer service and satisfaction, guaranteed service levels and focus areas for future service improvement.

More detail on Western Water's engagement is available in its price submission.<sup>22</sup>

Evidence that Western Water's engagement influenced its submission includes its proposals to:

- maintain its current service standards in response to feedback in Western Water's annual customer satisfaction survey
- introduce a new guaranteed service level in response to support from customers who responded to Western Water's service standards and guaranteed service levels poll.

### Draft decision on service levels

Our draft decision approves Western Water's proposed service standards and guaranteed service level commitments.

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<sup>21</sup> Essential Services Commission 2018, Guidance – Western Water 2020, op. cit., p. 11.

<sup>22</sup> Western Water's price submission is available on our website at [www.esc.vic.gov.au](http://www.esc.vic.gov.au).

## Outcomes

Our guidance required Western Water to propose a set of outcomes that its customers will receive during the next regulatory period.

Western Water has retained the outcomes it committed to in its 2018 price submission, after confirming that they were still priorities for customers.

The outcomes Western Water proposes to deliver for the next regulatory period starting 1 July 2020 are to:

- have fair and affordable charges
- provide reliable, safe services
- provide innovative approaches to addressing customer needs
- care for the environment
- provide sustainable contributions to the community and regional liveability.

Western Water's proposed outcomes, measures and targets are provided on pages 17 to 19 of its price submission.

Essentially, Western Water has refined and updated its set of measures and targets from the 2018 price review. We note some measures have been removed, mostly completed activities, while several new measures have been added. We also note that following customer feedback, targets for some existing measures have become more ambitious.

Overall, we consider that Western Water's proposed outcomes are consistent with the guidance. It has set out clearly defined measures and targets that are relevant to its proposed outcomes. It has confirmed its outcomes with its customers and has explained how customer preferences have informed its commitments. Western Water has also specified how its activities, programs and other deliverables are connected to its outcomes.

We will engage with Western Water to ensure it captures its proposed changes when it prepares its summary outcomes report for the 2019-20 reporting year. Western Water will need to account for these changes to its outcome commitments through its direct self-reporting to customers.

## 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.

Western Water's proposed GSLs are set out on page 21 of its price submission. It proposes to retain its current five GSLs and introduce a new GSL addressing the maximum number of water supply interruptions in a twelve-month period. Customers experiencing more than five water supply interruptions will receive a payment of \$100. It has made no changes to the hardship GSL. We

Our assessment



note that Western Water's proposed GSLs were informed by customer feedback via its customer satisfaction surveys and a separate poll on service standards and GSLs.

### **Draft decision on guaranteed service levels**

We propose to accept Western Water's proposed GSLs because they were developed in consultation with its customers, reflect their concerns and long-term interests, and incentivise Western Water to provide efficient service levels to all customers, as required by our guidance.

Final GSLs will be subject to our consideration of any feedback following the release of this draft decision.

## **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.<sup>23</sup>

Having regard to the WIRO, we do not consider Western Water's proposed revenue requirement is consistent with the promotion of efficient use of prescribed services by customers or the promotion and provision of incentives for efficiency in the regulated entities, as well as efficiency in, and the financial viability of, the regulated water industry.<sup>24</sup>

Our guidance clearly indicated that we required Western Water to provide us with forecasts in the financial model based on robust underlying assumptions.<sup>25</sup> Our guidance also outlined the consequences if we assess that its price submission and financial model are not consistent and did not meet the requirements of our guidance (for example, set a lower revenue requirement).

Western Water proposed a forecast revenue requirement of \$302.3 million over a three-year period starting 1 July 2020. Our draft decision proposes not to accept the revenue requirement in Western Water's submission for reasons outlined in this decision, including:

- our proposed adjustments to Western Water's forecast operating expenditure
- our proposed adjustments to Western Water's forecast capital expenditure

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<sup>23</sup> We received input from 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 Western Water in the regulatory period from 1 July 2020. We had regard to their views in our draft decision. It is the water corporation's responsibility to ensure it has priced accordingly to meet all its legislative and regulatory obligations and requirements during the pricing period.

<sup>24</sup> WIRO, Clause 8(b).

<sup>25</sup> Essential Services Commission 2018, Guidance – Western Water 2018, op. cit., p. 3.

- our proposed reduction to the return on equity
- revenue from new customer contributions could not be confirmed <sup>26</sup>
- Western Water’s late change to its proposed tax allowance
- Western Water’s late change to its proposed regulatory depreciation.

### Draft decision on revenue requirement

For the purposes of making our draft decision, we have established a notional revenue requirement of \$290.7 million, reflecting our assessment of each element that comprises the revenue requirement, as shown in Table 2.1 below.

**Table 2.1** Draft decision revenue requirement  
(\$ million 2019-20)

	2020-21	2021-22	2022-23	Total
Operating expenditure	60.3	62.3	63.5	186.2
Return on assets	18.9	20.9	23.2	63.0
Regulatory depreciation	7.3	8.9	11.2	27.4
Non-prescribed revenue offset of revenue requirement	-0.1	-0.1	-0.1	-0.2
Tax allowance	7.5	4.6	2.2	14.3
<b>Notional revenue requirement</b>	<b>93.9</b>	<b>96.7</b>	<b>100.1</b>	<b>290.7</b>

Note: numbers have been rounded.

In its response to this draft decision, Western Water must resubmit its tax proposal and its depreciation schedule, consistent with our guidance, as well as respond to our other proposed adjustments, in order to calculate a final revenue requirement.

Our final decision will be based on the most recent and best available information. Western Water will need to update its revenue requirement and prices to reflect our April 2020 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, Western Water should update its price submission and also provide us with an updated financial model. Any updates will be publicly available on our website.

<sup>26</sup> New customer contribution is a component that is deducted from gross capital expenditure to arrive at forecast regulatory asset base. Return on asset and regulatory depreciation are calculated based on the forecast regulatory asset base – these are two of the elements that make up the building block model to derive draft decision revenue requirement.

## Tax allowance

The tax allowance is an input into the revenue requirement. Western Water's tax allowance is set out in table 33 on page 39 of its price submission, and is also included in its financial model.

Western Water has proposed a tax allowance of \$15.1 million in its revenue requirement for the period from 2020-21 to 2022-23. Western Water stated in its price submission that tax on revenue from gifted assets will be excluded from its tax allowance in the regulatory building block model. However, we noticed that the tax allowance had been calculated inclusive of the revenue from gifted assets in the financial model.

In following this up, we were informed by Western Water on 18 February 2020 that the calculations for tax allowance and regulatory depreciation for existing assets in the financial model were incorrect and Western Water sent us a revised model with updated numbers which reduced the tax allowance by \$13.2 million.

### Draft decision on tax allowance

For our draft decision, we have left the tax allowance as per Western Water's original submission, which after our other draft decision adjustments has reduced to \$14.3 million. Our draft decision on tax allowance is shown in Table 2.1.

In response to our draft decision, Western Water must clarify its proposals relating to tax, demonstrating how it has considered the requirements of our guidance, and resubmit its proposed tax schedule.

Our final decision will confirm the tax allowance to be reflected in the revenue requirement.

## Regulatory depreciation

Regulatory depreciation is an input to calculating the regulatory asset base.<sup>27</sup> Regulatory depreciation allows a water corporation to recover the cost of investing in assets.

Western Water calculated its forecast regulatory depreciation for new assets using a straight line depreciation profile. We noted in our guidance that we prefer this approach.<sup>28</sup> Western Water also calculated regulatory depreciation for new assets in a manner consistent with our guidance.

However, Western Water used the depreciation override option in the financial model to calculate the forecast regulatory depreciation for existing assets. We noted in our guidance that if Western

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<sup>27</sup> Regulatory depreciation in the financial model is the sum of regulatory depreciation for new assets (forecast capital expenditure) and regulatory depreciation for existing assets.

<sup>28</sup> Essential Services Commission 2018, Guidance – Western Water 2020, op. cit., p. 29.

Water chooses to use the depreciation override option instead of the model's built-in straight line calculation, then it must provide us with a separate depreciation reconciliation workbook. Western Water did not provide this workbook with its original submission, nor following two subsequent requests in November 2019.

During our review of the calculation of tax allowance, we found a discrepancy in the methodology used to calculate tax allowance between the price submission and the financial model (discussed above). In following this up, we were informed by Western Water on 18 February 2020 that the calculations for tax allowance and regulatory depreciation for existing assets in the financial model were incorrect, and Western Water sent us a revised model with updated numbers (tax allowance was reduced, and regulatory depreciation for existing assets was increased by \$14.1 million).

### **Draft decision on regulatory depreciation**

For our draft decision, we have left the regulatory depreciation for existing assets as per Western Water's original submission. Our draft decision on regulatory depreciation is shown in Table 2.1.

In response to our draft decision, Western Water must provide us with a revised depreciation schedule based on a straight line approach, in accordance with our guidance. It must also take into account our draft decision's proposed changes to the capital expenditure forecast.

Our final decision will confirm the regulatory depreciation to be reflected in the forecast regulatory asset base.

## **Operating expenditure**

Operating expenditure is an input to the revenue requirement. Operating expenditure is recurrent costs that can be fully allocated to a single year (such as labour or maintenance). This contrasts with capital expenditure which is up-front costs for assets that are used over many years (such as water meters or treatment plants). Western Water's price submission provides detail on its forecast operating expenditure from pages 25 to 32.

We assess both:

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

For controllable operating expenditure, our assessment process first confirms an efficient baseline, based on the last year of actual costs prior to our price review (in this case, 2018-19). 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

Our assessment

Deloitte Access Economics to provide expert advice to inform our assessment of controllable operating expenditure. Deloitte’s report on its assessment of Western Water’s expenditure forecast is available on our website.<sup>29</sup>

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 2.2 sets out our draft decision on Western 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 Western Water’s proposal follow, with a summary of our adjustments shown at Table 2.3.

**Table 2.2 Draft decision – operating expenditure**  
(\$ million 2019-20)

	2020-21	2021-22	2022-23	Total
<b>Controllable costs</b>	<b>44.3</b>	<b>46.3</b>	<b>47.0</b>	<b>137.6</b>
<b>Non-controllable costs</b>	<b>16.0</b>	<b>16.0</b>	<b>16.6</b>	<b>48.5</b>
- Bulk services <sup>a</sup>	12.9	12.9	13.5	39.3
- Environmental contribution <sup>b</sup>	3.0	2.9	2.9	8.8
- Licence fees – ESC <sup>c</sup>	0.039	0.039	0.058	0.135
- Licence fees – DHHS <sup>c</sup>	0.027	0.027	0.027	0.081
- Licence fees – EPA <sup>c</sup>	0.054	0.054	0.053	0.161
<b>Draft decision – operating expenditure</b>	<b>60.3</b>	<b>62.3</b>	<b>63.5</b>	<b>186.2</b>

<sup>a</sup> Bulk services covers the supply of bulk water and sewerage services.

<sup>b</sup> The environmental contribution collects funds from water corporations under the Water Industry Act.

<sup>c</sup> 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.

<sup>29</sup> Deloitte Access Economics 2020, Expenditure review – Western Water, February.

We consider our proposed operating expenditure in this draft decision better reflects the expenditure that a prudent service provider would incur when acting efficiently to achieve the lowest cost in delivering the outcomes specified in Western Water’s price submission.<sup>30</sup>

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

### **Controllable operating expenditure assessment**

Western Water proposed a total forecast controllable operating expenditure of \$143.4 million over a three-year regulatory period. This comprised \$139.16 million in baseline operating expenditure and \$4.25 million in variations to the baseline. Included in this proposed expenditure is an allowance for wage growth in excess of the Victorian Government’s wages policy (three per cent instead of two per cent) and an increase in directors’ fees.

For the reasons set out below, our draft decision is to reduce the benchmark controllable operating expenditure allowance for Western Water to \$137.6 million over the same period.

Baseline controllable operating expenditure:

- Western Water’s 2018-19 baseline year controllable operating expenditure was \$44.2 million. After adjusting for non-recurring expenditure, this reduced to \$43.2 million: two per cent above the benchmark of \$42.3 million we allowed for 2018-19 in the 2018 price determination. Deloitte assessed the proposed 2018-19 baseline amount and recommended no adjustment.<sup>31</sup> Customer growth was higher than forecast for the 2018 price review (4.7 per cent actual growth compared to 4.1 per cent forecast) and actual water demand was 3.7 per cent higher. We accept Deloitte’s recommendation as we consider this reflects an efficient baseline cost to forecast annual operating expenditure.

Efficiency improvement:

- Baseline operating expenditure will increase at the growth rate of customer connections, less the efficiency improvement rate proposed by the water corporation. Western Water’s proposed efficiency improvement rate on controllable operating costs is 2.0 per cent per annum, which is lower than the 4.0 per cent it adopted for its 2018 price submission. This rate is lower than Western Water’s forecast connection growth rate of 4.8 per cent per annum, resulting in an

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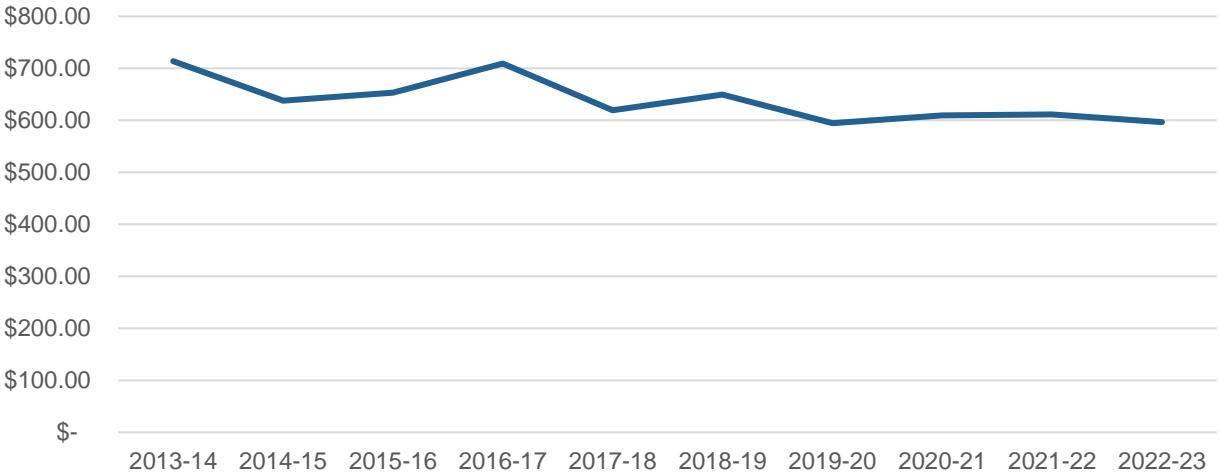
<sup>30</sup> WIRO, clauses 8(b)(i), (ii) and (iii).

<sup>31</sup> Deloitte Access Economics 2020, op. cit., p. 16.

increasing annual baseline operating cost. The resulting net growth-efficiency factor of 2.8 per cent is by far the highest of all Victorian water corporations. However, Deloitte recommended no adjustment to the proposed efficiency improvement rate, noting that Western Water’s operating expenditure per connection is low relative to other regional water corporations.

- We accept Deloitte’s recommendation noting that Western Water’s proposed controllable operating expenditure per customer decreases slightly over the period 2020-23 (Figure 2.1 below). Although we accept Deloitte’s recommendation, we note that we consider the net growth-efficiency factor is likely to be generous for the following reasons:
  - The net growth-efficiency factor is much higher than those for all other Victorian water corporations, some of which committed to attempting to absorb all of the costs associated with growth in their service areas.
  - Western Water’s assumption that wages will increase at a rate of three per cent rather than the two per cent specified in the Victorian Government’s wages policy suggests that Western Water’s efficiency factor could be higher.

**Figure 2.1 Controllable operating expenditure per water connection**  
(\$ 2019-20)



Note: actuals for 2013-14 to 2018-19 and forecasts for 2019-20 to 2022-23.

**Proposed cost changes:**

- Western Water proposed an increase of \$2 million to its IT software costs over the 2020–23 period. Deloitte reviewed Western Water’s variation for software costs and the IT costs in its baseline expenditure. Deloitte noted that Western Water’s IT expenditures had increased significantly over recent years. It also noted that from the clarifying information provided by Western Water, it was not clear what items were part of the variation and which were part of baseline expenditure. It was also not clear for those items how much was included in the variation and how much was in baseline expenditure. Deloitte could not find the proposed



increase to IT costs prudent and efficient, so recommended it be removed for the draft decision. We accept Deloitte's recommendation.

- Western Water proposed an increase of \$70,000 for director remuneration over the coming regulatory period. Western Water provided Deloitte with a ministerial direction substantiating the increase, and Deloitte recommended we accept the variation because Western Water's customer growth has now moved its board into a higher remuneration bracket. We accept Deloitte's recommendation.
- Western Water proposed an additional \$0.55 million for preparing its 2023 regulatory pricing submission, having removed the costs for preparing its 2020 submission from its baseline operating expenditure. Deloitte recommended that the variation to baseline expenditure be reduced to \$0.45 million over the regulatory period, noting Western Water did less community engagement for its current pricing submission than for its 2018 submission, and having now prepared two price submissions under the PREMO framework Western Water should be able to achieve some efficiencies for the next review. This results in a decrease to forecast controllable operating expenditure of \$0.1 million over the 2020-23 period. We accept Deloitte's recommendation.
- Western Water proposed an increase of \$0.3 million over the coming regulatory period for its Integrated Water Management Plan (IWMP). IWMP activities relate to projects where Western Water collaborates with other government bodies to improve water delivery. While Western Water proposed a variation to increase baseline operating expenditure for IWMP activities, it also removed \$0.47 million in establishing its baseline. Deloitte recommended that we accept expenditure for environmental flows for the Werribee river as it relates to commitments made by Victorian Government. Deloitte recommended a reduction in costs (\$0.04 million in 2021-22 and 2022-23) for Toolern Stormwater Harvesting because documentation provided by Western Water did not justify the full amount. It also recommended we remove a further \$0.04 million per annum for integrated water management forums because Western Water did not provide a list of the projects included in these activities. We accept Deloitte's recommendations.
- Western Water proposed an additional allowance of \$0.1 million over the coming regulatory period for a waterborne gypsum trial, where it will add gypsum to treated wastewater before supplying it to a recycled water customer, rather than the customer applying gypsum directly to the soil. This trial began in March 2019. Deloitte recommended we accept the expenditure because Western Water has committed to delivering the project with DELWP. However, we do not accept Deloitte's recommendation for three reasons:
  - because the trial began in March 2019 there will be costs for this project included in the 2018-19 base year



- the recycled water customer currently administers gypsum to the soil at their own cost – we consider Western Water should be able to recover at least some of the cost of the trial from the benefitting customer <sup>32</sup>
- to the extent there are already some funds included in the baseline year, the additional costs are likely to be immaterial, and could be absorbed within normal annual cost fluctuations.

Accordingly, we have removed the \$0.1 million allowance for this trial from the expenditure forecast.

- Western Water proposed an additional \$0.15 million to contribute to the Central Region South Sustainable Water Strategy, a government initiative to meet the Victorian central region's water needs. Under the Water Act 1989 (Vic) the strategy must be reviewed at least every ten years. Deloitte accepted the proposed expenditure because it is an infrequent requirement. We accept Deloitte's recommendation.
- Western Water proposed an additional \$0.41 million over the period to meet its emissions reduction pledge to the Department of Environment, Land, Water and Planning (DELWP) to reduce its greenhouse gas emissions by 10 per cent of 2016 levels by 2025. Most of this reduction will come from the purchase of emissions offsets via large-scale renewable generation certificates (LGCs). Deloitte recommended we accept the variation. It found Western Water's forecast of the cost of the certificates was broadly in line with expectations in futures markets. We accept Deloitte's recommendation. While purchasing offsets was not an intended means for delivering the emissions reduction pledges, one of Western Water's original reduction options is no longer available and purchasing LGCs is permissible as an interim alternative within the DELWP framework.
- Western Water proposed a total additional allowance of \$0.5 million in sewage treatment lagoon desludging costs for the three-year period, having also removed \$0.17 million of desludging costs from its baseline operating expenditure. Deloitte recommended we accept the proposed change, noting desludging expenditure had irregular timing while also being material, and this approach means the annual growth factor does not apply to desludging costs. We accept Deloitte's recommendation.
- Western Water also proposed a change to its electricity forecasts with a decrease in the first year, offset exactly by increases in the following two years. Deloitte recommended we accept this variation. However, Deloitte also noted a reduction would be required to reflect reductions to electricity distribution and transmission tariffs that will come into effect during 2021-22 (distribution) and 2022-23 (transmission). Western Water subsequently lowered its electricity cost forecasts by \$0.42 million to account for these reductions, and we have accepted this for our draft decision.

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<sup>32</sup> Western Water, Project Definition Document: Waterborne Gypsum Trial, 3 April 2017, p. 2.

- Deloitte identified that Western Water was proposing to escalate its labour costs by four per cent per annum in nominal terms following the expiry of the current enterprise bargaining agreement (EBA) – this includes a three per cent wage escalation, and another one per cent in forecast bonuses. This is far above the Victorian Government’s current benchmark of two per cent. Deloitte has recommended we reduce labour costs to reflect the government benchmark following the conclusion of Western Water’s current EBA in June 2021. This results in a total reduction of \$0.53 million over the period 2020–23. We accept Deloitte’s recommendation as a more realistic forecast of efficient wage growth over the 2020–23 period.
- Deloitte identified that Western Water’s corporate costs grew significantly in the base year and will continue to increase in the 2020–23 regulatory period. Deloitte noted it had not received any justification for this increase in corporate costs (aside from cost increases related to IT and directors’ fees which it considered separately). Deloitte recommended the increase in corporate costs should be limited to Western Water’s net growth factor. This would result in a reduction in operating expenditure of \$2.4 million. We agree with this recommendation because Western Water has not justified its corporate cost escalations represent prudent and efficient expenditure.

Other operating expenditure assessments:

- Deloitte’s expenditure review included consideration of Western Water’s proposed forecasts of significant operating expenditure areas. On the basis of these considerations Deloitte proposed adjustments to electricity costs and labour (corporate costs) as described above. Further detail can be found in Deloitte’s report.

Deloitte’s review has identified a number of areas where the expenditures in Western Water’s submission do not appear to be prudent and efficient. For this reason, we do not consider the overall controllable operating expenditure forecast presented by Western Water reflects the requirements of the WIRO and the criteria for prudent and efficient expenditure outlined in our guidance.<sup>33</sup>

### **Draft decision on controllable operating expenditure**

Accordingly, for the purposes of making this draft decision, we propose to reduce Western Water’s controllable operating expenditure forecast to \$137.6 million, down from the \$143.4 million proposed in its price submission.<sup>34</sup>

<sup>33</sup> Essential Services Commission 2018, Guidance – Western Water 2020, op. cit., p. 21.

<sup>34</sup> WIRO, clauses 8(b)(i), (ii) and (iii); ESC Act, sections 8A(1)(a), 8A(1)(b) and 33(3)(b).

## Non-controllable operating expenditure assessment

For non-controllable operating expenditure, we have adjusted Western Water's forecasts where required based on the latest information received from the relevant government bodies on their licence fees and the environmental contribution. The values we have adopted for our draft decision are set out in Table 2.3 below.

For the environmental contribution, we have used the values provided by the Department of Environment, Land, Water and Planning and for this draft decision assumed it will remain flat in nominal terms (decline in real terms) across the 2020–23 regulatory period. However, the department is currently reviewing the environmental contribution to be recovered over the four years from 1 July 2020, and we will adjust for any changes to the forecast in our final decision.

We have assumed the licence fees for the Department of Health and Human Services, the Environment Protection Authority Victoria (EPA Victoria) and the Essential Services Commission (ESC) 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 major regulatory price review cycle.<sup>35</sup>

We verified Western Water's forecast external bulk water and sewage charges against Melbourne Water's current price determination.

### Draft decision on non-controllable operating expenditure

We have decreased Western Water's forecast non-controllable operating expenditure by \$0.1 million across the 2020–23 period, resulting mainly from our adjustment to bulk water costs and ESC licence fees. Overall, non-controllable expenditure will remain at a similar level from 2019-20 to 2020-21.

Prior to making our final decision, we will adjust Western Water's forecast non-controllable operating expenditure for the latest inflation data.

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<sup>35</sup> The Department of Health and Human Services and EPA Victoria provided their latest 2018-19 licence fees for making our draft decision. We have also based our forecast on our 2018-19 commission licence fee.

**Table 2.3 Adjustments to operating expenditure**  
(\$ million 2019-20)

	2020-21	2021-22	2022-23	Total
<b>Proposed total operating expenditure</b>	<b>62.0</b>	<b>64.3</b>	<b>65.7</b>	<b>192.0</b>
– Price submission	0.12	-0.15	-0.07	-0.10
– Integrated Water Management Planning	-0.04	-0.08	-0.08	-0.20
– Waterborne gypsum trial	-0.10	0.00	0.00	-0.10
– Energy costs	-0.01	-0.11	-0.30	-0.42
– IT costs	-0.60	-0.71	-0.71	-2.03
– Labour costs	0.00	-0.18	-0.35	-0.53
– Remaining corporate cost adjustment	-1.02	-0.75	-0.62	-2.40
<b>Total adjustments to controllable costs</b>	<b>-1.65</b>	<b>-1.99</b>	<b>-2.14</b>	<b>-5.77</b>
– Licence fees – Essential Services Commission	-0.009	-0.009	-0.025	-0.042
– Licence fees – Department of Human Services	-0.0001	-0.0001	-0.0001	-0.0003
– Licence fees – Environment Protection Authority	-0.002	-0.002	-0.002	-0.005
– Environment contribution	-0.002	-0.003	-0.005	-0.009
– Bulk services – Water	-0.015	-0.004	-0.011	-0.030
– Bulk services – Sewerage	0.002	-0.005	-0.007	-0.010
<b>Adjustments to non-controllable costs</b>	<b>-0.025</b>	<b>-0.023</b>	<b>-0.049</b>	<b>-0.097</b>
<b>Draft decision – total operating expenditure</b>	<b>60.3</b>	<b>62.3</b>	<b>63.5</b>	<b>186.2</b>

Note: numbers have been rounded.

## Regulatory asset base

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

- closing regulatory asset base at 30 June 2019
- forecast regulatory asset base for each year of the regulatory period from 1 July 2020.

### 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 2019. This helps to ensure prices reflect the actual net expenditure of a water corporation.<sup>36</sup>

We compared Western Water's actual net capital expenditure for 2017-18 and 2018-19 with the forecast used to approve maximum prices for the period from 1 July 2018. We undertake a prudency 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 2018. We believe this approach is reasonable given capital expenditure can be 'lumpy' in nature.

Western Water proposed \$100.1 million net capital expenditure over the period from 2017-18 to 2018-19. This figure is 9.7 per cent lower than the forecast used to approve maximum prices for the period from 1 July 2018. This is well below the 10 per cent threshold identified above, so we have not undertaken a prudency and efficiency review of its past net capital expenditure.

#### Draft decision on closing regulatory asset base

Western 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 2019 of \$501.7 million.

Table 2.4 sets out our draft decision on Western Water's regulatory asset base at 30 June 2019.

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<sup>36</sup> 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 2.4 Closing regulatory asset base**  
(\$ million 2019-20)

	2017-18	2018-19
Opening RAB 1 July	416.8	458.4
Plus gross capital expenditure	64.8	71.0
Less government contributions	0.0	0.0
Less customer contributions	15.2	20.4
Less proceeds from disposals	0.5	0.5
Less regulatory depreciation	7.4	6.7
<b>Closing RAB 30 June</b>	<b>458.4</b>	<b>501.7</b>

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.

As mentioned in the revenue requirement section, we were not able to adequately assess the calculation methodology for new customer contributions in Western Water's financial model.

Table 2.5 sets out our draft decision on Western Water's proposed forecast regulatory asset base from 1 July 2020.<sup>37</sup> Later sections provide an overview of our assessment of the components of the forecast regulatory asset base.

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<sup>37</sup> Our guidance required Western Water to provide an estimate of the components of its regulatory asset base for 2019-20. This is so we can assess the opening asset base for 1 July 2020. Our guidance noted that where the 2019-20 forecasts for net capital expenditure (gross capital expenditure less government and customer contributions) is lower than the forecast benchmark for that year in its 2018 price determination, the lower amount must be used (otherwise the 2018 determination forecast applies). The estimates for 2019-20 will be confirmed at the price review following the 2020 water price review.

**Table 2.5 Forecast regulatory asset base**  
(\$ million 2019-20)

	2019-20	2020-21	2021-22	2022-23
Opening RAB 1 July	501.7	532.0	590.0	655.1
Plus gross capital expenditure	74.7	89.1	92.5	97.1
Less government contributions	0.0	0.0	0.0	0.0
Less customer contributions	35.3	23.0	17.7	12.7
Less proceeds from disposals	0.8	0.8	0.8	0.8
Less regulatory depreciation	8.3	7.3	8.9	11.2
<b>Closing RAB 30 June</b>	<b>532.0</b>	<b>590.0</b>	<b>655.1</b>	<b>727.5</b>

Note: numbers have been rounded.

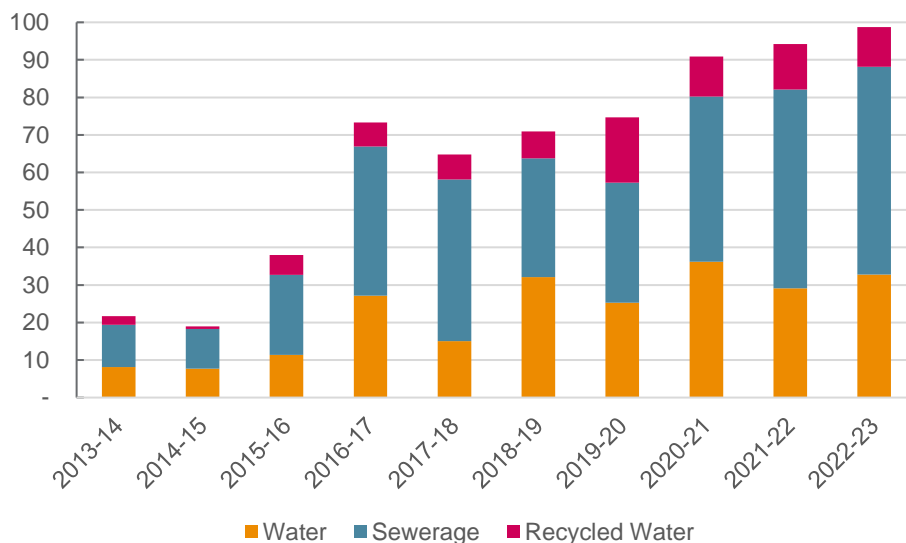
### Capital expenditure

Capital expenditure is an input to estimating the regulatory asset base. Western Water proposed total gross capital expenditure of \$283.8 million over the three-year regulatory period – its forecast capital expenditure and supporting information is provided at pages 33 and 34 and in appendix 4 of its price submission. This is summarised in Figure 2.2, which shows the capital investment in 2022-23 is five times the expenditure in 2014-15.

We engaged Deloitte Access Economics to provide expert advice to inform our assessment of capital expenditure. Deloitte’s report on its assessment of Western Water’s expenditure forecast is available on our website.<sup>38</sup>

<sup>38</sup> Deloitte Access Economics 2020, Expenditure review – Western Water, February.

**Figure 2.2 Gross capital expenditure by service category**  
(\$ million 2019-20)



Note: actuals for 2013-14 to 2018-19 and forecasts for 2019-20 to 2022-23.

Our guidance indicated that we would undertake in-depth analysis of Western Water’s expenditure forecasts.<sup>39</sup> For the reasons set out below and having regard to economic efficiency and financial viability considerations, customer interests and other relevant considerations under the WIRO, we propose not to accept Western Water’s proposed capital expenditure, because we do not consider it is prudent and efficient.<sup>40</sup>

- Deloitte requested documents for selected capital projects and programs from Western Water as a representative sample to demonstrate its asset management processes and justification for its capital expenditure program. In most cases, inadequate, insufficient and missing information in the documentation provided did not allow Deloitte to confirm if Western Water’s proposed capital expenditure was prudent and efficient. Deloitte stated that its review has been hampered by a lack of sound project information from Western Water, particularly in relation to the following matters:
  - Business cases were supplied for the selected major projects to be reviewed, however these were predominantly the documents used in Western Water’s 2018 price submission. Most parts of the documents had not been updated. While they had been updated to include a table of expenditure proposed for the 2020 submission period, this expenditure was often in conflict with the remainder of the document and the 2020 submission financial template itself.

<sup>39</sup> Essential Services Commission 2018, Guidance – Western Water 2020, op. cit., p. 2.

<sup>40</sup> WIRO, clauses 8(b)(i), (ii) and (iii), 11(d)(ii); ESC Act, sections 8(1), 8(2), 8A(1)(a), 8A(1)(b), 8A(1)(c), 8A(1)(d), 33(3)(b), 33(3)(a); Water Industry Act 1994 sections 4C(b) and 4C(c).



- The business cases included few specific details, apart from generic statements, on establishing the need for the works.
  - Costs identified in the business cases supplied were typically significantly higher than what was proposed in the 2020 submission and financial template.
  - No information on actual expenditure to date was provided for existing projects. Western Water provided commentary indicating it had recently updated its financial systems and had difficulty extracting actual expenditure for projects.
  - Specifically identified documents requested were provided, however more general requests for supporting information were sometimes not fulfilled, leading to multiple information requests.
- Of the five major projects reviewed by Deloitte, it recommended adjustments to two. A summary of its analysis follows.
    - **M1 Parwan Balliang irrigation district network:** Western Water’s preferred strategic response to the increase in volumes at Melton, Bacchus Marsh and Sunbury recycled water plants is to develop an irrigation district supplied with recycled water from the plants. Deloitte found the project is a good example of a regional strategic solution to address discharge licence issues, and has recommended no amendment to the project.
    - **M2 Melton Recycled Water Plant (RWP) additional on-site recycled water storage stage 1:** The Melton catchment is experiencing rapid customer growth and the current irrigation and storage system is at capacity, so it must be increased to maintain compliance. Western Water identified construction of a winter storage was the best option to achieve compliance. Deloitte found the unit rate (cost/volume) for this storage is significantly higher (by almost 50 per cent) than the average unit rate for the similar sized proposed storage associated with the M1 irrigation district network project. Western Water did not provide evidence to explain this higher cost. Deloitte recommended that the proposed expenditure for the Melton RWP additional storage be adjusted to \$11.6 million (a reduction of \$3.54 million) reflecting the average unit rate for Western Water’s similarly sized storage projects.
    - **M3 Melton RWP and Bacchus Marsh RWP interconnection:** With the projected growth in customer connections in the catchments of both the Melton and Bacchus Marsh recycled water plants, Western Water has been investigating options for reuse of the additional volumes of recycled water. To make best use of the recycled water, Western Water will build a two-way interconnecting pipeline between the Bacchus Marsh and Melton plants. Deloitte found that this project is a critical part of Western Water’s M1 irrigation network project and did not recommend any adjustment to the project.
    - **M5 Gisborne RWP – stage 1 bioreactor:** Customer connection growth in Gisborne is increasing sewage loads on the existing recycled water plant, and the treatment plant requires a substantial upgrade. Deloitte found that given the significant growth in connections in the area, it would be expected that augmentation capital expenditure would be required. It

also found that the costs included in Western Water's price submission appeared reasonable, and recommended no adjustment to the proposed expenditures for this project.

- **M7 Sewer Spill Prevention Strategy – sewer relining program:** As sewers age they become increasingly susceptible to blockages from tree roots, cracks, infiltration and general debris. This ongoing program targets actions to prevent sewage spills to minimise unacceptable effects to the environment. Western Water has proposed a significant increase in average annual expenditure on the program for the 2020–23 period. Deloitte stated that Western Water had not provided compelling evidence to support the increase, and there was a lack of historical actual expenditure provided for the program. Deloitte also identified some issues with Western Water's prioritisation process for the program. Deloitte recommended we allow half the requested increase in expenditure over the historical expenditure levels. This results in expenditure of \$5.85 million over the 2020–23 period, a reduction of \$1.45 million from the proposed amount in Western Water's price submission.

We note that Deloitte had difficulty obtaining requested information from Western Water while reviewing its proposed capital expenditure. Western Water was at times unable to provide up-to-date business cases and project justifications when requested, a clear requirement established in our guidance, clause 15(a) of the WIRO, and our expectation of all water corporations. Further, when Deloitte requested updated information it was often not provided in a timely manner. Also of concern, the costs set out in the business cases sometimes did not match the costs presented in the price submission and the financial template.

Western Water had sought a two-year price determination at the 2018 price review to allow it more time to prepare a strong capital program to meet the infrastructure investments required by its rapid customer growth. Given this, and the very significant proposed increase in its regulatory asset base, our guidance indicated that we expected well justified capital expenditure forecasts in this price submission.<sup>41</sup> We are concerned that Western Water cannot readily demonstrate the prudence and efficiency of its capital expenditure program – costs that it seeks to recover through customer prices.

### **Draft decision on capital expenditure**

Our draft decision is to reduce Western Water's capital expenditure for the 2020–23 period to \$278.8 million from the \$283.8 million proposed in its price submission (see Table 2.6 below). This adjusted benchmark amount is used to calculate the forecast regulatory asset base (Table 2.5) and the draft decision revenue requirement (Table 2.1).

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<sup>41</sup> Essential Services Commission 2018, Guidance – Western Water 2020, op. cit., p. 2, p. 20 and p. 23–27.

The benchmark that we adopt for Western Water does not represent the amount that the water corporation is required to spend or allocate to particular capital projects. Rather, it represents assumptions about the overall level of capital expenditure (to be recovered through prices) that we consider sufficient to operate the business and to maintain or improve services over the regulatory period. Western Water determines how to best manage the allocation of its revenue and priority of its capital expenditure within a regulatory period.

**Table 2.6 Draft decision – capital expenditure**  
(\$ million 2019-20)

Project/program name	Status	2020-21	2021-22	2022-23	Total
M1 Parwan-Balliang Irrigation District Network	Proposed	2.53	6.82	8.38	17.73
	Draft decision	2.53	6.82	8.38	17.73
	Adjustment	0.00	0.00	0.00	0.00
M2 Melton RWP Additional on-site recycled water storage Stage 1	Proposed	4.18	5.86	5.10	15.14
	Draft decision	3.00	4.68	3.92	11.60
	Adjustment	-1.18	-1.18	-1.18	-3.54
M3 Melton RWP and Bacchus Marsh RWP Interconnection	Proposed	4.81	6.73	2.88	14.42
	Draft decision	4.81	6.73	2.88	14.42
	Adjustment	0.00	0.00	0.00	0.00
M5 Gisborne RWP – Stage 1 bioreactor	Proposed	0.84	4.81	4.85	10.51
	Draft decision	0.84	4.81	4.85	10.51
	Adjustment	0.00	0.00	0.00	0.00
M7 SSPS – Sewer Relining Program	Proposed	2.62	2.43	2.25	7.30
	Draft decision	2.10	1.95	1.80	5.85
	Adjustment	-0.52	-0.48	-0.45	-1.45
<b>Total adjustments</b>		<b>-1.70</b>	<b>-1.66</b>	<b>-1.63</b>	<b>-4.99</b>
Total proposed by Western Water		90.84	94.19	98.75	283.78
<b>Draft decision – capital expenditure</b>		<b>89.14</b>	<b>92.53</b>	<b>97.12</b>	<b>278.79</b>

Note: numbers have been rounded

## Revenue from customer contributions

Revenue from customer contributions is deducted from gross capital expenditure so it is not included in the regulatory asset base.<sup>42</sup>

In response to a request for further information, Western Water confirmed that its customer contribution forecasts comprise forecast New Customer Contributions (NCC) revenue collected for both greenfield and infill connections, but reduced by the tax on gifted capital assets from new development, and incremental financing charges associated with the construction of capital assets that have been brought forward. The effect of these two exclusions is to reduce the customer contributions revenue, and thereby increase the regulatory asset base (RAB), and the subsequent return on the RAB. Western Water has not provided adequate explanation as to why these two items have been removed from its forecast customer contribution revenue.

### Draft decision on revenue from customer contributions

Because we have not approved Western Water's proposed NCC charges, our draft decision is not to approve its forecast customer contributions revenue. Western Water must resubmit its new customer contributions revenue in response to our draft decision, including a justification of its approach to calculating this figure, along with its revised NCC charge proposal (see our discussion in the new customer contributions charges section on pages 39 to 40).

## Cost of debt

Our guidance required Western Water to use estimates of the cost of debt we provided to estimate its revenue requirement and prices, subject to any updates before we make a price determination.<sup>43</sup>

Western Water has not used the cost of debt values we specified to calculate its revenue requirement and prices.<sup>44</sup> Western Water has proposed its own revised 2019-20 estimate as set out at pages 36 to 37 of its price submission.<sup>45</sup>

We sought further information from Western Water on its proposal.<sup>46</sup> Western Water has proposed a revised 2019-20 nominal cost of debt estimate of 3.32 per cent, reflecting six months of actual

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<sup>42</sup> Revenue from new customer contributions reflects revenue raised from new connections made to a water corporation's water, sewerage or recycled water networks.

<sup>43</sup> Essential Services Commission 2018, Guidance – Western Water 2020, op. cit., pp. 30–31

<sup>44</sup> Our guidance for Western Water, released in December 2018, assumed a 2019-20 nominal cost of debt of 4.6 per cent, based on the latest value for 2018-19 at that time.

<sup>45</sup> Western Water 2019, Western Water 2020 water price review, Price Submission 2020-23, November, pp. 36–37.

<sup>46</sup> We note that Western Water did not initially provide details on the method or inputs in deriving its revised estimate.

Our assessment

Reserve Bank of Australia cost of debt data and future cost of debt estimates for the remaining six months.

Our guidance stated that the nominal cost of debt for the 2019-20 financial year will be updated to reflect actual data, prior to the final decision.<sup>47</sup> This allows the water corporation to adjust prices to reflect movements in the cost of debt, and ensures 2020-21 prices reflect our assessment of efficient costs for a BBB-benchmarked business. Western Water has effectively used a more up-to-date forecast in its price submission.

Given that we will true-up the cost of debt prior to making our final decision, for the purposes of making this draft decision we will accept Western’s Water’s proposed 2019-20 cost of debt as set out in Table 2.7. However, our final decision will update its 2019-20 cost of debt with actual data – that is, we will replace Western Water’s six months of forecast data with the Reserve Bank of Australia 10-year BBB-rated corporate bond rates, consistent with the approach set out in our guidance.<sup>48</sup>

**Table 2.7 Historical cost of debt provided by the commission**  
Nominal

	2010-11	2011-12	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20
Cost of debt	7.0%	6.3%	5.3%	7.1%	5.4%	5.3%	4.9%	4.5%	4.6%	3.3% <sup>a</sup>

<sup>a</sup> Western Water’s estimated cost of debt – we will update the 2019-20 figure to reflect the latest actual data 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.<sup>49</sup> We consider the ten-year trailing average approach helps to minimise risk to water corporations and provides better incentives for long-term investment.<sup>50</sup>

<sup>47</sup> Essential Services Commission 2018, Guidance – Western Water 2020, op. cit., pp. 30–31.

<sup>48</sup> We will provide Western Water with the 2019-20 actual cost of debt in April 2020.

<sup>49</sup> 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 and approach, op. cit., p. 27.

<sup>50</sup> We acknowledge that our 2019-20 cost of debt estimate, set in our guidance in December 2018, is well above the current estimate for the ‘on-the-day’ cost of debt. This is a result of the early years of our ten-year rolling average calculation being well above the current estimate for the ‘on-the-day’ cost of debt. We expect over time our 10-year

## Return on equity

Our guidance specified that Western Water was not required to self-assess and give itself a PREMO rating. We said we would set Western Water's return on equity at 4.5 per cent, consistent with a 'Standard' rated water corporation, provided we were satisfied it had met the requirements of our guidance.<sup>51</sup>

For the reasons set out throughout this assessment (Chapter 2) and our PREMO rating discussion (Chapter 3), we are not satisfied that Western Water has met the requirements of our guidance. We do not consider Western Water's price submission reflects the minimum requirements established in our guidance for a 'Standard' PREMO rating.

### Draft decision on return on equity

We have not assigned a PREMO rating for our draft decision on Western Water's price submission. Our draft decision proposes to set the return on equity to 3.9 per cent (in real terms, after tax), which is the minimum return on equity for a water corporation established for our 2018 water price review.<sup>52</sup>

## Demand

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

Western Water's demand forecasts are set out at pages 40 to 43 of its price submission, and are also included in its financial model.

During the 2018 price review, we accepted Western Water's demand forecasts which assumed a significant fall in per capita consumption. Our decisions noted we considered the forecast reductions were optimistic, given recent historical average consumption had been relatively steady. However, because it was only for a two-year period, we adopted Western Water's forecasts, which it had committed to achieving, and said we would monitor actual demand during this period to inform Western Water's 2020 price submission.<sup>53</sup> Actual water sales for the past three years, as well as its revised estimate for 2019-20, are shown against Western Water's forecasts in Table 2.8.

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trailing average cost of debt will fall closer to the current 'on-the-day' cost of debt as those early years in the ten-year rolling average will no longer be included in the calculation.

<sup>51</sup> Essential Services Commission 2018, Guidance – Western Water 2020, op. cit., p. 2 and p. 31.

<sup>52</sup> Essential Services Commission 2016, 2018 Water Price Review, Guidance Paper, p. 45.

<sup>53</sup> Essential Services Commission 2018, Western Water draft decision – 2018 Water Price Review, April, p. 24. We stated: In its 2020 submission Western Water will need to demonstrate that its demand forecasts: represent the best available estimates derived from an appropriate forecasting methodology; and reflect assumptions on the key drivers of demand that are well explained and reasonable.

**Table 2.8 Actual water sales versus proposed forecasts**  
(Megalitres)

	2016-17	2017-18	2018-19	2019-20
Forecast sales <sup>a</sup>	12,234	12,825	12,722	12,764
Actual/estimated sales <sup>b</sup>	12,506	14,101	14,861	14,482
Variance from forecast (%)	272 (2%)	1,276 (10%)	2,139 (17%)	1,718 (13%)

<sup>a</sup> Water demand forecasts for 2016–18 from Western Water 2013 Price Determination, 1 July 2013 – 30 June 2018, page 34. Forecasts for 2018–20 from Western Water 2018 Price Determination, 1 July 2018 – 30 June 2020, page 34.

<sup>b</sup> Actual/estimated sales provided by Western Water in its 2020 price submission financial template.

The table shows Western Water’s actual water volume sales have been significantly above its demand forecasts, exceeding them by 10 per cent or more for three straight years, including for both 2018-19 and its latest forecasts for 2019-20. We also note actual water consumption volumes provided by Western Water via other reporting channels show different values than those provided in its financial template.<sup>54</sup>

The total water volume sold is higher than forecast because:

- customer connection growth was higher than forecast
- per capita consumption was also higher than forecast, as shown in Figure 2.3 below (the black line was the basis for Western Water’s 2018 demand forecast).

In our guidance, we indicated to Western Water that we would undertake in-depth analysis of its demand forecasts.<sup>55</sup> We expected Western Water’s 2020 price submission would adjust its demand forecast to reflect this recent higher consumption. Western Water’s proposed demand forecasts for the 2020–23 period are based on the pink trend line in Figure 2.3, which still assumes a falling per capita consumption, and does not reflect the most recent actual consumption levels which appear to be trending upwards (the blue trend line). Throughout our review, Western Water has not provided us with evidence that we consider demonstrates its forecast is based on reasonable assumptions, and its forecast contradicts information provided elsewhere by Western Water (for example, it said its electricity costs were higher than forecast because average consumption per connection had increased).<sup>56</sup>

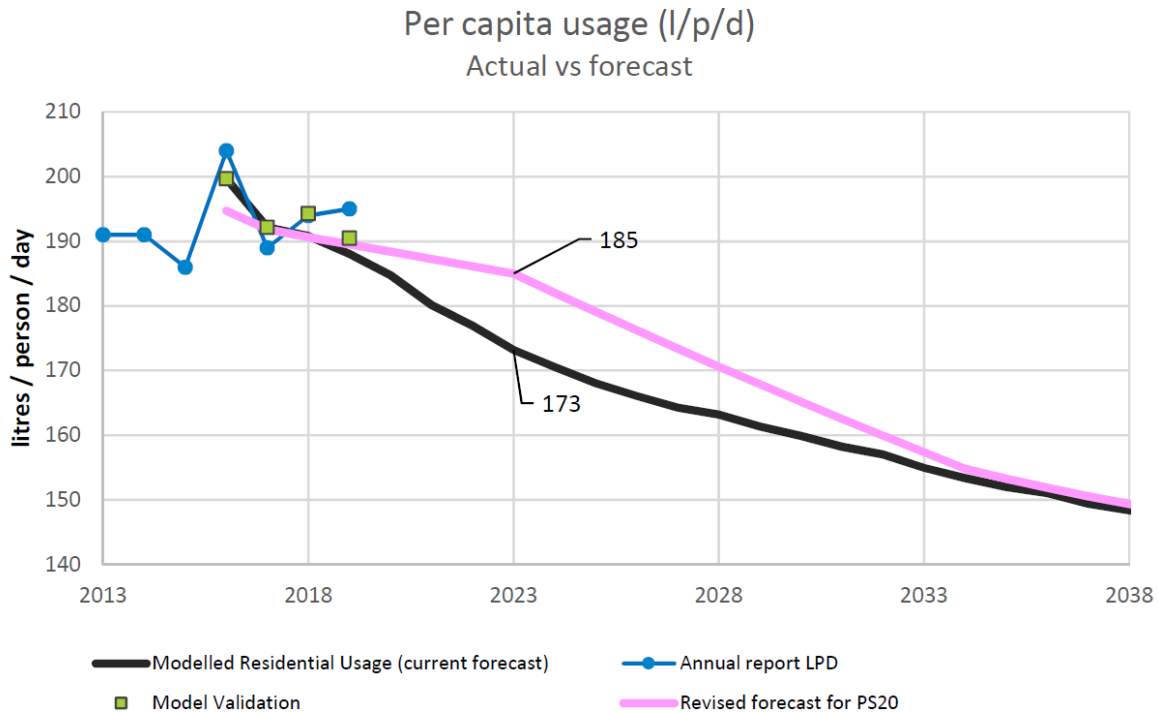
<sup>54</sup> Western Water’s 2018-19 audited water consumption figure provided for our annual water performance report was 14,718 megalitres. Western Water’s own Annual Water Outlook report, available on its website, states 2018-19 water consumption was 16,477 megalitres.

<sup>55</sup> Essential Services Commission 2018, Guidance – Western Water 2020, op. cit., p. 2 and p. 33.

<sup>56</sup> Deloitte Access Economics 2020, op. cit., p. 26.



**Figure 2.3 Per capita water usage – actual and forecast**  
(Litres/person/day)



Source: Western Water, provided in response to request for further information

### Draft decision on demand forecast

Our draft decision does not accept Western Water’s proposed demand forecasts, because Western Water has not demonstrated its consumption forecasts represent the best available estimates or are based on reasonable assumptions.

We do accept that its proposed water and sewerage connection growth forecasts are reasonable because they are based on the latest Victoria In Future forecasts issued by the Victorian Government, overlaid with confirmed developer plans in its region. Western Water’s proposed growth forecasts were also verified by its expert consultants.

Western Water must respond to our draft decision with updated demand forecasts which represent the best available estimates derived from an appropriate forecasting methodology, with well explained and reasonable assumptions, consistent with the requirements set out in our guidance.



## Form of price control

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

Normally we would approve a price cap if put forward by a water corporation, particularly when it reflects a continuation of current arrangements. However, noting our draft decision on demand above, Western Water should consider proposing a revenue cap form of price control.

Compared to a price cap, a revenue cap provides a water corporation with relatively more flexibility to adjust tariffs (within pre-determined constraints) on an annual basis to account for differences between actual and forecast demand. We note that should Western Water choose to propose a revenue cap, it will still need to provide justification for this against the WIRO principles.

## Tariff structures

Western Water's proposed tariffs are set out on pages 44 to 49 of its price submission.

Western Water's prices will be affected by our draft decision on the revenue requirement, which is outlined on pages 9 to 10, and our draft decision on its proposed tariff structures, discussed below. Western Water must respond to our draft decision with proposed prices that consider our draft decision. Because of this our draft decision does not approve maximum prices for each tariff. Our draft decision considers proposals related to tariff structures, and any submissions relating to the level of prices or bills.

As outlined in our guidance, we have provided the water corporations with a large degree of discretion to decide on individual tariff structures.<sup>57</sup> 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.

Our guidance also noted that we will have regard to whether tariffs are continuing in the same form as applied during the last period, or whether changes are proposed. Where changes are proposed, our guidance requires Western Water to provide evidence that the amended tariff structure better satisfies the requirements in clause 11 of the WIRO, than the existing structure.

## Overview of Western Water's proposals

Western Water proposed multiple adjustments to its fixed and variable water and sewerage tariffs. We note the tariff changes proposed by Western Water seek to address the impact of the removal

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<sup>57</sup> Essential Services Commission 2018, Guidance – Western Water 2020, op. cit., p. 35.

of an efficiency rebate, which is currently paid to customers against the variable water usage component of a bill.<sup>58</sup> Western Water's proposal includes:

- embedding the efficiency savings funding the rebate into the fixed charges for owner-occupiers from 2020 (as a result, owner-occupiers' fixed charges will decrease by \$103, the equivalent of the current rebate amount, in 2020)<sup>59</sup>
- continuing to pay a \$103 efficiency rebate to tenants in 2020, then gradually reducing the rebate amount by \$14.75 per annum, commencing from 2021 until it reduces to \$0 by 2028
- introducing a new customer sub-category – residential vacant landowner and landlord – with a fixed water and sewerage service charge that will differ from that of owner-occupiers
- reducing the vacant landowner and landlord fixed charge by \$14.75 per annum, commencing from 2021 until 2028 when it will match the fixed charge for owner-occupiers
- applying a 1.5 per cent increase on water and sewerage service charges across all customer groups who pay the fixed water and sewerage charges, commencing from 2020
- increasing the tier three variable water usage charge by 1.95 per cent per annum commencing from 2020.

For other services, Western Water proposes a continuation of existing tariff structures. We confirmed with Western Water that its proposed tariffs for recycled water, trade waste and miscellaneous services are calculated in accordance with the pricing principles in our guidance. Western Water's proposal retains the current charges on trade waste and Class A recycled water.

### **Our assessment of proposed tariff structure changes**

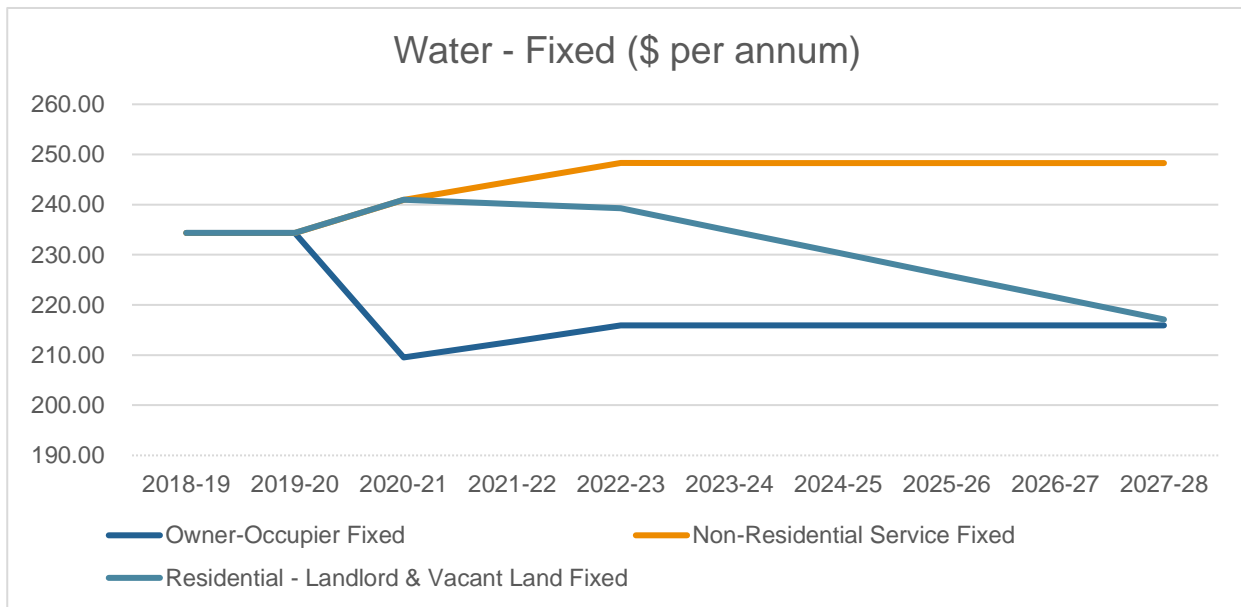
Western Water's proposal introduces differential prices for its fixed water and sewerage service charges, compared with the current uniform charge. This is represented in Figure 2.4 and Figure 2.5. Western Water's proposal re-establishes a uniform fixed service tariff for residential services in 2028, however this is beyond the 2020–23 pricing period. We can only assess and approve prices for the pricing period established in our guidance.

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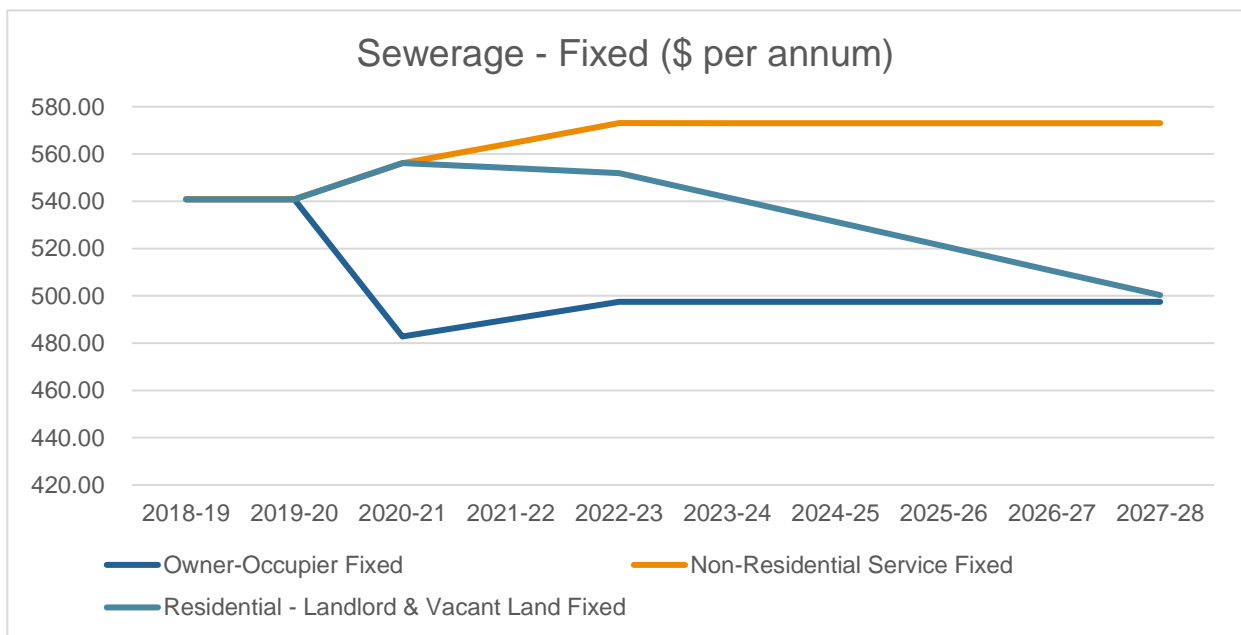
<sup>58</sup> From 2014-15, Western Water's residential customers receiving a bill with water usage charges received an annual rebate of \$100. The rebate reflects the outcomes of a government efficiency review, and was to end after 2017-18. However, after seeking a two-year continuance of its existing prices at the 2018 price review, Western Water has continued to provide the rebate to customers, and has increased the amount in line with inflation each year.

<sup>59</sup> Western Water's customer consultation revealed a preference for higher variable charges and lower fixed charges, to provide more control over their bill through lower water use. Western Water considers this approach of embedding the government efficiency rebate amount into the fixed service charges for water and sewerage achieves this objective.

**Figure 2.4 Western Water’s proposed fixed water charges across customer groups (\$ 2019-20)**



**Figure 2.5 Western Water’s proposed fixed sewerage charges across customer groups (\$ 2019-20)**



We note that under Western Water’s proposal, owners of vacant land and landlords would pay a higher fixed charge compared to owner-occupiers. Its main justification for this is to help manage the impacts of the removal of the efficiency rebate. We note that Western Water applied its efficiency rebate to tariffs that we had already assessed as meeting WIRO requirements, including

Our assessment

objectives related to the efficiency and cost-reflectivity of prices. We consider Western Water has not sufficiently considered the efficiency implications of its proposals.

### **Draft decision on tariffs**

We propose not to approve Western Water's proposed changes to the structure of its residential fixed water and sewerage tariffs because:

- Western Water has not demonstrated how its proposals better satisfy the requirements in clause 11 of the WIRO, as required by our guidance. In particular, demonstrating why vacant land owners should pay more than owner-occupiers for the same service.
- its proposal does not provide signals to customers about the efficient cost of providing water and sewerage services to customers<sup>60</sup>
- its proposal does not enable customers or potential customers of the regulated entity to easily understand the prices charged by the regulated entity for prescribed services or the manner in which such prices are calculated, determined or otherwise regulated.<sup>61</sup>

Given our draft decision proposes not to accept Western Water's proposals relating to fixed water and sewerage tariffs, Western Water could also reconsider its proposal to increase the third tier of its inclining block tariff for residential water usage relative to the other tiers.

Prior to our final decision and price determination, Western Water must submit updated tariff structures and prices in response to our draft decision revenue requirement, that also reflect the requirements of the WIRO and our guidance. These must also reflect our updates to cost of debt and inflation estimates, which we will provide in late April 2020.

### **Adjusting prices**

Western Water's proposed price adjustment mechanisms are set out on pages 38 to 39 and page 50 of its price submission. It proposed:

- to continue with its existing uncertain and unforeseen events mechanism<sup>62</sup>
- to pass-through Melbourne Water's bulk water charges (including price and changes in cost of debt for Melbourne Water)

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<sup>60</sup> WIRO clause 11(d)(ii)

<sup>61</sup> WIRO clause 11(d)(i)

<sup>62</sup> This includes adjustment for regulatory, legislation or ministerial directive changes as well as exposure to natural disaster or extreme weather events that result in a material impact to Western Water.

- a new annual cost of debt adjustment mechanism that smooths the total expected revenue adjustment over a profile set by Western Water.

We noted in our guidance that existing mechanisms have worked well and are consistent with efficiency objectives, and proposed that Western Water continues with these arrangements.<sup>63</sup>

Our guidance also allowed Western Water to take into account differences between forecast and actual non-controllable costs associated with Melbourne Water.

Our draft decision accepts Western Water's proposed:

- existing uncertain and unforeseen events mechanism
- pass-through of Melbourne Water's bulk water charges (including price and changes in cost of debt for Melbourne Water).

We will work with Western Water to include adjustment mechanisms for this in our final decision.

Western Water has proposed a new annual cost of debt adjustment mechanism that smooths the revenue adjustments over the regulatory period, as set out on page 38 of its submission.

Our guidance stated that we expected Western Water to continue using the existing annual adjustment mechanism to adjust prices to reflect the latest changes in the cost of debt. This ensures prices reflect the efficient costs of a BBB benchmarked business. Where a change is proposed, however, Western Water must demonstrate how the new adjustment mechanism better meets the WIRO requirements.<sup>64</sup> In addition, Western Water must also specify the proposed process and/or formula for adjusting prices, clearly explaining how the adjustments would work and demonstrate how Western Water has sought to appropriately balance revenue and cost risk between the corporation and its customers.<sup>65</sup>

We sought further information from Western Water on its proposal.<sup>66</sup> The key elements of its proposed approach are:

- to calculate the annual cost of debt adjustment using our proposed approach, but to then re-balance the resultant revenue adjustments across the pricing period

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<sup>63</sup> Essential Services Commission 2018, Guidance – Western Water 2020, op. cit., p. 38.

<sup>64</sup> Essential Services Commission 2018, Guidance – Western Water 2020, op. cit., p. 31 and P. 38.

<sup>65</sup> Essential Services Commission 2018, Guidance – Western Water 2020, op. cit., p. 38-39.

<sup>66</sup> Western Water's price submission did not include the formula, did not clearly explain the process and did not explain how the new approach better meets any of the WIRO principles.

- a commitment to a ‘smoothing adjustment’ by bringing forward \$1.51 million of expected future revenue reductions to reduce the revenue requirement in the first year 2020-21 to deliver an average household bill outcome of \$1,019
- additional ‘smoothing adjustments’ to revenue in years two and three of the regulatory period, to deliver an average household bill path of one per cent per annum.<sup>67</sup>

In a further information request we asked Western Water to explain how its proposed mechanism better aligns with the WIRO requirements. In its response, Western Water stated:

- its customers find the existing mechanism difficult to understand, but acknowledged its proposal would not be any easier for customers to understand
- its proposal does not provide additional benefits in providing signals of efficient costs of a benchmark BBB rated business to its customers, but that it does align with customer preferences for smooth bills over the next three years.

We consider Western Water’s proposed adjustment mechanism is complex and difficult to understand, and it is not transparent on the manner in which prices are calculated.<sup>68</sup> We consider Western Water’s proposal does not better signal our assessment of the efficient financing costs of a BBB rated benchmark business. We acknowledge that Western Water is taking into consideration the interest of its customers for smooth bills, however we consider its proposed cost of debt adjustment does not better meet WIRO requirements. We consider a water corporation can achieve price stability through simpler and more transparent approaches.

Our draft decision is to not accept Western Water’s proposed cost of debt annual adjustment mechanism because:

- Western Water has not demonstrated that its proposed mechanism better satisfies the requirements of the WIRO than the existing structure <sup>69</sup>
- the proposed mechanism is complex and not transparent, and we consider it difficult to understand the way in which prices would be calculated.<sup>70</sup>

<sup>67</sup> The smoothing revenue adjustments allow Western Water to not pass-through the full cost of debt adjustment annually, but by the end of the regulatory period. This means Western Water may potentially withhold from customers cost of debt savings that should be passed through in any given regulatory year.

<sup>68</sup> Clause 11(d)(i) of the WIRO requires the commission to have regard to whether Western Water’s prices enable customers or potential customers of the regulated entity to easily understand prices charged by the regulated entity for prescribed services or the manner in which such prices are calculated, determined or otherwise regulated.

<sup>69</sup> Consistent with clause 11(b) of the WIRO, the commission has had regard to the ESC Act which involves considering the efficiency in the industry and incentives for long term investment (section 8A(1)(a)) and the return on assets in the regulated industry (section 33(3)(c)).

<sup>70</sup> See WIRO, clause 11(d)(i).

Our assessment

Western Water must respond to our draft decision and propose a cost of debt adjustment mechanism which is consistent with our guidance and the WIRO.

## New customer contribution charges

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

Western Water’s proposed charges for new customer contributions are set out at page 51 of its price submission. Western Water proposed to continue applying separate standard charges for infill and greenfield connections. Standard charges for infill connections are to remain flat in real terms for the three years of the 2020-23 regulatory period. Due to unprecedented connections growth in Western Water’s service region, it proposed a five per cent annual real increase on its 2019-20 greenfield connection charge for the next three years, continuing the transition towards full cost recovery over the next two regulatory periods. Western Water submitted its own NCC model to demonstrate how its proposed standard contribution charges would still result in under-recovery of incremental costs.

**Table 2.9 Proposed standard NCC charge per lot**  
(\$2019-20)

	Current level	2020-21	2021-22	2022-23
Infill NCC charge	\$2,696.34	\$2,696.34	\$2,696.34	\$2,696.34
Greenfield NCC charge	\$5,392.69	\$5,662.25	\$5,945.36	\$6,242.63

Note: numbers have been rounded to two decimal places.

We assessed Western Water’s NCC model and found a number of material issues, including:

- various assumptions surrounding financial variables were not updated for the 2020 price review
- the method for calculating incremental operating costs does not reflect our guidelines
- the model also includes revenue to be recovered from new connections other than standard 20 millimetre diameter meters <sup>71</sup>
- there are inconsistencies between the NCC model and the financial template

<sup>71</sup> Essential Services Commission 2013, New Customer Contributions: Explanatory Note, December, p. 7.

- Western Water has not justified a number of the key assumptions in its model, including the connection growth period.

### **Draft decision on new customer contribution charges**

For these stated reasons, we consider Western Water's submitted NCC model does not support its proposed new customer contribution charges. Further, because we have not approved Western Water's proposed tariff structures, our draft decision proposes to not approve its proposed standard new customer contributions.<sup>72</sup>

In response to this draft decision, Western Water must resubmit its proposed new customer contribution charges, and its supporting standard NCC model to address the following matters:

- Update to reflect any relevant expenditure adjustments arising from our draft decision
- Justify its approach to estimating incremental operating costs meets the minimum new customer contribution pricing principles outlined in our guidance
- Clarify and justify the approach used in estimating the financing costs associated with incremental connection costs
- Update to reflect the lower return on equity set in our draft decision and the updated cost of debt
- Update to reflect Western Water's revised prices
- Clarify the forecasts of customer contributions revenue for each service (water, sewerage, recycled water) for each regulatory year.

For negotiated new customer contributions, Western Water proposed to continue to calculate a charge in accordance with the requirements of our new customer contribution pricing principles.<sup>73</sup>

## **Financial position**

In approving prices, we must have regard to the financial viability of the water industry.<sup>74</sup> 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.

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<sup>72</sup> This is because calculating NCCs is dependent on the other tariffs charged by a water corporation.

<sup>73</sup> Essential Services Commission 2018, *Guidance – Western Water 2020*, op. cit., p. 40. In response to a request for information, Western Water confirmed the use of NCC pricing principles in calculation of negotiated charges as outlined in its *Guide to New Customer Contributions*.

<sup>74</sup> WIRO clause 8(b)(ii) and ESC Act s.8A(1)(b).



We assess a water corporation's forecast financial position using four key indicators.<sup>75</sup> Our assessment takes into account our proposed adjustments to revenue and costs, including our draft decision on the return on equity.

The outcomes of this assessment are shown at Table 2.10. We note that interest cover remains above the minimum bound we use to assess financial viability. This indicates Western Water will have sufficient cash flow to meet its debt repayment obligations and cover recurrent operating costs. Gearing is expected to rise slightly above our upper bound in 2022-23.<sup>76</sup> The increase in gearing, and values for FFO/Net debt and internal financing, are consistent with a business undergoing rapid growth and corresponding high capital investment such as Western Water.<sup>77 78</sup> We note that the estimates for the financial indicators under our draft decision are similar to those under Western Water's original proposal.

Given forecasts for interest cover, we consider our draft decision will provide sufficient cash flow for Western Water to meet its service commitments, and cover financing costs over the next three-year period. Our review of Western Water's recent 2018-19 statutory financial report, indicates that the business as a whole (including non-prescribed services) is in a relatively sound position.<sup>79</sup>

**Table 2.10 Draft decision – financial performance indicators**

	Commission threshold	2020-21	2021-22	2022-23
FFO interest cover (times)	> 1.5 times	2.11	2.03	1.92
Net Debt / RAV (Gearing) (%)	< 70 per cent	67.2%	69.6%	71.2%
FFO / Net debt (%)	> 10 per cent	5.8%	5.0%	4.3%
Internal financing ratio (%)	> 35 per cent	33.1%	28.9%	25.3%

Note: FFO refers to 'funds from operations' and RAV refers to the 'regulatory asset value (same as regulated asset base).

<sup>75</sup> Essential Services Commission 2018, Guidance – Western Water 2020, op. cit., p. 41.

<sup>76</sup> Net Debt / Regulatory Asset Value (Gearing) measures the debt component of the regulatory capital structure.

<sup>77</sup> FFO / Net debt measures the extent to which the serviceability of debt is improving, remaining stable, or declining.

<sup>78</sup> Internal financing ratio measures the extent to which an entity has cash remaining to finance a prudent portion of capital expenditure after making dividends.

<sup>79</sup> Western Water, 2018-19 annual report, pg. 52. For the period 2018-19, cash interest cover was 3.03 times (better than its target of 2.20 times) and gearing ratio was 26.1 per cent (better than its target of 30.9 per cent).



### 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. Western Water was not required to give itself a PREMO rating for this regulatory period, but was required to be satisfied it had met the requirements of our guidance, which outlined minimum requirements for meeting a 'Standard' PREMO rating.<sup>80</sup> We said if we agreed Western Water had met those requirements, we would set the return on equity at 4.5 per cent per annum, which reflects the rate of return a 'Standard' rated water corporation would receive under the PREMO incentive mechanism. But if we assessed Western Water had not met the minimum requirements, then we may specify a lower return on equity.

In its price submission, Western Water claimed it was satisfied it could demonstrate a 'Standard' PREMO rating.

However, we consider that Western Water has not met the minimum requirements for a 'Standard' rated corporation under our PREMO incentive mechanism, as set out in our guidance. While we consider the Engagement and Outcomes elements did meet these requirements, we found Western Water's price submission fell well short of our requirements for both the Management and Risk elements of PREMO.

#### **Draft decision on PREMO rating**

Our view is that the overall price submission did not meet the requirements for a 'Standard' rating, and we have not assigned an overall rating.<sup>81</sup>

In Chapter 2 we noted our draft decision proposes to set the return on equity at 3.9 per cent per annum, which is currently the lowest return rate under our PREMO framework.

In support of our assessment of Western Water's price submission, we note the following.

For Outcomes and Engagement – meets requirements for 'Standard' rating:

- Western Water has an established customer engagement program, and its consultation for its 2020 price submission built on its 2018 engagement work, using a range of methods including deliberative forums.

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<sup>80</sup> Essential Services Commission 2018, Guidance – Western Water 2018, op. cit., p. 2.

<sup>81</sup> Our PREMO framework paper defined a 'red-zone' in the PREMO ratings matrix for ratings below 'Basic', wherein the commission would reserve its discretion – for example, to set a lower return on equity, or a shorter regulatory period. See Essential Services Commission 2016, Water Pricing Framework and Approach: Implementing PREMO from 2018, October, pp. 12–13.

- It sought views from community representatives including advocates of vulnerable and low income customers, business groups, traditional owners, and a community engagement reference group established by the corporation.
- The price submission shows that the views of customers were taken into consideration and informed the final proposal.
- We noted Western Water’s discussions with customers focused on bills and bill movements, rather than how the underpinning prices were established.
- Western Water has retained the customer outcomes it committed to in its 2018 price submission, after confirming they were still priorities for customers. The measures and targets have been reviewed and updated for the three-year period 2020–23.

For Management – does not meet requirements for ‘Standard’ rating:

- The financial template contained numerous errors, and we found many inconsistencies between the written price submission and the template. Requests to clarify often resulted in a new set of numbers provided by Western Water, including late changes to the tax allowance and depreciation. These inconsistencies and changes made our assessment difficult, and lowered our confidence in the data provided by Western Water.
- Western Water’s price submission in many instances did not meet the requirements of our guidance or demonstrate how it met the requirements of the WIRO.
- Western Water was unable to provide substantive evidence to support many of the claims made in its price submission.
- Deloitte’s expenditure review identified reductions to both operating and capital expenditure forecasts, and some business cases for major projects provided by Western Water were based on outdated cost assumptions.
- We considered the prices and tariffs proposed by Western Water were not easy for customers to understand.
- The proposed rising price path movements were understated because Western Water did not use the current price as its starting point.
- The demand forecast provided was not based on reasonable assumptions.
- The new customer contributions model provided by Western Water contained errors and was not based on reasonable assumptions.

For Risk – does not meet requirements for ‘Standard’ rating:

- Western Water’s proposed tariffs introduced differential pricing for the same services that have not been justified taking into account the WIRO and pricing principles. The proposal means non-connected customers would pay a higher service charge than connected customers.

PREMO rating

- Western Water’s proposed revenue requirement was not based on prudent and efficient cost forecasts, and had errors in other key inputs (tax and depreciation).
- The demand forecast was based on average water consumption below current trends without supporting evidence. This was despite our concerns it had understated its demand forecasts in its 2018 price review, and a clear requirement to explain its future forecasts in light of this. Understating demand forecasts passes demand risk to customers, and will result in an over-collection of revenue.

Our guidance stated Western Water’s price submission must clearly and succinctly identify and explain how its proposals demonstrate value for money for customers.<sup>82</sup> Because of our assessment of the Management and Risk elements, we do not consider that Western Water has demonstrated its price submission represents best value for its customers.

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<sup>82</sup> Essential Services Commission 2018, Guidance – Western Water 2018, op. cit., p. 11.



## 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 2020.

Stakeholders may comment on any aspect of our draft decision, including the information we have relied upon in our assessment (such as Western 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 Western 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 Sunbury on 23 April 2020. 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](http://www.esc.vic.gov.au/waterpricereview).

### **Provide written comments or submissions**

Written comments or submissions in response to this draft decision are due on 30 April 2020.

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](http://www.esc.vic.gov.au/waterpricereview).

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

2020 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.

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

We invite feedback

## Next steps

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

- 23 April 2020 – public forum.
- 30 April 2020 – closing date for submissions on our draft decision.
- June 2020 – release of final decision and price determination.



## Appendix A: Submissions received

Name or organisation	Date received
R Stewart	24 December 2019



## Appendix B: Our consideration of legal requirements

Clause 11 of the Water Industry Regulatory Order 2014 (WIRO) specifies the mandatory factors we must have regard to when making a price determination. The WIRO covers matters that are included in the *Water Industry Act 1994* (WI Act) and the *Essential Services Commission Act 2001* (ESC Act).

Below, we describe how we apply the mandatory factors and where we have done so in our draft decision for Western Water.

In addition to the mandatory factors set out below, clause 11 of the WIRO requires the commission to have regard to the matters specified in the commission's guidance.<sup>83</sup> We have had regard to the matters specified in our guidance in reaching our preliminary view. Our draft decision provides further information on where we have considered our guidance, and Western Water's compliance with our guidance, in reaching our preliminary view.

Note: all page numbers referenced below refer to our draft decision for Western Water.

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<sup>83</sup> Essential Services Commission 2018, Guidance – Western Water 2020, op. cit.,

## **Economic efficiency and viability matters**

**WIRO clause 8(b)(i) requires us to have regard to the ‘promotion of efficient use of prescribed services by customers’.**

We consider that the efficient use of prescribed services by customers is promoted when a tariff is applied to customers benefiting from the service covered by the tariff, and tariffs send appropriate signals about efficient costs.

The following sections of our draft decision involved consideration of this factor:

- Our consideration of customer engagement (page 7).
- Our assessment of the revenue requirement (pages 9 to 10).
- Our assessment of efficient operating expenditure (pages 12 to 20) and capital expenditure (pages 23 to 27).
- Our assessment of tariffs (pages 33 to 36).

**WIRO clause 8(b)(ii) requires us to have regard to the ‘promotion of efficiency in regulated entities as well as efficiency in, and financial viability of, the regulated water industry’.**

We consider that the delivery of outcomes which reflect customer service priorities at an efficient cost promotes efficiency in regulated entities and the water industry. Our draft decision has therefore had regard to the extent that Western Water has demonstrated its proposed outcomes reflect customer service priorities, and whether its tariffs and forecast costs reflect efficient levels of expenditure.

The following sections of our draft decision involved consideration of this factor:

- Our consideration of customer engagement (page 7).
- Our assessment of the revenue requirement (pages 9 to 10).
- Our assessment of efficient operating expenditure (pages 12 to 20) and capital expenditure (pages 23 to 27).
- Our assessment of tariffs (pages 33 to 36).
- Our assessment of financial viability (pages 40 to 41).

**WIRO clause 8(b)(iii) requires us to have regard to the ‘provision to regulated entities of incentives to pursue efficiency improvements’.**

We consider that the delivery of outcomes which reflect customer service priorities at an efficient cost provides regulated entities incentives to pursue efficiency improvements. The following sections of our draft decision involved consideration of this factor:

- Our consideration of customer engagement (page 7).
- Our consideration of outcomes (page 8).
- Our assessment of the revenue requirement (pages 9 to 10).

Appendix B: Our consideration of legal requirements

- Our assessment of efficient operating expenditure (pages 12 to 20) and capital expenditure (pages 23 to 27).
- Our assessment of tariffs (pages 33 to 36).

Additionally, our pricing approach allows a water corporation to retain the benefits of any cost efficiencies it generates until the end of its regulatory period. In other words, a water corporation has an incentive to outperform the operating and capital expenditure benchmarks we accept for the purpose of estimating its revenue requirement and prices. This is consistent with providing incentives for water corporations to pursue efficiency improvements.

**ESC Act section 8A(1)(a) requires us to have regard to ‘efficiency in the industry and incentives for long term investment’.**

We consider that adopting forecasts of efficient expenditure that reflect the service priorities of the customers of each water corporation promotes efficiency in the water industry.

The following sections of our draft decision involved consideration of this factor:

- Our consideration of customer engagement (page 7).
- Our consideration of outcomes (page 8).
- Our assessment of the revenue requirement (pages 9 to 10).
- Our assessment of efficient operating expenditure (pages 12 to 20) and capital expenditure (pages 23 to 27).
- Our assessment of tariffs (pages 33 to 36).

We have had regard to incentives for long term investment by adopting:

- A ten-year trailing average approach to estimating the benchmark cost of debt (see pages 28 to 29).
- A regulatory rate of return that we consider will enable Western Water to recover costs associated with its investment in services.<sup>84</sup>

**ESC Act section 8A(1)(b) requires us to have regard to the ‘financial viability of the industry’.**

We consider that the financial viability of the industry is secured by approving prices that provide a high degree of certainty that each water corporation can maintain an investment grade credit rating. Further, prices should enable each corporation to generate cash flow to service financing costs arising from investments to meet service expectations.

We have had regard to this matter on pages 9 to 10 and pages 40 to 41.

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<sup>84</sup> The regulatory rate of return is comprised of the cost of debt and the return on equity.

**ESC Act section 33(3)(b) requires us to have regard to the ‘efficient costs of producing or supplying regulated goods or services and of complying with relevant legislation and relevant health, safety, environmental and social legislation applying to the regulated industry’.**

In preparing our draft decision, we have had regard to the extent Western Water has demonstrated its forecasts reflect efficient costs to deliver services valued by customers, and to deliver on relevant legislation and relevant health, safety, environmental and social obligations.

The following sections of our draft decision involved consideration of this factor:

- Our consideration of customer engagement (page 7).
- Our assessment of the revenue requirement (pages 9 to 10).
- Our assessment of efficient operating expenditure (pages 12 to 20) and capital expenditure (pages 23 to 27).
- Our assessment of tariffs (pages 33 to 36).

## **Industry specific matters**

**ESC Act section 33(3)(a) requires us to have regard to the ‘particular circumstances of the regulated industry and the prescribed goods and services for which the determination is being made’.**

Our pricing approach allows each water corporation to propose outcomes, tariff structures and expenditure that reflect its particular circumstances. We consider that taking into account the particular circumstances of each water corporation is consistent with taking into account the particular circumstances of the water industry.

The following sections of our draft decision involved consideration of this factor:

- Our consideration of customer engagement (page 7).
- Our consideration of outcomes (page 8).
- Our assessment of the revenue requirement (pages 9 to 10).
- Our assessment of efficient operating expenditure (pages 12 to 20) and capital expenditure (pages 23 to 27).
- Our assessment of tariffs (pages 33 to 36).

We have had regard to the prescribed services listed in the WIRO in making our decision. This includes adopting operating and capital expenditure benchmarks that we consider will allow Western Water to deliver services that are covered by the prescribed services listed in the WIRO.

**ESC Act section 33(3)(c) requires us to have regard to the ‘return on assets in the regulated industry’.**

Our draft decision provides for Western Water to generate a return on assets through:

Appendix B: Our consideration of legal requirements

- Our consideration of the regulatory asset base (pages 21 to 28).
- Our consideration of the cost of debt (pages 28 to 29).
- Our consideration of the return on equity (page 30).

**ESC Act Section 33(3)(d) requires us to have regard to ‘any relevant interstate and international benchmarks for prices, costs and return on assets in comparable industries’.**

In assessing costs, prices and return on assets we have had regard to relevant interstate benchmarks:

- indicative bills paid by customers in other jurisdictions in Australia<sup>85</sup>
- operating and capital expenditure costs per connection throughout Australia<sup>86</sup>
- tariff structures applied by water corporations throughout Australia<sup>87</sup>
- the regulatory rate of return set by other regulators.<sup>88</sup>

We are not aware of any international benchmarks that are relevant to our decision.

**WI Act section 4C(b) requires us to ‘ensure that regulatory decision making and regulatory processes have regard to any differences between the operating environments of regulated entities’.**

Our pricing approach allows each water corporation to propose outcomes, a revenue requirement, expenditure and tariffs that reflect its particular circumstances and operating environment.

The following sections of our draft decision involved consideration of this factor:

- Our consideration of customer engagement (page 7).
- Our consideration of outcomes (page 8).
- Our assessment of the revenue requirement (pages 9 to 10).
- Our assessment of efficient operating expenditure (pages 12 to 20) and capital expenditure (pages 23 to 27).
- Our assessment of tariffs (pages 33 to 36).

Our price review also considers the views of stakeholders affected by Western Water’s proposals, including through submissions and public meetings.

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<sup>85</sup> Bureau of Meteorology 2018, *National performance report 2017-18; urban water utilities, part A*, Melbourne.

<sup>86</sup> Ibid.

<sup>87</sup> Includes Icon Water, Sydney Water, Hunter Water, Gosford City Council, Wyong Shire Council, Power and Water Corp, Urban Utilities, Unity Water, SA Water and TasWater.

<sup>88</sup> Essential Services Commission of South Australia 2018, *SA Water Our Plan 2020–24*, December; Independent Pricing and Regulatory Tribunal 2019, *WACC biannual update*, August.

## **Customer matters**

**ESC Act section 8(1) requires us to have regard to the fact that the ‘objective of the Commission is to promote the long term interests of Victorian consumers’.**

We consider that promoting efficiency in delivering outcomes that align to service priorities of customers is consistent with promoting the long term interests of Victorian consumers.

The following sections of our draft decision involved consideration of this factor:

- Our consideration of customer engagement (page 7).
- Our consideration of outcomes (page 8).
- Our assessment of the revenue requirement (pages 9 to 10).
- Our assessment of efficient operating expenditure (pages 12 to 20) and capital expenditure (pages 23 to 27).
- Our assessment of tariffs (pages 33 to 36).

**ESC Act Section 8(2) requires us to ‘have regard to the price, quality and reliability of essential services’ in seeking to achieve the objective in section 8(1) of the ESC Act.**

We consider that promoting efficiency in delivering outcomes that align to service priorities of customers, and allowing businesses to meet regulatory and policy obligations is consistent with this objective.

In terms of prices, the following sections of our draft decision involved consideration of this factor:

- Our consideration of the revenue requirement (pages 9 to 10).
- Our assessment of efficient operating expenditure (pages 12 to 20) and capital expenditure (pages 23 to 27).
- Our consideration of demand (pages 30 to 32).
- Our consideration of tariffs (pages 33 to 36).

In terms of the quality and reliability of services, the following sections of our draft decision involved consideration of this factor:

- Our consideration of customer engagement (page 7).
- Our consideration of outcomes (page 8).



**WIRO Clause 11(d)(i) requires us to have regard to whether Western Water’s prices ‘enable customers or potential customers of the regulated entity to easily understand prices charged by the regulated entity for prescribed services or the manner in which such prices are calculated, determined or otherwise regulated’.**

We consider that the following matters are relevant when considering whether Western Water’s prices enable customers or potential customers to easily understand prices, or the manner in which prices are calculated, determined or otherwise regulated:

- feedback from customers during a water corporation’s engagement
- the structure of individual tariffs
- the proposed form of price control
- any changes to tariffs and how water corporations explain them to customers.

The following sections of our draft decision involved consideration of this factor:

- Our consideration of the form of price control and tariffs (pages 33 to 36).

**WIRO Clause 11(d)(ii) requires us to have regard to whether Western Water’s prices ‘provide signals about the efficient costs of providing prescribed services to customers while avoiding price shocks where possible’.**

We consider prices can provide signals about efficient costs when a tariff is applied to customers benefiting from the service covered by the tariff, and tariffs send appropriate signals about efficient costs.

The following sections of our draft decision involved consideration of this factor:

- Our consideration of customer engagement (page 7).
- Our assessment of the revenue requirement (pages 9 to 10)
- Our assessment of efficient operating expenditure (pages 12 to 20) and capital expenditure (pages 23 to 27).
- Our assessment of tariffs (pages 33 to 36).

**WIRO Clause 11(d)(iii) requires us to have regard to whether Western Water’s prices ‘take into account the interests of customers of the regulated entity, including low income and vulnerable customers’.**

In considering the above factor, we had regard to:

- Western Water’s customer engagement, noting that affordability was one of the major priorities identified by its customers (page 7).
- Western Water’s proposed tariff structure and our views on its compliance with various matters in the WIRO and our guidance (pages 33 to 36).

- Western Water’s range of payment options and advice for customers experiencing difficulty paying bills. We consider these options and advice provide avenues for low income and vulnerable customers to seek assistance.

## **Health, safety, environmental and social obligations**

**ESC Act Section 8A(1)(d) requires us to have regard to ‘the relevant health, safety, environmental and social legislation applying to the industry’.**

Our draft decision proposes to approve a revenue requirement that will enable Western Water to deliver on its legal and regulatory obligations.

The following sections of our draft decision involved consideration of this factor:

- Our assessment of the revenue requirement (pages 9 to 10).
- Our assessment of efficient operating expenditure (pages 12 to 20) and capital expenditure (pages 23 to 27).
- Our assessment of the form of price control (page 33).

**WI Act section 4C(c) requires us to ‘ensure that regulatory decision making has regard to the health, safety, environmental sustainability (including water conservation) and social obligations of regulated entities’.**

Our draft decision proposes to approve a revenue requirement that will enable Western Water to deliver on its health, safety, environmental sustainability and social obligations.

The following sections of our draft decision involved consideration of this factor:

- Our assessment of the revenue requirement (pages 9 to 10).
- Our assessment of efficient operating expenditure (pages 12 to 20) and capital expenditure (pages 23 to 27).
- Our assessment of tariffs (pages 33 to 36).

## **Other matters**

**ESC Act section 8A(1)(c) requires us to have regard to ‘the degree of, and scope for, competition within the industry, including countervailing market power and information asymmetries’.**

In relation to the above, Western Water does not face any competition in the delivery of its prescribed services within its region. Our draft decision takes this into account through our consideration of forecast efficient costs, and considering the service priorities of customers as revealed through a business’s customer engagement.

The following sections of our draft decision involved consideration of this factor:

Appendix B: Our consideration of legal requirements

- Our assessment of engagement (page 7)
- Our assessment of outcomes (page 8)
- Our assessment of efficient operating expenditure (pages 12 to 20) and capital expenditure (pages 23 to 27).

We consider that our pricing approach helps to address market power and information asymmetries relating to the water corporations. Our PREMO water pricing approach provides incentives for a water corporation to provide its “best offer” to customers in its price submission. This is described in further detail in a report we released in 2016.<sup>89</sup>

**ESC Act section 8A(1)(e) requires us to have regard to the ‘benefits and costs of regulation (including externalities and gains from competition and efficiency) for: (i) consumers and users of products or services (including low income and vulnerable consumers); and (ii) regulated entities’.**

We have had regard to benefits and costs of regulation by:

- Focusing our assessments of price submissions on the materiality of proposals to customer interests (including low income and vulnerable services), including in terms of price, bill and service impacts.
- Designing our guidance so we minimise the compliance costs for water corporations. Our guidance noted that much of the information required in price submissions should be readily available to water corporations as it would be relevant for other purposes such as corporate planning and project prioritisation and justification.<sup>90</sup>

A benchmarking study found that the cost of the commission’s price reviews in the past has been lower than those of regulators in other Australian jurisdictions (after being normalised for revenue covered by price decisions).<sup>91</sup>

**ESC Act section 8A(1)(f) requires us to have regard to ‘consistency in regulation between States and on a national basis’.**

Similar to other state and national regulators, our economic regulatory approach:

- uses the building block method to estimate a water corporation’s revenue requirement
- allows water corporations to implement various forms of price control, including price caps and revenue caps

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<sup>89</sup> Essential Services Commission 2016, Water Pricing Framework and Approach, Implementing PREMO from 2018, October, pp. 11–13.

<sup>90</sup> Essential Services Commission 2018, Guidance – Western Water 2020, op. cit., p. 4.

<sup>91</sup> Essential Services Commission 2014, Information paper for the Independent Review of the Economic Regulatory Framework, April.

- allows for consultation with key stakeholders during a price review, including through the release of a draft decision.

**WI Act section 4C(a) requires us to ‘ensure that the costs of regulation do not exceed the benefits’.**

We have sought to ensure that the costs of regulation do not exceed the benefits by:

- Implementing a price review process so that water corporations may receive streamlined price reviews if they submit a high quality price submission. This reduces the costs of regulation for water corporations and the commission.
- Focusing our assessments of price submissions on the materiality of proposals to customer interests (including low income and vulnerable services), including in terms of price, bill and service impacts.
- Designing our guidance so we minimise the compliance costs for water corporations. Our guidance noted that much of the information required in price submissions should be readily available to water corporations as it would be relevant for other purposes such as corporate planning and project prioritisation and justification.<sup>92</sup>

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<sup>92</sup> Essential Services Commission 2018, Guidance – Western Water 2020, op. cit., p. 4.