ESSENTIAL SERVICES COMMISSION

Lower Murray Water final decision – urban services

2018 Water Price Review

19 June 2018

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Contents

Summary

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

This final decision paper covers Lower Murray Water's urban services. A separate paper provides our final decision on Lower Murray Water's rural infrastructure services.[1]

In March 2017, we released our draft decision on Lower Murray Water's price submission.[2] The draft decision set out our initial views on Lower Murray Water's proposals, and invited interested parties to make further submissions. We also held a public meeting in April 2018. In addition to a response from Lower Murray Water, we received three written submissions on our draft decision, which are available on our website. A list of these submissions is included in Appendix A to this final decision.

After considering feedback, we have made a price determination for Lower Murray Water.[3] The price determination sets out the maximum prices Lower Murray Water may charge for prescribed services (or the manner in which its prices are to be calculated, determined, or otherwise regulated) for the five year period from 1 July 2018 (2018–23). This final decision paper sets out our supporting reasons and analysis for the price determination.

Where our final decision on a particular aspect is unchanged from our draft decision, we have not detailed the supporting reasons in our final decision. Rather, we have noted that our final decision confirms the reasons and position we reached in the draft decision.

Where we have reached a different decision to that proposed in our draft decision, or where new information required our consideration, we have set out our reasons in full in this final decision. This final decision should be read in conjunction with our draft decision.

[1] Our final decision for Lower Murray Water's rural infrastructure services is available on our website.

[2] Clause 16 of the Water Industry Regulatory Order 2014 requires us to issue a draft decision. Lower Murray Water's price submission and our draft decision are available at www.esc.vic.gov.au/waterpricereview.

[3] Before the commencement of a regulatory period, clause 10 of the Water Industry Regulatory Order 2014 requires us to make a price determination which determines the maximum prices a water corporation may charge, or the manner in which its prices are to be calculated, determined or otherwise regulated during the regulatory period. See Essential Services Commission 2018, *Lower Murray Water Determination: 1 July 2018 – 30 June 2023*, June.

Our final decision has updated the revenue to be collected by Lower Murray Water

Our final decision approves a revenue requirement of $187.6 million over the five year period starting 1 July 2018.[4] This is $0.4 million or 0.2 per cent lower than our draft decision, and mainly reflects our updates to the cost of debt (see pages 18 to 19) as foreshadowed on our draft decision.

A summary of approved maximum prices for major services delivered by Lower Murray Water is set out on pages 23 to 24. The estimated typical bills for residential customer groups under Lower Murray Water's proposal and our final decision are provided in Table A. In 2018-19 the estimated annual bill for a residential owner occupier will fall by around $4, with further reductions in the following four years (in constant price $2018-19 terms).

Table A Estimated typical water and sewerage bills
$ 2018-19

Customer group	Average consumption (kL p.a.)	2017-18 annual bill	2018-19 annual bill	2022-23 annual bill
Residential (Owner occupier)	477	$976	$972	$959
Residential (Tenant)	477	$280	$279	$275

Note: Numbers have been rounded

Lower Murray Water will improve services

Our final decision approves prices that will allow Lower Murray Water to deliver on its customer service commitments, government policy, and obligations monitored by the Environment Protection Authority Victoria and the Department of Health and Human Services.

Some of the ways Lower Murray Water plans to improve outcomes for customers are by:

- reducing fixed and variable water, sewerage and trade waste prices
- investing in water supply infrastructure to improve water quality for Swan Hill.

Tariff structures are the same

Our final decision approves Lower Murray Water's proposed tariff structures, which reflect a continuation of its current approach. For water services, we have approved Lower Murray Water's

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

proposal for a fixed service charge and a variable component that depends on water use. For residential customers, the variable component includes an inclining block structure where prices increase as higher amounts of water are used. For sewerage services, we have approved Lower Murray Water's proposal for a fixed charge only.

Our final decision also approves Lower Murray Water's proposed tariff basket form of price control. A tariff basket allows Lower Murray Water flexibility to adjust individual tariffs, subject to the overall price change remaining within the maximum allowed in the price determination. Lower Murray Water currently uses a tariff basket.

For more detail on tariffs and the form of price control, see pages 21 to 24.

Lower Murray Water's price submission is rated as 'Standard' under PREMO

Our final decision approves a PREMO rating of 'Standard' for Lower Murray Water's price submission. In support of its PREMO rating, we note Lower Murray Water's forecast for controllable operating expenditure incorporated assumptions for higher rates of improvement (on a per connection basis) than most other water corporations. As well, our review of Lower Murray Water's forecast expenditure also identified no changes to its proposals, an indication that its expenditure forecasts reflect efficient costs. Both factors indicate that the corporation is seeking to minimise costs, prices and bills for its customers.

Figures A and B summarise our final decision on PREMO. More detail on our assessment of Lower Murray Water's PREMO rating is provided in Chapter 3. Lower Murray Water is one of four businesses for which we have approved a 'Standard' PREMO price submission rating.

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

Figure A PREMO Rating

	Overall PREMO rating	Risk	Engagement	Management	Outcomes
Lower Murray Water's rating	**Standard**	Standard	Standard	Standard	Standard
Commission's rating	**Standard**	Standard	Standard	Standard	Standard

Figure B Final decision on PREMO – overall rating

Leading	Advanced	Standard	Basic	Not rated
Goulburn Valley Water	Barwon Water	East Gippsland Water	Wannon Water	South Gippsland Water
	Central Highlands Water	Gippsland Water		Western Water *
	City West Water	Lower Murray Water (urban)		
	Coliban Water	Westernport Water		
	GWMWater			
	North East Water			
	South East Water			
	Southern Rural Water			
	Yarra Valley Water			

* We have not assessed Western Water under PREMO, as prior to lodging its price submission it notified us of its intention to target a short-term pricing outcome rather than the overall value for money outcome expected under PREMO. Western Water adopted this approach to provide time for it to undertake a review to inform longer-term prices.

1. Our role and approach to water pricing

We are Victoria's independent economic regulator

Our role in the water industry is based on the Water Industry Regulatory Order 2014 (WIRO) which is made under the *Water Industry Act 1994* (Vic) (WI Act) and sits within the broader context of the *Essential Services Commission Act 2001* (Vic) (ESC Act). Our role under the WIRO includes regulating the prices and monitoring service standards of the 19 water corporations operating in Victoria.

We are reviewing the prices 17 water corporations propose to charge customers from 1 July 2018

Our review of the prices proposed by the water corporations covers the prescribed services listed in the WIRO.[5] The prescribed services include retail water and sewerage services, and bulk water and sewerage services delivered by the water corporations.[6]

Our task is to assess price submissions by water corporations against the legal framework that governs our role, and make a price determination that takes effect from 1 July 2018. We make a price determination after issuing a draft decision, and considering feedback from interested parties.

The price determination specifies the maximum prices a water corporation may charge for prescribed services, or the manner in which prices are to be calculated, determined or otherwise regulated. We also issue a final decision that sets out the supporting reasons for our price determination.

We assess prices against the WIRO and other legal requirements

Clause 11 of the WIRO specifies the mandatory factors we must have regard to when making a price determination, including matters set out in the WIRO, the WI Act and the ESC Act. In making a price determination, we have had regard to each of the matters required by clause 11 of the WIRO, including:

- the objectives and matters specified in clause 8 of the WIRO, which include economic efficiency and viability matters, industry specific matters, customer matters, health, safety, environmental and social matters, and other matters which are specified in sections 8 and 8A of the ESC Act and section 4C of the WI Act

[5] The review excludes Melbourne Water and Goulburn-Murray Water. In 2016 we approved prices for Melbourne Water to 30 June 2021 and for Goulburn-Murray Water to 30 June 2020.

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

- the matters specified in our guidance[7]
- 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.

Our consideration of legal requirements document lists the specific objectives and the various matters the commission must have regard to when making a price determination and provides a guide to where we have done so for our final decision for Lower Murray Water.[8]

In 2016, we issued guidance to Lower Murray Water to inform its price submission. The guidance set out how we will assess Lower Murray 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 Lower Murray Water's proposed prices.[9]

If we consider the submission does not have adequate regard for the matters specified in clause 11 of the WIRO or comply with our guidance, we may specify maximum prices, or the manner in which prices are to be calculated, determined or otherwise regulated.[10]

The power for water corporations to impose fees is set out in the *Water Act 1989* (Vic) (Water Act). Provisions in the Water Act also govern the manner in which water corporations may impose fees, and it is for each water corporation to ensure that it complies with them.[11]

The 2018 price review is the first we've undertaken under our new water pricing approach

In 2014, the Victorian Government reviewed and revised the WIRO. The changes allowed us more flexibility to decide on the pricing approach we use in Victoria's water sector. In April 2015 we released a consultation paper to start reviewing our pricing approach.[12]

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

[8] Essential Services Commission 2018, *Lower Murray Water final decision – urban services, 2018 Water Price Review – commission's consideration of legal requirements*, 19 June. This is available at www.esc.vic.gov.au/waterpricereview.

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

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

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

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

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

In May 2016, we released a position paper setting out our proposed new pricing approach, and invited submissions.[13] We met with each water corporation and other interested parties to help inform their submissions. Submissions were supportive of the overall proposal, in particular the greater focus on customer engagement and value.

We finalised our new approach to water pricing in October 2016.[14]

Our new pricing approach builds on many aspects of the previous approach. We continue to use the building blocks to estimate the revenue requirement for a water corporation.[15] Our guidance explains the building blocks and how we use it to estimate the revenue requirement.[16]

Among the key changes, the new approach introduces new incentives to help ensure water corporations deliver the outcomes most valued by customers. Our new PREMO framework rewards stronger customer value propositions in price submissions, and an early draft decision is available for price submissions we can assess in a short timeframe.[17] The PREMO incentive is described next.

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

PREMO

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

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

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

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

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

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

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

The 2018 water price review is the first time we've applied our PREMO incentive mechanism. A water corporation's ambition in terms of delivering customer value is being assessed against four elements of PREMO – Risk, Engagement, Management and Outcomes.[18]

A water corporation must self-assess and propose a rating for its price submission as 'Leading', 'Advanced', 'Standard' or 'Basic'. Its proposed return on equity will then reflect its PREMO rating. A 'Leading' submission has the highest return on equity, and a 'Basic' submission the lowest. We assess the justification for the PREMO rating, and also rate the price submission. This process determines the return on equity reflected in the revenue requirement.[19]

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

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

2. Our assessment of Lower Murray Water's price submission

We have made our price determination for Lower Murray Water after considering: Lower Murray Water's price submission, its responses to our queries and our draft decision, and written submissions from interested parties. A list of submissions responding to our draft decision is provided in Appendix A. We also held a public meeting in April on our draft decision to receive feedback.

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

Lower Murray Water's price submission and financial model presented clear and comprehensive information to support its proposals. Lower Murray Water also provided evidence that its engagement sought to capture the main priorities and concerns of customers, and that it has taken this feedback into account (see customer engagement on page 6).

Our guidance included a number of matters water corporations must address in their price submissions. Lower Murray Water's price submission addressed each of these matters, with our preliminary assessment set out in our draft decision. Our final decision is set out below.

Regulatory period

Our draft decision accepted the five year regulatory period proposed by Lower Murray Water (1 July 2018) in its price submission. Our guidance proposed to approve a five year regulatory period, subject to any alternative and justified proposal.[20]

In response to our draft decision, Consumer Action Law Centre (CALC) recommended the regulatory period should be the same for all water corporations, unless there are special circumstances.[21] In support of this, it noted factors such as greater community attention when all price reviews are undertaken at the same time.

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

[21] Consumer Action Law Centre 2018, *Submission on standard draft decisions: 2018 Water Price Review*, 8 May, p. 10.

Our final decision is to approve the five year regulatory period proposed by Lower Murray Water. This is the same period we have approved for all but three water corporations in our current price review.

Customer engagement

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

The engagement by Lower Murray Water:

- took place between September 2016 and September 2017
- used a range of methods including face-to-face and online interviews, quantitative on-line survey, pop-up kiosks, social media platforms and focus group meetings
- sought views from residential and commercial customers and major stakeholders
- was informed by a customer consultative committee which, in conjunction with an external consultant, developed the customer outcomes and measures
- covered topics such as pricing, customer financial hardship, and water security.

More detail on Lower Murray Water's engagement is available in its price submission.[22]

Evidence that Lower Murray Water's engagement influenced its proposals includes:

- its focus on maintaining services and containing costs, in response to feedback from customers indicating a low willingness to pay for improved services
- investing in water treatment and system improvements in all towns to better manage poor raw water quality events and provide greater assurance about drinking water quality.

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

CALC suggested we could play a greater role to promote best practice customer engagement and identify areas for improvement.[24] We note that following our price review, we will continue to work with water corporations to promote best practice customer engagement.

[22] Lower Murray Water's price submission is available on our website at www.esc.vic.gov.au. See pages 3 to 7.

[23] See for example, WIRO clauses 8(b)(i), 8(b)(ii), 8(b)(iii), 11(d)(iii), and ESC Act Sections 8(1), 8A(1)(a).

[24] Consumer Action Law Centre, op. cit., p. 4.

Outcomes

The outcomes Lower Murray Water proposes to deliver over the five year period starting 1 July 2018 are:

- keep costs to a minimum
- be easy to contact and quick to respond
- provide consistent, safe drinking water
- provide reliable sewerage services
- be present and active in the community
- be mindful of the environment
- comply with government obligations.

Lower Murray Water's proposed measures and targets for reporting against these outcomes are set out at pages 65 to 71 of its price submission. Lower Murray Water has committed to reporting to customers annually against each of these measures. It has proposed to make performance information available on its webpage and to present to a representative focus group twice a year. Lower Murray Water will also undertake additional customers' surveys to check performance and relevance of its outcomes.

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

In its submission, CALC commented on the need for additional funding for regional water corporations to strengthen existing hardship programs or adopt new practices to assist vulnerable customers.[25] CALC cited our 2013 price review where we provided an additional allowance for metropolitan water corporations to expend existing hardship programs or introduce new hardship programs.

We have not adopted CALC's recommendation in our final decision. We note that the additional allowance in our 2013 price review was provided in recognition of the large one-off price increases approved for the metropolitan corporations during the review.[26] Further, water corporations already allocate funds to programs aimed to deliver payment options and hardship support required by our customer service codes. Lower Murray Water has responded to customer views on affordability by

[25] ibid., p. 3.

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

proposing to lower prices and maintaining payment options and assistance for customers experiencing difficulty paying bills.

Service Standards

Lower Murray Water has also provided a list of service standards relating to reliability and attending faults that it will include in its customer charter. These service standards and Lower Murray Water's targets until 2023 are set out in Appendix B.

CALC noted a range of ambitions by water corporations when it comes to proposed service standards and that water corporations should be encouraged to 'improve service standards over time'.[27] We note that Lower Murray Water proposed standards for reliability and attending faults mostly in line with past targets and performance. Some targets will improve.

Lower Murray Water's service levels were informed by its engagement program to reflect the priorities of customers. This aligns with our expectation that water corporations consider customer preferences when forming service targets.

> Approved service standards relating to reliability and attending faults are set out in Appendix B and form part of the manner in which Lower Murray Water's services are regulated.

Guaranteed service levels

Guaranteed service levels (GSLs) define a water corporation's commitment to deliver a specified level of service. For each GSL, a water corporation commits to a payment or a rebate on bills to those who have received a level of service below the guaranteed level. We expect water corporations to include GSLs in its customer charter.

Lower Murray Water's proposed GSLs are set out on page 13 of its price submission. It proposed a substantial increase in the payment amount for a sewer spill within a house, and no change to its other three GSLs.

In our draft decision we provided an overview of Lower Murray Water's proposed GSLs. In its submission on our draft decisions, CALC supported GSL payments increasing over time.[28] Lower Murray Water noted it considered higher payments or lower thresholds for all its GSLs, however focus groups only supported increasing payments for its GSL relating to sewer spills.

[27] Consumer Action Law Centre, op. cit., p. 6.

[28] ibid., p. 1.

Lower Murray Water's proposed GSLs were informed by feedback from customer focus groups to reflect the aspects of service delivery most important to customers. For this reason our final decision approves Lower Murray Water's proposed GSLs.

Lower Murray Water's GSLs are set out in Appendix C to this final decision.

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

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.[29] Along with forecast demand, it is an input to calculating prices.

Our draft decision accepted Lower Murray Water's proposed revenue requirement of $187.9 million over a five year period starting 1 July 2018. Our final decision approves a slightly lower revenue requirement of $187.6 million. This reflects our final decision on each element of the revenue requirement, as set out in Table 2.1.

The reduction for our final decision is mainly due to updates we made to Lower Murray Water's cost of debt, reducing its allowance for return on assets in the revenue requirement. Adjustments to the revenue requirement since our draft decision are set out at Table 2.2, with the reasons set out in the following sections.

[29] We met with officers of the Department of Environment, Land, Water and Planning, Department of Health and Human Services, and Environment Protection Authority Victoria, to discuss their expectations of Lower Murray Water in the regulatory period from 1 July 2018. We had regard to their views in our draft and final decisions.

Table 2.1 Final decision – Revenue requirement
$ million 2017-18

	2018-19	2019-20	2020-21	2021-22	2022-23	Total
Operating expenditure	24.2	23.1	22.5	22.7	22.6	115.1
Return on assets	6.4	6.7	6.9	7.0	7.1	34.1
Regulatory depreciation	8.1	8.5	8.6	8.7	9.0	42.9
Non-prescribed revenue offset of revenue requirement	-0.9	-0.9	-0.9	-0.9	-1.0	-4.6
Tax allowance	0.0	0.0	0.0	0.0	0.0	0.0
Revenue requirement	**37.9**	**37.4**	**37.1**	**37.5**	**37.7**	**187.6**

Note: Numbers have been rounded

Table 2.2 Adjustments to draft decision revenue requirement
$ million 2017-18

	2018-19	2019-20	2020-21	2021-22	2022-23	Total
Draft decision – revenue requirement	**38.0**	**37.4**	**37.1**	**37.6**	**37.9**	**187.9**
Operating expenditure	-0.04	0.02	0.03	-0.03	-0.09	-0.12
Return on assets	-0.05	-0.05	-0.05	-0.05	-0.05	-0.26
Total adjustments	**-0.09**	**-0.03**	**-0.02**	**-0.08**	**-0.14**	**-0.37**
Final decision – revenue requirement	**37.9**	**37.4**	**37.1**	**37.5**	**37.7**	**187.6**

Note: Numbers have been rounded

Operating expenditure

Operating expenditure is an input to the revenue requirement. In our draft decision (pages 9 to 16), we proposed to accept Lower Murray Water's controllable operating expenditure forecast of $103.2 million for the 2018–23 period. The reasons for this were:

- Evidence indicating its baseline controllable operating expenditure reflects an efficient benchmark.[30]
- Lower Murray Water proposed additional operating expenditure above the adjusted baseline of only $0.26 million. Lower Murray Water is the only water corporation for which Deloitte recommended no adjustments to controllable operating expenditure.

We noted in our draft decision that we would update the forecast non-controllable operating expenditure for our final decision, and also adjust for the latest inflation and external bulk charges data.[31]

Lower Murray Water's response to our draft decision accepted the commission's adjustments, but provided updated forecasts for controllable operating expenditure based on the latest information for labour and energy.

- The 2018-19 Victorian budget cut the payroll tax from 3.65 per cent to 2.425 per cent for regional corporations from 1 July 2018. As a result, Lower Murray Water has proposed a reduction of $0.57 million across the 2018–23 period. This is consistent with our draft decision requirement to be provided with updated forecasts if there is a change in legislation or government policy.
- In its price submission, Lower Murray Water proposed additional electricity costs of $1.61 million above the baseline for the 2018–23 period. In its response to our draft decision, Lower Murray Water has increased this to $2.19 million above the baseline based on its latest energy contract until 30 June 2020 and then expected prices until 30 June 2023 using advice from Ernst & Young and SavvyPlus Consulting. It highlighted 30 per cent of its controllable costs are for electricity, and that it has adopted a progressive procurement strategy so prices are not fixed for the term of the contract. We have verified the forecast electricity prices and costs for 2018–23.[32] However, the forecasts from SavvyPlus were expressed in nominal terms, so we have adjusted these for inflation to produce a revised forecast of $1.95 million. We consider the revised electricity forecast better reflects efficient operating expenditure and for our final decision we accept a $0.34 million increase from our draft decision.
- Lower Murray Water also updated its balancing adjustment in its financial model, which reduced its controllable operating expenditure forecast by $0.012 million across the 2018–23 period. This item was added to its proposed cost variation above the baseline to absorb model corrections (refer to page 11 of our draft decision for more details).

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[30] Controllable costs are those that can be directly or indirectly influenced by a water corporation's decisions.

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

[32] We requested our expenditure consultant, Deloitte Access Economics, to review the updated electricity price forecasts and compare against the information received for our draft decision. Deloitte recommended a $0.34 million increase for our final decision.

No other new considerations were presented in submissions received following the draft decision which caused us to change our views on operating expenditure.

Our final decision for controllable operating expenditure adopts a $0.24 million reduction from our draft decision for 2018–23.

For non-controllable operating expenditure, we have revised our draft decision forecasts where required based on the latest March 2018 inflation and external bulk charges information. We have revised our forecast environmental contribution from our draft decision, and made no changes to forecast licence fees or external bulk charges.[33]

Based on the latest inflation data, we have revised the forecast 2018-19 environmental contribution from $1.71 million to $1.73 million, which results in a total increase of $0.13 million across the 2018–23 period.

Accordingly, we have increased our draft decision forecast for Lower Murray Water's non-controllable operating expenditure by $0.13 million to $12.13 million across the 2018–23 period.

Table 2.3 sets out our adjustments from our draft decision for controllable and non-controllable operating expenditure. Table 2.4 sets out the benchmark operating expenditure we have adopted for our final decision.

[33] For the environmental contribution, we have used the 2018-19 value provided by the Department of Environment, Land, Water and Planning and assumed that this will remain flat in nominal terms (decline in real terms) across the 2018–23 regulatory period.

Table 2.3 Adjustments to operating expenditure
$ million 2017-18

	2018-19	2019-20	2020-21	2021-22	2022-23	Total
Draft decision – total operating expenditure	**24.2**	**23.1**	**22.5**	**22.7**	**22.7**	**115.2**
Updated balancing adjustment	-0.002	-0.002	-0.002	-0.002	-0.002	-0.012
Electricity	0.05	0.11	0.12	0.06	0.00	0.34
Payroll tax	-0.12	-0.12	-0.11	-0.11	-0.11	-0.57
Total adjustments to controllable costs	**-0.07**	**-0.01**	**0.01**	**-0.06**	**-0.11**	**-0.24**
Environmental contribution	0.03	0.03	0.03	0.02	0.02	0.13
Total adjustments to non-controllable costs	**0.03**	**0.03**	**0.03**	**0.02**	**0.02**	**0.13**
Final decision – total operating expenditure	**24.2**	**23.1**	**22.5**	**22.7**	**22.6**	**115.1**

Note: Numbers have been rounded

We have adopted the benchmark for operating expenditure set out in Table 2.4 for the purpose of making our final decision on Lower Murray Water's revenue requirement (Table 2.1). We consider our final decision for Lower Murray Water's forecast operating expenditure is consistent with the requirements of the Water Industry Regulatory Order 2014 (WIRO) and the criteria for prudent and efficient expenditure outlined in our guidance.[34]

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

Table 2.4 Final decision – operating expenditure
$ million 2017-18

	2018-19	2019-20	2020-21	2021-22	2022-23	Total
Controllable costs	**21.7**	**20.6**	**20.1**	**20.3**	**20.2**	**102.9**
Non-controllable costs	**2.5**	**2.5**	**2.4**	**2.4**	**2.4**	**12.1**
Bulk services[a]	0.7	0.7	0.7	0.7	0.7	3.5
Environmental contribution[b]	1.7	1.7	1.7	1.6	1.6	8.3
Licence fees – ESC[c]	0.018	0.018	0.018	0.018	0.029	0.103
Licence fees – DHHS[c]	0.017	0.017	0.017	0.017	0.017	0.083
Licence fees – EPA[c]	0.039	0.039	0.039	0.039	0.039	0.195
Other	0.0	0.0	0.0	0.0	0.0	0.0
Final decision – total operating expenditure	**24.2**	**23.1**	**22.5**	**22.7**	**22.6**	**115.1**

[a] Bulk services covers the supply of bulk water and sewerage services

[b] The Environmental Contribution collects funds from water corporations under the *Water Industry Act 1994* (Vic)

[c] Licence fees are paid to cover costs incurred by Department of Health and Human Services, Environment Protection Authority Victoria, and the Essential Services Commission in their regulatory activities related to the water corporation

Note: Numbers have been rounded

The benchmark operating expenditure that we have adopted for Lower Murray Water does not represent the amount that Lower Murray 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 and to provide services over the regulatory period.

Regulatory asset base

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

- closing regulatory asset base at 30 June 2017

- forecast regulatory asset base for each year of the regulatory period from 1 July 2018.

Closing regulatory asset base

We update the regulatory asset base to reflect actual capital expenditure, government and customer contributions, and asset disposals for the period to 30 June 2017. This helps to ensure prices reflect the actual expenditure of a water corporation.

Our draft decision proposed to approve a closing regulatory asset base for 30 June 2017 of $155.0 million. We proposed to approve this amount as Lower Murray Water's actual net capital expenditure was 27.5 per cent lower than the forecast used to approve maximum prices for the period from 1 July 2013.[35] [36] Lower Murray Water also calculated its closing regulatory asset base in accordance with the requirements of our guidance.

No other new considerations were raised in submissions on our draft decision that affected our assessment of the closing regulatory asset base. Our final decision approves a closing regulatory asset base at 30 June 2017 of $155.0 million. The calculations are provided at Table 2.5.

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[35] Net capital expenditure is calculated by deducting government and customer contributions from gross capital expenditure.

[36] We take a risk-based approach to including past capital expenditure in the regulatory asset base. We undertake a prudency and efficiency review where a water corporation has exceeded its net capital expenditure forecasts by more than 10 per cent. We believe this approach is reasonable given capital expenditure can be relatively 'lumpy' in nature.

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

	2012-13	2013-14	2014-15	2015-16	2016-17
Opening RAB 1 July	147.3	148.0	152.9	153.8	157.4
Plus gross capital expenditure	6.6	13.0	9.4	11.5	6.4
Less government contributions	0.0	0.0	0.0	0.0	0.0
Less customer contributions	0.7	1.6	1.5	0.9	1.7
Less proceeds from disposals	0.3	0.7	0.6	0.2	0.1
Less regulatory depreciation	4.9	5.8	6.4	6.8	7.1
Closing RAB 30 June	**148.0**	**152.9**	**153.8**	**157.4**	**155.0**

Note: Numbers have been rounded

Forecast regulatory asset base

The forecast regulatory asset base is calculated having regard to the closing asset base, and forecasts for capital expenditure, government and customer contributions, and asset disposals.

Table 2.6 sets out our final decision on Lower Murray Water's forecast regulatory asset base from 1 July 2018.[37] This is the same amount we proposed to approve in the draft decision.

[37] Our guidance required water corporations to provide an estimate of the components of its regulatory asset base for 2017-18. This is so we can assess the opening asset base for 1 July 2018. Our guidance noted that where the 2017-18 forecasts for net capital expenditure (gross capital expenditure less government and customer contributions) is lower than the forecast benchmark for that year in its 2013 price determination, the lower amount must be used. The estimates for 2017-18 will be confirmed at the price review following the 2018 water price review.

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

	2017-18	2018-19	2019-20	2020-21	2021-22	2022-23
Opening RAB 1 July	155.0	156.1	168.0	170.7	175.8	177.7
Plus gross capital expenditure	9.8	21.2	12.3	14.9	11.8	12.3
Less government contributions	0.0	0.0	0.0	0.0	0.0	0.0
Less customer contributions	0.8	0.8	0.8	0.8	0.8	0.8
Less proceeds from disposals	0.4	0.4	0.4	0.4	0.4	0.4
Less regulatory depreciation	7.5	8.1	8.5	8.6	8.7	9.0
Closing RAB 30 June	**156.1**	**168.0**	**170.7**	**175.8**	**177.7**	**179.8**

Note: Numbers have been rounded

Capital expenditure

Capital expenditure is an input to estimating the regulatory asset base. In our draft decision (pages 19 to 22), we proposed to accept Lower Murray Water's gross capital expenditure forecast of $72.4 million for the 2018–23 period. The reasons for this were:

- Lower Murray Water's price submission and business cases provided evidence that its forecasts for capital expenditure are efficient.
- We considered the planned capital expenditure program is achievable, given Lower Murray Water's past track record delivering its capital expenditure program.
- Lower Murray Water has an appropriate approach for managing expenditure associated with uncertain projects.
- We considered Lower Murray Water's approach to forecasting its capital expenditure is consistent with the requirements of our guidance.

Lower Murray Water's response to our draft decision proposed no adjustments to the draft decision.

No other new considerations were presented in submissions received following the draft decision which caused us to change our views on capital expenditure.

Accordingly, we have adopted the gross capital expenditure benchmark proposed in our draft decision for the purpose of making our final decision on Lower Murray Water's forecast regulatory asset base (Table 2.6) and its revenue requirement (Table 2.1). We consider this benchmark is consistent with our guidance and WIRO principles.[38]

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

In our draft decision, we accepted Lower Murray Water's approach for addressing uncertain capital expenditure. We reiterate that Lower Murray Water will need to demonstrate the prudency and efficiency of additional costs incurred during the 2018–23 period if seeking to include them in the regulatory asset base.

Customer contributions

Customer contributions are deducted from gross capital expenditure so they are not included in the regulatory asset base.

Our draft decision considered Lower Murray Water's forecast revenue from customer contributions was reasonable, having regard to past trends and its growth forecasts. We proposed to accept Lower Murray Water's forecast. No other new considerations were presented in submissions received following the draft decision which caused us to change our views on revenue from customer contributions.

For the reasons set out above, our final decision on revenue from customer contributions is the same as our draft decision. Our final decision adopts the benchmarks set out at Table 2.6.

Cost of debt

In our draft decision we proposed to approve the cost of debt proposed by Lower Murray Water as it used the cost of debt values we specified in our guidance to calculate its revenue requirement. We also noted that we will update the value of the estimated cost of debt for 2017-18 with our calculation of the actual cost, applying the method outlined in our guidance.[39]

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[38] Essential Services Commission 2016, *Guidance Paper*, op. cit., p. 35; WIRO clause 8(b).

[39] We received data on the actual trailing average cost of debt for 2017-18 from Treasury Corporation Victoria in April 2018 and we updated the 2017-18 estimates for our final decision.

CALC recommends that we set the benchmark cost of debt at five per cent or around one per cent lower than the amount allowed in our draft decision (6.05 per cent per annum in nominal terms).[40] CALC submits that government owned water corporations carry less risk than private corporations and as such, the allowed cost of debt and the return on equity should be lowered compared with the rates allowed in our draft decision. These recommendations are based on a report prepared by CME for CALC.[41]

A submission by the Water Services Association Australia (WSAA) addressed CALC's submission.[42] Among other things, WSAA's submission noted that competitive neutrality principles have been embedded in government policy, including in Victoria via the Financial Accommodation Levy. As a result, water corporations face a cost of debt that reflects the commercial cost of debt.

In keeping with government policy, the approach we take to the cost of debt is to adopt a benchmark rate that applies to all water corporations. The benchmark reflects our estimate of the efficient financing costs for a privately owned business facing a similar degree of economic risk to a regulated water corporation. We consider this is consistent with the requirements of the WIRO.[43]

In our view, adopting the approach recommended by CALC would mean a benchmark efficient water corporation may not have a reasonable opportunity to recover their debt costs.

A more detailed response to the issues raised by CALC is set out at Appendix D.

Our final decision adopts the benchmark cost of debt as set out in Table 2.7.

Table 2.7 Final decision – Trailing average cost of debt

	2008-09	2009-10	2010-11	2011-12	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18
Cost of debt (nominal)	6.9%	7.4%	7.0%	6.3%	5.3%	7.1%	5.4%	5.3%	4.9%	4.5%

Note: Numbers have been rounded

40 Consumer Action Law Centre, op. cit.

41 ibid., Appendix A.

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

43 Including, in particular, the requirements that our decision have regard to: the promotion of efficiency in regulated industries and the financial viability of the regulated water industry (cl 8(b)(ii) WIRO); efficiency in the industry and incentives for long term investment (s 8A(1)(a) ESC Act); and consistency in regulation between States and on a national basis (s 8A(1)(f) ESC Act).

Return on equity – PREMO rating

Lower Murray Water rated its price submission as 'Standard'. Based on its PREMO self-rating, Lower Murray Water proposed a return on equity of 4.5 per cent per annum. This reflects the maximum return rate allowed in our guidance for a price submission rated as 'Standard'.[44]

Our draft decision accepted Lower Murray Water's proposed return on equity. This reflected our preliminary review of its PREMO self-rating.

CALC recommended a one per cent reduction to each return on equity value in the PREMO matrix.[45] CALC's recommendation is based on the findings of a report prepared by CME. The main reason CME proposed the reduction is due to comparisons with returns allowed for UK water entities, and that government owned water corporations carry less risk than private corporations.

The most relevant comparisons for the return on equity are other economic regulators in Australia. We note the rate for the return on equity (and the regulatory rate of return, comprising the cost of debt and the return on equity) approved in our draft decision are similar to rates recently estimated by other Australian regulators of the water sector.[46] We also consider the allowed return on equity should not be adjusted to reflect government ownership, as the exposure of a water corporation to market risk will not be materially affected by government ownership.

A more detailed response to the issues raised by CALC is set out at Appendix D.

We consider our approach to the return on equity is consistent with our requirements under the WIRO, and in particular, that our estimate provides water corporations with an incentive to invest efficiently, and that our approach has regard to the financial viability of the water industry.

Our final decision accepts Lower Murray Water's proposed return on equity of 4.5 per cent per annum, reflecting our views above, and our final decision on its PREMO rating (Chapter 3).

Regulatory depreciation

Regulatory depreciation is an input to calculating the regulatory asset base. Our draft decision proposed to accept Lower Murray Water's forecast regulatory depreciation, as it was calculated in

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

45 Consumer Action Law Centre, op. cit.

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

a manner consistent with the requirements of our guidance.[47] No new considerations for depreciation were raised in submissions on our draft decision for regulatory depreciation.

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

Tax allowance

The tax allowance is an input into the revenue requirement. Our draft decision accepted Lower Murray Water's forecasts for zero tax in its revenue requirement, as it was calculated consistently with the method required by our guidance.[48] No new considerations were presented in submissions received following the draft decision which caused us to change our views on the tax allowance.

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

Demand

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

For these reasons, our final decision confirms our draft decision on demand.

Our price determination for Lower Murray Water includes the benchmark demand forecasts adopted for our final decision.

Form of price control

Our draft decision proposed to accept Lower Murray Water's proposal to continue with a tariff basket form of price control, which incorporates a 10 per cent upper constraint on individual tariff movements. We considered that the tariff basket allows the recovery of sufficient revenue to cover the forecast efficient costs of providing services, and for it to deliver on any health, safety, social and environmental obligations. We also noted that by limiting price increases under its tariff basket, Lower Murray Water helps to provide customers with price stability, while providing revenue certainty for the business.

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[47] Essential Services Commission 2016, *Guidance paper*, op. cit., p. 42.

[48] ibid., pp. 50-51.

No other new considerations were presented in submissions received following the draft decision which caused us to change our views on the form of price control.

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

Tariff structures and prices

Our draft decision proposed to accept Lower Murray Water's proposed tariff structures, comprising:

- For residential and non-residential water services – a two-part tariff structure with a fixed service charge and a variable component that depends on water use. For residential customers, this includes an inclining block structure where prices increase as higher amounts of water are used.
- For residential and non-residential sewerage services – a fixed service charge only.

We considered the two-part structure for water services will promote efficient use. It also provides customers with a signal regarding their water use costs, and is an approach that is commonly applied in other states and territories.[49] We also considered two-part tariff structures are easy to understand.

Our draft decision noted that we provide water corporations with a large degree of discretion to decide on individual tariff structures.[50] This recognises water corporations are often best placed to consider the interests of customers in designing tariffs.

We proposed to accept Lower Murray Water's proposal to calculate tariffs for recycled water, trade waste and miscellaneous services in accordance with the pricing principles referenced in our guidance. These pricing principles promote cost reflectivity of tariffs.

In its response to our draft decision, Lower Murray Water proposed tariffs reflecting our draft decision on its revenue requirement. We consider these proposed tariffs take into account customers' interests, including low income and vulnerable customers, because:

- the proposed tariffs reflect the forecast efficient costs of delivering services
- the proposed two-part structure for water services tariffs will promote efficient water use, and provide customers a signal about the costs of their water use
- the proposed tariffs were informed by an extensive customer engagement program

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

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

- the proposed tariffs would allow the corporation to recover revenue sufficient to cover forecast efficient costs
- Lower Murray Water has payment options and assistance for customers experiencing difficulty paying bills.

No new considerations were presented in submissions received following the draft decision which caused us to change our views on Lower Murray Water's proposed tariff structures. [51]

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

Our price determination for Lower Murray Water sets out the maximum prices it may charge for the five year period from 1 July 2018 (or the manner in which its prices are to be calculated, determined, or otherwise regulated for each tariff). Approved maximum prices for water and sewerage services applying to most residential and non-residential customers are set out in Tables 2.8 and 2.9 (in $2018–19).

Table 2.8 Final decision – water prices
$ 2018-19

	2018-19	2019-20	2020-21	2021-22	2022-23
Residential					
Variable ($/kL)					
1st tier	0.4482	0.4466	0.4450	0.4434	0.4419
2nd tier	0.8156	0.8128	0.8099	0.8070	0.8042
3rd tier	1.0482	1.0445	1.0408	1.0371	1.0334
Fixed ($/year)	206.33	205.60	204.87	204.15	203.43
Non-residential					
Variable ($/kL)	0.8156	0.8128	0.8099	0.8070	0.8042
Fixed ($/year)	206.33	205.60	204.87	204.15	203.43

Note: Numbers have been rounded down

[51] On 23 May 2018 (after our consultation period had closed on our draft decision for Lower Murray Water), we received a submission from Kingspan Environmental and Urban Water Cycle Solutions under our consultation process for Western Water's draft decision. We have considered the views raised in the submission for our final decision and price determination for Lower Murray Water. Our response to the submission is set out in our final decision paper for Western Water.

Table 2.9 Final decision – sewerage charges
$ 2018-19

	2018-19	2019-20	2020-21	2021-22	2022-23
Residential					
Fixed ($/year)	487.07	485.35	483.64	481.93	480.23
Non-residential					
Fixed ($/year)	487.07	485.35	483.64	481.93	480.23

Note: Numbers have been rounded

Adjusting prices

In our draft decision we:

- Accepted Lower Murray Water's proposal to continue the existing uncertain and unforeseen events mechanism. We noted in our guidance that we propose that the mechanism continues in its current form.
- Did not accept Lower Murray Water's proposed cost of debt adjustment mechanism. We noted the proposed mechanism is based on a price cap, and not its proposed form of price control, which is a tariff basket. We required Lower Murray Water to propose a revised adjustment mechanism that is consistent with the requirements of our guidance.
- Did not accept Lower Murray Water's proposed electricity cost pass through mechanism. We noted that Lower Murray Water proposes to share the risk of electricity cost increases with its customers in an effort to reduce the impact of forecast increases on prices. It was unclear at the time of this draft decision if Lower Murray Water requires an electricity pass-through mechanism for costs that are above its proposed forecast increase to energy costs, given the change to market conditions since its submission.[52] We also considered that the proposed pass through formula is not easy to understand.

Our final decision has approved the uncertain and unforeseen mechanism proposed by Lower Murray Water (noting submissions responding to our draft decision presented no new information to change the views we expressed in our draft decision).

In response to a request from Lower Murray Water, we have also developed a price adjustment mechanism to allow prices to adjust to changes in the cost of debt. The mechanism is set out in

[52] We note Lower Murray Water has stated on page 42 of its submission that it intends to provide the commission with an update on electricity costs in response to this final decision, that better reflects the current market.

Lower Murray Water's price determination. We consider the mechanism is consistent with objectives related to efficiency and that prices reflect efficient costs.

In response to our draft decision, Lower Murray Water requested that the commission reconsider its draft decision, and approve the electricity cost pass through mechanism proposes in its price submission. In support of this, it noted:

- The business is particularly exposed to electricity prices. Electricity prices account for over 30 per cent of the corporation's controllable costs for the rural business, and around 10 per cent of costs for the urban business.
- Electricity price uncertainty continues to exist.
- Since the draft decision, it sought customer committee member views on the proposed mechanism. The feedback was that committee members thought the adjustment mechanism was an appropriate option for addressing the energy requirements of the business.

Given the above, our final decision approves Lower Murray Water's proposed electricity cost pass through mechanism. We consider Lower Murray Water's proposal satisfies our guidance and the WIRO as the mechanism:

- is supported by its customer committees
- is symmetrical – if it is triggered then customers would benefit from lower electricity prices (and would pay more if electricity prices rise)
- is consistent with providing for the financial viability of Lower Murray Water (given the cost exposure of the business to electricity prices)
- will continue to provide incentives for Lower Murray Water to manage electricity costs, given the mechanism will only be triggered if electricity costs were to increase substantially above forecast.

The approved mechanism is set out in Lower Murray Water's price determination.[53]

New customer contributions

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

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[53] The approved mechanism has been altered from Lower Murray Water's original submission to ensure the mechanism trigger is dependent on total actual electricity costs incurred breaching the upper or lower bound collar.

Our draft decision proposed to accept Lower Murray Water's proposed charges for new customer contributions, which included a continuation of its existing structure of standard contribution charges. Lower Murray Water proposed a relatively small decrease to its standard water new customer contribution charges and a small increase to its standard sewerage new customer contribution charges for 2018-19. Lower Murray Water proposed standard charges would increase annually with inflation throughout the regulatory period.

For negotiated new customer contributions, we proposed to approve Lower Murray Water's proposed method of calculating a charge in accordance with the requirements of our new customer contribution pricing principles.[54]

No other new considerations were presented in submissions received following the draft decision which caused us to change our views on new customer contributions charges.

We consider Lower Murray Water's proposed new customer contribution charges, including its method of calculating negotiated contribution charges, are consistent with the requirements of our guidance.[55]

For the reasons set out above, our final decision confirms our draft decision.

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

Lower Murray Water should update and publish any development servicing plans and negotiation protocols to assist developers understand the underlying assumptions of its new customer contribution charges.[56]

Financial position

In approving prices, we must have regard to the financial viability of the water industry.[57] We interpret the financial viability requirements under the *Essential Services Commission Act 2001* (Vic) and the WIRO to mean that the prices we approve should provide a level of certainty that each water corporation can generate sufficient cash flow to deliver on service commitments, including financing costs arising from investments to meet service expectations.

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[54] Essential Services Commission 2016, *Guidance paper,* op. cit., p. 62.

[55] ibid., pp. 62-63.

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

[57] WIRO clause 8(b)(ii) and ESC Act section 8A(1)(b).

Our guidance set out key indicators of forecast financial performance. We have reviewed forecasts for these key indicators based on our final decision on Lower Murray Water's prices. We have assessed that, under our final decision, Lower Murray Water will generate sufficient cash flow to deliver on service commitments, including financing costs arising from investments to meet service expectations.

3. PREMO rating

PREMO is an incentive mechanism that links the return on equity to a water corporation's level of ambition in delivering value to its customers.

For the 2018 price review, a water corporation must rate its price submission as 'Leading', 'Advanced', 'Standard' or 'Basic'. The rating is based on an assessment against the Risk, Engagement, Management and Outcomes elements of PREMO. A 'Leading' price submission is allowed the highest return on equity, and a 'Basic' the lowest.

The assessment tool included in our guidance directs a water corporation to consider its level of ambition in relation to matters covered in its price submission, such as proposals related to operating and capital expenditure, the form of price control, and tariffs.

In Chapter 2, we noted our final decision is to accept Lower Murray Water's proposed return on equity of 4.5 per cent, based on our PREMO review.

Our review of Lower Murray Water's PREMO

Lower Murray Water's proposed PREMO rating, and our draft and final decision are summarised below (Table 3.1).

Table 3.1 PREMO Rating

	Overall PREMO rating	Risk	Engagement	Management	Outcomes
Lower Murray Water's rating	**Standard**	Standard	Standard	Standard	Standard
Commission's draft decision rating	**Standard**	Standard	Standard	Standard	Standard
Commission's final decision rating	**Standard**	Standard	Standard	Standard	Standard

We agree with Lower Murray Water's proposed overall PREMO self-rating of 'Standard'. This is reflected in the return on equity we have approved for Lower Murray Water at page 20. We also agree with Lower Murray Water's proposed self-rating for each element of PREMO.

In support of its proposed PREMO rating, we note:

- Lower Murray Water's forecast for controllable operating expenditure incorporated assumptions for higher rates of improvement (on a per connection basis) than most other water corporations (Figure 3.1).
- Our review of Lower Murray Water's forecast expenditure identified no changes to its proposals, an indication that its expenditure forecasts reflect efficient costs.

These factors indicate that the corporation is seeking to minimise costs, prices and bills for its customers.

In support of its Engagement self-rating of 'Standard', our review found Lower Murray Water engaged early and widely. It used a mix of online and face-to-face engagement methods such as focus groups, and used social media to update and inform the community about its proposals.

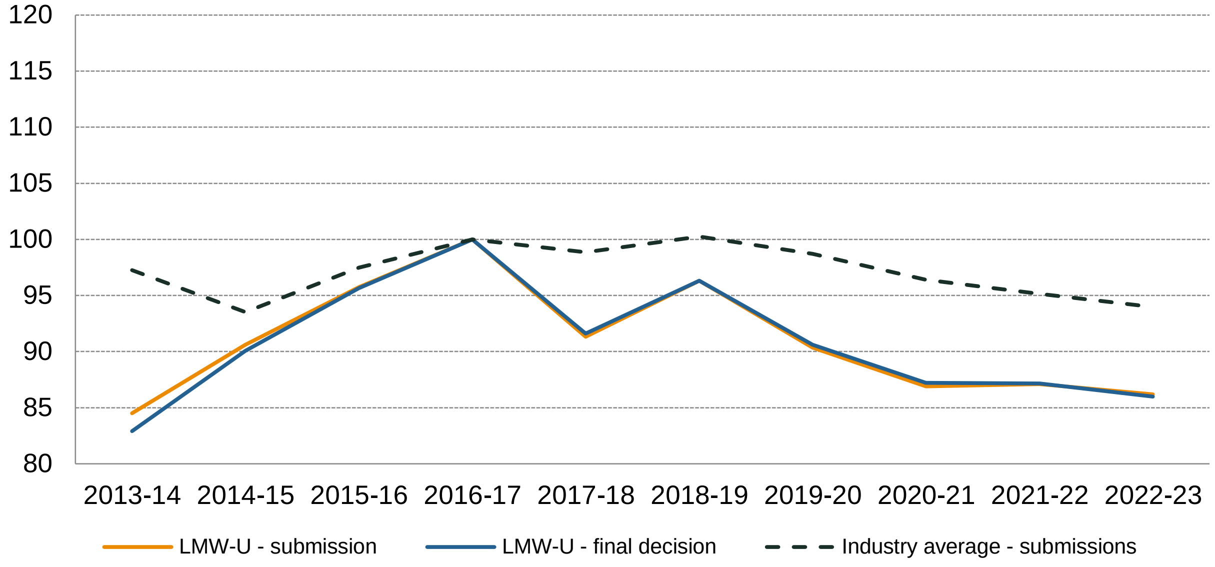
The range of engagement methods used by Lower Murray Water was in response to low levels of engagement in the past by its urban customers, demonstrating the corporation has used past experience to better target its community engagement.

While (on average) customer prices and bills will remain the same or fall, Lower Murray Water proposed to improve services in key areas, including water quality and customer service standards. It has also committed to improve overall customer satisfaction (measured through customer surveys). These factors support its self-rating of 'Standard' for Outcomes.

Lower Murray Water has also increased its acceptance of risk, proposing a higher customer rebate amount for its guaranteed service level related to sewer spills within houses, in response to customer feedback about the inconvenience caused by sewer spills.

Figure 3.1 Controllable operating expenditure per water connection

Index: 2016-17=100



Submission – based on actual historical and forecast values provided by the water corporation in its price submission. Final decision – includes any corrections or adjustments to historical and forecast values arising from our assessment. Industry average – drawn from the price submissions for all urban water corporations (excludes rural expenditure).

Appendix A – submissions received on draft decision

Name or organisation	Date received
Kingspan Environmental and Urban Water Cycle Solutions	23 May 2018
Water Services Association of Australia	16 May 2018
Consumer Action Law Centre	8 May 2018

Appendix B – approved service standards

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

Lower Murray Water's approved service standards

Service Standard	2018-19	2019-20	2020-21	2021-22	2022-23
Water					
Number of customers experiencing more than 5 unplanned water supply interruptions in the year (number)	0	0	0	0	0
Average time taken to attend bursts and leaks (priority 1) (minutes)	20	20	20	20	20
Average time taken to attend bursts and leaks (priority 2) (minutes)	20	20	20	20	20
Average time taken to attend bursts and leaks (priority 3) (minutes)	20	20	20	20	20
Average duration of unplanned water supply interruptions (minutes)	9	9	9	9	9
Average duration of planned water supply interruptions (minutes)	180	9	9	9	9
Sewerage					
Customers receiving more than 3 sewer blockages in the year (number)	0	0	0	0	0
Average time to attend sewer spills and blockages (minutes)	18	18	18	18	18
Average time to rectify a sewer blockage (minutes)	70	70	70	70	70
Spills contained within 5 hours (per cent)	97	97	97	97	97

Note: Numbers have been rounded

Appendix C – approved GSL schemes

We have approved the following service level obligations and corresponding amounts of payment for failure to attain the stated obligation as the guaranteed service level (GSL) scheme for Lower Murray Water.

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

Lower Murray Water is not required to make a payment where the failure to meet the service level is due to the action or inaction of the customer or a third party. For the avoidance of doubt, third party does not include any person or firm acting on behalf of Lower Murray Water.

Lower Murray Water's approved GSL scheme

Approved service level obligation	Approved payment ($)
More than 5 unplanned water supply interruptions in a year	75
More than 3 sewer blockages in a year	75
Sewerage spill caused within house caused by Lower Murray Water assets where customer's internal plumbing is functioning correctly	1500
Restricting the water supply of, or taking legal action against a customer prior to taking reasonable endeavours (as defined by the commission) to contact the customer to test for hardship	300

Appendix D – rate of return

A submission from the Consumer Action Law Centre (CALC) recommended we set the benchmark cost of debt at five per cent or around one per cent lower than the amount allowed in our draft decision (6.05 per cent per annum in nominal terms). It also recommended that we reduce each of the equity values in the PREMO matrix by one per cent. CALC submits that government owned water corporations carry less risk than private corporations, and as such, the allowed cost of debt and the return on equity should be lowered, compared with the rates allowed in our draft decision.[58] These recommendations are based on a report prepared by CME for CALC.[59]

Victoria's water corporations are subject to the competitive neutrality measures the Victorian government agreed to implement as part of the national competition policy agreement and related reforms.[60] This includes ensuring that borrowing costs reflect an estimate of a water corporation's standalone risk profile and credit rating. We note that:

- Victoria's water corporations do not access debt capital markets directly, but rather, their debt is managed by the state government treasury corporation, through the issuance of government bonds. While the treasury corporation may have access to lower debt funding costs due to government's higher credit rating, the water corporation's borrowing costs do not reflect this. Rather, the water corporations borrow from the state treasury corporation at rates consistent with the risk inherent in the businesses as reflected in their stand-alone credit rating.
- The difference between the government's borrowing costs and the costs faced by water corporations represents consideration for state taxpayers accepting the corporations' credit risk. This is achieved via the Financial Accommodation Levy (FAL), which seeks to ensure the borrowing cost faced by each water corporation reflects the nature of their businesses, not the tax powers of government. If state-owned service providers accessed debt markets directly, then they would face debt financing interest rates that reflected their stand-alone credit ratings.

In keeping with these policy parameters, the approach we take to the cost of debt is to adopt a benchmark rate that applies to all water corporations. The benchmark reflects our estimate of the efficient financing costs for a privately owned business facing a similar degree of economic risk to

[58] Consumer Action Law Centre, op. cit.

[59] ibid., Appendix A.

[60] We note the Water Services Association of Australia supports application of competitive neutrality principles, see Water Services Association of Australia 2016, *Submission to the Essential Services Commission: A new model for pricing services in Victoria's water sector*, July, p. 11.

a regulated water corporation. We consider this is consistent with the requirements of the Water Industry Regulatory Order 2014 (WIRO).[61]

Adopting the approach recommended by CALC would mean the allowed rate for the cost of debt may be lower than the rate faced by a benchmark efficient water corporation. As well as being inconsistent with government policy that water corporations pay an estimate of a commercial equivalent borrowing rate, it would also be inconsistent with the WIRO's viability and efficiency objectives. Our approach is also similar to that adopted by other Australian economic regulators.

CALC's submission also recommended a one per cent reduction to each return on equity value in the PREMO matrix.[62] CME proposed the reduction mainly based on comparisons with the return allowed for UK water entities, and its view that government-owned water corporations carry less risk than comparable privately owned businesses.

We believe the most relevant comparisons for the return on equity are other economic regulators in Australia. We note the rate for the return on equity (and the overall regulatory rate of return, comprising the cost of debt and the return on equity) approved in our draft decision are within the range of rates estimated by other Australian-based regulators.[63]

Also, our current view is that the allowed return on equity should not be adjusted to reflect government ownership. In deriving the values for the return on equity in the PREMO matrix, we had regard to the return on equity we had allowed in the past, and the incentives for water corporations to provide high quality price submissions in the interests of their customers.

CME also argues for a reduction in return on equity to reflect the prevailing revenue cap form of price control. This reflects that a revenue cap provides a water corporation with greater revenue certainty than other forms of price control, such as a price cap. We note however, that only one urban water corporation in Victoria (Yarra Valley Water) has a revenue cap form of price control. As well, a revenue cap does not necessarily change the level of systematic risk faced by a water corporation. For example, it is possible that a water corporation operating under a revenue cap is more exposed to cost risks than a corporation operating under a price cap.[64]

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[61] Including, in particular, the requirements that our decision have regard to: the promotion of efficiency in regulated industries and the financial viability of the regulated water industry (cl 8(b)(ii) WIRO); efficiency in the industry and incentives for long term investment (s 8A(1)(a) ESC Act); and consistency in regulation between States and on a national basis (s 8A(1)(f) ESC Act).

[62] Consumer Action Law Centre, op. cit.

[63] Essential Services Commission of South Australia, op. cit.; Independent Pricing and Regulatory Tribunal 2017, *WACC biannual update*, August.

[64] For example, increases in water demand can lead to increased costs for a water corporation, which would not be matched by an increase in revenue, under a revenue cap. By contrast, under a price cap increases in water demand would also lead to an increase in revenue.

While our final decision has not agreed with CALC’s recommendations, we will re-consider its arguments as part of any future review of the PREMO framework.