



# Yarra Valley Water draft decision

2018 Water Price Review

7 December 2017



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# Summary

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

This draft decision sets out our preliminary views on Yarra Valley Water's price submission.<sup>1</sup> Our draft decision is to accept Yarra Valley Water's proposed revenue requirement of \$4,790.4 million over the five year period starting 1 July 2018, for the purpose of approving maximum prices.<sup>2</sup>

The typical bill impacts of Yarra Valley Water's proposal and our draft decision are provided below.

**Table 1.1** Typical water and sewerage bills  
\$ 2017-18

Customer group	Average consumption (kL p.a.)	2017-18 annual bill	2018-19 annual bill	2022-23 annual bill
Residential (Owner occupier)	150	\$1,059 <sup>a</sup>	\$1,035	\$1,006
Residential (Tenant)	150	\$524 <sup>a</sup>	\$513	\$498
Non-residential (Small)	100	\$1,890 <sup>b</sup>	\$1,848	\$1,794
Non-residential (Medium)	150	\$2,123 <sup>b</sup>	\$2,075	\$2,016
Non-residential (Large)	250	\$2,590 <sup>b</sup>	\$2,531	\$2,458

<sup>a</sup> Following a \$100 rebate paid to customers from a government efficiency review.

<sup>b</sup> Includes a trade waste contract fee.

Note: Numbers have been rounded.

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

Our draft decision should be read together with Yarra Valley Water's price submission.<sup>3</sup>

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

## **We have released an early draft decision for Yarra Valley Water**

Yarra Valley Water's price submission provided clear and comprehensive information supporting its proposals. Yarra Valley Water also provided evidence that its engagement captured the main priorities and concerns of customers and that it has taken this feedback into account. This enabled us to quickly assess its price submission against the legal framework that governs our role.

We also accept Yarra Valley Water's proposals. While we are seeking further information to inform our final decision, we consider our requests do not involve matters that materially impact on customer prices or outcomes.

For these reasons we are releasing this draft decision now, rather than March 2018 as currently planned for most other water corporations. We are releasing a fast-tracked draft decision for four of the sixteen water corporations that have provided a submission to us.<sup>4</sup>

Our draft decision provides an opportunity for us to test our preliminary views with stakeholders before we make a final decision and determination on Yarra Valley Water's prices in May or June 2018.

### **Our draft decision should allow Yarra Valley Water to deliver the outcomes outlined in its price submission**

Our draft decision should allow Yarra Valley Water to deliver on its customer service commitments, government policy, and obligations monitored by Environment Protection Authority Victoria and Department of Health and Human Services.

Some of the ways Yarra Valley Water plans to improve outcomes for customers are by:

- reducing water and sewerage prices
- extending access to services and programs for disadvantaged customers
- increasing rebates for customers who experience multiple service failures
- offering a discount for customers that opt into e-billing
- upgrading its water network to address population growth and climate change.

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<sup>3</sup> Yarra Valley Water's price submission is available on our website at <https://www.esc.vic.gov.au/project/water/36640-2018-water-price-review/>

<sup>4</sup> At the time of preparing this draft decision, Western Water has not yet lodged its price submission with the commission. We will provide separate guidance specific to Western Water, requiring its price submission to be lodged early in 2018.

## Summary

## **Tariff structures are the same**

Our draft decision approves Yarra Valley Water's proposed tariff structures, which are the same as its current structures. For water services, Yarra Valley Water proposed 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, Yarra Valley Water proposed a fixed service charge and a variable component.

We propose to approve Yarra Valley Water's proposed revenue cap form of price control. This means the revenue Yarra Valley Water can earn is fixed at the start of its regulatory period, but customer prices may vary annually – within pre-defined limits – so the corporation can meet its revenue requirement. Yarra Valley Water currently uses a revenue cap.

## **Yarra Valley Water's price submission is rated as 'Advanced' under PREMO**

Our draft decision is to accept Yarra Valley Water's PREMO self-rating of its price submission of 'Advanced'.





# 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.<sup>5</sup> The prescribed services include retail water and sewerage services, and bulk water and sewerage services delivered by the water corporations.<sup>6</sup>

In September 2017, Yarra Valley Water provided a submission to us proposing prices for a five year period starting 1 July 2018. Our task is to assess the price submission against the legal framework that governs our role, and make a price determination that takes effect from 1 July 2018. The price determination will specify the maximum prices Yarra Valley Water may charge for prescribed services, or the manner in which prices are to be calculated, determined or otherwise regulated. We also issue a final decision that explains the reasons for our price determination.

## **We assess prices against the WIRO and other legal requirements**

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

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<sup>5</sup> 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.

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

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

- the matters specified in the 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.

A separate document 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.<sup>8</sup>

In 2016, we issued guidance to Yarra Valley Water to inform its price submission. The guidance sets out how we will assess Yarra Valley 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 Yarra Valley Water's proposed prices.<sup>9</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>10</sup>

### **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.<sup>11</sup>

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.

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<sup>7</sup> Essential Services Commission 2016, *2018 Water Price Review – Guidance Paper*, November.

<sup>8</sup> Essential Services Commission 2017, *Yarra Valley Water draft decision: 2018 Water Price Review – Commission's consideration of legal requirements*, December. This is located on our website at [www.esc.vic.gov.au](http://www.esc.vic.gov.au)

<sup>9</sup> This is a requirement of the WIRO, clause 14(b).

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

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

In May 2016, we released a position paper setting out our proposed new pricing approach, and invited submissions.<sup>12</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>13</sup>

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.<sup>14</sup> Our guidance explains the building blocks and how we use it to estimate the revenue requirement.<sup>15</sup>

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 a fast-track provision is now available for price submissions we can readily assess in a short timeframe. These incentives are described below.

Our consultation on the pricing approach informed the guidance we issued water corporations in November 2017 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.

For the 2018 water price review, a water corporation's ambition in terms of delivering customer value is being assessed against four elements of PREMO: Risk, Engagement, Management and Outcomes.<sup>16</sup>

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<sup>12</sup> Essential Services Commission 2016, *A new model for pricing services in Victoria's water sector*, Position Paper, May.

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

<sup>14</sup> 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.

<sup>15</sup> Essential Services Commission 2016, *Guidance paper*, op. cit., pp. 8-9.

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.<sup>17</sup>

### **Early draft decisions**

We may fast track a price submission to an early draft and final decision if it provides comprehensive and clear information in support of its proposals. Final decisions for fast-tracked price submissions will be made in May rather than June 2018.

We may release a fast-tracked draft decision in response to a price submission if we consider that:

- the price submission is sufficiently clear and comprehensive to facilitate our timely assessment against our legal framework
- the price submission demonstrates that customer priorities and concerns have been identified and taken into account
- we consider any changes required to allow us to accept prices are relatively minor
- we agree with the overall PREMO rating proposed in the price submission.

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<sup>16</sup> The Performance element of PREMO will be assessed at the review following the 2018 water price review.

<sup>17</sup> For more information, see Essential Services Commission 2016, *Guidance paper*, op. cit., pp. 45-49.

## 2. Our assessment of Yarra Valley Water's price submission

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

Yarra Valley Water's price submission and financial model presented clear and comprehensive information to support its proposals. Yarra Valley 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).

For these reasons, we were able to form an early view to accept Yarra Valley Water's proposals for our draft decision.

If consultation on our draft decision does not result in significant further review being required, we intend to make a price determination for Yarra Valley Water in May 2018. If consultation, or our ongoing assessment, causes us to form a view that significant further review is required, we may defer our price determination for Yarra Valley Water until June 2018.

Our guidance included a number of matters water corporations must address in their price submissions. Yarra Valley Water's price submission addressed each of these matters. Our preliminary assessment of these matters is provided below.

In some cases, we have asked Yarra Valley Water to provide more information to inform our final decision and price determination. We consider our requests do not involve matters that materially impact on customer prices or outcomes.

Yarra Valley Water must submit a response to our draft decision and provide an updated financial model by 9 March 2018 (via email to [water@esc.vic.gov.au](mailto:water@esc.vic.gov.au)). The response will be publicly available on our website.

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

## Regulatory period

Yarra Valley Water proposed a five year regulatory period. Our draft decision approves Yarra Valley Water's proposal as it is consistent with our guidance. Our guidance proposed to approve a five year regulatory period, subject to any alternative and justified proposal.<sup>18</sup>

## Customer engagement

Our guidance required Yarra Valley Water to engage with customers to inform its price submission. The engagement by Yarra Valley Water:

- took place between March 2016 and September 2017
- included a range of methods including face-to-face interviews, online surveys, focus groups, and a citizens' jury – the citizens' jury was a deliberative process in which a representative group of customers met for five and half days over four months
- covered matters such as the outcomes to be delivered, guaranteed service levels, tariff structures, and price and service trade-offs. The citizens' jury provided recommendations to Yarra Valley Water on "a balance between price and service which is fair for everyone".<sup>19</sup>

More detail on Yarra Valley Water's engagement is available in its price submission.<sup>20</sup>

Evidence that Yarra Valley Water's engagement influenced its price submission includes it accepting eight recommendations of the citizens' jury in full. It accepted the remaining two recommendations with some minor variation.<sup>21</sup>

The influence of Yarra Valley Water's engagement on its proposals supports the objectives in our pricing framework relating to efficiency and the interests of consumers.<sup>22</sup>

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<sup>18</sup> 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.

<sup>19</sup> Yarra Valley Water 2017, op. cit., p. 6.

<sup>20</sup> Yarra Valley Water 2017, op. cit., pp. 18-28.

<sup>21</sup> Yarra Valley Water 2017, op. cit., Appendix 2.

<sup>22</sup> See for example, WIRO clauses 8(b)(i), 8(b)(ii), 8(b)(iii), 11(d)(iii), and ESC Act Sections 8(1), 8A(1)(a).

## Outcomes

The outcomes Yarra Valley Water proposes to deliver over the five years starting 1 July 2018 are:

- safe drinking water
- reliable water and sewerage
- timely response and restoration
- modern flexible service
- fair access and assistance for all
- care for and protect the environment
- water availability and conservation.

For each outcome, Yarra Valley Water proposed a measure and target that it will use to report on performance on each outcome. These are listed in appendix 5 of its price submission.

Yarra Valley Water has committed to reporting annually to customers on how it has delivered on its proposed outcomes on its website, its engagement portal, social media and inserts with bills.

For each outcome where Yarra Valley Water does not meet the specified target it proposes to lower prices in the following year to reduce the revenue recovered from customers by \$1.5 million.

The WIRO provides us with the power to specify standards and conditions of service in a code we make under the WI Act. In early 2018-19, we will update our urban customer service code to reflect the outcomes proposed by Yarra Valley Water and the measures it will use to report on performance.<sup>23</sup> We will engage with Yarra Valley Water to finalise the measures, and how it reports on outcomes.

## 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.

Yarra Valley Water's proposed GSLs are set out on pages 96 and 97 of its price submission. It has proposed to revise some of its existing GSLs, and introduce new GSLs relating to water flow rate, response time to customer letters, and water quality complaints. Revisions include increasing the

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<sup>23</sup> Essential Services Commission 2017, *Customer Service Code Urban Water Businesses*, April.

payments where it does not deliver on the specified service level. Yarra Valley Water's proposed GSLs were based on recommendations of its citizens' jury.<sup>24</sup>

In early 2018-19, we will update our urban customer service code to reflect the proposed GSLs, subject to our consideration of any feedback following the release of our draft decision.<sup>25</sup>

## 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>26</sup>

Yarra Valley Water proposed a revenue requirement of \$4,790.4 million over a five year period starting 1 July 2018. Our draft decision proposes to accept the revenue requirement proposed by Yarra Valley Water as set out at Table 2.1. This reflects our assessment of each element that comprises the revenue requirement.

Our final decision will be based on the latest available information. As well as responding to our draft decision and providing a price schedule, Yarra Valley Water must update its revenue requirement and prices to reflect:

- our updates to cost of debt and inflation estimates, which we will provide in late April 2018
- changes to its forecast bulk water charges, arising from changes to Melbourne Water's prices.

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, Yarra Valley Water should update its price submission and also provide us with an updated financial model. Any updates will be publicly available on our website.

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<sup>24</sup> Yarra Valley Water 2017, op cit., Appendix 2.

<sup>25</sup> Essential Services Commission 2017, op.cit.

<sup>26</sup> 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 Yarra Valley Water in the regulatory period from 1 July 2018. We had regard to their views in our draft decision.



**Table 2.1 Revenue requirement**  
\$ million 2017-18

	2018-19	2019-20	2020-21	2021-22	2022-23	Total
Operating expenditure	682.5	678.2	664.5	662.9	661.3	3,349.5
Return on assets	172.4	176.5	181.2	185.3	187.9	903.4
Regulatory depreciation	96.1	99.6	95.7	97.0	99.3	487.7
Adjustments from last period <sup>a</sup>	-8.7	-8.7	0.0	0.0	0.0	-17.4
Tax allowance	11.7	12.8	14.0	14.2	14.7	67.3
<b>Revenue requirement<sup>b</sup></b>	<b>954.0</b>	<b>958.5</b>	<b>955.5</b>	<b>959.3</b>	<b>963.2</b>	<b>4,790.4</b>

<sup>a</sup> the adjustments in 2018-19 and 2019-20 are amounts Yarra Valley Water expects to return to customers due to earning revenue earned above its revenue cap in prior years.

<sup>b</sup> the revenue requirement differs from Yarra Valley Water's price submission due to a correction in 2012-13 capital expenditure. The correction resulted in a \$120,000 reduction to Yarra Valley Water's proposed revenue requirement (or less than 0.01 per cent of its revenue), through changed assumptions for return on assets and regulatory depreciation.

Note: Numbers have been rounded

## Operating expenditure

Operating expenditure is an input to the revenue requirement. Yarra Valley Water's forecast operating expenditure is provided at Table 2.2, broken down into controllable and non-controllable components. Yarra Valley Water's price submission provides detail on its forecast operating expenditure from pages 48 to 52.

For controllable operating expenditure, our assessment process first confirms an efficient baseline, based on the last year of actual costs prior to our price review (that is, 2016-17). We then consider the forecast costs relative to this baseline, including the proposed efficiency improvement rate and forecast growth, and any proposed cost changes relative to the baseline.

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

**Table 2.2 Operating expenditure**  
\$ million 2017-18

	2018-19	2019-20	2020-21	2021-22	2022-23
Controllable costs <sup>a</sup>	136.9	136.0	135.0	133.9	132.7
Non-controllable costs <sup>b</sup>	545.6	542.3	529.6	529.0	528.6
- Bulk services <sup>c</sup>	502.7	500.3	488.5	488.9	489.2
- Environmental contribution <sup>d</sup>	41.9	40.9	40.0	39.1	38.2
- Licence fees <sup>e</sup>	1.0	1.0	1.0	1.0	1.2
- Other non-controllable costs	0.0	0.0	0.0	0.0	0.0
<b>Operating expenditure</b>	<b>682.5</b>	<b>678.2</b>	<b>664.5</b>	<b>662.9</b>	<b>661.3</b>

<sup>a</sup> Controllable costs are those that can be directly or indirectly influenced by a water corporation's decisions.

<sup>b</sup> Non-controllable costs are those that cannot be directly or indirectly influenced by a water corporation's decisions.

<sup>c</sup> Bulk services costs are paid to Melbourne Water for the supply of bulk water and sewerage services.

<sup>d</sup> The environmental contribution collects funds from water corporations under the *Water Industry Act 1994*.

<sup>e</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.

For the reasons set out below, we have accepted the controllable forecast operating expenditure proposed by Yarra Valley Water in making our draft decision on its revenue requirement.

Baseline controllable operating expenditure:

- Yarra Valley Water has proposed downward adjustments of \$5.90 million to its actual 2016-17 baseline year controllable operating expenditure. The resultant figure of \$134.45 million is eight per cent below the 2016-17 benchmark allowance of \$146.62 million established in the previous price determination. We consider this reflects an efficient baseline cost to forecast annual operating expenditure.
- We also note other evidence indicating its baseline controllable operating expenditure reflects a reasonable benchmark:

Our assessment

- Yarra Valley Water’s price submission (page 49) referred to an independent study that showed its operating costs per head of population were lower than 95 per cent of participating Australian water utilities.<sup>27</sup>
- In a benchmarking study undertaken for the commission, Yarra Valley Water ranks fourth among Victorian urban water corporations on technical efficiency.<sup>28</sup>

#### Efficiency improvement:

- Yarra Valley Water’s proposed efficiency improvement rate on controllable operating costs is 2.5 per cent per annum. This is relatively high compared to its past performance (where it met our mandated 1 per cent efficiency rate) and the rate proposed by other water corporations in their price submissions. It also exceeds Yarra Valley Water’s forecast average connection growth rate of 1.7 per cent per annum, giving a reducing annual baseline operating cost.

#### Proposed cost changes:

- Yarra Valley Water has only sought additional operating expenditure for two items arising directly from its citizens’ jury process, namely additional support for disadvantaged customer segments, and increased water conservation education and awareness programs. Forecast increases in wages (above inflation) and electricity prices will be absorbed within the proposed efficiency improvement targets.

We consider Yarra Valley Water’s approach to forecasting its operating expenditure is consistent with the requirements of our guidance, and we are satisfied that its proposed forecast represents efficient controllable operating expenditure. There is evidence that the corporation has significantly tested its controllable expenditure requirements, resulting in a forecast decline (in real terms) in controllable operating expenditure per customer connection. The rate of the forecast decline in controllable operating expenditure per customer connection from 2016-17 is greater than the average for urban water corporations in our review (Figure 2.1).

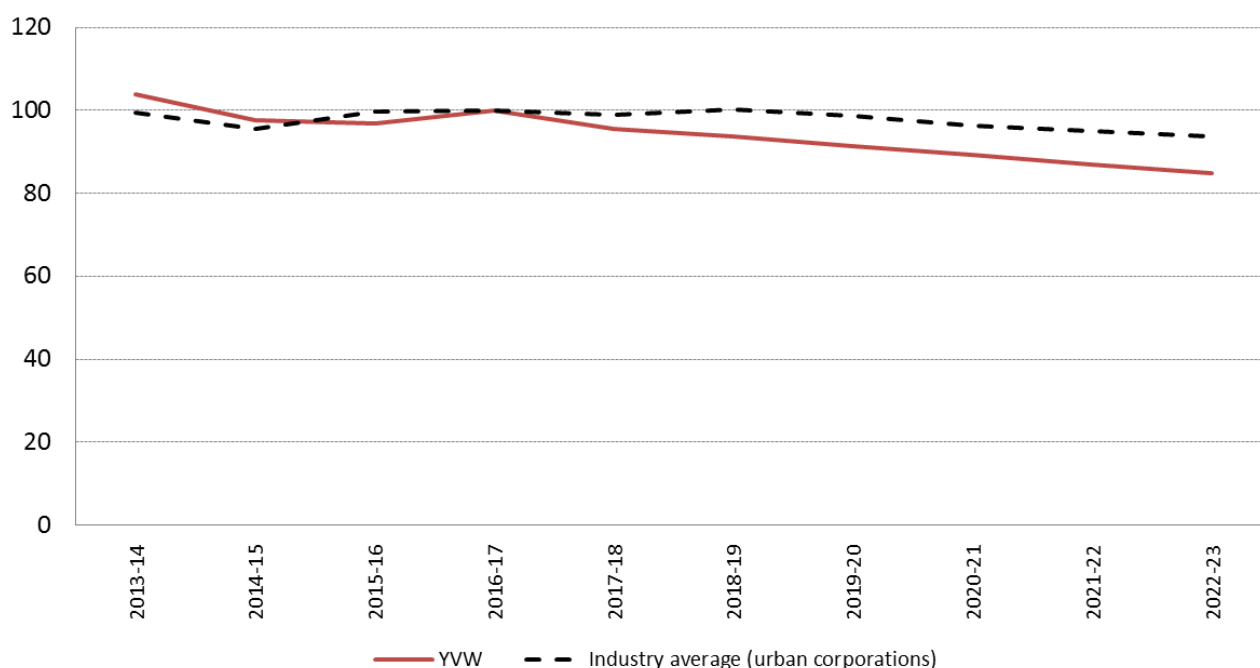
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<sup>27</sup> A financial benchmarking exercise undertaken by the Water Services Association of Australia (WSAA).

<sup>28</sup> Economic Insights 2014, *Victorian Urban Water Utility Benchmarking*, 31 July. Available at [www.esc.vic.gov.au](http://www.esc.vic.gov.au)

**Figure 2.1 Controllable operating expenditure per water connection**

Index: 2016-17=100



Non-controllable operating expenditure increases by \$13 million in 2018-19, due mainly to an increase in the environment contribution as advised by the Department of Environment, Land, Water and Planning. This is largely offset from 2020-21 by a reduction in the external bulk water charges, which we have verified are consistent with Melbourne Water’s price determination.

We will accept Yarra Valley Water’s proposed non-controllable operating expenditure for our draft decision. Prior to making our final decision, we will update the forecast values for licence fees with the relevant regulatory bodies and also adjust for the latest inflation and external bulk charges data.

Our draft decision is to accept Yarra Valley Water’s proposed operating expenditure, as set out in Table 2.2.

## 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 Yarra Valley 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.

Our assessment

## 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.

Table 2.3 sets out Yarra Valley Water's proposed regulatory asset base at 30 June 2017.

We compared Yarra Valley Water's actual net capital expenditure for the period from 2012-13 to 2016-17 with the forecast used to approve maximum prices for the period from 1 July 2013.<sup>29</sup>

Yarra Valley Water's net capital expenditure was \$221 million lower than forecast.<sup>30</sup> It also calculated its closing regulatory asset base in accordance with the requirements of our guidance. For these reasons, our draft decision accepts Yarra Valley Water's proposed closing regulatory asset base for 30 June 2017 of \$3,938.4 million.

**Table 2.3 Closing regulatory asset base\***  
\$ million 2017-18

	2012-13	2013-14	2014-15	2015-16	2016-17
Opening RAB at 1 July	3,418.2	3,579.7	3,660.5	3,717.2	3,841.9
Plus gross capital expenditure	252.1	211.1	181.2	257.1	227.4
Less government contributions	3.8	0.0	0.0	0.0	0.0
Less customer contributions	25.8	31.5	37.9	50.3	47.3
Less proceeds from disposals	0.3	0.9	2.3	6.1	2.0
Less regulatory depreciation	60.7	97.9	84.3	75.9	81.6
<b>Closing RAB at 30 June*</b>	<b>3,579.7</b>	<b>3,660.5</b>	<b>3,717.2</b>	<b>3,841.9</b>	<b>3,938.4</b>

\* Some of the numbers differ from the price submission due to a correction in 2012-13 gross capital expenditure.

Note: Numbers have been rounded

<sup>29</sup> Net capital expenditure is calculated by deducting government and customer contributions from gross capital expenditure.

<sup>30</sup> We take a risk-based approach to including past capital expenditure in the regulatory asset base. We undertake a prudence and efficiency review where a water corporation has exceeded its net capital expenditure forecasts by more than 10 per cent. We believe this approach is reasonable given capital expenditure can be relatively 'lumpy' in nature.

## 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 2.4 sets out Yarra Valley Water's proposed opening regulatory asset base from 1 July 2018.<sup>31</sup> Our draft decision is to accept Yarra Valley Water's forecast regulatory asset base for the period from 1 July 2018, as we are satisfied it meets the requirements of our guidance.

**Table 2.4 Forecast regulatory asset base\***  
\$ million 2017-18

	2017-18	2018-19	2019-20	2020-21	2021-22	2022-23
Opening RAB at 1 July	3,938.4	4,058.1	4,153.7	4,251.9	4,374.8	4,448.7
Plus gross capital expenditure	248.3	238.8	245.8	263.4	214.4	194.4
Less government contributions	0.0	0.0	0.0	0.0	0.0	0.0
Less customer contributions	42.7	46.1	47.0	43.8	42.5	41.9
Less proceeds from disposals	1.0	1.0	1.0	1.0	1.0	1.0
Less regulatory depreciation	84.9	96.1	99.6	95.7	97.0	99.3
<b>Closing RAB at 30 June</b>	<b>4,058.1</b>	<b>4,153.7</b>	<b>4,251.9</b>	<b>4,374.8</b>	<b>4,448.7</b>	<b>4,500.9</b>

\* Some of the numbers differ from the price submission due to a small correction in the 2012-13 capital expenditure

Note: Numbers have been rounded

## Capital expenditure

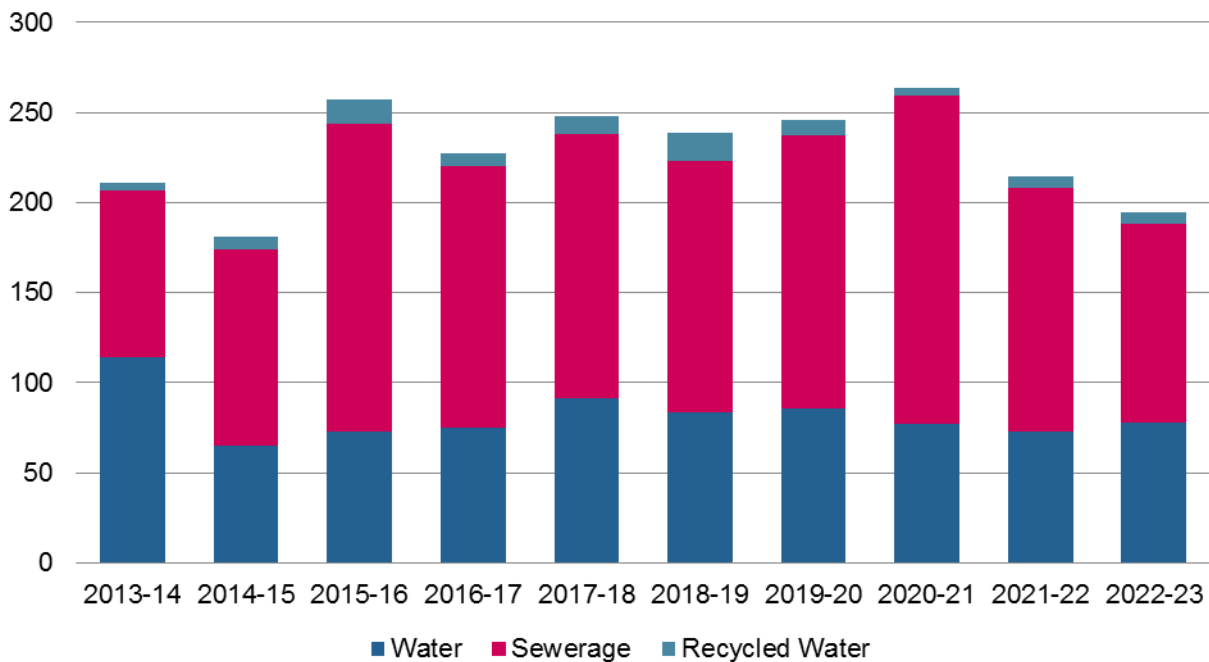
Capital expenditure is an input to estimating the regulatory asset base. Yarra Valley Water's forecast capital expenditure and supporting information is provided at pages 52 to 82 of its price submission. Its proposed major projects are set out at pages 91 to 93 of its price submission.

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<sup>31</sup> 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.

A summary of capital expenditure over the ten years to June 2023 is provided in Figure 2.2. Values in the period to 2016-17 reflect actual expenditure, with following years reflecting Yarra Valley Water’s forecasts.

**Figure 2.2 Gross capital expenditure by service category**  
\$ million 2017-18



Note: actuals 2013-14 to 2016-17 and forecasts for 2017-18 to 2022-23

For the reasons set out below, we have accepted the forecast capital expenditure proposed by Yarra Valley Water for our draft decision on its revenue requirement.

- Yarra Valley Water’s price submission provided evidence that its forecasts for capital expenditure are efficient. Total capital expenditure forecast for the 2018–23 period of \$1,186 million is very similar to the current period, with some shifts in the distribution across the various cost drivers and capital expenditure programs.
- We requested selected documents from Yarra Valley Water as a representative sample to demonstrate its asset management processes and justification for its capital expenditure program. We requested and reviewed the business case for the Lockerbie main sewer project, which is Yarra Valley Water’s largest project for the period. We also reviewed the business cases for three expanding capital programs under the business improvement and compliance cost driver:
  - Improve quality of drinking water
  - Sewer improve system capacity

Our assessment

- Sewerage treatment and recycling.
- We consider the planned capital expenditure program is achievable, given Yarra Valley Water’s past track record delivering its capital expenditure program. We note that over the period from 2013-14 to 2017-18, Yarra Valley Water is expected to deliver most of its planned major projects, with the Lockerbie main sewer project deferred following an upgrade to the Wallan Sewage Treatment Plant.<sup>32</sup>
- Where there is uncertainty in timing, cost, scope or benefits, Yarra Valley Water has either excluded all costs or only included the minimum forecast costs for the 2018–23 regulatory period. This results in \$71.8 million of uncertain project costs being excluded from pricing, in accordance with our guidance. The corporation will also absorb any financing costs associated with this additional expenditure should it be required during the period. In addition, Yarra Valley Water will undertake two new projects supported by the citizens’ jury, but with uncertain beneficial outcomes. It proposes to minimise the cost impact of these projects on its customers as follows:
  - \$27 million for additional activities to reduce water leakage by 2.5 gigalitres – only the lesser of the investment cost or the value of water saved will be passed on to customers.
  - \$18 million to pilot digital water metering – the capital and interest costs for the pilot will only be recovered in the following regulatory period if a full roll-out of digital metering proceeds.
- For our draft decision, we accept Yarra Valley Water’s proposal for addressing uncertainty, noting the following:
  - Yarra Valley Water will need to demonstrate the efficiency of these costs if they are indeed incurred during the 2018–23 period if seeking to include them in the regulatory asset base.
  - Variations in capital expenditure from forecast during the 2018–23 period will form a key part of our assessment of the Performance element of PREMO at the next price review.
  - In response to this draft decision, we request Yarra Valley Water define the success criteria for the digital water metering pilot before any broader roll-out could proceed. At a minimum, we expect this would include the requirement that expenditure for a full roll-out would deliver a positive net present value for the water corporation.
- We consider Yarra Valley Water’s approach to forecasting its capital expenditure is consistent with the requirements of our guidance.

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<sup>32</sup> Essential Services Commission 2016, *Performance of Victorian urban water and sewerage businesses 2015-16*, December, p. 108.



Our draft decision for gross capital expenditure is to accept Yarra Valley Water’s proposed benchmark as set out in Table 2.4.

### Customer contributions

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

We compared Yarra Valley Water’s forecast for customer contributions with past outcomes, and its forecasts for growth in customer connections.<sup>33</sup> We consider Yarra Valley Water’s forecast contributions are reasonable, having regard to past trends and its growth forecasts.<sup>34</sup>

Our draft decision proposes to accept Yarra Valley Water’s forecasts for customer contributions.

### Cost of debt

Our guidance required Yarra Valley Water to use estimates of the cost of debt provided by the commission to estimate its revenue requirement. Yarra Valley Water used the cost of debt values we specified to calculate its revenue requirement. For this reason, our draft decision accepts the cost of debt assumed by Yarra Valley Water, as set out in Table 2.5.

**Table 2.5** Trailing average cost of debt

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

\* Estimated cost of debt – we will update the 2017-18 figure before the final decision and price determination.

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>35</sup> We consider the ten year trailing average approach helps to minimise risk to water corporations and provides incentives for long-term investment.

<sup>33</sup> Growth in customer connections can be used as an indicator of growth in customer contributions.

<sup>34</sup> In response to a request for information, Yarra Valley Water provided further information regarding the method of forecasting customer contributions.

<sup>35</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: Implementing PREMO from 2018*, October, p.27.

## **Return on equity – PREMO rating**

Yarra Valley Water rated its price submission as ‘Advanced’. Based on its PREMO self-rating, Yarra Valley Water proposed a return on equity of 4.9 per cent per annum. This reflects the maximum return rate allowed in our guidance for a price submission rated as ‘Advanced’.<sup>36</sup>

The return on equity is similar to rates we have approved in past reviews for the water industry. We have also had regard to the return on equity allowed or estimated by regulators in other Australian jurisdictions recently for the water industry.<sup>37</sup>

Our draft decision accepts Yarra Valley Water’s PREMO self-rating and proposed return on equity of 4.9 per cent per annum. Our assessment of Yarra Valley Water’s proposed PREMO rating is set out in Chapter 3.

## **Regulatory depreciation**

Regulatory depreciation is an input to calculating the regulatory asset base.

Yarra Valley Water’s forecast regulatory depreciation was calculated using a straight line depreciation profile. We noted in our guidance that we prefer this approach.<sup>38</sup> Yarra Valley Water calculated regulatory depreciation in a manner consistent with our guidance.

For these reasons, our draft decision proposes to accept Yarra Valley Water’s forecast regulatory depreciation.

## **Tax allowance**

The tax allowance is an input to the revenue requirement. Our draft decision is to accept Yarra Valley Water’s forecast tax allowance as set out at table 38 of its price submission, as it was calculated consistently with the method required by our guidance.<sup>39</sup>

## **Demand**

Along with the revenue requirement, demand forecasts are an input to calculating prices. Yarra Valley Water proposed a revenue cap form of price control (see below), which means its

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<sup>36</sup> Essential Services Commission 2016, *Guidance paper*, op. cit., p. 49.

<sup>37</sup> Essential Services Commission of South Australia 2016, *SA Water regulatory determination 2016*, Final Determination, June; Independent Pricing and Regulatory Tribunal 2017, *WACC biannual update*, August

<sup>38</sup> Essential Services Commission 2016, *Guidance paper*, op. cit., p. 42.

<sup>39</sup> Essential Services Commission 2016, *Guidance paper*, op. cit., pp. 50-51.

connection forecasts and first year of volume forecasts are the most important demand variables for estimating prices.

Yarra Valley Water's demand forecasts are set out at pages 115 to 123 of its price submission, and are also included in its financial model. Our draft decision proposes to accept Yarra Valley Water's demand forecasts as we consider they were estimated in a manner that is consistent with the requirements of our guidance. This includes basing demand forecasts on the latest *Victoria In Future* population growth forecasts issued by the Victorian Government.

## **Form of price control**

Yarra Valley Water proposed a revenue cap form of price control. A revenue cap allows prices to be adjusted to reflect under or over-recovery of revenue in prior years, usually due to deviations in demand from forecast. Yarra Valley Water proposed to limit any annual price increase to 2 per cent (not including inflation). Its proposal is similar to its current approach which we approved in 2013.<sup>40</sup>

Yarra Valley Water proposed some changes to its existing revenue cap formula, explained on page 94 of its price submission. We prefer a revenue cap formula written in real terms and state our reasons in the adjusting prices section (page 22).

Subject to minor amendments to its revenue cap formula, our draft decision is to approve Yarra Valley Water's proposed form of price control as it 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. Also, by limiting price increases arising from variations in demand from forecast, its proposal helps to minimise the impact of price changes on customers that can arise under a revenue cap.

## **Prices and tariff structures**

Yarra Valley Water's proposed tariffs are set out at pages 124 to 130 of its price submission. Proposed prices for water and sewerage services applying to most residential and non-residential customers are set out at Tables 2.6 and 2.7.

From 2014-15, Yarra Valley Water's residential customers receiving a bill including water usage charges received an annual rebate of \$100. The rebate ends after 2017-18. The removal of the rebate means the bill impact of the price changes proposed will vary across customer groups.<sup>41</sup> In particular, for some customers such as relatively low water users (including some residential

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<sup>40</sup> Essential Services Commission 2013, *Price Review 2013: Greater Metropolitan Water Businesses — final decision*, June, p.129.

<sup>41</sup> Noting the rebate applied to residential water users only.

tenants), bills may rise as a result of the rebate being removed. This issue was raised in a submission by the Consumer Action Law Centre.<sup>42</sup>

We note the price changes proposed by Yarra Valley Water seek to address the impact of the rebate removal on customers. This is achieved mainly through rebalancing prices for the various bill components (as shown in Table 2.6). It has also proposed additional assistance for customers experiencing a bill increase, particularly tenants.

**Table 2.6 Proposed water prices**  
\$ 2017-18

	2017-18	2018-19	2019-20	2020-21	2021-22	2022-23
<b>Residential</b>						
Variable (\$/kL)						
1st tier	2.64	2.58	2.57	2.55	2.53	2.51
2nd tier	3.11	3.04	3.01	2.99	2.97	2.95
3rd tier	4.62	4.52	4.48	4.45	4.42	4.39
Fixed (\$/year)	177.87	76.12	75.56	75.01	74.46	73.92
<b>Non-residential</b>						
Variable (\$/kL)						
	2.85	2.79	2.77	2.75	2.73	2.71
Fixed (\$/year)	288.72	282.23	280.17	278.12	276.09	274.08

<sup>42</sup> Consumer Action Law Centre, 2017, *Initial Feedback: 2018 Price Review*, November.

**Table 2.7 Proposed sewerage prices**  
\$ 2017-18

	2017-18	2018-19	2019-20	2020-21	2021-22	2022-23
<b>Residential</b>						
Variable (\$/kL)	2.05	1.11	1.11	1.10	1.09	1.08
Fixed (\$/year)	356.81	446.54	443.28	440.04	436.83	433.64
<b>Non-residential</b>						
Variable (\$/kL)	2.02	1.97	1.96	1.94	1.93	1.91
Fixed (\$/year)	555.29	542.81	538.84	534.91	531.00	527.13

We consider Yarra Valley Water’s proposed tariffs will allow it to recover revenue sufficient to cover efficient costs. As outlined in our guidance, we have provided the water corporations with a large degree of discretion to decide on individual tariff structures.<sup>43</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.

Yarra Valley Water proposed to maintain its existing tariff structures, consistent with its engagement that found no strong support for tariff structure changes. For water services, Yarra Valley Water proposed a two-part tariff with a fixed service charge and a variable component that depends on water used. For residential customers, the variable component includes a three-tier inclining block, where the price increases with each higher tier.

We consider the two-part structure for water services will promote efficient use. It also provides customers a signal about their water use costs, and is an approach that is commonly applied in other states and territories.<sup>44</sup> We also consider two part tariff structures are easy to understand.

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

<sup>43</sup> Essential Services Commission 2016, *Guidance paper*, op. cit. p. 55.

<sup>44</sup> 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.

essential versus discretionary use.<sup>45</sup> The submission also noted inclining blocks can confuse households.

A number of Victorian water corporations and interstate water businesses have removed inclining block structures in recent years. We have previously noted our preference for a single volumetric charge for water services on efficiency grounds.<sup>46</sup> We generally consider a simple two-part tariff with a single variable charge may be a more efficient approach to pricing and reduce complexity for customers. We note South East Water and City West Water have both proposed to reduce the number of steps in the inclining block from three to two, reflecting a shift towards our preferred tariff structure. We note Yarra Valley Water has proposed to adjust the water volume step charge based on the number of people in a property. Given there is no clear evidence its customers wish to move from existing structures, our draft decision proposes to accept Yarra Valley Water's three-tier inclining block tariff.

Yarra Valley Water confirmed that its proposed tariffs for recycled water, trade waste and miscellaneous services are calculated in accordance with the pricing principles referenced in our guidance.<sup>47</sup>

A submission by John James outlined the potential for payment difficulties arising from Yarra Valley Water's proposed tariffs.<sup>48</sup> Mr James calculated that customers in tenant type arrangements, who, like him, consume about 78 kilolitres of water each day, may experience bill increases of up to 6.4 per cent. The submission from the Consumer Action Law Centre also highlighted the impact price changes may have on some customers, particularly those with low or fixed incomes who 'already carefully manage their consumption and budget'.<sup>49</sup>

We consider Yarra Valley Water's proposed tariffs take into account customers' interests, including low income and vulnerable customers, because:

- tariffs reflect efficient costs for delivering services
- tariffs were informed by an extensive customer engagement program
- Yarra Valley Water has payment options and assistance for customers experiencing difficulty paying bills.

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<sup>45</sup> Consumer Action Law Centre 2017, op. cit.

<sup>46</sup> Essential Services Commission 2011, *2013 Water Price Review – Tariff Issues Paper*, July 2011 p.26

<sup>47</sup> Following a request from the commission for further information.

<sup>48</sup> John Peter James 20 October 2017.

<sup>49</sup> Consumer Action Law Centre 2017, op. cit.

Yarra Valley Water plans to allocate an additional \$6 million over five years to improve awareness and access to hardship services and programs.

For the reasons above, our draft decision accepts Yarra Valley Water's proposed tariff structures, as set out at pages 124 to 130 of its price submission.

Prior to our final decision and price determination, Yarra Valley Water must submit updated prices to reflect our draft decision on the revenue requirement and:

- our updates to cost of debt and inflation estimates, which we will provide in late April 2018
- changes to its forecast bulk water charges, arising from changes to Melbourne Water's prices.

## **Adjusting prices**

Yarra Valley Water proposed a number of price adjustment mechanisms, as set out at pages 202 to 208 of its price submission. It proposes:

- to continue with its existing uncertain and unforeseen events mechanism
- a new revenue cap formula, with annual price adjustments calculated in nominal terms
- pass-throughs for a number of specific costs, such as sales and purchases of water allocations and bulk service charges, to account for differences between forecast and actual expenditure.

Our draft decision proposes to accept Yarra Valley Water's proposal to continue the existing uncertain and unforeseen events mechanism. We noted in our guidance that we propose that the mechanism continue in its current form.<sup>50</sup>

On Yarra Valley Water's proposed revenue cap formula, our preference is to calculate annual price adjustments in real terms for consistency with other businesses, and our preferred approach to estimating the regulated rate of return.<sup>51</sup> We invite Yarra Valley Water to resubmit a revised revenue cap formula in real terms.

We seek further information from Yarra Valley Water on its proposal to pass through costs relating to the sale and purchase of water allocations. We understand these water allocations reflect temporary water purchases. Our view is that the pass through of these costs transfers demand risk to customers, and that demand risk is most efficiently managed by a water corporation.

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<sup>50</sup> Essential Services Commission 2016, *Guidance paper*, op. cit. pp. 59-61.

<sup>51</sup> Our regulated rate of return is calculated in real terms.

Our draft decision proposes to accept the remaining cost pass-throughs listed on page 206 of its price submission. We have accepted them for our draft decision on the basis that they are consistent with efficiency objectives.<sup>52</sup>

## **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.

Yarra Valley Water's proposed prices for new customer contributions are set out on pages 128 and 129 of its price submission. Yarra Valley Water proposed to continue to phase-in increases to location specific charges in areas where contributions are below full cost recovery. The proposed transitional arrangements include the following increases to the current charges of \$1,812.75 each for water and sewerage:<sup>53</sup>

- in the new urban growth boundary, a \$170 annual increase for water and sewerage contributions (\$340 combined) for each year of the regulatory period, and
- in the Greenvale/Mickelham area, a \$170 annual increase for water and sewerage contributions (\$340 combined) during 2018-19 and 2019-20 followed by a \$17.50 increase (\$35 combined) in 2020-21.

Yarra Valley Water proposed to maintain the existing charges for standard new customer contributions and location specific charges in Epping North.

We have reviewed Yarra Valley Water's proposed new customer contribution prices and consider they are consistent with the requirements of our guidance. For this reason, our draft decision proposes to accept Yarra Valley Water's proposed new customer contribution prices.

Yarra Valley Water proposed to maintain the existing backlog connection charge, explained on page 129 of its price submission. We have reviewed Yarra Valley Water's proposed charge and consider it is consistent with the requirements of our guidance. For this reason, our draft decision proposes to accept Yarra Valley Water's proposed backlog connection charge.

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<sup>52</sup> WIRO clauses 14(1)(a)(vi) and 14A(B)(viii)

<sup>53</sup> In response to an information request, Yarra Valley Water provided modelling to support its proposed transition.



## Financial position

In approving prices, we must have regard to the financial viability of the water industry.<sup>54</sup> 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 high level 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.

Yarra Valley Water provided estimates of key indicators of forecast financial performance in a manner consistent with our guidance. We have reviewed these indicators and assessed that Yarra Valley Water's forecast financial position, given its proposed prices, is consistent with an investment grade credit rating.

Yarra Valley Water received a credit opinion on its proposed price submission by an independent credit rating agency. The credit opinion supports our initial view that Yarra Valley Water's financial position is consistent with an investment grade credit rating.

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<sup>54</sup> WIRO clause 8(b)(ii) and Essential Services Commission Act s.8A(1)(b).



### 3. PREMO rating

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

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

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

In Chapter 2, we noted our draft decision is to accept Yarra Valley Water's proposed return on equity of 4.9 per cent, based on the justification provided for the level of ambition in its price submission. Below, we set out our preliminary assessment of Yarra Valley Water's proposed PREMO rating.

#### Our review of Yarra Valley Water's PREMO self-rating

Yarra Valley Water's proposed PREMO rating, and our draft decision are summarised below:

**Table 3.1** PREMO Rating

	Overall PREMO rating	Risk	Engagement	Management	Outcomes
Yarra Valley Water's rating	<b>Advanced</b>	Leading	Leading	Leading	Advanced
Commission's rating	<b>Advanced</b>	Advanced	Leading	Leading	Advanced

We agree with Yarra Valley Water's proposed overall PREMO self-rating of 'Advanced'. This is reflected in the return on equity we have approved for Yarra Valley Water at page 18. We agree with Yarra Valley Water's proposed self-rating for the Engagement, Management and Outcomes elements of PREMO. In support of its self-ratings we note:

- The high quality of Yarra Valley Water’s price submission, and supporting financial model. Its price submission clearly demonstrated the links between its engagement and proposed outcomes, and provided sufficient information for us to assess its proposals.
- Yarra Valley Water’s engagement, which we consider provided a fair opportunity for customers to participate and to influence its proposals. In particular, we note the quality of the information Yarra Valley Water provided to its citizens’ jury<sup>55</sup> and its decision to accept the recommendations of the jury in its price submission.
- Yarra Valley Water’s efficiency level and forecast improvement rate for operating expenditure, which are high relative to other water corporations. This contributes to the price declines proposed by Yarra Valley Water.

Our draft decision considers a rating of ‘Advanced’ is more appropriate for the Risk element of PREMO, rather than the ‘Leading’ rating proposed by Yarra Valley Water. Our reasons are:

- Yarra Valley Water proposed to retain a revenue cap form of price control, and a pass-through mechanism for the sale and purchase of water allocations. We consider these proposals transfer demand risk to customers. For urban water services, our view is that demand risk is best managed by a water corporation.
- Yarra Valley Water’s relatively conservative price assumptions for sales relating to its water entitlements, relative to the other metropolitan retail water corporations.

However, we note there are other factors supporting its proposed Risk rating, such as:

- The proposed limit to the annual increase in prices under its revenue cap of two per cent (not including inflation), if demand is lower than forecast.
- Yarra Valley Water’s progression to attain ISO 55001 certification.
- Yarra Valley Water’s commitment to delivering an annual 2.5 per cent efficiency applied to operating expenditure, despite uncertainty about how it will be achieved.
- Yarra Valley Water increasing the revenue it has at risk for failure to deliver on key service outcomes.

On balance, we consider the transfer of risk to customers through the revenue cap, pass-through mechanism for the sale and purchase of water orders, and relatively conservative assumptions about water sales are not consistent with a ‘Leading’ rating for the Risk element of PREMO.

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<sup>55</sup> Yarra Valley Water’s *Citizens’ jury information pack* is available on our website at <https://www.esc.vic.gov.au/project/water/36640-2018-water-price-review/>

## 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 May or June 2018.

Stakeholders may comment on any aspect of our draft decision, including the information we have relied upon in our assessment (such as Yarra Valley Water's price submission). Feedback may also cover:

- additional matters or issues we should consider before making our final decision
- whether our draft decision to accept Yarra Valley 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 may hold a public forum in February or March 2018. Forums provide an opportunity for interested parties to discuss key features of our draft decisions. We will publish details of public forums at [www.esc.vic.gov.au/waterpricereview](http://www.esc.vic.gov.au/waterpricereview).

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

Written comments or submissions in response to this draft decision will be due in early March 2018. 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:

2018 Water Price Review  
Essential Services Commission  
Level 37, 2 Lonsdale Street  
Melbourne VIC 3000

We usually make all comments and submissions publicly available in the interests of transparency. If you wish part or all of your submission to be private, please discuss with commission staff.

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).

- February or March 2018 – public forum.
- 9 March 2018 – closing date for submissions on our draft decision.
- May or June 2018 – release date for final decision and price determination.

## APPENDIX A – submissions received

Name or organisation	Date received
John James	20 October 2017
Consumer Action Law Centre	16 November 2017
Mr G Mallon	7 November 2017