ESSENTIAL SERVICES COMMISSION

PRICE REVIEW 2013: GREATER METROPOLITAN WATER BUSINESSES

Final Decision

June 2013

An appropriate citation for this paper is:

Essential Services Commission 2013, *Price Review 2013: Greater Metropolitan Water Businesses — final decision,* June.

PREFACE

This final decision completes the Essential Services Commission's review of the greater metropolitan water businesses. Service standards, total expenditure and a price path (with maximum water and sewerage prices) have been approved for City West Water, South East Water, Yarra Valley Water and Western Water for the next five years commencing 1 July 2013. Maximum bulk water and sewerage prices, and drainage and waterway prices have been approved for Melbourne Water for the next three years commencing 1 July 2013.

The Commission has assessed the Water Plans of the greater metropolitan water businesses in accordance with the Water Industry Regulatory Order. The Commission has also taken into account the views of customers and independent assessments by experts engaged to assist the Commission. In reaching its final decision, the Commission's main focus has been to ensure that prices are fair and reasonable; that is, as low as possible but still sufficient to recover the businesses' efficient costs of providing services.

Consistent with the Commission's charter and practice, this review has been undertaken in an open and consultative manner. This has included the release of a draft decision in March 2013 and numerous public meetings in April and May 2013. In total, 173 public submissions were received during the review. The Commission also met with the water businesses, community and business organisations and customer advocacy groups to obtain further information and feedback.

The Commission was not in the position to decide on the amount of desalination costs to be capitalised by Melbourne Water given insufficient information. Accordingly, the Commission has shorten the regulatory period for Melbourne Water to three years so that this matter can be properly examined and decided in the interests of customers in Melbourne Water's fourth regulatory period. The regulatory period for the other businesses has remained the same, namely five years. This is discussed in chapter 3.

The Commission's final decision has reduced the revenue allowance of the greater metropolitan water businesses by slightly over $1.0 billion as compared with their original proposals (and based on estimates for years four and five for Melbourne Water). Consequently, price increases are lower than initially proposed in the Water Plans, though there is some variation between the businesses.

Transparency about service delivery and value for money remains integral to the regulatory regime for the Victorian water sector. To this end, the Commission will continue to monitor, audit and publicly report on the performance of the greater metropolitan water businesses in delivering services to their customers.

The Commission thanks the water businesses and the many customers (including customer and welfare groups) who have contributed to this price review. The Commission also appreciates the assistance provided by the other technical regulators involved in the review.

Dr. Ron Ben-David

Chairperson

GLOSSARY

bounce back	An increase in water use following a period of reduced water demand
building blocks	The underlying components that sum to the allowed revenue of the regulated firm: the return on capital, the return of capital (also known as depreciation), the operating expenditure, and various other components such as taxes and incentive mechanisms
bulk water	Water supplies provided between water businesses
business-as-usual (BAU) operating expenditure	The baseline level of operating expenditure. It is based on 2011-12 data, which was the last year of actual operating data. This expenditure excludes once-off or temporary costs associated with the drought and related major projects
capital expenditure	Expenditure that a business incurs to buy fixed assets or to add to the value of an existing fixed asset with a useful life extending beyond the taxable year
class A	Recycled water treated to a level that allows it to be used for residential uses such as toilet flushing, washing machines and gardens. It is not fit for human consumption
consumer price index (CPI)	The consumer price index published by the Australian Bureau of Statistics
core miscellaneous services	'Top 10' miscellaneous services that make up a majority of the revenue from miscellaneous services

core service standards	A common set of measurable aspects of metropolitan and regional water businesses' performance, established by the Commission. The core set is intended to reflect aspects of water businesses' services of greatest concern to customers All water businesses are required to propose annual targets, in their Water Plans for each of the standards.
Customer Service Code	A code issued under section 4F of the *Water Industry Act 1994* that sets out the terms and conditions of service and supply
environmental contribution	An amount payable by a water business to meet the costs of managing environmental water. It is determined by the Minister for Water under section 193 of the *Water Industry Act 1994* and administered by the Department of Environment and Primary Industries
fixed charge / fixed service fee	A charge for service that is the same regardless of the quantity used
form of price control	The high level structure that is adopted for price limits — for example, price caps or revenue caps
greater metropolitan water businesses	City West Water, Melbourne Water, South East Water, Western Water and Yarra Valley Water
guaranteed service level (GSL) scheme	An arrangement whereby water businesses provide a payment or rebate on bills to customers who receive services that do not meet predefined performance levels
headworks	Dams, weirs and associated works used for the harvest, storage and supply of water
inclining block tariff	The provision of two or more prices for water used, whereby each price applies to a customer's use within a defined tier. Prices rise with each successive tier

licence fee — EPA Victoria
A fee payable to EPA Victoria that is determined by the Minister for the Environment under section 24 of the *Environment Protection Act 1970*, for costs that the agency incurs in administering discharge licences and works approvals. The fee amount depends on the type of operation and the volume and quality of any discharge to the environment

licence fee — Department of Health
A fee payable to the Victorian Government that is determined by the Minister for Health under section 51 of the *Safe Drinking Water Act 2003*, for costs that the Department of Health incurs in administering the Safe Drinking Water Regulations

licence fee — Essential Services Commission
A fee determined by the Minister for Finance in consultation with the Minister for Water under section 4H(2) of the *Water Industry Act 1994*, for costs that the Essential Services Commission incurs in administering the economic regulatory framework

long run marginal cost (LRMC)
The change in total cost resulting from a one unit change in output, over a long enough timeframe such that no inputs are 'fixed'. It is the sum of short run marginal operating and long run marginal capital costs

marginal cost
The change in total cost when one additional unit is produced

megalitre
1000 kilolitres = 1 million litres

metropolitan retailers
City West Water, South East Water and Yarra Valley Water

miscellaneous services
Prescribed services that water businesses may provide to customers — for example, new connections, special meter reads and meter testing, the provision of property information statements, and the review of applications to build over easements

new customer contribution (NCC)	An upfront payment that a water business may levy when a customer builds or develops a property and connects to that business's water, sewerage or recycled water network. Also known as developer charges
operating expenditure	The ongoing cost of running a service or business
potable water	Water treated to a drinkable standard
pre-treatment	When a trade waste customer establishes processes to pre-treat or pre-clean trade waste before it is discharged into the sewerage system
price cap	An imposed limit on how high a price is charged for a product
price determination	A determination for a water business that the Commission makes under section 33 of the *Essential Services Commission Act 2001* and clause 8 of the Water Industry Regulatory Order 2012
recycled water	Wastewater that is treated to a standard appropriate for its intended use
regulatory depreciation	An amount set to allow the regulated water businesses to recover the cost of capital investments over time. Also known as return of assets
reticulation	A network of local pipelines used for transporting water or sewage
revenue cap	An approved maximum amount of revenue that a business is allowed to collect in each year of the regulatory period
revenue requirement	The revenue needed by each water business to cover operating costs and taxes, and provide a return on assets and a return of assets (depreciation)

seasonal factors (for sewage disposal charge)

An adjustment factor for the season used by some water businesses when estimating the sewage volume discharged from customers' properties. In summer, for example, a lower proportion of water consumed flows into the sewerage system

second regulatory period

The period commencing 1 July 2009 and expiring 30 June 2013

service standard targets

Specific targets proposed by businesses for each of the core service standards (see: core service standards) and any additional service standards in their water plan. Each target sets the performance the business aims to achieve for that service standard in each year of the regulatory period

sewage

Liquid waste discharged into the sewerage system

sewerage

A physical arrangement of pipes and plant for the collection, removal, treatment and disposal of liquid waste

Statement of Obligations

For each water business, a specification of the requirements of the business. The statements were made by the Minister for Water under section 4I of the *Water Industry Act 1994*, commencing from 16 September 2012

stormwater

Water that originates during precipitation events. Stormwater that does not soak into the ground becomes surface runoff, which either flows directly into surface waterways or is channelled into storm sewers, which eventually discharge to surface waters

tariff basket

A form of price control that allows flexibility for the business to change tariffs within a regulatory period. However, the weighted average price change across all the business's tariffs must not exceed an approved overall percentage price change over the regulatory period

tariff schedules	A list of prices arranged or organised in a particular order
tariff structure	The way in which prices are organised, which can provide different incentives and signals to customers — for example, a two-part tariff (a fixed service charge and an inclining block tariff variable charge)
third pipe / dual reticulation	The mechanism whereby treated effluent or recycled water is supplied for urban re-use
third regulatory period	For City West Water, South East Water, Western Water and Yarra Valley Water the period commencing 1 July 2013 and expiring on a date specified by the Commission (30 June 2018) For Melbourne Water the period commencing 1 July 2013 and expiring on a date specified by the Commission (30 June 2016)
trade waste	Industrial and commercial liquid waste (other than sewage) that is suitable to be discharged to the sewerage system
variable charge	A charge for a product/service based on the quantity used. Also known as a volumetric charge
wastewater	Grey water, sewage and stormwater
Water Plan	A document prepared and published by a water business, setting out the services, key projects and prices that the business proposes to deliver over the third regulatory period
weighted average cost of capital (WACC)	The rate that a company is expected to pay on average to all its security holders to finance its assets

ACRONYMS

ACCC	Australian Competition & Consumer Commission
CALC	Consumer Action Law Centre
CPI	Consumer price index
CUAC	Consumer Utilities Advocacy Centre
DEPI	Department of Environment and Primary Industries, formerly Department of Sustainability and Environment
DoH	Department of Health
EPA Victoria	Environmental Protection Agency (Victoria)
ESC	Essential Services Commission
EWOV	Energy and Water Ombudsman (Victoria)
FAL	Financial accommodation levy
GSL	Guaranteed service level
IFC	Incremental financing costs
ISD	Intelligent Software Development
LRMC	Long run marginal cost
NCC	New customer contributions
PPP	Public Private Partnership
RAB	Regulatory asset base

SA	South Australia
SCADA	Supervisory control and data acquisition
VCOSS	Victorian Council of Social Services
WACC	Weighted average cost of capital
WIRO	Water Industry Regulatory Order

CONTENTS

SUMMARY

BACKGROUND AND COMMISSION'S TASK

In October 2012, Melbourne Water, City West Water, South East Water, Yarra Valley Water and Western Water submitted Water Plans to the Essential Services Commission (the Commission) for assessment.

The businesses' Water Plans were for the five year regulatory period commencing on 1 July 2013. The Water Plans set out each business's expected costs of delivering water and sewerage services, planned capital works programs, the forecast volumes of water to be delivered and the levels of service promised to customers. Each business also proposed prices that they considered would raise sufficient revenue to recover expected costs. The water businesses were required to consult their customers when developing their Water Plans.

The Commission is required to assess proposed prices and revenue against the regulatory principles set out in the Water Industry Regulatory Order (WIRO) issued by the Minister for Water. The WIRO principles require that prices are set to:

- generate a business's revenue requirement and allow it to meet the costs of efficiently delivering services to customers
- ensure the business's financial viability, including a reasonable return on capital
- reflect the costs of and provide incentives for sustainable water use and
- account for the interests of customers.

The Commission's task is to approve the proposed prices or alternatively to specify prices to apply if it is not satisfied they were calculated or determined consistent with the regulatory principles.

In reaching its final decision, the Commission consulted widely and undertook an extensive analysis of the proposals included in the businesses' Water Plans. The Commission's consultation process included:

- releasing a summary paper (November 2012) and a draft decision (March 2013) for public comment
- conducting public meetings in November and December 2012, and in April and May 2013 to obtain feedback from stakeholders
- conducting two further workshops in May 2013 with water businesses, the Property Council of Australia, the Urban Development Institute of Australia and individual developers on developer charges and
- forming and meeting with a Customer Reference Panel to obtain further information and feedback.

The Commission also engaged consultants with technical expertise to assess whether the businesses' proposed expenditures were reasonable.

In April 2013, the Commission released a draft decision for the greater metropolitan water businesses setting out the Commission's detailed analysis, its proposed adjustments and requests for further information from the businesses. Each of the businesses was given the opportunity to submit a revised pricing proposal in response to the draft decision. Generally, the greater metropolitan water businesses agreed with the substantial elements of the draft decision, but proposed some modifications or clarifications.

This paper sets out the Commission's final decisions on the prices to apply from 1 July 2013. The prices or manner in which prices are determined over the regulatory period are set out in a determination specific to each business. The determinations take effect from 1 July 2013. For City West Water, South East Water, Western Water and Yarra Valley Water, the determinations will apply to 30 June 2018 or when the Commission makes a new determination. For Melbourne Water the determination will apply to 30 June 2016 or when the Commission makes a new determination. Table 1 shows the regulatory period that applies for each business. This final decision also contains the reasons and analysis supporting the Commission determination for each business.

TABLE 1 LENGTH OF REGULATORY PERIOD

Water business	Length of regulatory period	Dates
City West Water, South East Water, Western Water and Yarra Valley Water	5 years	1 July 2013 – 30 June 2018
Melbourne Water	3 years	1 July 2013 – 30 June 2016

All documents associated with the Commission's price review can be found at: www.esc.vic.gov.au

KEY ISSUES

The second regulatory period was overshadowed by a period of drought that resulted in major investments in new sources of water supply.

The key issues for this price review have include the:

- price impacts on customers, particularly in light of the already substantial increase in prices over the past five years. A major cost driver in the third regulatory period is the commencement of payments for the desalination plant which was commissioned formally on 17 December 2012
- ensuring water businesses continue to deliver services valued by customers and improve efficiency
- understanding customers' expectations and their willingness to pay for different service offerings.

Specific concerns raised by customers, and community and business groups include:

- the impact of past and proposed price increases, particularly for vulnerable and low income customers
- whether any price increases should be 'smoothed' over a number of years rather than implemented as a one-off step increase in 2013-14
- the mix of fixed and variable water charges and the consequences for different customer groups such as tenants (who directly pay the variable charge)
- expectations that service levels should at least be maintained
- the manner in which the costs associated with the desalination plant will be reflected in prices and

- the magnitude of developer charges proposed by water businesses and the impact on housing affordability.

Unless otherwise specified, all values shown in this final decision and supporting material are nominated in $2012-13, that is, the Commission has excluded the effects of inflation.

FINAL DECISION OUTCOMES

This final decision is largely consistent with the Commission's draft decision in April 2013. Discussed below are the key outcomes of the final decision.

INTERPERIOD PRICE SMOOTHENING

The Commission has confirmed the need to capitalise a portion of the desalination costs and accepted the assessment by Melbourne Water that the capacity to do so lie in the later years in the five year regulatory period. However, the Commission was not in the position to decide on the amount to be capitalised in these years given insufficient information. In particular, this was due to material but unclear changes to the modelling assumptions made by Melbourne Water following the draft decision. Accordingly, the Commission has shortened the regulatory period for Melbourne Water to three years so that these matters can be properly examined and decided in the interests of customers in Melbourne Water's fourth regulatory period. The regulatory period for the other businesses has remained the same, namely five years, with the last two years' bulk charges based on the indicative estimates for Melbourne Water had a five year regulatory period decision been made for Melbourne Water.

SERVICE STANDARDS

The Commission has approved all service standard targets proposed by the metropolitan water businesses and Western Water for the coming regulatory period. These generally reflect historical performance achieved by the businesses over the previous five years. The Commission has also approved all Guaranteed Service Levels and rebate amounts proposed by the businesses and will reflect these in the Customer Service Code.

REVENUES

In their Water Plans, the businesses identified their revenue requirements for the third regulatory period. These revenue forecasts reflect their expected operating expenditure, a return on assets (existing and new assets) and regulatory depreciation (return of assets).

Melbourne Water sought revenue totalling $8611.9 million for a five year regulatory period. Due to reasons outlined in chapter 3, the Commission has shortened the next regulatory period for Melbourne Water to three years. As a result the Commission has approved revenue of $4786.0 million (table 2) for the period 2013-14 to 2015-16.

TABLE 2 MELBOURNE WATER'S REVENUE REQUIREMENT 2013-14 TO 2015-16 — FINAL DECISION
$m 2012-13

	2013-14	2014-15	2015-16	Total	2016-17 *estimate*	2017-18 *estimate*
Final decision	1 563.3	1 599.1	1 623.6	4 786.0	1 618.9	1 643.0

Note: Melbourne Water charges the retailers for services (and to a lesser extent Western Water), to recover its revenue requirement. The last two years revenue requirements are indicative estimates for Melbourne Water had the Commission approved a five year regulatory period.

The other four water businesses covered in this final decision (City West Water, South East Water, Yarra Valley Water and Western Water) sought combined revenues totalling $13 059.3 million over the next five years. The Commission's final decision results in a lower revenue for those businesses of $12 065.7 million. This is $993.6 million (or 7.6 per cent) lower than that proposed by the businesses (table 3). The revenue requirements for these four businesses incorporate estimates of Melbourne Water's bulk charges for 2016-17 and 2017-18.

TABLE 3 BUSINESSES REVENUE REQUIREMENT – FINAL DECISION
gross of Melbourne Water's bulk charges [a]

$m 2012-13

	Proposed by business	Final decision	Difference	
			$m	*per cent*
City West Water	3 157.2	2 917.5	-239.7	-7.6
South East Water	4 560.5	4 210.1	-350.4	-7.7
Yarra Valley Water	4 936.6	4 569.7	-366.9	-7.4
Western Water	405.1	368.4	-36.7	-9.1
Total retail businesses	**13 059.3**	**12 065.7**	**-993.6**	**-7.6**

[a] The greater metropolitan retailers and Western Water charge end-use customers for services to recover their revenue requirements. In turn, the retailers (including Western Water) pay Melbourne Water for bulk water and sewerage services.

This downward adjustment to the water businesses' proposed revenue reflects the Commission's assessment of the efficient costs of delivering services. The major proposed areas of adjustments to the businesses' costs, include:

- lower financing costs
- operating expenditure reductions for costs such as labour, energy and licences
- required productivity improvements
- reduced or deferred capital programs
- Melbourne Water's revised estimates for desalination costs.

By way of comparison, in the last price review, the comparable amount approved by the Commission was $8634.4 million for the four water retail businesses. Over 80 per cent of the increase in this period is due to commencement of payments for the desalination plant. Revenue requirements are discussed more fully in chapter 6.

OPERATING EXPENDITURE

The Commission has approved $2979.1 million of operating expenditure for Melbourne Water over the next three years.

For the other four businesses, the Commission has approved $9135.6 million over the five year period from 2013-14. This is $85.4 million (or 0.9 per cent) lower than the draft decision, or $567.1 million (or 5.8 per cent) lower than proposed by the businesses.

CAPITAL EXPENDITURE

The Commission has approved $1549.6 million of capital expenditure for Melbourne Water over the next three years.

For the other four businesses, the Commission has approved $3193.1 million over the next five years from 2013-14. This is almost the same as the draft decision and $135.5 million (or 4.1 per cent) lower than that proposed by the businesses.

The final approved capital expenditure reflects changes to the timing of delivery of certain projects and the removal of some projects.

FINANCING COSTS

Based on current market conditions, the Commission has approved a real post tax weighted average cost of capital of 4.5 per cent. This is lower than the WACC estimate applied in the draft decision (of 4.7 per cent) and the 5.1 per cent that applies in the current regulatory period.[1]

PRICES

The Commission is responsible for approving the maximum prices each water business can charge its customers in each year during the outlook period and lower than was proposed in the draft decision.

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[1] The WACC applied in the current regulatory period to Western Water and Melbourne Water's drainage and waterways revenue requirements is 5.8 per cent.

As a result of downward revision to the water businesses' expenditure and revenue requirements, the Commission has approved maximum price increases that are lower than those proposed by each of the water businesses.

Excluding the impact of inflation, the price increases over five years proposed by the four greater metropolitan water businesses ranged from 31.7 per cent to 35.8 per cent. Much of this increase reflected Melbourne Water's proposed bulk services (wholesale) price increase. Following the adjustments made by the Commission, these price increases have been moderated. The Commission has approved price increases that range from 12.3 per cent for Western Water, to 19.2 per cent up to 24.6 per cent for the metropolitan retailers (table 4).

In most instances, the proportional reduction in prices exceeds the reduction in revenues because of some upward revisions the Commission has made to the water businesses' forecasts of growth in water consumption over the next five years (chapter 10).

TABLE 4 AVERAGE PRICE INCREASES – FINAL DECISION
compared with business proposals — average 2013-14 to 2017-18

	Proposed by business	Final decision	Difference
City West Water	31.7	19.2	-12.5
South East Water	34.9	22.8	-12.0
Yarra Valley Water [a]	35.8	24.6	-11.3
Western Water	35.6	12.3	-23.3

[a] Prices shown for Yarra Valley Water are indicative because the business proposed a revenue cap form of price control. Maximum allowable prices may change during the regulatory period.

Melbourne Water provides waterways and drainage services to end-use customers. The business proposed to increase prices for those services by 14.1 per cent over 5 years. The Commission's final decision is to allow these prices to increase by 4.7 per cent over three years. This is higher than the 0.5 per cent provisionally approved in the draft decision and reflects more detailed information submitted by Melbourne Water following the draft decision on the cost of delivering waterways and drainage services. This has a minimal impact on Melbourne Water's total revenue as there is a corresponding reduction in prices for its water and sewerage services.

TABLE 5 MELBOURNE WATER WATERWAYS AND DRAINAGE PRICES – FINAL DECISION
compared with business's proposal — average 2013-14 to 2015-16

	Proposed by business	Final decision	Difference
	per cent	*per cent*	*per cent*
Waterways and drainage 5 years	14.1	na	na
Waterways and drainage 3 years	8.2[a]	4.7	3.5

[a] This figure is the equivalent of Melbourne Water's five year proposal of 14.1 per cent, but for a three year period to enable comparison. **na.** Not applicable.

HOUSEHOLD BILLS AND CUSTOMER SUPPORT

The revised tariffs in this final decision result in increases in household water and sewerage bills lower than those sought by the businesses in their Water Plans. For Melbourne household, there will be a one off significant increase in the first year (2013-14). The bill increases will then plateau and will only move in line with inflation for the rest of the regulatory period. Western Water's bills will increase slightly each year under its proposal to smooth the price increase over the five year regulatory period. Table 6 compares indicative bills for owner-occupiers in 2012-13 and 2017-18, based on the prices proposed by the businesses and prices resulting from the Commission's final decision. Table 7 compares indicative bills for tenants. These indicative bills shown are based on typical consumption figures for owner-occupiers and tenants serviced by each water retailer. Outcomes will vary for individual customers.

Because the Commission has approved Yarra Valley Water's proposal to adopt a revenue cap as its price control mechanism, the typical bills shown in tables 6 and 7 for that retailer may change slightly, but by no more than its annual rebalancing constraint of 2 per cent.

Tables 8 and 9 show residential owner-occupier and tenant bills, respectively, in 2013-14 as they appear to customers – that is in actual or nominal dollars.

TABLE 6 INDICATIVE ANNUAL RESIDENTIAL OWNER-OCCUPIER BILLS[a]
$2012-13

	Current bill	Bills based on businesses' proposals		Bills based on final decision	
	2012-13	2013-14	2017-18	2013-14	2017-18
City West Water	848	1 091	1 091	991	991
South East Water	863	1 166	1 166	1 058	1 058
Yarra Valley Water[b]	949	1 272	1 272	1 143	1 143
Western Water	975	1 035	1 330	997	1 092

Note: real values. [a] Based on the businesses' proposed prices and final decision prices. Bills are calculated using each business's average consumption. Bills are based on average consumption of: City West Water (150 kL per year), South East Water (150 kL per year), Yarra Valley Water (155 kL per year), Western Water (180 kL per year). These consumption amounts are different to those used in the draft decision. Comparable bill tables using the same consumption as the final decision are available in appendix F. [b] Bills shown for Yarra Valley Water are indicative because the Commission has approved a revenue cap form of control, therefore prices may change during the regulatory period.

TABLE 7 INDICATIVE ANNUAL RESIDENTIAL TENANTS BILLS[a]
$2012-13

	Current bill	Bills based on businesses' proposals		Bills based on final decision	
	2012-13	2013-14	2017-18	2013-14	2017-18
City West Water	461	600	600	538	538
South East Water	445	625	625	579	579
Yarra Valley Water [b]	508	698	698	636	636
Western Water	264	287	410	272	310

Note: real values. [a] Based on the businesses' proposed prices and final decision prices. Bills are calculated using each business's average consumption. Bills are based on average consumption of: City West Water (150 kL per year), South East Water (150 kL per year), Yarra Valley Water (155 kL per year), Western Water (180 kL per year). These consumption amounts are different to those used in the draft decision. Comparable bill tables using the same consumption as the final decision are available in appendix F. [b] Bills shown for Yarra Valley Water are indicative because the Commission has approved a revenue cap form of control, therefore prices may change during the regulatory period.

TABLE 8 INDICATIVE ANNUAL RESIDENTIAL OWNER-OCCUPIER BILLS

	Current bill	Approved 2013-14 *including inflation*	Difference
City West Water	848	1 016	167
South East Water	863	1 085	222
Yarra Valley Water[a]	949	1 171	222
Western Water	975	1 022	47

Note: Bills based on 2013-14 business proposed estimated consumption. Bills are based on average consumption of: City West Water (150 kL per year), South East Water (150 kL per year), Yarra Valley Water (155 kL per year), Western Water (180 kL per year). [a] Bills shown for Yarra Valley Water are indicative because the Commission approved a revenue cap form of price control, so prices may vary slightly during the regulatory period.

TABLE 9 INDICATIVE ANNUAL RESIDENTIAL TENANT BILLS

	Current bill	Approved 2013-14 *including inflation*	Difference
City West Water	461	552	91
South East Water	445	593	148
Yarra Valley Water[a]	508	652	144
Western Water	264	279	15

Note: Bills based on 2013-14 business proposed estimated consumption. Bills are based on average consumption of: CWW (150kL per year), SEW (150kL per year), YVW (155kL per year), WW (180kL per year). [a] Bills shown for Yarra Valley Water are indicative because the business proposed a revenue cap form of price control, so prices may vary slightly during the regulatory period.

The Commission's final decision to moderate price increases will go some way to addressing concerns about affordability. However, the Commission recognises that the final increases are still material. The Commission has allowed an additional $5 million for the metropolitan retailers to help them assist customers in managing the impact of the proposed price increases over the five year period (instead of confining it to just 2013-14 as in the draft decision). This is in response to the views expressed by a joint submission about the ongoing need to assist hardship customers.[2] The Commission has also separately approved $250 000 over five years for Western Water in its final decision for similar reasons. The businesses are required to continue to consult with customer and welfare groups and put in place improved measures to support customers who may have difficulty paying their bills, particularly low income and vulnerable customers. Businesses will be required to update the Commission regularly (and make public) on how the additional allowances are being spent during the third regulatory period.

REPORTING OF OUTCOMES OVER THE REGULATORY PERIOD

The Commission will monitor the progress of each water business in delivering the outcomes outlined in its Water Plan. The businesses will have an opportunity, through the annual performance report, to explain to customers where and why projects have been delayed or replaced by other projects. It is important to note that expenditure assumptions made by the Commission to determine prices do not represent amounts the businesses are required to spend or direct to particular activities or projects. Over the regulatory period, it is reasonable to expect that businesses may need to reprioritise or alter their capital programs in response to changing circumstances. The Commission's annual performance report will provide an opportunity for businesses to explain any changes as well as implications for any outcomes committed to in their Water Plans.

[2] Consumer Action Law Centre (CALC), Consumer Utilities Advocacy Centre (CUAC) and the Victorian Council of Social Service (VCOSS) 2013, *Submission to the Water Price Review draft decision 2013-18*, May.

The Commission will also continue to monitor the following areas during the regulatory period:

- desalination costs (chapter 3)
- customer support funding (chapter 4)
- major projects reporting (chapter 8)
- trials of customer choice (chapter 13)
- new customer contributions framework implementation (chapter 18).

1 INTRODUCTION

The Essential Services Commission is Victoria's independent economic regulator of essential services. The Commission's role in the water industry includes regulating the prices and monitoring the service standards of the 19 Victorian Government owned water businesses.

This is the Commission's fifth review of water prices. The Commission previously completed price reviews in June 2005 for 17 metropolitan and regional businesses, in June 2006 for five rural businesses, in June 2008 for regional and rural businesses and Melbourne Water's drainage and sewerage, and in June 2009 for metropolitan retail businesses and Melbourne Water.

This final decision covers the four greater metropolitan water retailers and Melbourne Water. These businesses submitted final Water Plans to the Commission in October and November 2012. The final decision sets out the Commission's analysis, reasons and conclusions about the prices that will apply from 1 July 2013. This final decision should be read in conjunction with the Commission's draft decision released in April 2013.[3] Separate final decisions were prepared for regional and rural water businesses.[4]

1.1 LEGISLATIVE FRAMEWORK

In carrying out its role, the Commission is guided by the regulatory framework set out in the *Essential Services Commission Act 2001* and the *Water Industry Act 1994*. The Water Industry Act sets out additional objectives and provides for

[3] Essential Services Commission 2013, *Price Review 2013: greater metropolitan water businesses — draft decision, volume I*, April.

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

the Governor in Council to set out more detail on the regulatory framework in a Water Industry Regulatory Order (WIRO).[5]

The WIRO requires the Commission to approve or specify the price arrangements for each water business for each regulatory period. The Commission must approve the price arrangements if satisfied the prices, or the manner in which prices are to be calculated or otherwise determined, comply with procedural requirements and the regulatory principles in the WIRO. If not satisfied, the Commission may specify the prices a business may charge, or the manner in which those prices are to be calculated or otherwise determined.

Procedural requirements include the need for businesses to consult with customers and relevant regulatory agencies before submitting their Water Plan to the Commission for assessment. The WIRO sets out regulatory principles the businesses must comply with in proposing prices and the Commission must comply with in approving prices (this is discussed in more detail below).

[5] The WIRO is available on the Commission's website: www.esc.vic.gov.au.

BOX 1.1 THE COMMISSION’S REGULATORY OBJECTIVES

The *Essential Services Commission Act* (ESC Act) outlines the objective and the matters the Commission must consider in undertaking its functions across all industries. The Commission’s objective is to promote the long term interests of Victorian consumers in terms of the price, quality and reliability of essential services. In pursuing this objective, the Commission must have regard to the following matters, as set out in section 8(A) of the ESC Act:

- efficiency in the industry and incentives for long term investment;
- the financial viability of the industry;
- the degree of, and scope for, competition within the industry, including countervailing market power and information asymmetries;
- the relevant health, safety, environmental and social legislation applying to the industry;
- the benefits and costs of regulation (including externalities and the gains from competition and efficiency) for:
  - (i) consumers and users of products or services (including low income and vulnerable consumers);
  - (ii) regulated entities;
- consistency in regulation between States and on a national basis;
- any matters specified in the empowering instrument.

Continued on next page

BOX 1.1 (CONTINUED)

The *Water Industry Act* contains the following additional objectives (which take precedence over the objectives of the ESC Act in the event of conflict) that the Commission must meet in regulating the water sector:

- wherever possible, ensure the costs of regulation do not exceed the benefits
- ensure regulatory decision making and regulatory processes have regard to any differences in the operating environments of regulated entities
- ensure regulatory decision making has regard to the health, safety, environmental sustainability (including water conservation) and social obligations of regulated entities.

The Commission must also have regard to the procedural requirements and regulatory principles in the Water Industry Regulatory Order (see box 1.2 for the WIRO's regulatory principles).

1.2 WATER PRICE REVIEW

This final decision follows a period of extensive consultation by the water businesses and the Commission.

In October 2011 the Commission released a guidance paper to help the water businesses prepare their Water Plans. [6] The paper provided the businesses with comprehensive guidance about the Commission's expectations for the content of Water Plans. It also detailed the Commission's expectations for businesses' consultation with customers and other stakeholders to inform their Water Plans.

[6] Essential Services Commission 2011, *2013 Water Price Review — guidance on Water Plans*, October.

Specifically, the Commission's guidance paper noted its expectation that customer prices will reflect:

- prudent and efficient expenditure only
- ongoing productivity improvement and
- initiatives that garner customer support and reflect their willingness to pay, or reflect clearly defined Government obligations.

The Commission also allowed flexibility for the businesses to adapt to changing industry conditions and customer needs. The Commission provided a framework for businesses to provide customers with tariff choice, and for businesses to apply for a regulatory period of more than five years, for example.

Further, to increase customer protection the Commission required all Victorian water businesses to propose a Guaranteed Service Level (GSL) scheme for the third regulatory period. Under the scheme, businesses provide an automatic payment to customers who receive a level of service that is significantly worse than the average level of performance expected by most customers. The scheme helps businesses to identify the worst served customers and specific service areas that require improvement. In addition, the scheme provides financial incentives for businesses to focus on providing good quality, reliable services to all customers.

The greater metropolitan water businesses submitted final Water Plans to the Commission in October and November 2012. In November 2012, the Commission released a Water Plan summary paper that provided an overview of the businesses' proposals, key issues for consultation, and also invited submissions from interested parties.[7] In December 2012, the Commission held 17 public meetings across the state to provide an opportunity for interested parties to comment. The Commission received 63 written submissions in response to the summary paper.

The Commission released its draft decision on prices on 23 April 2013.[8] The draft decision set out the Commission's initial views on the prices that will apply from 1 July 2013, based on the information available to the Commission at the time. The Commission sought feedback from interested parties on the draft decision through

[7] Essential Services Commission 2012, *Summary of metropolitan businesses Water Plans*, November.

[8] Essential Services Commission 2013, *Price Review 2013: greater metropolitan water businesses — draft decision, volume* I, April.

public forums and submissions. The Commission held 14 public forums in April and May 2013. The Commission received 113 written submissions in response to the draft decision. The views put forward at public forums and in submissions, information provided by the water businesses, the views of the Commission's expert consultants, and the Commission's own analysis informed the final decision.

1.3 COMMISSION'S APPROACH TO ASSESSING PROPOSED PRICES

The Commission is required to assess the prices proposed by the water businesses against the regulatory principles of the WIRO.

In deciding whether to approve a business's proposed prices, the Commission must be satisfied those prices provide the business with sufficient revenue to meet its obligations and deliver the level of service customers require. Revenue must be sufficient to allow the business to recover operating expenditure and the cost of financing capital expenditure, as well as to receive a reasonable return on assets, but not allow monopoly profits.

The Commission must also be satisfied that expenditure forecasts reflect the efficient delivery of the outcomes proposed in the Water Plan and account for a long term planning horizon, signal to customers the costs of using water and sewerage services, and give customers incentives to use water sustainably.

The full list of the WIRO regulatory principles is provided in box 1.2. The WIRO was enhanced in 2012 to include new clauses that provide for customer tariff choice and strengthen requirements for cost-reflective new customer contributions. The changes also established that accounting for the interests of low income and vulnerable customers is a standalone regulatory principle rather than a subordinate of the pricing principle (as was the case previously).

BOX 1.2 WIRO PRICING PRINCIPLES

Clause 14(1) of the WIRO requires the Commission to be satisfied prices are set so as to:

1 provide for a sustainable revenue stream to the regulated entity that nonetheless does not reflect monopoly rents or inefficient expenditure by the regulated entity

2 allow the regulated entity to recover its operational, maintenance and administrative costs

3 allow the regulated entity to recover its expenditure on renewing and rehabilitating existing assets

4 allow the regulated entity to recover:

  a a rate of return on assets as at 1 July 2004 that are valued in a manner determined by, or at an amount otherwise specified by, the Minister at any time before 1 July 2004

  b a rate of return on investments made after 1 July 2004 to augment existing assets or construct new assets

  c in the case of Gippsland and Southern Rural Water Corporation only, all costs associated with existing debt incurred to finance expenditure prior to 1 July 2006 in a manner determined by the Minister at any time before 1 July 2006

  d investment in an asset or asset class as at 1 July 2004 using the value calculated in the manner determined by, or the amount otherwise specified by, the Minister for that asset or asset class at any time before 1 July 2004

  e investment in an asset or asset class made after 1 July 2004 to augment existing assets or construct new assets

Continued next page

BOX 1.2 (CONTINUED)

5 provide appropriate incentives and signals to customers or potential customers about:

  a the sustainable use of Victoria's water resources by reference to the costs of providing prescribed services to customers (either collectively or to an individual customer or class of customers), including costs associated with balancing supply and demand

  b the costs associated with servicing a new development in a particular location

6 provide the regulated entity with incentives to pursue efficiency improvements and to promote the sustainable use of Victoria’s water resources

7 enable customers or potential customers of the regulated entity to readily understand the prices charged by the regulated entity for prescribed services, or the manner in which such prices are to be calculated or otherwise determined

8 provide for an appropriate adjustment mechanism to minimise the extent of any under- or over-recovery of revenue for the costs associated with the desalination plant during a regulatory period

9 where appropriate, facilitate choice and innovation in the prescribed services and associated prices offered to customers.

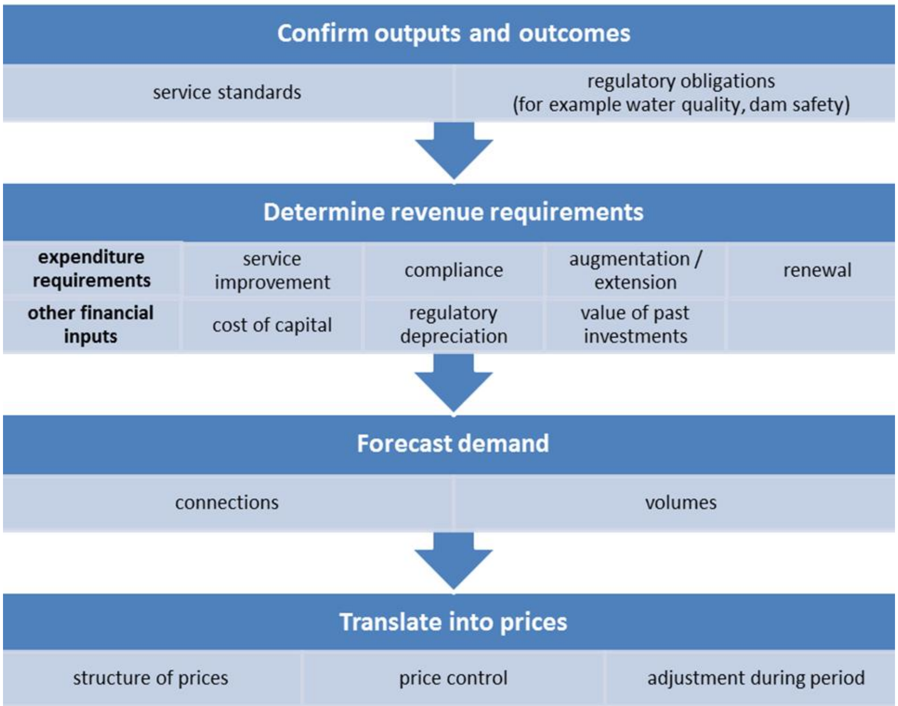
The Commission must be satisfied the expenditure forecasts contained in the Water Plan reflect the efficient delivery of the proposed outcomes contained in the Water Plan and account for a planning horizon that extends beyond the term of the Water Plan.

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

Source: Water Industry Regulatory Order, clause 14(1).

The Commission adopts a 'building block' approach to assess prices. The approach is characterised by four steps (figure 1.1).

FIGURE 1.1 STEPS IN ASSESSING AND APPROVING PRICES



The first step is to establish the service standards and outcomes a business proposes to deliver over the regulatory period. These standards and outcomes reflect obligations imposed by the Minister for Water through the Statement of Obligations,[9] EPA Victoria, the Department of Health, the Department of Environment and Primary Industries, and customer preferences.

[9] There is a Statement of Obligations that applies to each water business specifying a number of requirements the businesses must follow. There are additional Statement of Obligations for City West Water, South East Water, Yarra Valley Water and Melbourne Water for managing augmented water supply. The obligations are based on a combination of water legislation requirements and government policy. They were made by the Minister for Water under section 4I of the *Water Industry Act 1994*, commencing from 16 September 2012.

In the second step, the Commission determines the revenue the business requires to meet the service obligations and expected outcomes. The Commission must assess whether the business's expenditure forecasts are efficient, whether its capital works program is deliverable within the timeframes proposed, and whether its business strategy reflects a long term planning horizon. The Commission must also ensure the business receives an efficient return on its capital investments.

The Commission makes assumptions about efficient expenditure to assess whether prices will result in the business earning sufficient revenue to deliver services. However, the assumed expenditure levels do not represent amounts a business is required to spend or direct to particular activities or projects. In consultation with customers, businesses are free to determine their expenditure priorities to reflect changing circumstances during the regulatory period, and to pursue innovation and efficiencies that enable them to outperform the cost assumptions. The Commission's methodology does not bind water businesses' spending to particular projects or activities.

Sometimes, given changing circumstances, a business may not proceed with a project or activity that it proposed in its Water Plan and that the Commission included when calculating assumed expenditure. It might do so when it identifies, in consultation with its customers, a higher priority project or activity that should be undertaken instead. Similarly, if costs increase by more than forecast at the time of the price review, the business might defer or cancel a lower priority project or activity to ensure projects and activities more highly valued by customers can go ahead without the business then needing to recoup a revenue shortfall from customers.

The third step in the process is to assess a business's forecast level of demand for water and sewerage services, and the assumed level of growth in customer connections.

The final step is approving the prices that will apply during the regulatory period. For each business, the Commission must ensure prices will generate the business's revenue requirement, accounting for demand forecasts. It assesses whether the business's demand forecasts are reasonable and reflect the best available information. It also considers whether prices and proposed tariff structures provide appropriate signals about the costs of providing services, and provide incentives for sustainable water use.

1.4 STRUCTURE OF THIS FINAL DECISION

This paper sets out the Commission's analysis, reasons and conclusions about the prices that will apply from 1 July 2013.

Chapter 2 of this paper provides an overview of customer bills and prices. Chapter 3 sets the regulatory treatment for desalination security payments. Chapter 4 provides an overview of customer support. Chapter 5 sets out the Commission's assessment of the key outcomes and service levels to be delivered by the businesses during the regulatory period.

Chapter 6 sets out the Commission's decision on the total revenue required by each business, based on its operating expenditure (chapter 7), capital expenditure (chapter 8) and the costs of financing its capital expenditure program (chapter 9). Chapter 10 sets out the demand forecasts applied by the Commission to calculate approved prices for the applicable regulatory period.

Chapter 11 discusses the form of price control applied to each business's prices. Chapters 12–19 discuss the approved tariff structures for bulk water and sewerage (chapter 12), retail water service (chapter 13), retail sewerage service (chapter 14), recycled water (chapter 15), trade waste (chapter 16), waterways and drainage (chapter 17), new customer contributions (chapter 18) and miscellaneous charges (chapter 19). Chapter 20 outlines how prices will be adjusted during the regulatory period, including mechanisms for dealing with uncertainty.

In addition, the Commission issued each greater metropolitan water business with a determination that specifies the prices it may charge during the regulatory period and the manner in which those prices are to be calculated or otherwise determined. It includes a schedule of tariffs that may be levied from 1 July 2013 and the manner for adjusting those tariffs during the regulatory period. The determinations are available on the Commission's website (www.esc.vic.gov.au).

2 PRICES AND CUSTOMER BILLS

2.1 PRICES

Based on the Commission's final decision, the greater metropolitan water businesses will all have real price increases over the third regulatory period, but at a level much lower than the businesses had proposed in their Water Plans. Table 2.1 compares the total price changes proposed by each metropolitan retail water businesses in their Water Plans with the Commission's final decision (measured as an average of the price changes across water, sewerage and other services).

Under the Commission's final decision, Yarra Valley Water will have the biggest percentage increase in prices over the next regulatory period with an increase of 24.6 per cent. Western Water will have the smallest percentage increase (12.3 per cent) over the same period.

Western Water will have the greatest reduction in prices from its proposal with a decrease of 23.3 per cent. Yarra Valley Water will have the smallest change from its proposal with a decrease of 11.3 per cent.

Appendix C discusses the effect of price freeze — started from 1 July 2012 to return unrequired desalination payments to customers — on water prices over the next regulatory period.

TABLE 2.1 ESTIMATED AVERAGE ANNUAL PRICE RISE — FINAL DECISION PRICE PATH

percentage change

	Final decision							
	2013-14	**2014-15**	**2015-16**	**2016-17**	**2017-18**	**Total final decision**	**Total proposed by businesses**	**Change**
City West Water	19.2	0.0	0.0	0.0	0.0	19.2	31.7	–12.5
South East Water	22.8	0.0	0.0	0.0	0.0	22.8	34.9	–12.0
Yarra Valley Water[a]	24.6	0.0	0.0	0.0	0.0	24.6	35.8	–11.3
Western Water	2.4	2.3	2.3	2.3	2.3	12.3	35.6	–23.3

[a] Prices shown for Yarra Valley Water are indicative because the business proposed a revenue cap form of price control, so prices may vary slightly during the regulatory period.

2.1.1 PRICE PATHS

In response to the draft decision, South East Water, Yarra Valley Water and Western Water reiterated customer feedback supported their proposed price paths.[10] A joint submission from the Consumer Action Law Centre (CALC), Consumer Utilities Advocacy Centre (CUAC) and Victorian Council of Social Service (VCOSS) stated they are:

> *pleased that the Commission has:*
>
>> *Examined the consumer impacts arising from the proposed price paths and increases, including their impacts on vulnerable and low income customers…*[11]

The Commission maintained its draft decision to adopt the three metropolitan retail water businesses' (City West Water, South East Water and Yarra Valley Water) proposed one-off increase in water and sewerage prices for the first year of the regulatory period, followed by no real increase for the remainder of the period. It also adopted Western Water's proposed smooth price path over the period.

2.2 CUSTOMER BILLS

As a result of this final decision, household water and sewerage bills will not increase as much as sought by the businesses in their Water Plans.

Note that the Commission's final decision does not include the effect of inflation, that is, it is expressed in *real dollar terms* (in 2012-13). Nominal prices can be calculated by including inflation using the Consumer Price Index (CPI).

[10] South East Water 2013, *Submission to the Water Price Review draft decision 2013–18*, May, p. 31; Yarra Valley Water 2013, *Submission to the Water Price Review draft decision 2013–18*, May, p. 11; Western Water 2013, *Submission to the Water Price Review draft decision 2013–18*, May. In their Water Plans, City West Water, South East Water and Yarra Valley Water proposed one-off increase in water and sewerage prices for the first year of the regulatory period, followed by no real increase for the remainder of the period while Western Water proposed smooth price path over the period.

[11] Consumer Action Law Centre (CALC), Consumer Utilities Advocacy Centre (CUAC) and the Victorian Council of Social Service (VCOSS) 2013, *Submission to the Water Price Review draft decision 2013-18*, May, p. 2.

2.2.1 OWNER-OCCUPIER BILLS

Table 2.2 compares indicative bills in 2013-14 and 2017-18 for residential owner-occupiers, based on the prices proposed in the businesses' Water Plans and prices resulting from the Commission's final decision (in real $2012-13).

After increasing in 2013-14, residential owner-occupier bills for the metropolitan retailers (City West Water, South East Water and Yarra Valley Water) under this final decision will remain the same in real terms over the five year period. Western Water's bills will increase slightly each year under its proposal to smooth the price increase over the five year regulatory period.

TABLE 2.2 INDICATIVE ANNUAL RESIDENTIAL OWNER-OCCUPIER BILLS

$2012-13

	Current bill	Bills based on businesses' proposals		Bills based on final decision	
	2012-13	*2013-14*	*2017-18*	*2013-14*	*2017-18*
City West Water	848	1 091	1 091	991	991
South East Water	863	1 166	1 166	1 058	1 058
Yarra Valley Water[a]	949	1 272	1 272	1 143	1 143
Western Water	975	1 035	1 330	997	1 092

Note: Bills based on 2013-14 business proposed estimated consumption. Bills are based on average consumption of: CWW (150 kL per year), SEW (150 kL per year), YVW (155 kL per year), WW (180 kL per year). [a] Bills shown for Yarra Valley Water are indicative because the business proposed a revenue cap form of price control, so prices may vary slightly during the regulatory period. These consumption amounts are different to those used in the draft decision. Comparable bill tables using the same consumption as the final decision are available in appendix F.

Based on this final decision, Yarra Valley Water will have the highest average owner-occupier bills in 2013-14, at $1143. City West Water will have the lowest average owner-occupier bills in 2013-14, at $991 (table 2.2).

Table 2.2 also shows that South East Water and Yarra Valley Water will have the greatest dollar increase in their customers' bills over the period, with an increase of $195 per customer and $194 per customer, respectively. Western Water will have the smallest increase over the period, at $117 per customer.

Customer bills shown in table 2.2 do not include inflation. Table 2.3 shows residential bills in $2013-2014 as they will appear to customers — that is in actual or nominal dollars.[12]

TABLE 2.3 INDICATIVE ANNUAL RESIDENTIAL OWNER-OCCUPIER BILLS

	Current bill	Approved 2013-14 *including inflation*	Difference
City West Water	848	1 016	168
South East Water	863	1 085	222
Yarra Valley Water[a]	949	1 171	222
Western Water	975	1 022	47

Note: Bills based on 2013-14 business proposed estimated consumption. Bills are based on average consumption of: CWW (150 kL per year), SEW (150 kL per year), YVW (155 kL per year), WW (180 kL per year). **a** Bills shown for Yarra Valley Water are indicative because the business proposed a revenue cap form of price control, so prices may vary slightly during the regulatory period.

2.2.2 TENANT BILLS

Unlike owner-occupiers, water businesses only bill tenants variable water and sewerage charges (Western Water does not have variable sewerage charges).[13] Table 2.4 compares indicative bills in 2013-14 and 2017-18 for residential tenant bills, based on the prices proposed in the businesses' Water Plans and prices resulting from the Commission's final decision (in real $2012-13).

[12] Table 2.3 shows 2013-14 residential owner-occupier bills including an inflation of 2.5 per cent.

[13] The property owner is billed for the fixed component of the water bill.

TABLE 2.4 INDICATIVE ANNUAL RESIDENTIAL TENANT BILLS

$2012-13

	Current bill	Bills based on businesses' proposals		Bills based on final decision	
	2012-13	*2013-14*	*2017-18*	*2013-14*	*2017-18*
City West Water	461	600	600	538	538
South East Water	445	625	625	579	579
Yarra Valley Water[a]	508	698	698	636	636
Western Water	264	287	410	272	310

Note: Bills based on 2013-14 business proposed estimated consumption. Bills are based on average consumption of: CWW (150 kL per year), SEW (150 kL per year), YVW (155 kL per year), WW (180 kL per year). [a] Bills shown for Yarra Valley Water are indicative because the business proposed a revenue cap form of price control, so prices may vary slightly during the regulatory period. These consumption amounts are different to those used in the draft decision. Comparable bill tables using the same consumption as the final decision are available in appendix F.

Based on this final decision, Yarra Valley Water will have the highest average tenant bills in 2013-14, at $636. Western Water will have the lowest bills for these customers, at $272 (table 2.4).

South East Water and Yarra Valley Water would also have the highest dollar increase in average tenant bills at $134 and $128 per customer, respectively. Western Water would have the lowest increase for those customer bills, $46 per customer.

Customer bills shown in table 2.4 do not include inflation. Table 2.5 shows residential bills in 2013-2014 as they will appear to customers — that is in actual or nominal dollars.[14]

[14] Table 2.5 shows 2013-14 residential owner-occupier bills including an inflation of 2.5 per cent.

TABLE 2.5 INDICATIVE ANNUAL RESIDENTIAL TENANT BILLS

	Current bill	Approved 2013-14 *including inflation*	Difference
City West Water	461	552	91
South East Water	445	593	148
Yarra Valley Water[a]	508	652	144
Western Water	264	279	15

Note: Bills based on 2013-14 business proposed estimated consumption. Bills are based on average consumption of: CWW (150kL per year), SEW (150kL per year), YVW (155kL per year), WW (180kL per year). [a] Bills shown for Yarra Valley Water are indicative because the business proposed a revenue cap form of price control, so prices may vary slightly during the regulatory period.

3 MELBOURNE WATER'S DESALINATION EXPENDITURE

3.1 INTRODUCTION

This chapter sets out the Commission's final decision on Melbourne Water's proposal relating to the recovery of its desalination security payments; that is, payments that it makes for the Victorian Desalination Plant (desalination plant) to be available to produce water.

In addition, this chapter sets out our final decision on Melbourne Water's proposal to recover payments for desalination project management services provided by the Department of Environment and Primary Industries (DEPI).

The desalination project is being delivered through a public private partnership (PPP) between the Victorian Government and AquaSure. While Melbourne Water is not a party to the desalination PPP and is not managing the contract with AquaSure (DEPI is carrying out this role), Melbourne Water has entered into arrangements that place specific obligations on it in relation to the desalination plant. These are detailed in:

- a Statement of Obligations issued to Melbourne Water under the Water Industry Act (1994)
- the Water Interface Agreement, executed in March 2012, between the Minister for Water, Melbourne Water and DEPI and
- the Supplementary Agreement to the Water Interface Agreement executed in July 2012.

Under these arrangements, the financial obligations of the Victorian Government in relation to the desalination plant are to be met by Melbourne Water. Specifically, Melbourne Water is required to:

- pay all monies payable by the Victorian Government to AquaSure
- pay $320 million to the Victorian Government for the right to acquire the residual interest in the asset that reverts to Government ownership at the end of the PPP term and
- reimburse DEPI for ongoing project management costs that the department incurs in managing the contract on behalf of the Victorian Government over the period of the contract.

Given the quantum of the desalination security payments Melbourne Water is forecast to make, the recovery of these payments will have a significant impact on customer prices and bills. Further, because the desalination plant is recognised as a finance lease for accounting purposes, the desalination plant costs also have a large impact on Melbourne Water's financial position irrespective of their regulatory treatment for pricing purposes.[15]

Chapter 20 addresses how customer prices will adjust if any water is ordered from the desalination plant, and how prices will adjust on an annual basis if Melbourne Water's desalination security payments vary from current forecasts.

3.2 OVERVIEW OF DRAFT DECISION

3.2.1 TREATMENT OF DESALINATION SECURITY PAYMENTS

The Commission's draft decision accepted that all costs associated with the availability of the desalination plant must ultimately be reflected in Melbourne Water's bulk services charge to retailers, and the metropolitan retailers customer tariffs.

The Partnerships Victoria process that led to the desalination PPP seeks to ensure issues such as value for money are achieved through a competitive tendering

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[15] For more information, see: Essential Services Commission 2013, *Price Review 2013: Greater Metropolitan Water Businesses – Draft Decision, Volume I*, April, p.p. 48-49.

process. Therefore, the Commission considered that Melbourne Water's desalination security payments will reflect an efficient overall level of expenditure.

However, the proposed method of recovery of desalination security payments is relevant to the Commission's assessment of the prices in Melbourne Water's Water Plan.

Melbourne Water proposed that the desalination security payments that it is contractually required to meet in each year of the regulatory period be recovered in full from water retailers[16] in the same year the costs are incurred. The retailers, in turn, proposed to recover these costs directly from their customers. This approach does not necessarily take into account whether the stream of costs borne by end-use customers matches the stream of benefits they receive.

The security payments reflect a 27 year contractual payment profile, after which Melbourne Water will take full ownership of the desalination plant. The desalination plant is expected to have a further 23 year operating life. In other words, the arrangements set out in Melbourne Water's Water Plan imply that customers over the next 27 years would pay for a facility that will provide benefits for at least 50 years. The Commission considered that all customers should contribute to the costs of a service from which they benefit. In this case, the benefit is reflected in the knowledge (or 'option value')[17] that the desalination plant can be used to supplement Melbourne's water supply at short notice at any time in the next 50 years.

[16] City West Water, South East Water, Yarra Valley Water and Western Water.

[17] For more detail, see Essential Services Commission 2013, *Explanatory Note: Deriving a time profile for Melbourne Water's recovery of its desalination security payments based on customer value*, April.

In its draft decision, the Commission:

- was not satisfied that Melbourne Water had consulted adequately with the water retailers and end-use customers in order to develop its proposed approach. Nor did it appear from what had been submitted to us that the water retailers had made adequate representations on behalf of their customers.
- was not satisfied that Melbourne Water's proposed prices:
  - took into account the interests of customers (including low income and vulnerable customers)[18] or
  - provided appropriate incentives and signals to retailers and end-use customers (or potential customers) about the sustainable use of Victoria's water.[19]
- required Melbourne Water to develop an alternative proposal for the recovery of its desalination security costs, consistent with the WIRO principles.

Chapter 21 of the draft decision outlined the issues that the Commission believed required further elaboration and consultation by Melbourne Water. In particular, this included exploration of the trade-off between:

- spreading Melbourne Water's security costs over a period that better matched the expected life of the desalination plant and
- introducing a potential risk that either Melbourne Water's service obligations could be compromised or its prices could increase erratically.

The Commission requested that Melbourne Water develop its proposal in consultation with all interested parties. This consultation was to include the water retailers, end-use customers and representative bodies.

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[18] WIRO clause 14 (c).

[19] WIRO clause 14(1)(a)(v)(A).

BOX 3.1 CAPITAL EXPENDITURE - INTER-PERIOD SMOOTHING OF COST RECOVERY BY WATER BUSINESSES

The Commission considers that as a general principle, the capital costs of an asset should be recovered over a period that approximates the useful life of the asset. This approach ensures that customers contribute to the costs of assets as they receive the benefits of those investments.

In most cases, this means that capital costs are recovered through customer prices over multiple regulatory periods. This can also be described as inter-period smoothing.

This approach is well established in regulated utility industries, and forms a key part of the building block methodology used by the Commission to calculate maximum prices (see chapter 1). Businesses are not disadvantaged under this approach as they are allowed to generate a return on their investment (which includes a component to cover estimated costs of finance) and a return of their investment (through a depreciation allowance) over the assets life.

This central regulatory principle underpinned the Commission's consideration of the appropriate treatment of Melbourne Water's desalination security costs in the draft decision.

3.2.2 DESALINATION PROJECT MANAGEMENT COSTS

Melbourne Water proposed operating expenditure to recover approximately $8 million in project costs associated with the desalination plant in each of the final two years of the next regulatory period. The payments are made to DEPI in return for project management services.

On the basis of advice provided to the Commission by DEPI, the Commission's draft decision proposed not to include the proposed additional costs for desalination project management in Melbourne Water's revenue requirement. The proposed adjustments to Melbourne Water's revenue requirement are shown in table 3.1.

TABLE 3.1 ADJUSTMENTS TO DESALINATION PROJECT MANAGEMENT COSTS – DRAFT DECISION
$m 2012-13

	2013-14	2014-15	2015-16	2016-17	2017-18
Proposed	0	0	0	8.2	8.0
Draft decision	0	0	0	0	0
Difference	0	0	0	-8.2	-8.0

Commission’s assessment and final decision

The Commission notes that there were no comments from stakeholders in relation to the draft decision on Melbourne Water’s recovery of desalination project management costs. For the final decision, the Commission confirms its draft decision not to provide for the recovery of additional desalination project management costs in Melbourne Water’s prices.

The remainder of this chapter therefore focuses on the regulatory treatment of Melbourne Water’s desalination security costs.

3.3 RESPONSES TO THE DRAFT DECISION

3.3.1 MELBOURNE WATER

Melbourne Water’s response to the draft decision was informed by consultation with interested parties and consideration of its financial position.

Consultation

Melbourne Water’s consultation included a series of end-use customer focus groups (conducted by a research agency engaged by Melbourne Water) to explore community views on options for the treatment of its desalination security costs.

These focus groups compared the trade-offs associated with selected options for the treatment of the desalination security costs in relation to bill impacts and

Melbourne Water's financial position. The options and information presented to focus group participants is summarised in table 3.2.

The research concluded that 58 per cent of focus group participants did not support capitalisation (albeit on a very small sample of 102 end-use customers).[20] More information is available in the report prepared for Melbourne Water on this matter (available on the Commission's website).[21]

TABLE 3.2 FOCUS GROUP OPTIONS FOR CAPITALISATION

Blue (No Capitalisation)	• 27 years (desalination costs recovered over the contract life) • $1,100 avg annual water bill • $4.8 billion in borrowing for MW by the end of year 5 • $37 million profit average per year
Purple (Capitalisation)	• 50 years (desalination costs recovered over the period for which benefits are received) • $1,090 - $1,095 avg annual water bill • $4.9 billion in borrowing for MW by the end of year 5 • $25 million profit average per year
Yellow (Capitalisation)	• 50 years (desalination costs recovered over the period for which benefits are received) • $1,100 avg annual water bill first 2 years • $1,100 -$1,090 avg annual water bill year 3 • $1,090 -$1,085 avg annual water bill year 4 • $1,085 -$1,075 avg annual water bill year 3 • $4.9 billion in borrowing for MW by the end of year 5 • $25 million profit average per year

Source: TKP.[22]

Melbourne Water noted consumer representative groups indicated a clear preference for the lowest price outcome. Ai Group indicated to Melbourne Water that its members (a range of manufacturing and service firms) are facing significant competitive pressure and put a strong value on upfront price reductions. Ai Group's view was that its members would place more importance on the pricing benefits of inter-period price smoothing.

[20] Capitalisation smooths a businesses' recovery of expenditure over multiple years or regulatory periods (see box 3.1). Capitalised expenditure earns a return on investment and a return of the investment through depreciation.

[21] TKP 2013, *Desalination security payment community engagement*, May.

[22] TKP 2013, *Desalination security payment community engagement*, May, p. 3.

Approach to desalination security payments

Based on its consultation and an assessment of its financial position by KPMG, Melbourne Water presented two proposals in response to the Commission's draft decision. Its first option involved some capitalisation of security payments. The second option suggested additional funding for supporting vulnerable customers. Melbourne Water stated emphatically that the two proposals were mutually exclusive.

1 Smoothing the recovery of desalination security costs

Melbourne Water responded to the Commission's draft decision with two options for smoothing the recovery of its desalination security costs through capitalisation.

Under its preferred approach, Melbourne Water proposed to capitalise $140 million of its desalination security payments over the third regulatory period. Capitalisation starts in 2015-16 at $22.5 million, rising to $45.0 million in 2016-17 and $72.5 million in 2017-18. The estimated reduction on a typical bill (compared with a no capitalisation scenario) is $55 over the next five years or $11 per year.

Melbourne Water stated that this capitalisation approach was based on the condition that the Commission would support other aspects of its response to the draft decision – namely, the reinstatement of a greater amount elsewhere in its revenue allowance.

Table 3.3 summarises Melbourne Water's estimates of the impact of its preferred option on its financial position over the ten years from 2013-14. Melbourne Water noted that care needs to be taken when using the estimates beyond 2017-18 as they are highly dependent on assumptions about the future.

The data supplied by Melbourne Water suggests there is little correlation between the amounts being capitalised each year and movements in other key indicators. Melbourne Water forecast its net profit after tax to remain above $20 million over the period from 2013-14 to 2017-18, before rising relatively strongly to more than $200 million by 2022-23. Interest cover is estimated to remain at 1.6 in each year from 2013-14 to 2018-19, before increasing to 2.0 by 2022-23.

Melbourne Water considered that its preferred approach is consistent with the WIRO, the Commission’s draft decision, and would mitigate price volatility by limiting the need to reopen its price determination.

TABLE 3.3 MELBOURNE WATER'S PREFERRED APPROACH TO INTER-PERIOD SMOOTHING: ESTIMATED FINANCIAL INDICATORS – 2013-14 TO 2022-23

	2013-14	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20	2020-21	2021-22	2022-23
Amount capitalised ($2012-13)	0	0	22.5	45.0	72.5	72.5	72.5	72.5	72.5	72.5
Cash - Interest Cover (times)	1.6	1.6	1.6	1.6	1.6	1.6	1.7	1.8	1.9	2.0
Gearing (%)	66.2	66.6	66.8	66.9	66.6	67.3	67.6	67.4	67.0	66.3
Net Profit after Tax ($m nominal)	30.3	34.3	23.8	26.8	22.0	28.7	62.6	104.4	158.8	220.2
Total Borrowings ($m nominal)	4312.1	4560	4778.7	4896.1	4896.7	5229.3	5442.1	5466.1	5475.6	5385.9
Movement in Borrowings[a] ($m nominal)	129.8	247.9	218.7	117.4	0.5	332.7	212.8	24.0	9.4	-89.7

Source: Melbourne Water submission.

[a] Total borrowing figures exclude desalination finance lease.

Melbourne Water proposed that an alternative capitalisation option would apply were the Commission not to accept all its other revenue claims and maintain a revenue stream that reflects the draft decision. Capitalisation would start in 2016-17 at $25 million, rising to $30 million in 2017-18. The estimated reduction on a typical bill (compared with a no capitalisation scenario) would be $20 over the next five years (or $4 per year).

Estimates of key financial indicators for the period from 2013-14 to 2017-18 are similar to outcomes under Melbourne Water's preferred option above, albeit net profit after tax is lower (but positive) in each year and total borrowings higher. For more detail, see page 55 of Melbourne Water's submission.

2 Supporting Vulnerable Customers proposal

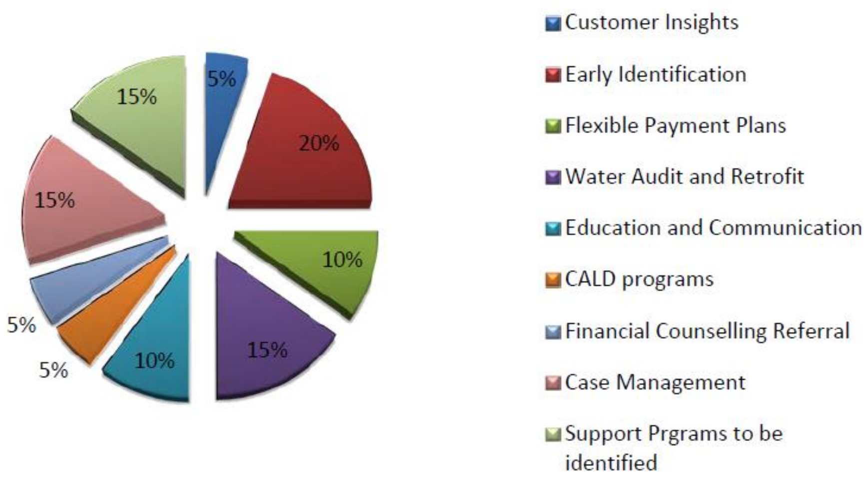
In its submission, Melbourne Water stated that if the Commission were not to approve its proposal for capitalisation, it would provide funding to the retailers in support of programs to assist vulnerable customers.

On 31 May 2013, Melbourne Water submitted a joint proposal with the greater metropolitan water businesses in which it suggested it could fund an extension of retailer support for low income and vulnerable customers. This submission is available on the Commission's website.

Under the proposal, Melbourne Water would provide the retailers with $10 million between 2013-14 and 2017-18 (which would not be reflected in its cost base and therefore, prices), to add to existing programs and provide additional targeted support. The funding provided by Melbourne Water would be in addition to the $5 million allowance the Commission proposed to approve in retailer prices in its draft decision (chapter 4). The proposed allocation of the total funds ($15 million) is summarised in figure 3.1.

FIGURE 3.1 FUNDING ALLOCATION – SUPPORTING VULNERABLE CUSTOMERS PROPOSAL

Per cent



Source: Melbourne Water.

The businesses provided the following key arguments in support of the Supporting Vulnerable Customers proposal:

- Capitalisation delivers a small benefit to all customers whereas the Supporting Vulnerable Customers proposal delivers a much larger benefit to the people who will be most adversely affected by the price rise.
- Based on Melbourne Water's focus group research, the majority of customers support paying for the desalination plant over the 27 year contract period (in other words, the majority of customers do not support smoothing the recovery of Melbourne Water's desalination security costs).
- The Supporting Vulnerable Customers proposal meets the requirements of the WIRO.
- The Supporting Vulnerable Customers proposal provides Melbourne Water with the funds to meet desalination payment requirements while not adding to the State government's debt burden.
- The Supporting Vulnerable Customers proposal has the support of a number of key welfare groups.

3.3.2 OTHER SUBMISSIONS

In addition to the joint Supporting Vulnerable Customers proposal, the greater metropolitan water retailers provided separate submissions to the Commission.

City West Water indicated that it supports both the capitalisation options put forward by Melbourne Water and the additional hardship program funding.[23] South East Water—similar to Western Water—did not oppose capitalisation but expressed support for additional funding for hardship:

> *The benefits of this proposal are that it could potentially provide a larger benefit to those in need rather than a smaller benefit to all customers and will not require Melbourne Water to increase debt levels.*[24]

Yarra Valley Water was the only retailer that did not support the capitalisation of Melbourne Water's desalination security costs.

The Commission received a number of submissions from customers and consumer groups supporting the lowest possible price outcome.

The Consumer Action Law Centre (CUAC), Consumer Utilities Advocacy Centre (CUAC) and Victorian Council of Social Service (VCOSS) joint submission (supported by Community Information and Support Victoria, Good Shepherd Youth and Family Services, and National Seniors Australia) commented on Melbourne Water's focus groups (which were discussed in section 3.3.1).

While the joint submission complimented Melbourne Water on its efforts to consult with end-use customers, it was concerned with several elements of the focus groups. In their view, the information presented to participants was complex and would be difficult for consumers to absorb in the time provided. CALC, CUAC and VCOSS considered that the relevance of debt and Melbourne Water's profits or losses to the smoothing of Melbourne Water's recovery of its desalination costs would have been difficult for focus group participants to grasp.

[23] City West Water 2013, *Response to Commission's Draft Decision*, May, p. 2.

[24] South East Water 2013, *South East Water Response to 2013 Water Price Review*, May, p. 14.

The submission also noted that some of the images used to present information to customers were potentially leading. The joint submission concluded that the outcomes from the focus group process were therefore undermined.

The joint submission also considered the merits of smoothing Melbourne Water's recovery of desalination security costs. The submission noted that:

- The Commission should focus on minimising price increases for all customers.
- Melbourne Water should capitalise as much of the security payments as possible without jeopardising its financial stability.
- Matching the benefits and costs of a service over time is an efficient way of paying for services.
- A key role of utilities such as Melbourne Water is to shoulder risk on behalf of consumers.

The joint submission considered that it was appropriate for Melbourne Water to capitalise a proportion of its desalination security costs, and provide additional funds for retailers to better support customers in hardship (in addition to the $5 million allowed by the Commission in its draft decision).

3.4 COMMISSION'S ASSESSMENT

The Commission's draft decision required Melbourne Water to resubmit its proposal for the recovery of its desalination security costs demonstrating it has taken into account the requirements of the WIRO, *Water Industry Act* 1994 and the *Essential Services Commission Act* 2001. The Commission's draft decision required Melbourne Water to consult widely in developing its response.

3.4.1 CONSULTATION

The Commission considers that Melbourne Water attempted to consult as much as possible in the limited time available since the Commission's draft decision, when the Commission indicated it was not satisfied with the quality of analysis Melbourne Water had submitted in its Water Plan. The Commission notes the following comment from CUAC, CALC and VCOSS:

> *We were given the opportunity for genuine exchange to better understand Melbourne Water's drivers and options under consideration.*[25]

Nevertheless, the Commission notes the concerns raised by CUAC, CALC and VCOSS about the complexity of the material presented to customers during the focus groups.

The Commission also considers that the capitalisation options presented to customers were limited due to the exclusive priority Melbourne Water placed on satisfying financial conditions such as maintaining a profit in each year of the next regulatory period. While the Commission acknowledges profit is important, other factors such as the regulated nature of Melbourne Water's business and the regulatory safeguards it affords to the water businesses should also have been given emphasis. The narrow focus on annual accounting profits constrained the options presented to customers. It also prevented exploration of the trade-off specified in the Commission's draft decision: namely, the trade-off between smoothing (lower prices) and subsequent possibility of prices increasing erratically.

For these reasons, the Commission considers the focus group findings, while of interest, cannot be relied upon to represent end-use customer views regarding the merits or otherwise of inter-period smoothing of Melbourne Water's desalination security costs.

[25] CUAC, CALC and VCOSS 2013, *Price Review 2013: greater melbourne water business – draft decision*, May, p. 3.

3.4.2 THE CONDITIONAL APPROACH BY MELBOURNE WATER

Obligations under the WIRO propose-respond model

The WIRO establishes a 'propose and respond' model of economic regulation. Under its pricing framework, water businesses must propose prices for the next regulatory period and provide supporting information (such as proposed expenditure, major projects and tariff structures). The role of the Commission is to decide whether or not to approve proposed revenues and prices.

The pricing framework relies on businesses proposing maximum prices, indicating their preferences without ambiguity, and providing information that enables the Commission to make an informed decision. Doing so means that businesses are rightly responsible for their Water Plan proposals, including the services to be delivered and the prices charged for those services.

The Commission considers that Melbourne Water has not fully discharged its obligations under the pricing framework due to the conditional nature of its proposals; the conditions being that it has:

- proposed that the Commission approve either (i) capitalisation of a proportion of its desalination security payments or (ii) additional support for hardship/vulnerable customers, and
- proposed amounts for capitalisation that are conditional on the Commission's favourable decisions in relation to other determinants of its allowed revenues (for example, the weighted average cost of capital should not change from its draft decision, and expenditure related to other proposed projects are endorsed by the Commission in its final decision).

In response to the first set of conditions, the Commission considers that Melbourne Water, in failing to make a clear recommendation on its preferred approach to the treatment of its desalination security costs, has inappropriately deferred consideration of the issue to the Commission. Failure by businesses to present clear, unambiguous proposals undermines their accountability to their customers, shareholders and the community more broadly. Deferring such decisions to the Commission confuses the role of the regulator with the role of the Board and management of Melbourne Water. Businesses are best placed to consider the options, trade-offs, and provide the information that enables the Commission to decide whether to approve or not approve the proposals of the water businesses, in line with the requirements of the regulatory framework.

The second set of conditions, which inappropriately seek to link capitalisation with the Commission's final decision on Melbourne Water's revenue allowance, is similarly disregarding of the regulatory framework and its focus on outcomes. Melbourne Water has neither explored nor clearly demonstrated the financial outcomes it claims constrain its options regarding the capitalisation of some proportion of the desalination security payments. To the extent that these constraints included matters pertaining to statutory accounting treatments, Melbourne Water neither explained why these concerns were of relevance to a regulatory decision nor demonstrated that it had explored other options to ameliorate its concerns.

The Commission finds that the conditional approach adopted by Melbourne Water fails to uphold the requirements of the regulatory framework. On this basis, the Commission does not consider itself bound by the conditionality asserted by Melbourne Water.

Below, the Commission addresses the various aspects of Melbourne Water's proposal, on their own merits as required by the WIRO.

Inter-period smoothing of the recovery of desalination security costs

The Commission's draft decision outlined a scenario under which inter-period smoothing of Melbourne Water's recovery of desalination security payments could be achieved through capitalising 15 per cent (or around $90 million per annum on average) of Melbourne Water's annual payments. This was based on the findings of a Preliminary Report prepared for the Commission by Deloitte.[26]

Melbourne Water's response to the draft decision argued that it could only sustain a lower amount of capitalisation. It argued this was an adequate response given: its customer consultation, expert financial advice, and the WIRO requirements.

Following Melbourne Water's response to the draft decision, the Commission engaged Deloitte to undertake a further review of Melbourne Water's capacity to smooth the recovery of its desalination security costs through capitalisation, having regard for Melbourne Water's financial viability. The Deloitte report is available on the Commissions website.[27]

[26] Deloitte 2013, *Desalination capitalisation scenarios*, April.

[27] Deloitte 2013, *Desalination capitalisation scenarios*, June.

Deloitte's analysis and the Commission's review considered the following significant changes to financial parameters since the release of the Commission's draft decision (and Deloitte's Preliminary Report):

- The Commission has reduced the weighted average cost of capital from 4.7 per cent in the draft decision to 4.5 per cent in the final decision.

  All things being equal, the impact of this change reduces Melbourne Water's revenue by around $100 million over the next five years.

- Melbourne Water has revised down its forecast income from developer contributions.[28]

  The revenue impact of this change on Melbourne Water is claimed to be around $70 million over the next five years.

- Melbourne Water had rephased its capital expenditure program, increasing expenditure in the early years of the regulatory period without explanation. This revision would have had the effect of limiting Melbourne Water's capacity to capitalise costs associated with the desalination plant.

  When this rephasing was questioned by the Commission, Melbourne Water reverted to the capital expenditure profile in the draft decision.

- An adjustment by Melbourne Water to the timing of cash flow associated with the goods and services tax (GST).[29]

  The GST adjustments reduce Melbourne Water's forecast cash flow by around $480 million over the next five years. This was partly offset by other adjustments which had a positive impact on cash flow (in net terms, these adjustments reduce overall cash flow by around $335 million over the next five years).

In the context of assessing the scope for inter-period smoothing of the desalination security payments, the updates by Melbourne Water to the timing of cash flows associated with the GST are significant. Melbourne Water's written response to the draft decision did not disclose the updates, save for including the revised amounts in financial templates. As a consequence, in the time available prior to the final decision, neither Deloitte nor the Commission had the opportunity to establish the reasonableness of these changes to inform the final decision.

[28] This change was noted in Melbourne Water's response to the draft decision.

[29] These updates were included in the detailed financial model provided to the Commission with Melbourne Water's response to the draft decision.

In the limited time available to it, Deloitte had no option but to take Melbourne Water's material but unexplained adjustments as given. It concluded that capitalisation of $50 million to $100 million in the next regulatory period represents the largest amount that Melbourne Water could reasonably support. The scenarios modelled by Deloitte focused on capitalisation commencing in 2015-16 or 2017-18, consistent with Melbourne Water's proposal.

Deloitte noted that if it reversed some of Melbourne Water's unsubstantiated adjustments, it may be possible to accommodate capitalisation of $140 million over the five years from 2013-14.

The Commission considers that given their materiality, Melbourne Water had an obligation to justify transparently the changes to its capital cash flow assumptions in its response to the draft decision.

Having regard to the likely timing of any possible capitalisation and the Commission's inability to rely on Melbourne Water's financial data without further forensic analysis, **the Commission's final decision is to approve prices that reflect no capitalisation of Melbourne Water's desalination security payments.**

The Commission's draft decision provisionally approved prices for Melbourne Water (and the other greater metropolitan water businesses) for five years from 2013-14. Melbourne Water's failure to highlight and provide justification for the changes to its financial assumptions has meant the Commission is not yet in a position to properly assess any financial constraints to capitalisation (a key issue raised in the Commission's draft decision for substantiation by Melbourne Water).

Based on the analysis of Melbourne Water's data that has been possible in the time available, the Commission is satisfied that capitalisation will become increasingly sustainable from 2016-17. However, due to the quality of the data submitted, the Commission has not been able to form a view with sufficient confidence about the amount of capitalisation that will be possible from that date. Accordingly, **the Commission has approved Melbourne Water's prices for a three year period only (that is, to 30 June 2016)**. [30]

[30] Clause 7 of the WIRO states that '(t)he Commission must set the term of each regulatory period that commences on or after the commencement date of this Order.'

The Commission notes that Melbourne Water will retain the discretion to capitalise some proportion of its desalination payments ahead of that time should its finances permit. Melbourne Water may also be able to achieve stronger financial outcomes during that time than it has assumed in the financial model submitted to the Commission.

The Commission further notes that given the community response to the recent over-recovery of desalination costs, customers are likely to view favourably any pass-though of unexpected financial gains by Melbourne Water voluntarily lowering prices through an earlier than expected capitalisation. Lower bulk water prices could be passed through to the retailers, and in turn, to end-use customer prices through the adjustment mechanisms approved in the Commission's final decision (chapter 20).

Assessment against the WIRO

In arriving at its final decision, the Commission has considered carefully that its approach satisfies the WIRO, the interests of customers, and the financial viability of Melbourne Water.

For the avoidance of doubt, the Commission considers that the interests of customers (including low income and vulnerable customers) are best supported by Melbourne Water smoothing the recovery of its desalination security payments over a period that matches the plant's life. This is consistent with the principle that customers contribute to the cost of assets as they receive the benefits of those investments. The Commission notes this is consistent with the CALC, CUAC and VCOSS submission which considered that matching the benefits and costs of a service over time is an efficient way of paying for services.

The Commission's cautious approach reflects the substantial weight it places on ensuring the financial viability of water businesses as required by the WIRO. Overcoming this cautiousness has not been assisted by Melbourne Water's response to the draft decision.

Supporting Vulnerable Customers

The Commission's draft decision provided an aggregate revenue allowance of $5 million for the metropolitan water retailers to review and expand hardship policies to provide support to customers experiencing financial hardship. This recognised the impact of large one-off price increases provisionally approved in the draft decision.[31] The Commission's final decision has confirmed this revenue allowance, as well as $250 000 for Western Water which was not allowed for in the draft decision (see chapter 4).

The Commission's customer service code requires that retail water businesses have policies that detail procedures for assisting residential customers experiencing financial hardship. That is, assistance for customers experiencing financial hardship is an obligation for the retail water businesses.

The Commission notes the work undertaken by the greater metropolitan water businesses to identify improvements to the approach to addressing customer financial hardship, as outlined in the Supporting Vulnerable Customers proposal. This proposal relies on Melbourne Water contributing $10 million to retailers. However, it was not being proposed that this funding would be reflected in prescribed costs, and regulated revenues or prices. Moreover, the Commission notes that there is no relationship between the payment of $10 million to the retailers and operational efficiencies for Melbourne Water.

On the grounds that the proposed expenditure does not require regulatory consideration of matters pertaining to Melbourne Water's regulated revenues or its operational efficiency, there are no grounds for the Commission to consider the proposal as part of its price determination. The proposal is rightly considered as a 'voluntary' payment by Melbourne Water to the retailers. Whether, and on what conditions, it chooses to make such a payment is a matter solely in the discretion of its Board and management. It is not a regulatory matter.

Although the Supporting Vulnerable Customers submission lacked sufficient details about the programs that would be involved, or the improved outcomes that were being sought, by virtue of the proposed additional expenditure, the Commission expects that the insights gained in preparing the submission will be used to more effectively direct the retailers' existing programs (as well as the additional $5 million allowed by the Commission — see chapter 4 for further discussion).

[31] Appendix B of the Supporting Vulnerable Customers proposal submitted by the greater metropolitan water businesses noted that they anticipate an increase of up to 30 per cent in the number of vulnerable and hardship customers who will be directly impacted by the large price increase in 2013-14.

3.5 FINAL DECISION

The Commission's final decision has approved:

- prices for Melbourne Water (and therefore, the other greater metropolitan water businesses) incorporating no capitalisation of the security payments and
- a three year regulatory period for Melbourne Water (that is, to 30 June 2016).

4 CUSTOMER SUPPORT

4.1 INTRODUCTION

Currently, there are a number of programs available to assist customers with their water and sewerage bills, including government initiatives and water businesses' hardship policies.

While the Commission has proposed to moderate the high price increases proposed by the metropolitan water businesses, the impact of a large one off price increase could still be significant for many Victorian households and small businesses. The Commission understands the increases in water and sewerage prices could materially affect the affordability of water bills for low income and vulnerable customers.

4.2 OVERVIEW OF DRAFT DECISION

As part of the draft decision, the Commission considered the joint submission from customer groups: Customer Action Law Centre, Customer Utilities Advocacy Centre, Community Information and Support Victoria, and the Financial and Consumer Rights Council, which stated:

> *We are concerned that insufficient attention has been given to affordability issues in the water plans. We urge the Commission to ensure that there is an appropriate price path to ameliorate the impact of the proposed price increases and that the hardship support proposed by the water retailers is adequate to address the substantial price rises. We are of the view that all water retailers should be addressing hardship as*

a specific issue in their water plans and specifying additional hardship support, in light of the large price rises.[32]

In the draft decision, the Commission agreed that the water businesses had paid insufficient attention to matters of hardship in light of the large one-off price increases being proposed by the retailers. The Commission emphasised the importance of businesses ensuring customers experiencing payment difficulty, whether temporarily or permanently, receive assistance and are treated fairly.

In an effort to address this shortcoming, the Commission allowed some additional revenue in the first year of the regulatory period to enhance hardship support programs. The Commission proposed to allow an additional $5 million for the metropolitan retailers in 2013-14 — City West Water ($1 million), South East Water and Yarra Valley Water ($2 million each) — to assist low income and vulnerable customers in managing the impact of the proposed price increases. In addition, the Commission's draft decision significantly moderated the price increases proposed by the water businesses.

As a result of the additional revenue allowance, the Commission required these businesses in the first year of the review period to:

- review their hardship policies
- step up efforts to provide readily accessible support and
- demonstrate how the funds will be used to improve support for low income and vulnerable customers experiencing hardships.

At the time of the draft decision, the Commission did not provide an additional hardship revenue allowance for Western Water because the Commission had proposed to approve significantly lower water price increases for its customers.

[32] Customer Action Law Centre, Customer Utilities Advocacy Centre, Community Information and Support Victoria and the Financial and Consumer Rights Council 2013, *Submission to the water price review,* 25 January, p 3.

4.3 SUBMISSIONS AND COMMISSION'S ASSESSMENT

The Commission received submissions from customer groups supporting the additional revenue allowance to boost programs to assist low income and vulnerable customers. It also received submissions from the water businesses accepting the additional allowance.

4.3.1 CUSTOMER SUBMISSIONS

The submissions from the Energy and Water Ombudsman Victoria (EWOV) and the joint customer submission from the Consumer Action Law Centre, the Consumer Utilities Advocacy Centre and the Victorian Council of Social Services (joint Consumer Action submission) strongly supported the Commission's proposal to provide an additional $5 million to assist retailers to support low income and vulnerable customers.

EWOV considered a mid-year review would be helpful to check how the extra funds were being used.[33] It also suggested the water corporations' credit and hardship departments strengthen their exchange of information to ensure hardship customers were identified quickly and appropriately.

The joint Consumer Action submission suggested the Commission extend the additional expenditure beyond the first year of the review period because some customers may need assistance and support in later years.[34] Further, it supported the Commission's proposal to monitor the water businesses' efforts in providing accessible support for customers experiencing hardship and requested that these reports are made available to the public.

The joint Consumer Action submission also suggested City West Water include 'more innovative measures' to complement its current hardship assistance, such as the hardship relief fund, conservation plumbing scheme, special circumstances customer listing and retrofits.

[33] Energy and Water Ombudsman Victoria 2013, *Submission to the Water Price Review draft decision 2013-18*, 16 May.

[34] Consumer Action Law Centre, Consumer Utilities Advocacy Centre and Victorian Council of Social Services 2013, *Submission to the Water Price Review draft decision 2013-18*, 21 May.

The joint Consumer Action submission also recommended all water businesses consider the following hardship measures:

- personal line of credit for customers (allowing customers a personalised smooth price path)
- debt waiver and incentives
- shorter billing frequency
- processes that make it easier for customers to arrange extensions (for example, calling a number to auto-arrange a payment extension without requiring the customer to speak to a customer service member)
- ensuring customers already in the hardship program receive additional support so they do not fall into more arrears when the price rise comes into effect
- seize opportunities to have discussions with customers about water efficiency
- monitor customers' (not just customers experiencing hardship) bill payments and flag accounts where payments have been late and
- train staff to be aware that a customer who calls about a 'high bill' might actually be experiencing payment difficulty (they may not belong to the 'traditional' low income and vulnerable category).

4.3.2 RESPONSES TO DRAFT DECISION

Greater metropolitan water businesses

In response to the draft decision, the four greater metropolitan water businesses formed the Vulnerable Customer Taskforce, an industry wide taskforce to support vulnerable customers, comprising senior representatives from the water businesses and CEOs from the Good Shepherd Youth and Family Service, Kildonan Uniting Care and the Adult Multicultural Education. The taskforce aims to research and develop additional measures to support low income and vulnerable customers and identify best practice programs to assist these customers.

Further, South East Water and Yarra Valley Water stated they will provide additional support measures for vulnerable customers.

South East Water submitted it is increasing customer support through the following initiatives:

- offering residential customers choice in timing of payments — fortnightly or monthly — to give them more flexibility and budgeting certainty
- giving customers on mySouthEastWater the ability to arrange payment plans and request payment extensions without the potential embarrassment of having to speak with someone
- proactively identifying customers regularly requesting more time to pay with outbound contact to establish potential hardship and support requirements
- strengthening partnerships with community service organisations, including financial counsellors, to better understand customers in need and find effective ways to help
- investing in additional training for front line staff to assist customers in need and handle difficult conversations and
- contributing to public forums to provide information and resources across a range of topics, such as budgeting and water efficiency.

Yarra Valley Water stated it would continue to promote its hardship programs through community engagement forums, welfare providers and outreach programs.

Western Water

In response to the draft decision, Western Water requested $50 000 each year to address programs directed to vulnerable and hardship customers within the businesses' region as it was not included in the original $5 million proposal. It argued its customer base is particularly vulnerable to pricing changes and therefore require special attention.

4.3.3 COMMISSION'S ASSESSMENT

The Commission has reviewed the information provided by the greater metropolitan water businesses and provides its assessment below.

Greater metropolitan water businesses

In its draft decision, the Commission emphasised the additional $5 million revenue allocation was to review and expand hardship policies to provide support to customers experiencing hardship due to the impact of large one-off price increases. The Commission notes the initial steps taken by the water businesses to review their hardship policies.

In a subsequent joint proposal made by Melbourne Water and the greater metropolitan water businesses, Melbourne Water proposed to contribute $10 million to the water businesses to provide support for hardship and vulnerable customers— see chapter 4 for further details. Under this proposal, the businesses would combine the initial $5 million revenue allocation with Melbourne Water's $10 million contribution, and in the first year, this money would be used to gain insights, through research, into vulnerable customers and their needs for financial assistance.

The Commission considers any research about hardship policies undertaken by the businesses should be internally funded. The Commission also considers this joint proposal lacked sufficient details about the programs that would be involved, or the improved outcomes that were being sought.

The additional $5 million revenue allocation should go into customer programs with verifiable and reportable outputs. Businesses will be expected to use this additional revenue allocation to enhance existing hardship policies, expand programs, adopt best practice and improve associated infrastructure. Businesses should consult with customer and welfare groups and are encouraged to consider the hardship assistance proposals proposed by the EWOV and in the joint Consumer Action submissions to improve on or expand current programs. The extra revenue allocation is not intended for direct financial customer assistance.

Further, in response to customer submissions the Commission accepts that vulnerable customers may need assistance that extends beyond the initial year's price increase. For this reason City West Water, South East Water and Yarra Valley Water will be allowed to phase the additional funding over the five year period in response to customers' needs.

Businesses will be required to update the Commission regularly (and make public) on how the additional $5 million is being spent during the third regulatory period.

Western Water

The Commission accepts Western Water's argument that its customer base is vulnerable to price increases and notes its final prices will be higher than those preliminarily approved in the draft decision. For these reasons, the Commission will allow $250 000 over five years to improve on or expand current hardship programs for vulnerable customers. This amount is consistent with the proportion of additional expenditure provided to the other metropolitan water businesses.

Similar to the other businesses, Western Water will be required to consult with customer and welfare groups and report to the Commission how the additional allowance is being spent over the regulatory period.

5 SERVICE STANDARDS AND GUARANTEED SERVICE LEVELS

5.1 INTRODUCTION

The Commission regulates standards and conditions for supplying retail water, sewerage and other declared services. Clause 15 of the Water Industry Regulatory Order (WIRO), states the Commission may specify standards and conditions of services and supply with which a regulated entity is obliged to comply in connection with its provision of declared services. It may approve standards set out in a water business's Water Plan, specify those standards in a code, or do both.

The Commission established a core set of service standards, based on consultation.

The Customer Service Code requires water businesses to propose targets for the core set of service standards, as well as any additional standards, in their Water Plans.[35] These service standard targets reflect the level of service businesses aim to achieve over the regulatory period. The core standards are listed in table 5.1.

The Commission has also required the greater metropolitan water businesses to implement a guaranteed service level (GSL) scheme. A GSL scheme is a financial mechanism that provides incentives for water businesses to meet defined service standards. The schemes involve businesses providing payments or rebates to customers that experience certain supply problems or do not receive defined levels of performance.

GSLs should reflect the most important aspects of service delivery identified by customers. GSLs should be based on customer consultation and be objectively

[35] Essential Services Commission 2012, *Urban water customer service code,* Issue No.8, June.

definable, easily understandable and able to be reported. Payment amounts must give businesses incentives to deliver appropriate service levels, not compensate the customer.

TABLE 5.1 CORE SERVICE STANDARDS — URBAN WATER BUSINESSES

Retail water
Number of unplanned water supply interruptions (per 100 kilometres)
Average time taken to attend bursts and leaks (minutes)
Unplanned water supply interruptions restored within [X] hours (per cent)
Planned water supply interruptions restored within [X] hours (per cent)
Average unplanned customer minutes off water supply (minutes)
Average planned customer minutes off water supply (minutes)
Average frequency of unplanned water supply interruptions (number)
Average frequency of planned water supply interruptions (number)
Average duration of unplanned water supply interruptions (minutes)
Average duration of planned water supply interruptions (minutes)
Number of customers experiencing [X] unplanned water supply interruptions in the year
Unaccounted for water (per cent)
Minimum flow rates at 20 millimetres (mm), 25 mm, 32 mm, 40 mm, 50 mm
Retail sewerage
Number of sewerage blockages (per 100 kilometres)
Average time to attend sewer spills and blockages (minutes)
Average time to rectify a sewer blockage (minutes)
Spills contained within [X] hours (per cent)
Customers receiving [X] sewer blockages in the year (number)
Retail customer service
Complaints to Energy and Water Ombudsman (Victoria) (EWOV) (per 1000 customers)
Telephone calls answered within 30 seconds (per cent)

5.2 OVERVIEW OF DRAFT DECISION

The Commission's draft decision noted businesses' targets for the core service standards should reflect their historical five-year average performance, unless otherwise justified (for example, to reflect customer feedback).

Generally, the Commission proposed to approve the service standards targets proposed by the greater metropolitan retail businesses. These businesses had generally proposed targets that were consistent with their historical five -year averages for each standard (consistent with the Commission's guidance to the water businesses).

Yarra Valley Water, City West Water, and Western Water each proposed at least one target that deviated from the historical five-year average performance. In most cases, businesses adequately explained the deviations from the historical average and the Commission proposed to approve the targets.

The Commission proposed to approve the GSL schemes proposed by the businesses. The Commission considered that the proposed GSLs and rebate amounts were consistent with the objectives of the GSL scheme and the Commission's guidance paper.

5.3 SUBMISSIONS AND COMMISSION'S ASSESSMENT

A joint submission from the Consumer Action Law Centre (CALC), the Consumer Utilities Advocacy Centre (CUAC) and the Victorian Council of Social Service (VCOSS) supported the Commission's decision on service standards and GSLs but reiterated a position expressed in CUAC and CALC's earlier joint submission that '…the regulatory regime should continually encourage business to improve service standards and efficiencies over time, rather than continuing to meet the average five-year standard'.[36]

The Commission has approved targets in line with the historical average, unless otherwise justified by the business. The Commission notes that continually improving service standards could result in upward pressure on customer prices.

The joint submission further noted GSL rebate levels should be periodically adjusted to ensure 'they do not lose their relative value'. The Commission has approved all payment levels for the third regulatory period. It considers that the rebate amounts provide sufficient incentives for the businesses to deliver appropriate service levels to all customers.

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[36] Consumer Action Law Centre, Consumer Utilities Advocacy Centre and Victorian Council of Social Services 2013, *Submission to the water price review draft decision 2013-18*, 21 May.

The Purple Pipe Association Inc.[37] (Purple Pipe) suggested the core set of service standards should include standards specifically relating to the supply and quality of recycled water. All metropolitan water businesses already include interruptions to recycled water supply in their definition of water supply interruptions in the context of service standards. The Commission did not modify the core set of service standards to include specific standards for recycled water.

Purple Pipe also suggested that businesses should incorporate GSLs relating to quality of recycled water (including such characteristics as turbidity, odour, pH, sulphur, salt and nitrogen content). The Commission has decided not to introduce these GSLs as the quality of recycled water is already regulated by the EPA and the Department of Health. None of the metropolitan businesses currently have GSLs in place relating to water quality.

In terms of the businesses' responses to the draft decision:

- Yarra Valley Water revised its target for 'average time taken to attend bursts and leaks Priority 3' to the five-year average.
- South East Water revised its standard for 'complaints to the Energy and Water Ombudsman of Victoria (EWOV) (per 1000 customers)' to bring it closer to the five-year average.
- City West Water noted that one target was listed incorrectly in the draft decision.
- Western Water accepted the Commission's draft decision on service standards without further comment.

The Commission is satisfied with the amendments to targets proposed by Yarra Valley Water and South East Water. The revisions imply that customer service levels will be maintained over the next regulatory period. The Commission has therefore approved the service standard targets proposed by the water businesses.

The service standard targets and GSLs the Commission approved will be published in a revised Customer Service Code after the final decision is released.

[37] Purple Pipe Association Inc., *Submission to the water price review draft decision 2013–18*, 17 May.

5.4 FINAL DECISION

The Commission has approved all service standard targets proposed by City West Water, South East Water, Western Water and Yarra Valley Water.

The Commission has approved all guaranteed service levels and rebate amounts proposed for City West Water, South East Water, Western Water and Yarra Valley Water. This will be reflected in the Customer Service Code.

All businesses are required to revise their Customer Charters to reflect the Commission's decision by 30 August, 2013.

6 OVERVIEW OF REVENUE REQUIREMENT

6.1 INTRODUCTION

The Commission must be satisfied maximum prices are set at a level that generates sufficient revenue for a water business to recover efficient costs of delivering services over a regulatory period. It must also ensure prices do not allow a business to collect revenue that reflects monopoly rents or inefficient expenditure.

The Commission used the 'building block' approach to derive forward looking estimates of the revenue that businesses require to deliver proposed service standards and outcomes over the regulatory period. Under this approach, the revenue requirement for a business reflects operating expenditure and a return on the regulatory asset value that is updated each year to reflect any additional capital expenditure (net of asset disposals, customer and government contributions), and regulatory depreciation. The Commission's guidance paper explains the building block approach in more detail.[38]

6.2 OVERVIEW OF DRAFT DECISION

In its draft decision, the Commission reviewed the businesses' assumptions about expenditure, demand and the return on and of assets for the third regulatory period. Each business's revenue requirement was adjusted to reflect the Commission's views at that time of the efficient level of revenue that would enable the businesses to deliver on their service obligations over the third regulatory period.

[38] Essential Services Commission 2011, *2013 water price review — guidance on Water Plans*, October, pp. 8–9.

6.2.1 MELBOURNE WATER

The Commission's draft decision proposed revenue requirement for Melbourne Water was $489 million (or 5.7 per cent) lower than that proposed by the business in its Water Plan.

The Commission was not satisfied that Melbourne Water's proposed approach to recovering desalination security payments met the requirements of the Water Industry Regulatory Order (WIRO). Nevertheless, for the draft decision, the Commission used Melbourne Water's proposed approach to estimate the revenue requirements for the metropolitan water businesses.

6.2.2 FOUR GREATER METROPOLITAN WATER BUSINESSES

The Commission's draft decision reduced the revenue requirement for the four greater metropolitan businesses compared with what the businesses proposed in their Water Plans. Over the five year regulatory period, the draft decision's revenue requirement for the four water businesses was $793.6 million (or 6.1 per cent) lower than that proposed by the businesses in their Water Pans.

6.3 IMPACT OF FINAL DECISION

For the final decision, the Commission has reviewed its draft decision on the businesses' assumptions and proposals, accounting for stakeholder submissions to the draft decision, businesses' proposed revisions to their expenditure, and new information received since the draft decision. It has also updated its calculation of the appropriate rate of return.

The Commission has shortened Melbourne Water's regulatory period to three years, for the reasons outlined in chapter 3. The final decision provides Melbourne Water with a total revenue requirement of $4.8 billion for its three-year regulatory period (table 6.1).

TABLE 6.1 MELBOURNE WATER'S REVENUE REQUIREMENT 2013-14 TO 2015-16 — FINAL DECISION
$m 2012-13

	2013-14	2014-15	2015-16	Total	2016-17	2017-18
Final decision	1 563.3	1 599.1	1 623.6	4 786.0	1 618.9	1 643.0

Note: Melbourne Water charges the retailers for services (and to a lesser extent Western Water), to recover its revenue requirement.

The final decision provides the four greater metropolitan water businesses with total revenue requirement of $12.1 billion for their five-year regulatory period, approximately $3 billion of which is for desalination costs. The total revenue requirement for each business is shown in table 6.2, which compares the businesses' proposals in their Water Plans, the draft decision and the final decision.

The revenue requirement for the four greater metropolitan water businesses includes assumptions about Melbourne Water's revenue requirement (as assessed during the price review) for 2016-17 and 2017-18 (these assumptions are shown in table 6.1).

TABLE 6.2 METROPOLITAN WATER RETAILERS' REVENUE REQUIREMENTS 2013-14 TO 2017-18 — FINAL DECISION
$m 2012-13

	Proposed by business	Draft decision	Final decision	Difference between draft and final decision	
					per cent
City West Water	3 157.2	2 926.1	2 917.5	–8.6	–0.3
South East Water	4 560.5	4 283.4	4 210.1	–73.3	–1.7
Yarra Valley Water	4 936.6	4 697.8	4 569.7	–128.1	–2.7
Western Water	405.1	358.4	368.4	10.0	2.8
TOTAL REVENUE REQUIREMENT — EXCLUDING MELBOURNE WATER	**13 059.30**	**12 265.66**	**12 065.66**	**–200.0**	**–1.6**

Note: Retailers charge end use customers to recover their revenue requirements. In turn, the retailers pay Melbourne Water for bulk water and sewerage services.

The lower revenue requirement for each business results in lower prices compared with the draft decision (see chapter 2).

Overall, the businesses' reduced revenue requirement in the final decision (when compared with the draft decision) was primarily driven by changed assumptions about the weighted average cost of capital (WACC), and therefore the cost of financing all of the businesses' assets. Given the large differences between the metropolitan retailers' regulatory asset bases (see chapter 9), the changed WACC assumptions have affected each business to a different extent.

Relevant adjustments are discussed in the following chapters:

- operating expenditure (chapter 7)
- capital expenditure (chapter 8)
- financing capital investments (chapter 9)
- new customer contributions (chapter 18).

7 OPERATING EXPENDITURE

7.1 INTRODUCTION

In their Water Plans, the greater metropolitan water businesses set out assumptions underpinning their forecast levels of operating expenditure over the next regulatory period. They also outlined the relationship between that expenditure and their delivery of obligations and service outcomes.

The Water Industry Regulatory Order (WIRO) requires the Commission to ensure the prices levied by the businesses provide them with a sustainable revenue stream that does not reflect monopoly profits or inefficient expenditure, and the manner in which prices are determined provides incentives for the businesses to pursue efficiency improvements over the regulatory period.[39] The Commission must also be satisfied that the proposed expenditure forecasts are efficient and account for a planning horizon that extends beyond the next regulatory period.[40]

The Commission assessed the businesses' operating expenditure by separately assessing the forecasts related to:

- bulk water charges and desalination payments
- business-as-usual expenditure, which incorporates the required productivity hurdle and is adjusted for growth relative to current expenditure
- additional expenditure required to meet new obligations (over and above business-as-usual expenditure)
- regulatory charges and the environmental contribution.

The Commission had regard to its consultant PricewaterhouseCoopers' (PwC) assessment of the businesses' operating expenditure forecasts. Each business was given an opportunity to respond to the consultant's expenditure assessment

[39] WIRO, clause 14(1)(a)(iii) and (iv).

[40] WIRO, clause 14(1)(b).

before the Commission released its draft decision. The consultant's report is available on the Commission's website (www.esc.vic.gov.au).

In the draft decision, the Commission sought to identify the extent to which the businesses' proposals reflected efficient levels of operating expenditure.[41] When it considered a proposal did not represent efficient expenditure, it recommended reducing or removing that expenditure and it made corresponding adjustments to reduce prices.

The operating expenditure adopted by the Commission does not represent the amount that a business must spend or allocate to particular operational, maintenance and administrative activities. Rather, it is a benchmark that represents assumptions about the overall level of expenditure to be recovered through prices, and that the Commission considers sufficient for the business to operate and to maintain services over the regulatory period.

If a business operates inefficiently or incurs additional expenditure on other activities, and its actual operating expenditure during the regulatory period exceeds the benchmarks used to set prices, then the business will bear those additional costs (rather than customers via higher prices). The converse is true if the business makes an efficiency gain during the regulatory period.

7.2 OVERVIEW OF DRAFT DECISION

In the draft decision, the Commission proposed to approve total operating expenditure over five years of $14.1 billion, which was around $683 million (or 4.9 per cent) lower than the total proposed by the water businesses in their Water Plans (table 7.1).

The difference was largely explained by adjustments to the businesses' bulk water and sewerage expenditure (which is expenditure that the businesses cannot directly control) to reflect the Commission's draft decision on Melbourne Water's bulk charges.

The significant controllable operating expenditure adjustments included defined benefits superannuation payments, energy costs, carbon tax related costs, water

[41] WIRO, clause 14(1)(b).

conservation and drought management costs, IT costs, hardship support, Melbourne Water’s waterways and drainage expenditure, and adjustments to operating expenditure related to capital expenditure.

The draft decision reduced Melbourne Water’s operating expenditure proposal by a total of $201 million, including $112 million in directly controllable costs.

Of the greater metropolitan retail water businesses, South East Water faced the largest proposed reduction in total operating expenditure, down $179 million (or around 5.2 per cent) from what it proposed. The draft decision proposed no adjustment to Western Water’s controllable operating expenditure, because the business’s proposed operating expenditure was less than the efficient level of expenditure assessed by the Commission’s expenditure consultant. The average reduction for the other businesses was around 5 per cent.

The Commission also adjusted the businesses’ forecasts to ensure regulatory licence fees and the environmental contribution was consistent with the latest advice provided by the relevant regulatory agencies.

TABLE 7.1 OPERATING EXPENDITURE, 2013-14 TO 2017-18 — DRAFT DECISION
$m 2012-13

	Total proposed by business	Total proposed in draft decision	Difference	
			$m	*per cent*
Melbourne Water				
Desalination payments	3 058.9	2 968.3	–90.5	–3.0
Controllable costs	1 983.3	1 871.5	–111.7	–5.6
Regulatory charges	10.2	10.8	0.7	6.5
City West Water				
Bulk charges	1 800.7	1 707.2	–93.5	–5.2
Controllable costs	539.3	501.4	–37.9	–7.0
Regulatory charges	88.6	88.5	–0.1	–0.1
South East Water				
Bulk charges	2 692.7	2 543.3	–149.4	–5.5
Controllable costs	607.3	589.1	–18.2	–3.0
Regulatory charges	144.7	133.0	–11.7	–8.1
Yarra Valley Water				
Bulk charges	2 753.1	2 607.6	–145.5	–5.3
Controllable costs	677.3	663.8	–13.4	–2.0
Regulatory charges	142.9	142.4	–0.5	–0.4
Western Water				
Bulk charges	61.7	50.8	–10.9	–17.7
Controllable costs	182.3	182.3	0.0	0.0
Regulatory charges	12.3	11.7	–0.6	–4.5

Note: Controllable operating expenditure represents the expenditure over which the businesses have direct control. It excludes regulated bulk water charges, licence fees paid to regulators and the environmental contribution.

7.3 RESPONSES AND COMMISSION'S ASSESSMENT

The businesses responded to the expenditure adjustments reflected in the Commission's draft decision by providing further information or arguments to support their original forecasts, further adjustments to their original forecasts, and errors or omissions identified by the businesses. The water businesses accepted the Commission's draft decision on non-controllable regulatory costs, which include licence fees and the environmental contribution.

In addition to the businesses' submissions, the Commission had regard to public submissions to inform its final decision. In particular, it received a joint submission on its draft decision from the Consumer Action Law Centre, the Consumer Utilities Advocacy Centre and the Victorian Council of Social Service, which stated:

> *In terms of operating expenditure, we welcome the Commission's proposal to reduce controllable operating expenditure by around $181m. In particular, the Draft Decision's reduced forecast labour and energy costs as well as the requirements around productivity and efficiency. We agree that it is incumbent on water businesses to expend no more than is efficient or necessary on operating costs, and that incentives to improve productivity and encourage good performance should thus be built into pricing determinations.*[42]

The Commission considered the businesses' responses to the draft decision and, when justified, adjusted the forecast operating expenditure for each business in this final decision.

The Commission assessed Melbourne Water's expenditure over the full five year period to provide indicative expenditure forecasts for 2016-17 and 2017-18. Expenditure for these two years will be reassessed for approval under Melbourne Water's Water Plan 4.

[42] Consumer Action Law Centre, Consumer Utilities Advocacy Centre and Victorian Council of Social Services 2013, *Submission to the water price review draft decision 2013-18*, 21 May.

7.3.1 ADDITIONAL INFORMATION IN SUPPORT OF WATER PLAN FORECASTS

All businesses provided additional information to support their Water Plan forecasts, mostly in response to direct requests in the draft decision. Table 7.2 shows the Commission's response to each of the matters raised by the water businesses.

TABLE 7.2 ADDITIONAL INFORMATION IN SUPPORT OF WATER PLAN FORECASTS

Business proposal	Commission response
Melbourne Water[43]	
Contract labour cost recovery — Melbourne Water requested additional expenditure of $15.86 million for real increases in labour costs for higher skilled contract labour, claiming these costs are not subject to the limits imposed by the government wages policy.	**Partly accepted** — The Commission accepts the contractor wages are not limited by the government wages policy, and asked PwC to review the proposed wages escalation rates. In conducting their analysis PwC used the Deloitte Access Economics report commissioned by the AER in the 2012 draft decision for SP AusNet for electricity, gas and water utility sector workers. The Commission accepts PwC's recommendation for real wage increases and has increased Melbourne Water's operating expenditure by an additional $9.89 million.

[43] Melbourne Water's adjustments account for the five year period.

Business proposal	Commission response
Energy — The business requested additional electricity generation costs $5.01 million and network charges $7.75 million to be consistent with the regional draft decision for known network charges increases.	**Partly accepted** — The Commission asked Deloitte to investigate Melbourne Water's requested electricity costs using the approach applied to the forecasts for the regional water businesses. The forecasts in the WSAA/SKM report[44] used to calculate Melbourne Water's energy costs were found to have overestimated energy costs when compared with the latest contract prices available and the reduced carbon price outlook post-2015. Deloitte recommended a net reduction in energy cost allowance of $0.192 million over the five year period.[45] This adjustment accounts for known increases in network charges and reductions in carbon price, as well as reductions in forecast energy requirements at the Eastern Treatment Plant.
Carbon tax scope 1 and scope 3 — In reassessing Melbourne Water's energy prices, the Commission also considered the changes to the carbon price outlook to reassess the allowance for scope 1 (direct emissions) and scope 3 (indirect emissions through supply chain) carbon tax costs.	**Adjusted** — The Commission asked PwC to update the carbon price outlook for post-2015 and to recalculate the allowances for Melbourne Water, following the Commonwealth Treasury's recent budget forecasts indicating a reduced carbon price. PwC's recommendation was to reduce the scope 1 allowance by $2.19 million and the scope 3 allowance by $1.49 million. The Commission accepted these recommendations and has reduced the operating expenditure allowance by $3.68 million.
Productivity requirement for 2012-13 — Melbourne Water questioned the Commission's productivity efficiency calculation method, and suggested the productivity adjustment should not apply for the 2012-13 calculations.	**Not accepted** — Melbourne Water had already raised this issue with PwC during the initial expenditure assessment, and the Commission confirmed PwC had correctly applied the productivity adjustment in 2012-13. The customer growth and productivity figures used to adjust the business-as-usual operating expenditure are both averages calculated across the period, applied each year. The Commission does not consider one should be applied without the other for any given year.

[44] Water Services Association of Australia 2012, *Energy price forecasts 2013 to 2032 report.*

[45] Deloitte 2013, *Melbourne Water energy costs report,* June.

Business proposal	Commission response
City West Water	
Energy – Carbon tax scope 3 — City West Water requested an additional $3.39 million over the regulatory period for price increases in supply chain costs incurred as a result of the carbon tax.	**Not accepted** — See discussion below for details.
Energy — City West Water requested additional energy costs ($0.44 million over the next regulatory period) relating to price increases due to the carbon tax for the Altona recycled water stage 2 project.	**Not accepted** — The Commission did not include the Altona project in the revenue requirement assumptions, so no adjustment is necessary. See chapter 8 for details.
Additional operating expenditure relating to alternative water — City West Water requested additional operating expenditure ($6.98 million over the regulatory period) for the re-instatement of the Altona recycled water stage 2 project.	**Not accepted** — The Commission did not include the Altona project in the revenue requirement assumptions, so no adjustment is necessary. See chapter 8 for details.
Water efficiency expenditure — City West Water provided the results of its customer willingness to pay survey. Based on the results of this survey it requested an additional $9.43 million over the next regulatory period.	**Partly accepted** — City West Water's original Water Plan included total expenditure of $12 million over the regulatory period. The Commission's draft decision allowed for $5.54 million, which was a benchmark amount recommended by PwC, because City West Water did not demonstrate the value of this expenditure to its customers. With the survey results now available, the Commission accepts the original Water Plan proposal of $12 million — an increase of $6.46 million on the draft decision.
Office relocation expenditure timing and costs for sublease — City West Water requested an additional $1.31 million over the next regulatory period to cover the costs of preparing for subleasing a portion of its new office space, and the removal of lease income for 2015-16.	**Accepted** — City West Water provided evidence of the value of the sublet space, the capital expenditure required to prepare the space for subleasing, and the sublease timing.

Business proposal	Commission response
South East Water	
Energy – real price increases should be allowed — South East Water requested $3.12 million for real cost increases in network charges, stating network charges were outside the control of the water businesses. The costs were based on the Water Services Association of Australia (WSAA) study prepared by SKM.	**Not accepted** — Deloitte's re-assessment of Melbourne Water's energy prices showed the WSAA/SKM forecasts are now outdated and overstate the increase in energy costs. It also showed the net change to the calculated energy prices was negligible after adjusting the scope 2 carbon tax allowance downwards to reflect the updated lower carbon price outlook post-2015. Given South East Water did not provide sufficient additional evidence of increases in input prices or breakdown of its costs (no contracts or contract negotiations for energy prices), the Commission considers no adjustment is necessary.
Energy – carbon tax scope 3 — South East Water claimed an additional $2.2 million over the regulatory period for increased prices in its supply chain due to the carbon tax. It based its supply chain increases on modelling using a carbon price of $23 per tonne.	**Not accepted** — See discussion below for details.
Agency fees for credit card collection — South East Water requested a change to the current arrangements for credit card fees. Currently the entire customer base covers the costs of these fees. South East Water proposed to pass on charges associated with service fees directly to those customers using credit cards from 2014-15. It asked for $0.3 million to cover 2013-14 until new arrangements are put in place.	**Accepted** — The Commission considers it efficient for the customers that benefit from credit card use to pay the associated fees. In the interim, the additional requested expenditure of $0.3 million is allowed for 2013-14. After that year, the Commission will allow for the pass through of credit card fees to those customers paying by credit card, so it removed the expenditure from 2014-15. The fee revenue collected will be considered non-regulated revenue.
Meter reading — South East Water requested an additional $0.15 million per year from 2013–14 for a new contract that was not in place in the 2011–12 base year.	**Accepted** — Based on updated information provided by South East Water, the Commission considered this cost to be additional to the 2011-12 baseline.
Western Water	
New electricity contract pricing — Western Water proposed a reduction of $2.1 million in operating expenditure resulting from the draft decision recommendation to use a revised quotation from Procurement Australia.	**Accepted** — The Commission has reduced the energy allowance by $2.1 million from the draft decision.

Business proposal	Commission response
Additional energy costs for increased demand and bulk water forecast changes in draft decision — Consistent with the additional bulk water purchases needed to meet the revised demand in the draft decision, the business requested additional electricity costs ($0.12 million) for the pumping and distribution of larger water volumes.	**Partly accepted** — The Commission recalculated the bulk water volumes, and has increased the draft decision energy allowance by $0.07 million.
Additional bulk water requirement to meet revised customer demand forecast — Western Water requested a bulk water expenditure adjustment to include the purchase of an additional 5055 megalitres from Melbourne Water to meet additional demand consistent with the draft decision.	**Partly accepted** — The Commission recalculated the bulk water volume requirement for Western Water. It decided to allow an increase of $3.2 million in the bulk charges expenditure adjustments (table 7.5).

CARBON TAX – SCOPE 3 EMISSIONS

In its draft decision, the Commission allowed Melbourne Water's proposed expenditure for scope 3 carbon tax emissions[46] (excluding those associated with the Victorian Desalination Plant), as recommended by its consultant PwC. Melbourne Water calculated the expenditure using carbon price forecasts from the WSAA/SKM report.[47] However, recent Commonwealth Treasury budget forecasts indicate a lower carbon price outlook from 2015-16 compared with the forecasts in the WSAA report, suggesting the expenditure allowed in the draft decision was overstated.

The Commission asked PwC to recalculate Melbourne Water's scope 3 emissions expenditure using the latest carbon price projections. The revised figure of $11.06 million is $1.49 million lower than the draft decision amount, and represents 0.6 per cent of Melbourne Water's total operating expenditure (excluding desalination payments). The Commission considers this cost impact is sufficiently material, so retains the draft decision to allow for this expenditure, but has adjusted the operating expenditure allowance to reflect the recalculated lower amount. If the

[46] Scope 3 carbon emissions are those indirect emissions associated with producing the goods and services that a business consumes.

[47] Water Services Association of Australia 2012, *Energy price forecasts 2013 to 2032 report.*

carbon tax changes over the period, the Commission may adjust both Melbourne Water's scope 1 and scope 3 allowances.

In response to the draft decision, both City West Water and South East Water claimed additional expenditure for their scope 3 emissions costs, citing Melbourne Water as precedent. Using the latest carbon price forecasts, PwC calculated City West Water's scope 3 costs to be 0.09 per cent of operating expenditure (excluding bulk charges) and South East Water's to be 0.25 per cent. The Commission considers annual consumer price index (CPI) adjustments will generally compensate for the secondary price impacts of the carbon tax as it works its way through the economy. The businesses have received some adjustments for scope 2 electricity prices and the impact through bulk prices. Given the uncertainty around future carbon pricing, and the very low proportion of revenue that this represents for these two businesses, the Commission did not include these costs in the operating expenditure allowance for City West Water and South East Water.

CUSTOMER GROWTH RATE REVISED FORECAST

A water business's operating costs generally increase as its customer base grows. The Commission thus uses an average annual growth rate (based on forecast customer numbers provided by the business) to adjust the business-as-usual operating expenditure.

In response to the draft decision, South East Water, Yarra Valley Water and Western Water each proposed a higher customer growth rate to calculate their business-as-usual operating expenditure allowance. However, they did not provide revised customer number forecasts.

The Commission considers changes in customer growth rates must be supported by evidence of changes to forecast customer numbers. Because it did not receive such evidence, the Commission retained for its final decision the customer growth rates that the businesses provided in their original Water Plans.

7.3.2 ERRORS OR OMISSIONS IN THE DRAFT DECISION

A number of businesses proposed adjustments that reflected errors or omissions in the operating expenditure analysis in the draft decision. The Commission reviewed the information provided, and any advice from the consultant, and adjusted the forecasts to reflect the changes in table 7.3.

TABLE 7.3 ERRORS OR OMISSIONS IN THE DRAFT DECISION

Business proposal	Commission response
Melbourne Water[48]	
Land tax payments — Melbourne Water sought to recover an additional $9.74 million (above the draft decision) for increases in land tax payments. It based this estimate on its original Water Plan submission, reflecting the land tax growth assumption in the Victorian Budget Papers.[49]	**Accepted** — The Commission asked PwC to recalculate Melbourne Water's estimated land tax payments using a revised rate of growth in land tax revenue based on updated Victorian Government forecasts. PwC compared its estimate with Melbourne Water's original Water Plan submission, which now appears reasonable. The Commission thus increased the draft decision allowance by $9.74 million, consistent with the original proposal.
Eastern Treatment Plant upgrade: maintenance expenditure increase — Melbourne Water requested an additional $1.72 million over the regulatory period for maintenance expenditure, to correct an error in its original submission.	**Accepted** — PwC confirmed the original input error in Melbourne Water's Water Plan, whereby real costs were taken to be nominal and deflated, rather than remaining steady in real terms. The correction resulted in an increase in operating expenditure.
City West Water	
Incorrect assessment of land tax — The business claimed the 2011-12 base year included a non-recurring negative operating expenditure of $238 800, which was a 2011-12 correction for over accrual of land tax in 2010-11. The business requested this amount be removed from the baseline, effectively increasing the baseline business-as-usual operating expenditure by $0.24 million.	**Accepted** — The Commission has added $0.24 million to the 2011-12 base year calculation. After adjusting for growth and productivity across the period, the net increase to operating expenditure is $1.29 million.
South East Water	
Bulk recycled water purchases from Melbourne Water — This expenditure is based on forecast recycled water volumes and Melbourne Water's bulk recycled water charge of $99.64 per megalitre and the business claimed it amounts to an additional $0.55 million over the next regulatory period.	**Accepted** — South East Water did not include this cost in its original Water Plan submission. In this final decision, the Commission allowed an increase of $0.55 million in the bulk charges expenditure adjustments (table 7.5).

48 Melbourne Water's adjustments account for the five year period.

49 Department of Treasury and Finance 2012, *Budget Paper no. 2: strategy and outlook*, May, p. 39.

Business proposal	Commission response
Western Water	
Southern Rural Water bulk charges — The draft decision had no allowance for bulk water charges for Western Water to purchase water from wholesaler Southern Rural Water. The business requested the final decision include an annual charge, totalling $8.3 million over the period.	**Accepted** — Southern Rural Water bulk costs were incorrectly excluded from the draft decision. The Commission included them in the final decision, as reflected in the bulk charges expenditure adjustments (table 7.5).

7.3.3 NEW EXPENDITURE ITEMS

In their submissions on the draft decision, some businesses proposed additional expenditure to their Water Plan proposals (table 7.4).

TABLE 7.4 NEW EXPENDITURE ITEMS

Business proposal	Commission response
South East Water	
Water (Estimation, Supply and Sewerage) Regulations 2013 — These Regulations are based on the *Water Amendment (Governance and other reforms) Act 2012*, which takes effect from late 2013. South East Water requested an additional $0.19 million per year and $0.15 million per year from 2013-14 for the replacement and maintenance respectively of service pipes greater than 50 mm, to comply with the new Regulations.	**Partly accepted** — The Commission has allowed the requested maintenance costs to be included in operating expenditure, but considered the replacement costs are capital expenditure. The Regulations commence part way through 2013-14, so the Commission has allowed $0.075 million for 2013-14 and then $0.15 million per year in operating expenditure. Likewise, $0.095 million capital expenditure has been allowed for 2013-14, and then $0.19 million per year.
Superannuation Guarantee (SG) levy — South East Water considered the *Superannuation Guarantee (Administration) Amendment Act (2012)* is a new obligation, and thus requested additional expenditure.	**Not accepted** — Under the Victorian Government's wages policy, changes due to the Superannuation Guarantee are to be addressed within the allowed 2.5 per cent annual adjustment.

Business proposal	**Commission response**
Western Water	
Expenditure for share of Goulburn-Murray Water's water storage costs — Western Water received a letter from Yarra Valley Water on 15 April 2013, advising Western Water that it is obliged to pay a share of Goulburn-Murray Water's water storage costs as stated in clause 17.1 of Western Water's Bulk Entitlement Order (2010). Western Water thus made an additional expenditure request for $0.14 million over the next regulatory period.	**Accepted** — This obligation on Western Water was not costed in its Water Plan.
Hardship Assistance — Western Water has requested an additional $0.25 million over the next regulatory period to provide extra assistance for low income and vulnerable customers in Western Water's region.	**Accepted** — The Commission accepted Western Water's argument and added this amount to the operating expenditure benchmark.
Insurance premium price rises — Western Water requested $0.91 million over the next regulatory period for increased insurance premiums. A quotation for the period beyond 2013-14 is not available, and the business requested additional revenue to deal with unanticipated premium rises.	**Not accepted** — These costs are considered part of business-as-usual expenditure, and the business must absorb any changes within its operating budget.
Increased debt collection fees — Western Water requested higher fees ($0.86 million over the next regulatory period) based on a new contract that commenced in January 2012.	**Not accepted** — These costs are considered part of business-as-usual expenditure, and the business must absorb any changes within its operating budget.
Asset Master software licence fees — Western Water requested $0.44 million additional expenditure over the next regulatory period.	**Not accepted** — These costs are considered part of business-as-usual expenditure, and the business must absorb any changes within its operating budget.
New People and Culture program — Western Water requested $0.25 million over the next regulatory period to implement leadership initiatives and facilitate cultural change after an organisational restructure.	**Not accepted** — These costs are considered part of business-as-usual expenditure, and the business must absorb any changes within its operating budget.
Other programmed items — The business requested $0.15 million over the next regulatory period.	**Not accepted** — These costs are considered part of business-as-usual expenditure, and the business must absorb any changes within its operating budget.

7.3.4 BULK CHARGES

The Commission's expenditure review and the lower financing costs resulted in the Commission proposing a lower revenue requirement in its draft decision for Melbourne Water. It thus also proposed lower bulk charges for the other four water businesses. Table 7.5 shows all expenditure adjustments resulting from changes to bulk charges and demand forecasts made between the draft and final decisions.

With the Commission's decision to reduce Melbourne Water's regulatory period to three years, the bulk charges for 2016-17 and 2017-18 are indicative for pricing purposes based on the assessment of Melbourne Water's costs over five years.

TABLE 7.5 BULK CHARGES EXPENDITURE ADJUSTMENTS — FINAL DECISION
$m 2012-13

	2013-14	2014-15	2015-16	2016-17	2017-18	Total
City West Water						
Draft decision	338.2	340.3	341.7	343.4	343.6	1 707.2
Final decision	332.4	334.5	336.0	337.7	337.8	1 678.3
South East Water						
Draft decision	512.2	508.7	508.2	507.7	506.5	2 543.3
Final decision[a]	505.4	502.0	501.7	501.3	500.1	2 510.4
Yarra Valley Water						
Draft decision	527.2	523.3	521.3	518.9	516.8	2 607.6
Final decision	518.5	514.9	513.1	510.7	508.7	2 565.8
Western Water						
Draft decision	5.7	6.5	6.4	16.1	16.0	50.8
Final decision[b]	7.5	8.2	8.4	19.6	19.5	63.2
Total draft decision	**1 383.3**	**1 378.7**	**1 377.7**	**1 386.2**	**1 382.9**	**6 908.8**
Total final decision	**1 363.8**	**1 359.6**	**1 359.1**	**1 369.2**	**1 366.1**	**6 817.8**

[a] Includes bulk recycled water costs. [b] Includes costs for the additional bulk water requirement to meet revised customer demand forecast and Southern Rural Water bulk charges.

7.3.5 ENVIRONMENTAL CONTRIBUTION AND LICENCE FEES

In its draft decision, the Commission adjusted the businesses' forecasts to ensure licence fees and the environmental contribution are consistent with the latest advice by the relevant regulatory agencies. The businesses agreed with the Commission's draft decision.

The environmental contribution is held constant in nominal terms across the regulatory period. The Commission updated the CPI estimates used to deflate these figures to convert to real $2012-13, resulting in a small increase in the operating expenditure benchmarks for the final decision.

7.4 FINAL DECISION

Based on the draft decision and additional information provided by the water businesses, the Commission adopted the operating expenditure benchmarks in table 7.6 and 7.7. The Commission considers the benchmarks provide a sufficient level of expenditure for the businesses to operate and deliver their proposed services.

With Melbourne Water's regulatory period reduced to three years, the benchmark expenditure for 2016-17 and 2017-18 is indicative only, based on a five year assessment. When this expenditure is reassessed for Water Plan 4, any material changes to forecasts for these years must be clearly reconciled by Melbourne Water.

TABLE 7.6 **OPERATING EXPENDITURE, 2012-13 TO 2017-18 — FINAL DECISION**
$m 2012-13

	Draft decision	Final decision						Difference	
		2013-14	**2014-15**	**2015-16**	**2016-17**	**2017-18**	**Total**	*$m*	*per cent*
Melbourne Water[a]	4 850.7	1 001.1	994.8	983.2	948.0	950.8	**4 877.8**	27.1	0.6
City West Water	2 297.1	447.8	455.1	457.1	457.9	459.5	**2 277.5**	–19.5	–0.9
South East Water	3 265.3	655.4	648.4	642.8	642.3	641.3	**3 230.2**	–35.2	–1.1
Yarra Valley Water	3 413.8	682.3	676.3	673.7	671.1	669.1	**3 372.5**	–41.3	–1.2
Western Water	244.8	44.9	46.2	46.6	58.8	59.0	**255.4**	10.6	4.3
TOTAL EXCLUDING MELBOURNE WATER	**9 221.0**	**1 830.5**	**1 826.0**	**1 820.2**	**1 830.1**	**1 828.9**	**9 135.6**	**–85.4**	**–0.9**

[a] Melbourne Water's expenditure for 2016-17 and 2017-18 is indicative only, based on a five year assessment.

TABLE 7.7 **OPERATING EXPENDITURE, 2013-14 TO 2017-18 — FINAL DECISION**
$m 2012-13

	Total proposed by business	Total proposed in final decision	Difference	
			$m	*per cent*
Melbourne Water				
Desalination payments	3 058.9	2 978.0	–80.8	–2.6
Controllable costs	1 983.3	1 889.0	–94.3	–4.8
Regulatory charges	10.2	10.8	0.7	6.5
City West Water				
Bulk charges	1 800.7	1 678.3	–122.3	–6.8
Controllable costs	539.3	510.4	–28.9	–5.4
Regulatory charges	88.6	88.8	0.2	0.3
South East Water				
Bulk charges	2 692.7	2 510.4	–182.3	–6.8
Controllable costs	607.3	586.3	–21.0	–3.5
Regulatory charges	144.7	133.4	–11.2	–7.8
Yarra Valley Water				
Bulk charges	2 753.1	2 565.8	–187.2	–6.8
Controllable costs	677.3	663.8	–13.4	–2.0
Regulatory charges	142.9	142.8	0.0	0.0
Western Water				
Bulk charges	61.7	63.2	1.5	2.5
Controllable costs	182.3	180.4	–1.9	–1.0
Regulatory charges	12.3	11.8	–0.5	–4.2

Note: Controllable operating expenditure represents the expenditure over which the businesses have direct control. It excludes regulated bulk water charges, licence fees paid to regulators, and the environmental contribution.

8 CAPITAL EXPENDITURE

8.1 INTRODUCTION

Capital expenditure is a key component of the greater metropolitan water businesses' revenue requirements.

The Water Industry Regulatory Order (WIRO) requires the Commission to ensure the prices levied by the businesses provide them with a sustainable revenue stream that does not reflect monopoly profits or inefficient expenditure, and that allows them to recover expenditure on renewing and rehabilitating existing assets.[50] The Commission must also be satisfied that the proposed expenditure forecasts are efficient and account for a planning horizon that extends beyond the next regulatory period.[51]

The Commission considered detailed assessments by its consultant PricewaterhouseCoopers (PwC) of the businesses' capital expenditure forecasts for the next regulatory period. The businesses were given an opportunity to respond to the consultant's assessment before the Commission released its draft decision. The consultant's report is available on the Commission's website (www.esc.vic.gov.au).

In making its final decision, the Commission considered the businesses' submissions in response to the draft decision, as well as other stakeholders' submissions. It adjusted the relevant benchmarks when appropriate.

[50] WIRO, clause 14(1)(a)(iii) and (iv).

[51] WIRO, clause 14(1)(b).

8.2 OVERVIEW OF DRAFT DECISION

The Commission's draft decision on total forecast capital expenditure was $5.6 billion, which is $184 million (about 3 per cent) lower than proposed by the businesses in their Water Plans (table 8.1). The Commission proposed to approve South East Water's and Yarra Valley Water's forecasts without adjustment. In making its draft decision the Commission generally agreed with PwC's recommendations on the businesses' capital expenditure proposals. Given the much smaller level of capital works intended for the next regulatory period compared with the second regulatory period, PwC considered the businesses can deliver their proposed capital works as forecast.

The Commission proposed adjustments to the businesses' forecast capital expenditure programs when:

- a key project could not be delivered within the proposed timeframe
- a business did not provide adequate information to justify the project expenditure or the forecast cost estimate
- a business provided insufficient evidence of having considered alternatives.

In its draft decision, the Commission considered that a number of projects had not been sufficiently justified by Melbourne Water, City West Water and Western Water in their Water Plans, but the Commission invited these businesses to provide additional information in support of those projects.

TABLE 8.1 CAPITAL EXPENDITURE, 2013-14 TO 2017-18 — DRAFT DECISION
$m 2012-13

	Total proposed by business	Total proposed in draft decision						Difference	
		2013-14	2014-15	2015-16	2016-17	2017-18	Total	*$m*	*per cent*
Melbourne Water	2 457.1	512.7	541.0	495.9	480.0	379.6	**2 409.1**	–48.0	–1.95
City West Water	794.8	185.3	117.4	108.7	136.9	130.4	**678.8**	–116.0	–14.60
South East Water	1 134.7	269.8	251.8	218.8	200.7	193.6	**1 134.7**	0.0	0.00
Yarra Valley Water	1 147.1	234.6	233.6	227.8	226.6	224.5	**1 147.1**	0.0	0.00
Western Water	251.9	24.0	32.2	44.6	62.5	68.3	**231.6**	–20.3	–8.07

8.3 RESPONSES AND COMMISSION'S ASSESSMENT

In response to the draft decision, Melbourne Water, City West Water and Western Water provided further information on issues raised in the draft decision and other matters they thought relevant. The Commission considered these responses and adjusted (when justified) its forecast capital expenditure for each business in this final decision.

The Commission has assessed Melbourne Water's expenditure over the full five year period to provide indicative expenditure forecasts for 2016-17 and 2017-18. Expenditure for these two years will be reassessed for approval under Melbourne Water's Water Plan 4.

The Commission also had regard to public submissions on its draft decision to inform its final decision. In particular, it received submissions from several large industrial customers of City West Water that would benefit from the cheaper costs of recycled water from the Altona stage 2 recycled water project.

Table 8.2 shows the Commission's responses to additional information provided by the businesses for its final decision.

TABLE 8.2 ADDITIONAL INFORMATION IN SUPPORT OF WATER PLAN FORECASTS

Business proposal	Commission response
Melbourne Water	
Western Treatment Plant (WTP) capacity augmentation, stage 2 — Melbourne Water provided additional justification for the timing of the WTP upgrade, as requested by the Commission in the draft decision.[52]	**Draft decision maintained** — The Commission is satisfied with Melbourne Water's explanation of the apparent discrepancy in timing of the expected breach of effluent ammonia limits.
WTP class A recycled water capacity upgrade — Melbourne Water noted expenditure for this project, removed in the draft decision, should be re-instated if the Commission re-instates City West Water's Altona stage 2 project.	**Not accepted** — The Commission did not re-instate the proposed expenditure for the Altona stage 2 project. So, the expenditure for the WTP is not required. No adjustment is required to the draft decision.

[52] Melbourne Water 2013, *Response submission to the ESC's draft decision*, May, pp. 33–36.

Business proposal	Commission response
City West Water	
Altona recycled water project, stage 2 — City West Water has been in lengthy consultation with the Altona stage 2 customers for over six years. Customers have been making internal investigations and arrangements to prepare for recycled water supply. City West Water's reputation would be adversely affected if the project does not proceed, given it committed to some customers to supply recycled water on a full cost recovery basis.	**Not accepted** — The Commission maintained its draft decision to not include the proposed expenditure in pricing for the next regulatory period. This decision is discussed below in more detail.
Western Water	
Information Technology (IT) program - SCADA — The business requested further consideration because the investment in SCADA systems is critical for it to achieve the necessary efficiency gains over the ESC benchmark for the regulatory period. SCADA investment is expected to result in real dollar savings and productivity benefits from network monitoring and preventative maintenance. Western Water provided information to justify the proposal and the business case to proceed. The project is also intended to support development of intelligent water networks (IWN) projects.	**Not accepted** — The Commission asked PwC to reconsider this issue. PwC had originally recommended the project be removed from the business's capital expenditure allowance, because there was no demonstrated critical need for the project. PwC maintained this position, because Western Water did not provide substantial additional evidence to demonstrate the need for, or direct benefits of, the project. The Commission agrees and retains its draft decision to exclude expenditure for this project.
Sunbury additional water storage - Bald Hill tank — The business provided the options analysis as requested by the Commission in its draft decision. It disagreed with the Commission's draft decision to delay project implementation by one year, and provided further information to support its view.	**Accepted** — In response to the Commission's draft decision, Western Water undertook an options analysis and provided the results to the Commission.[53] Results of the multi-criteria analysis showed the Bald Hill tank is the best option among those considered, and the other options had comparable costs.[54] The Commission considers Western Water met the draft decision requirements, and the expenditure will remain as per the draft decision but brought forward one year (consistent with the original Water Plan proposal).

[53] Western Water 2013, *Response to 2013–2018 water price review draft decision,* Attachment 3, May.

[54] Criteria considered in the options analysis were capital cost, operation and maintenance cost, operability, security of supply, environmental and community impact and flexibility with future supplies. The other options considered were a Riddel Road tank, a Western tank and no additional storage.

In its submission, South East Water requested additional operating expenditure for costs arising from the new *Water (Estimation, Supply and Sewerage) Regulations* 2013. As discussed in chapter 7 (table 7.4), the Commission considered the pipe replacement costs to be capital rather than operating expenditure. An additional $0.86 million has been included in South East Water's capital expenditure allowance.

In its draft decision, the Commission did not allow the proposed expenditure for City West Water's Docklands sewer mining project, but indicated it would reconsider this decision if City West Water could demonstrate the project is less costly than conventional water supply.[55] However, in its submission, City West Water stated it accepted the Commission's draft decision to remove these project costs for the third regulatory period.

City West Water — Altona recycled water project

City West Water proposed expenditure of $80 million to implement its Altona recycled water stage 2 project to provide recycled water from Melbourne Water's Western Treatment Plant to a number of large customers in the Altona Industrial Precinct.

The Commission's draft decision stated:

> *Based on information received from City West Water, PwC did not consider the justifications for the project were compelling. It recommended removing the project from the expenditure forecast ($80 million).* [56]

[55] Essential Services Commission 2013, *Price Review 2013: greater metropolitan water businesses draft decision* – volume 1, April, p. 114.

[56] Essential Services Commission 2013, *Price Review 2013: greater metropolitan water businesses draft decision* – volume 1, April, table 8.5, p. 113.

And further:

> *In its guidance paper, the Commission specified that proposals for further supply augmentation projects would require a clear justification, and would almost certainly need to be based on factors other than security of supply risk in the near term. The Commission's draft decision is to accept proposed alternative water expenditure if the water businesses have provided evidence that their proposals are efficient.* [57]

In response to the draft decision, City West Water did not provide additional supporting information, but sought further consideration of the project. It also provided the following justifications:[58]

- The project meets the customers' needs and is self-funding — The recycled water price is set at 85 per cent of the prevailing potable water tariff, which is consistent with the recycled water production cost for the Altona stage 2 project. The economic benefits identified for the project are deferred potable system augmentation and avoided desalination variable costs, thereby providing long term benefits not only to direct customers but also across the customer base.
- The project is consistent with government policy — The Living Victoria Ministerial Advisory Council's Implementation Plan supports the Victorian Government's priorities for urban water, particularly increased use of alternative water sources to decrease pressure on potable water supplies.
- There are additional benefits that are not quantified — The project is likely to offer substantial benefits in terms of avoided and deferred network augmentation, which have not been quantified. Other benefits of the project include environmental and liveability benefits, resilience within the water cycle from having local water sources of fit-for-purpose water, and more cost-effective operation of Melbourne Water's Class A recycled water facility.

[57] Essential Services Commission 2013, *Price Review 2013: greater metropolitan water businesses draft decision* – volume 1, April, p. 114.

[58] City West Water 2013, *Response to draft decision*, May, pp. 14–16.

- Deferral would have an adverse effect. Direct customers have prepared for recycled water supply, and City West Water and direct customers have signed a memorandum of understanding. Deferring the scheme might cause customers to lose interest in the scheme because some have already expressed dissatisfaction with the current supply date. City West Water committed to supply recycled water on a full cost recovery basis.

The Commission also received submissions from Victoria Wool Processors (Aust.) Pty. Ltd. and Mobil Refining Australia Pty. Ltd., which are two large industrial customers that would benefit from the cheaper costs of recycled water from the Altona stage 2 recycled water project. They both expressed support for the project to proceed as planned.[59]

Despite the additional arguments put forward by City West Water in its response to the draft decision, the business case remains unchanged. The Commission does not consider that City West Water has justified its proposal by clearly demonstrating that the timing for this investment is prudent. In its assessment, PwC noted that the positive net present value of the project would likely be greater if the project was deferred.

The Commission maintains its draft decision to not include City West Water's proposal capital expenditure for this project in prices for the next regulatory period. It made an adjustment in the draft decision to allow for additional bulk water in lieu of this project.

The Commission notes this project is not time critical, in that there is no window of opportunity (in terms of path dependent capital works) that will close if the project does not proceed at this time. However, City West Water could explore other cost recovery options for this project (besides general customer pricing) if it wishes to proceed sooner. The Commission notes the experience of Barwon Water whereby a large recycled water project was co-funded by a major customer.

[59] Victoria Wool Processors (Aust) Pty.Ltd., *Submission to the draft decision*, May 2013. Mobil Refining Australia Pty. Ltd., *Submission to the draft decision*, May 2013.

8.4 FINAL DECISION

Apart from the adjustment to the timing of Western Water’s Sunbury additional water storage (the Bald Hill tank project) and a small increase for South East Water's additional pipe replacement costs, the Commission’s final decision on capital expenditure remains unchanged from its draft decision. It provides for total capital expenditure of $5.6 billion over five years for the greater metropolitan water businesses.

The Commission has adopted the capital expenditure benchmarks in table 8.3. It considers the benchmarks provide sufficient expenditure for the businesses to deliver their proposed services and meet known regulatory obligations.

With Melbourne Water's regulatory period reduced to three years, the benchmark expenditure for 2016-17 and 2017-18 is indicative only, based on a five year assessment. When this expenditure is reassessed for Water Plan 4, any material changes to forecasts for these years must be clearly reconciled by Melbourne Water.

The Commission will monitor the progress of each water business in delivering its key capital projects. The annual performance report will provide an opportunity for businesses to explain any changes in the timing or scope of their major capital projects, and the implications for any outcomes to which they committed in their Water Plans.

TABLE 8.3 CAPITAL EXPENDITURE, 2013-14 TO 2017-18 — FINAL DECISION
$m 2012-13

	Draft decision	Final decision						Difference	
		2013-14	2014-15	2015-16	2016-17	2017-18	Total	*$m*	*per cent*
Melbourne Water[a]	2 409.1	512.7	541.0	495.9	480.0	379.6	**2 409.1**	0.0	0.0
City West Water	678.8	185.3	117.4	108.7	136.9	130.4	**678.8**	0.0	0.0
South East Water	1 134.7	269.9	252.0	219.0	200.9	193.8	**1 135.5**	0.9	0.1
Yarra Valley Water	1 147.1	234.6	233.6	227.8	226.6	224.5	**1 147.1**	0.0	0.0
Western Water	231.6	24.2	32.0	44.6	67.1	63.7	**231.6**	0.0	0.0
TOTAL	**5 601.4**	**1 226.7**	**1 176.1**	**1 096.0**	**1 111.6**	**991.9**	**5 602.2**	**0.9**	**0.1**

[a] Melbourne Water's expenditure for 2016-17 and 2017-18 is indicative only, based on a five year assessment.

9 FINANCING CAPITAL INVESTMENTS

9.1 INTRODUCTION

The Water Industry Regulatory Order (WIRO) requires prices to allow each water business to recover the cost of capital investments (which are initially funded by the water business) over time through regulatory depreciation, and to recover financing costs through a return on assets.

This chapter sets out the Commission's final decision on the greater metropolitan water businesses' financing of capital investments, namely the initial regulatory asset base (RAB), the rate of return on investments, tax, and methods for calculating regulatory depreciation.

The Commission approves an initial RAB as at 1 July 2012 to reflect verified net capital expenditure. The Commission forecasts an opening RAB for each subsequent year based on forecasts. An adjustment is made for any difference between assumed and actual net capital expenditure for 2012-13 when the opening RAB is calculated for the fourth regulatory period.

9.2 ROLLFORWARD OF THE REGULATORY ASSET BASE

9.2.1 OVERVIEW OF DRAFT DECISION

The Commission used the following formula to calculate the opening RAB for each business at 1 July 2013:

Western Water	
Opening RAB 1 July 2013 =	Opening RAB 1 July 2007
plus	Capital expenditure (net)$_{2007\text{-}08 \text{ to } 2011\text{-}12}$[60]
(minus)	Regulatory depreciation$_{2007\text{-}08 \text{ to } 2011\text{-}12}$
(minus)	Proceeds from disposal of assets$_{2007\text{-}08 \text{ to } 2011\text{-}12}$
plus	Assumed capital expenditure (net)$_{2012\text{-}13}$[60]
(minus)	Regulatory depreciation$_{2012\text{-}13}$
(minus)	Assumed proceeds from disposal of assets$_{2012\text{-}13}$
City West Water, Melbourne Water, South East Water and Yarra Valley Water	
Opening RAB 1 July 2013 =	Opening RAB 1 July 2008
plus	Capital expenditure (net)$_{2008\text{-}09 \text{ to } 2011\text{-}12}$[60]
(minus)	Regulatory depreciation$_{2008\text{-}09 \text{ to } 2011\text{-}12}$
(minus)	Proceeds from disposal of assets$_{2008\text{-}09 \text{ to } 2011\text{-}12}$
plus	Assumed capital expenditure (net)$_{2012\text{-}13}$[60]
(minus)	Regulatory depreciation$_{2012\text{-}13}$
(minus)	Assumed proceeds from disposal of assets$_{2012\text{-}13}$

For subsequent years in the third regulatory period, the opening asset base for each year is calculated using annual forecasts for net capital expenditure, regulatory depreciation and disposals.

When assessing actual net capital expenditure for the period 2007-08 to 2011-12, the Commission compared spending with the 2008 determination forecasts.

[60] Capital expenditure (net) is equal to gross capital expenditure minus any customer or government contributions.

Where a business underspent relative to forecast, the Commission proposed to roll forward the amount actually invested. If expenditure was less than 10 per cent above forecast, the Commission also proposed to roll forward the amount actually invested because such a divergence is within reasonable bounds, given the lumpy nature of capital costs. If expenditure was 10 per cent or more than forecast, the Commission proposed to roll forward the amounts above forecast only if a business justified the expenditure was prudent and efficient.

For 2012-13, the Commission proposed to roll forward the lesser of:

- actual net capital expenditure, or
- the 2008 determination forecast of 2012-13 net capital expenditure.

This approach to 2012-13 capital expenditure gives businesses an incentive to deliver projects on schedule. Even if unintentional, project delays unduly benefit businesses because they earn a return on the investment even though the project is not completed. Again, the Commission only included expenditure above the 2012-13 forecast businesses could adequately justify (for example, if the expenditure was a result of factors beyond the direct control of the business).

Tables 9.1 and 9.2 show the amounts the Commission's draft decision proposed to include in each business's RAB at 1 July 2012, and forecast amounts at 1 July 2013. The Commission's proposed adjustments mainly reflected the approach to 2012-13 capital expenditure. For more information see the Commission's draft decision.[61]

[61] Essential Services Commission 2013, *Price Review 2013: metropolitan water businesses — draft decision*, volume 1, March, pp. 99–107.

TABLE 9.1 PROPOSED REGULATORY ASSET BASE ROLLFORWARD – DRAFT DECISION
$m 2012-13

	Melbourne Water	City West Water	South East Water	Yarra Valley Water
Opening RAB as at 1 July 2008	**5 942.6**	**1 074.0**	**2 078.0**	**2 427.5**
Plus net capital expenditure 2008-09 to 2011-12[a]	3 402.1	453.5	630.6	878.0
Less regulatory depreciation 2008-09 to 2011-12	506.9	112.9	175.6	215.0
Less proceeds from disposal of assets 2008-09 to 2011-12	53.9	0.7	6.2	0.2
RAB as at 1 July 2012	**8 783.9**	**1 413.9**	**2 526.7**	**3 090.2**
Plus net capital expenditure (forecasts approved for the second regulatory period) 2012-13	179.2	54.3	126.7	251.5
Less regulatory depreciation 2012-13	155.1	32.0	52.4	54.9
Less assumed proceeds from disposal of assets 2012-13[b]	0.0	0.9	0.9	0.9
RAB as at 1 July 2013	**8 808.0**	**1 435.3**	**2 600.1**	**3 285.9**

[a] Includes an adjustment for new customer contributions. [b] Includes an adjustment for Western Water's Northern Victoria Irrigation Renewal Project contribution.

TABLE 9.2 WESTERN WATER'S PROPOSED REGULATORY ASSET BASE ROLLFORWARD - DRAFT DECISION
$m 2012-13

	Western Water
Opening RAB as at 1 July 2007	**144.6**
Plus net capital expenditure 2007-08 to 2011-12[a]	156.7
Less regulatory depreciation 2007-08 to 2011-12	26.5
Less proceeds from disposal of assets 2007-08 to 2011-12	3.8
RAB as at 1 July 2012	**270.9**
Plus net capital expenditure (forecasts approved for the second regulatory period) 2012-13[b]	16.6
Less regulatory depreciation 2012-13	6.2
Less assumed proceeds from disposal of assets 2012-13	0.9
RAB as at 1 July 2013	**280.5**

[a] Includes an adjustment for new customer contributions.[b] Includes an adjustment for Western Water's Northern Victoria Irrigation Renewal Project contribution.

The Commission revised down City West Water's, South East Water's and Yarra Valley Water's proposed RAB to account for a contribution to the Northern Victoria Irrigation Renewal Project (NVIRP) by regional water businesses connected to the Melbourne system.[62] The Commission revised up Western Water's RAB to account for its $2.6 million contribution to the NVIRP in 2012-13.

9.2.2 SUBMISSIONS AND COMMISSION'S ASSESSMENT

All submissions received from businesses in response to the draft decision were about 2012-13 capital expenditure. This amount is a forecast set for pricing purposes and it will be updated with actual expenditure (assessed as prudent and efficient) at the beginning of the fourth regulatory period.

[62] Barwon Water, South Gippsland Water, Western Water and Westernport Water will contribute $9.3 million over 2012-13 to 2013-14 to the NVIRP reflecting their access to the metropolitan water system. This amount is split equally between City West Water, South East Water and Yarra Valley Water.

Melbourne Water

Melbourne Water contended the latest capital expenditure forecast for 2012-13 should be included in the RAB, instead of the determination forecasts adopted in the Commission's draft decision. It argued previous Commission decisions used the most up-to-date information to determine the opening RAB for the regulatory period. It also referred to recent regulatory practice by the Australian Energy Regulator (AER)[63] and the Australian Competition and Consumer Commission's (ACCC) *Pricing principles for price approvals and determinations under the Water Charge (Infrastructure) Rules 2010* (WCIR).

The Commission acknowledges it adopted an updated forecast of capital expenditure for the last year of the regulatory period for each business for the 2008 and 2009 price reviews. This was a divergence from its intention, as set out in the 2008 guidance paper, which stated:

> *…for years where actual data is not available, the Water Plans should show the capital expenditure, contributions and proceeds value assumed in the initial pricing determinations.*[64]

The Commission adopted updated forecasts for the final year of the previous regulatory period to recognise a sharp increase in water security projects at the time, many of which were initiated in response to Government policy. This was an exception due to the unusual circumstances and the guidance paper (2011) noted a return to the preferred approach in order to minimise incentives to delay capital works until the last year of the regulatory period.

The Commission acknowledges Melbourne Water's reference to the AER's Powerlink final decision and the ACCC's WCIR. The Commission does not believe these should necessarily guide its final decision as each case must be reviewed in light of the relevant circumstances.

[63] Australian Energy Regulator 2012, *Powerlink transmission determination 2012-13 to 2016-17 final decision.*

[64] Essential Services Commission 2006, *2008 Water Price Review guidance on Water Plans*, September.

Following its response to the draft decision, Melbourne Water provided further justification for a number of specific projects for the Commission to consider rolling into its RAB:

- ETP Tertiary Upgrade Project: Melbourne Water explained that additional costs of $36.4 million (above 2012-13 forecast) were as a result of a change in scope for the project EPA Victoria (EPA) works approval. Melbourne Water noted that increased costs in the short term results in a better overall outcome for customers by negating the need to construct an outfall extension in the 2013 Water Plan period.
- Western Treatment Plant 55 East and 25 East Cover Renewal: the project costs escalated from $23.5 million to the current forecast of $45.9 million due to reliance on an early cost estimate prior to detailed design. The project was also delayed due to various reasons including; non-conformance with required specifications of early batches of covers, weather delays and unexpected labour intensiveness of installation works.
- Eastern Drop Structure (EDS): the project is currently forecast to cost $10 million in 2012-13 compared to a 2009 water plan approved amount of $4.3 million. The key drivers of the cost increase is the need to purchase land from the Port of Melbourne Corporation rather than Parks Victoria land which was to be provided at nil cost, and also an increase in size of the structure to ensure EPA compliance.
- Silvan Fluoride Plant Upgrade: re-profiling of expenditure and increased costs has meant $5.8 million will be incurred in 2012-13 compared to no expenditures which were approved in the 2009 water plan. Contributing factors include asbestos removal and separation of chlorine and fluoride spill containment systems to ensure compliance with the Department of Human Services issued Code of Practice for Fluoridation of Drinking Water Supplies (March 2009).
- IT Systems Renewal – Asset Management Program: Melbourne Water explained this project was approved by the Commission in its draft decision. In addition to the approved capital expenditure, offsetting operating expenditure efficiency savings have been incorporated into the draft decision. The $4 million expended in 2012-13 represents the commencement of the design phase of this project.

Based on the information provided, the Commission accepts the proposal to include projects listed in table 9.3 to be rolled forward into Melbourne Water's RAB.

For the ETP Tertiary Upgrade Project, Eastern Drop Structure and Silvan Fluoride Plant Upgrade, the Commission believes both the increase in cost and/or delay in expenditure was genuinely beyond the control of Melbourne Water, reflecting a need to meet EPA and Department of Human Services (DHS) requirements. Furthermore, as the efficiency savings related to the IT Systems Renewals have been accepted for the final decision, the Commission believes it is appropriate to recognise capital expenditure in 2012-13.

TABLE 9.3 FURTHER NET CAPITAL EXPENDITURE AMOUNTS TO BE ROLLED INTO MELBOURNE WATER'S 2012-13 RAB
$m 2012-13

Capital project	Amount
ETP Tertiary Upgrade Project	36.4
Eastern Drop Structure Air Treatment and Civil Works	6.9
Silvan Fluoride Plant Upgrade	5.8
IT System Renewals – Asset Management System	4.0

City West Water

City West Water proposed that 2012-13 capital expenditure for the following projects be reflected in its RAB:

- Arrow Program: PricewaterhouseCoopers (PwC) assessed the capital expenditure and found City West Water adequately justified the project. Further, City West Water included all the operating cost savings associated with the Arrow Program in its Water Plan and these were reflected in the draft decision.
- West Werribee Dual Water Supply Project: Originally, City West Water planned to complete the project by 2011-12, but it was delayed by factors outside the business's control. These factors included longer than anticipated processing times for applications made to the federal Department of Sustainability, Environment, Water, Population and Communities (DSEWAC), and a referral authority under the requirements of the *Environmental Protection and Biodiversity Act 1999* (EPBC Act). The total cost of the project also increased from $80.0 million to $131.7 million. As part of the second regulatory period review process, Halcrow-Deloitte (the Commission's 2009 expenditure

consultants) acknowledged project costs could go up to $131.7 million. Halcrow-Deloitte also acknowledged that, should the project costs exceed $80.0 million, City West Water would bear financing costs late in the regulatory period. Further, City West Water proposed to bear any such costs if they eventuated because the full value of works would be included in the RAB for the third regulatory period.

- Water and sewer mains renewals: City West Water stated it spent more on renewals in 2012-13 than the 2009 determination allowed ($41.2 million compared with $23.7 million) because it identified a higher than forecast number of pipeline sections needing replacement.

Based on this information, the Commission accepts the proposals to include the Arrow Program and West Werribee Dual Water Supply Project in the forecast RAB. It is appropriate to recognise the full capital expenditure incurred in 2012-13 for the Arrow Program because all the operating cost savings are allowed for in the prices approved under the final decision. The Commission also proposes to roll the full 2012-13 capital expenditure for West Werribee Dual Water into the RAB because the delay was beyond City West Water's control, and the last price review acknowledged a possible increase in expenditure.

Although the capital expenditure for renewals may have been prudent and/or efficient, City West Water did not demonstrate that the additional expenditure incurred in 2012-13 was beyond its control. The Commission does not accept its proposal to roll the additional amount spent in 2012-13 into the RAB.

The Commission notes City West Water's adjustments to customer contributions and although this affects the RAB, it is assessed separately in chapter 18.

The additional amounts included in the opening RAB for City West Water are outlined in table 9.3.

TABLE 9.4 FURTHER NET CAPITAL EXPENDITURE AMOUNTS TO BE ROLLED INTO CITY WEST WATER'S 2012-13 RAB
$m 2012-13

Capital project	Amount
Arrow Program	22.4
West Werribee Dual Water Supply Project	54.1

South East Water

South East Water's submission generally accepted the draft decision for its RAB. South East Water updated its estimates for new customer contributions (assessed in chapter 18). The revisions are also reflected in the Commission's final decision on the RAB for South East Water.

Yarra Valley Water

Yarra Valley Water largely accepted the Commission's draft decision on its RAB. However, it proposed the Commission's assumption for 2012-13 net capital expenditure be revised down to reflect lower actual expenditure by the business. Yarra Valley Water explained the lower figure was due to efficiency gains. The Commission welcomes this approach and accepts Yarra Valley Water's proposal to adopt a lower 2012-13 updated net capital expenditure than the determination forecast.

Yarra Valley Water also provided updated estimates for new customer contributions (assessed in chapter 18). The revisions are also reflected in the Commission's final decision on the RAB for Yarra Valley Water.

Western Water

Western Water accepted the Commission's draft decision on the closing asset base as at 1 July 2012. Western Water proposed to adjust new customer contributions (assessed in chapter 18). The revisions are also reflected in the Commission's final decision on the RAB for Western Water.

9.2.3 FINAL DECISION

The Commission has approved amounts for inclusion in each businesses' RAB as at 1 July 2012. Amounts are set out in table 9.5 and 9.6.

The Commission has also approved forecast amounts for 1 July 2013 which have been reflected in approved prices. Forecast net capital expenditure for years from 2012-13 will be reviewed as part of each businesses' next price review.

TABLE 9.5 REGULATORY ASSET BASE ROLLFORWARD – FINAL DECISION

$m 2012-13

	Melbourne Water	City West Water	South East Water	Yarra Valley Water
Opening RAB as at 1 July 2008	**5 942.6**	**1 074.0**	**2 078.0**	**2 427.5**
Plus net capital expenditure 2008-09 to 2011-12[a]	3 402.1	453.5	630.6	878.1
Less regulatory depreciation 2008-09 to 2011-12	–506.9	–112.9	–175.6	–215.0
Less proceeds from disposal of assets 2008-09 to 2011-12	–3.9	–0.7	–6.2	–0.2
RAB as at 1 July 2012	**8 783.9**	**1 413.9**	**2 526.7**	**3 090.3**
Plus net capital expenditure 2012-13	179.2	130.8	126.7	197.4
Less regulatory depreciation 2012-13	–102.0	–32.0	–52.4	–54.9
Less assumed proceeds from disposal of assets 2012-13[b]	–0.0	–0.9	–0.9	–0.9
RAB as at 1 July 2013	**8 861.1**	**1 511.8**	**2 600.1**	**3 231.9**

[a] Includes an adjustment for new customer contributions. [b] Includes an adjustment for Western Water's NVIRP contribution.

TABLE 9.6 WESTERN WATER'S REGULATORY ASSET BASE ROLLFORWARD – FINAL DECISION
$m 2012-13

	Western Water
Opening RAB as at 1 July 2007	**144.6**
Plus net capital expenditure 2007-08 to 2011-12[a]	156.7
Less regulatory depreciation 2007-08 to 2011-12	-26.5
Less proceeds from disposal of assets 2007-08 to 2011-12	-3.8
RAB as at 1 July 2012	**270.9**
Plus net capital expenditure 2012-13[b]	14.0
Less regulatory depreciation 2012-13	-6.2
Less assumed proceeds from disposal of assets 2012-13	-0.9
RAB as at 1 July 2013	**277.9**

[a] Includes an adjustment for new customer contributions.[b] Includes an adjustment for Western Water's NVIRP contribution.

9.3 RATE OF RETURN

The WIRO allows businesses to recover a rate of return on existing assets and on new capital expenditure. To estimate an efficient rate of return, the Commission uses a weighted average cost of capital (WACC), which reflects the cost of the two alternative sources of finance — debt and equity.

The WACC is expressed in real post-tax terms. The WACC is applied at a common rate to each business's forecast RAB for each year of the next regulatory period to calculate an allowance for return on assets.

9.3.1 OVERVIEW OF DRAFT DECISION

In its draft decision, the Commission calculated a feasible range for the WACC of 4.1 – 5.3 per cent. This range was calculated by adopting estimated ranges for the real risk free rate and the debt margin and point estimates for the other parameters. From the feasible range, the Commission adopted a WACC of 4.7 per cent.

The Commission considered actual borrowing costs when proposing a WACC in the middle of the range in its draft decision. Adopting a WACC at the lower end of the range could have created undue risk that businesses would not be able to cover their borrowing costs in the third regulatory period, if borrowing costs increase. Table 9.7 outlines the Commission’s assumptions for the individual WACC components in the draft decision.

TABLE 9.7 REAL POST-TAX WACC - DRAFT DECISION

WACC parameter	Value
Risk free rate of return	0.679 – 1.023
Equity beta	0.65
Equity (market risk) premium	6.0
Debt margin	3.03 – 4.53
Financing structure (debt/assets)	60
Franking credits	0.5
Forecast inflation	2.40 – 2.75
Vanilla post-tax WACC (real) range	4.1 - 5.3
Vanilla post-tax WACC (real) point	4.7

Key elements of the Commission’s draft decision on the WACC were:

- Risk free rate: The Commission estimated a range for the real risk free rate based on average nominal yield on 10 year Commonwealth Government Securities, accounting for market estimates of inflation.
- Debt margin: The debt margin range is based on the estimated additional cost of debt for a company with a BBB- to BBB+ rating, over the risk free rate
- The Commission adopted point estimates for the equity beta, market risk premium, financing structure and value of imputation credits reflecting previous decisions by the Commission and/or generally accepted regulatory precedent.

This approach was consistent with the Commission’s 2011 guidance paper and previous regulatory decisions by the Commission.

9.3.2 SUBMISSIONS AND COMMISSION'S ASSESSMENT

Consumer interest groups combined submission

The Consumer Action Law Centre (CALC), Consumer Action Utilities Centre (CUAC), and the Victorian Council of Social Service (VCOSS)[65] submitted the Commission should:

> *…[s]et the WACC based upon the businesses actual cost of capital (given the fact that they are government-owned), rather than theoretically constructed private businesses.*[66]

As noted in the draft decision, the Commission considers the estimate of the cost of capital should be based on an industry benchmark (that reflects efficient financing arrangements) rather than utility specific costs.

Using a benchmark WACC (rather than using a business-specific approach) ensures regulated entities have an incentive to adopt efficient financing structures. That is, using a benchmark WACC means customer prices will only reflect the assumption about efficient financing costs, and not the impact of any inefficient financing arrangements or structures adopted by a water business.

Estimated actual borrowing costs facing the water businesses are discussed in section 9.3.3.

[65] The submission from CALC, CUAC and VCOSS was also supported by Community Information and Support Victoria, Good Shepherd Youth and Family Services, and National Seniors Australia.

[66] Consumer Action Law Centre, Consumer Utilities Advocacy Centre and Victorian Council of Social Services 2013, *Submission to the water price review draft decision 2013-18*, 21 May. p 3.

The joint submission also noted there is a significant difference between the WACC recommended by the Independent Pricing and Regulatory Tribunal (IPART) in its March 2013 determination for Hunter Water, and the WACC of 4.7 per cent adopted in the Commission's draft decision. There were two main reasons for this variation:

- IPART adopted a lower real risk free rate, mainly reflecting its use of a debt instruments with a five year term to maturity to estimate the risk free rate while the Commission used a 10 year instrument.
- IPART adopted a lower debt margin, reflecting its approach of estimating the debt margin based on BBB to BBB+ rated debt, whereas the Commission estimated the margin based on BBB- to BBB+ rated debt.

Different measurement periods for market related data also contributed to the differences. The Commission notes IPART's recent final decision approved a WACC of 4.6 per cent for Hunter Water based on a revised methodology.

The Commission's methodology for estimating the WACC remains the same as that used in past price reviews.

Melbourne Water

Melbourne Water made several comments in its submission about the WACC. Generally, it encouraged the Commission to set a WACC estimate in its final decision of at least 4.7 per cent and to consider setting the cost of equity toward the upper end of its range. It also encouraged the Commission to make provisions for any unsustainable increases in the cost of debt to be managed via the uncertain and unforeseen events mechanism.[67]

Melbourne Water also commented on the calculation of the estimates of the cost of equity and the cost of debt.

[67] Melbourne Water, 2013, *Submission to the ESC draft decision,* 21 May, p. 2.

Cost of Equity

Melbourne Water submitted that in estimating the cost of equity the Commission should:

- calculate the nominal yield on government bonds on an annual basis, rather than a semi-annual basis
- estimate inflation over 10 years, consistent with the maturity of the bond used to estimate the risk-free rate. Further, it recommended the Australian Energy Regulator's (AER) approach. That is it recommended using short term forecasts published by the Reserve Bank of Australia (RBA), combined with the mid-point of the RBA's target inflation range of 2 – 3 per cent for the remainder of the 10 year period. This gives an inflation forecast of 2.5 per cent.
- avoid the effect that the current low risk free rate has on the cost of equity by either adopting a long term historical average risk free rate or adopting a cost of equity forecast at the upper end of the estimated range.

However, the Commission did not change its approach to estimating the cost of equity for the following reasons:

- The Commission uses a 40-day moving average annual yield on government bonds to calculate the risk free rate estimate, not semi-annual yields as suggested by Melbourne Water.
- The Commission takes a forward-looking approach to forecasting inflation, using a market based estimate of inflation, covering the full regulatory period. The Commission considers the use of current market based figures in its estimate better reflects expectations about future inflation.
- Evidence about the impact of the historically low risk free rate on the cost of equity is not clear. This issue can be further explored in our upcoming review of the rate of return methodology (see section 9.3.4).

Cost of Debt

Melbourne Water submitted the WACC largely reflects current market conditions. Given the cost of debt is at historic lows, there is a risk that the cost of debt allowance may be insufficient to cover Melbourne Water's actual cost of debt in the future (for example, if there are future changes in nominal borrowing rates or the Financial Accommodation Levy (FAL)). To mitigate this risk, Melbourne Water suggested the Commission include a reference to 'unsustainable differences between actual and forecast cost of debt' in the uncertain and unforeseen events mechanism.

The Commission did not include a specific reference to changes in interest rates or the FAL in the uncertain and unforeseen events mechanism listed in each business's determination. The Commission notes that changes in financial conditions may justify a mid-period price re-opening.

City West Water

City West Water accepted the draft decision WACC, though it noted the lower WACC for the third regulatory period puts pressure on its cash interest coverage. In response, the business proposed to lower the amount proposed for deferring its regulatory depreciation. This is discussed in section 9.5.

South East Water

South East Water accepted the WACC, and agreed the Commission should cross-check market based estimates of the cost of debt with the actual lending costs including any expected changes to the FAL.

For its final decision, the Commission has cross-checked market-based estimates of the cost of debt with the actual lending costs (see section 9.3.3).

Western Water

Western Water accepted the Commission's draft decision on the WACC, provided the WACC is not lowered in the final decision, suggesting lower WACC generally increases business risk.

9.3.3 ANALYSIS OF WACC PARAMETERS

The Commission considered the responses to the draft decision and changes in financial market conditions since the draft decision. The only WACC parameters that changed since the draft decision are the estimate of the risk free rate, and the debt margin.

Risk free rate

In its draft decision, the Commission constructed a range for the real risk-free rate using the average yield of 3.448 per cent on nominal Commonwealth Government Securities over the 40-day trading period to 28 February 2013, and an inflation range of 2.4 - 2.75 per cent.

The Commission used the same approach to estimate the real risk free rate for the final decision. It used the average yield on nominal Commonwealth Government Securities over the 40-day trading period to 5 June 2013 to calculate a nominal risk-free rate of 3.234 per cent.[68]

The Commission used current consumer price index results and inflation forecasts to determine the inflation forecast. Consumer Price Index (CPI) results for the March quarter 2013 indicated an annual inflation rate of 2.5 per cent. The Commission has also had regard for longer-term inflation forecasts provided by Deloitte Access Economics which imply an average inflation rate of around 2.7 per cent per year over the next regulatory period.

The Commission notes that some market practitioners forecast lower inflation, particularly in the near term. Some forecasts are below the mid-point of the Reserve Bank of Australia's target band of 2 - 3 per cent each year. The Department of Treasury and Finance forecast inflation to be around 2.5 per cent for 2012-13. National Australia Bank forecast inflation of 2.1 per cent in 2013 and 2.2 per cent in 2014.

For the purpose of estimating a real risk free rate of return, the Commission considered the recent trends in inflation, and the range of longer-term forecasts and adopted an inflation range of between 2.3 per cent and 2.8 per cent.

Together with the nominal risk free rate of 3.234 per cent, this inflation range results in a feasible range for the real risk free rate of between 0.422 - 0.913 per cent.

Debt margin

In the draft decision, the Commission derived a range for the debt margin by estimating the additional cost of debt (on top of the risk free rate) for a company with a BBB- to BBB+ credit rating. The draft decision adopted a debt margin range of 3.03 - 4.53 per cent, based on estimates provided by PwC.

The Commission adopted the same approach for the final decision. The Commission engaged PwC to provide updated estimates of the debt margin. PwC derived an estimate of the 10 year BBB+ debt risk premium by taking Bloomberg's BBB fair value curve to seven years, and extrapolating to 10 years based on the

[68] Reserve Bank of Australia data series: *capital market yields – government bonds – daily* (table F2).

average increment in the debt risk premium observed for pairs of bonds of different terms to maturity. PwC then estimated the incremental debt risk premium for BBB and BBB- rated bonds.[69]

PwC provided estimates of average debt margins for BBB+ to BBB- rated bonds over the 40-day trading period to 24 May 2013. Within this trading period, the average annual margin implied by this range of bonds was 2.97 per cent (the low recorded over the 40-day trading period) to 4.01 per cent (the high recorded over the trading period).

The Commission adopted PwC's estimates for the final decision. The range for the debt margin is lower than the range adopted in the draft decision.

Interest rates applying to new borrowings

As for the draft decision, the Commission used data from the Treasury Corporation of Victoria (TCV) to estimate the interest rates applying to new borrowings raised by the water businesses (noting the water businesses must borrow through TCV). While not directly used to calculate the WACC, the estimate of the WACC should consider actual borrowing costs facing the water businesses.

Since the draft decision, the Victorian Government raised the FAL from 110 basis points to a default rate of 252 basis points in 2013-14 (the default rate applying to an entity with a credit rating of BBB). The FAL applies to new borrowings made by government business enterprises (GBEs), including the water businesses. It is intended to account for the difference between normal commercial interest rates paid by private businesses, and rates paid by GBEs who, by borrowing through the TCV, benefit from State Government guarantees on their loan.

Increasing the FAL (all other things being equal) raises the interest rates payable on new debt for the water businesses.

On 24 May 2013 yields on 10 year TCV bonds were approximately 4 per cent. Allowing for debt raising costs (around 0.165 per cent) and the FAL (using the 2.52 per cent default rate to apply to BBB rated entities from 1 July 2013), implies that interest rates on new borrowings will be around 6.7 per cent.

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[69] For more detail on the methodology, see PricewaterhouseCoopers 2013, *Estimating a debt risk premium*, May.

9.3.4 UPDATING THE WACC ESTIMATE

Using the updated figures for the risk free rate and the debt margin, the Commission has calculated a feasible range for the real post-tax WACC of 3.8 - 4.9 per cent, as shown in table 9.8. The Commission has adopted the same values for the equity beta, market risk premium, and financing structure as for the draft decision. To do otherwise would have introduced a dangerous arbitrariness into the regulatory framework. The Commission notes that methodologies (such as calculating the WACC) can only be amended between price reviews (see below).

The Commission decided on a WACC of 4.5 per cent for the next regulatory period. It considered the borrowing costs that water businesses will likely face from 1 July 2013, taking into account the impact of the FAL. The Commission considers that adopting a WACC below 4.5 per cent would create an undue risk that the water businesses would not be able to recover the costs of finance over the next regulatory period.

TABLE 9.8 REAL POST-TAX WACC — FINAL DECISION

WACC parameter	Value
Risk free rate of return	0.422 - 0.913
Equity beta	0.65
Equity (market risk) premium	6.0
Debt margin	2.97 - 4.01
Financing structure (debt/assets)	60
Franking credit value	0.5
Forecast inflation	2.30 - 2.80
Vanilla post-tax WACC (real) range	3.8 - 4.9
Vanilla post-tax WACC (real) point	4.5

A WACC of 4.5 per cent (real post tax terms) implies nominal borrowing costs of around 6.9 - 7.3 per cent, depending on the inflation assumption. This compares sufficiently favourably with new borrowing costs of around 6.7 per cent (as discussed previously).

The Commission has also noted:

- the 4.5 per cent WACC the Essential Services Commission of South Australia (SA) adopted in its May 2013 final decision for SA Water's water and sewerage revenues,[70] and
- the 4.6 per cent WACC IPART adopted in its June 2013 final decision for Hunter Water.[71]

9.3.5 UPCOMING REVIEW OF WACC METHODOLOGY

The Commission will commence a review of the rate of return methodology in 2013-14. The review will include an assessment of alternative approaches, and inform the Commission's approach to estimating the rate of return for water businesses for the fourth regulatory period. The Commission will involve all interested parties in its review.

9.3.6 FINAL DECISION

The Commission has adopted a real post-tax weighted average cost of capital of 4.5 per cent.

[70] Essential Services Commission of South Australia 2013, *SA Water's water and sewerage revenues 2013-14 to 2015-16*, May.

[71] IPART 2013, *Hunter Water Corporation's water, sewerage, stormwater drainage and other services Review of prices from 1 July 2013 to 30 June 2017,* June.

9.4 TAX

9.4.1 OVERVIEW OF DRAFT DECISION

As government owned businesses, the water businesses are subject to a tax equivalence regime that reflects the corporate tax regimes faced by private sector firms. The WACC estimate adopted by the Commission is expressed in post-tax terms, as opposed to taxation being specifically included in the WACC formula. The businesses' revenue requirements therefore include an estimate of tax liabilities.

Generally, businesses adopted a benchmark taxation liability that reflects the assumptions about revenue and cash over the third regulatory period. However, Western Water provided a taxation liability forecast for the regulatory period that was more than 70 per cent above the benchmark. The large difference mainly reflected Western Water's assumption of a franking benefit of zero. It also used different financial inputs to calculate its forecast taxation liability, compared with the inputs used to prepare its Water Plan.

The Commission's draft decision adopted a consistent benchmarking approach to calculate the tax liability for each business. This resulted in downward adjustments to the tax forecasts estimated in businesses' Water Plans.

9.4.2 SUBMISSIONS AND COMMISSION'S ASSESSMENT

In most cases, businesses accepted downward revisions to forecast tax liability. Responses from South East Water and Western Water queried specific elements in the calculation of the benchmark liability.

South East Water adopted the benchmark tax liability calculation, except the adjustment for tax on non-prescribed revenues and costs. South East Water argued the overall tax calculation applies to prescribed revenues and costs, and thus should not be included in the benchmark calculation. The Commission considers the adjustment provides appropriate incentives about non-prescribed activities. Further, applying a different approach to one business would be inconsistent.

Western Water accepted the benchmark tax liability adopted in the draft decision but queried the deduction for imputation credits. It argued this would lead to a funding shortfall. In the past, the Commission adopted tax benchmarks that assume the regulated business was equivalent to a private firm in a competitive market. This methodology was described in the Commission's guidance paper (2011) and was not challenged. The Commission maintains it is appropriate to include franking credits in the calculation of a benchmark tax liability.

For the final decision, the Commission adopts the same benchmark tax liability calculation for all businesses as it did in its draft decision. This ensures a consistent approach across all businesses.

9.4.3 FINAL DECISION

The Commission has adopted benchmark tax liabilities for each business.

9.5 DEPRECIATION

9.5.1 OVERVIEW OF DRAFT DECISION

Generally, the Commission was satisfied with the businesses' straight line depreciation profiles, (City West Water proposed a depreciation deferral). The Commission considered South East Water, Western Water and Yarra Valley Water had not provided sufficiently disaggregated information for larger projects. It proposed to not approve the regulatory depreciation profiles and required all businesses to update their depreciation profiles. The Commission therefore asked the businesses to identify new initiative capital works and their expected date for completion as part of their capital expenditure proposals.

9.5.2 SUBMISSIONS AND COMMISSION'S ASSESSMENT

All businesses disaggregated their large capital projects in response to the draft decision. The Commission has approved each businesses' depreciation profiles. In addition, some businesses made further adjustments to their depreciation profiles:

- City West Water proposed to reduce the amount of depreciation being deferred on existing assets compared with its Water Plan proposal. (The business voluntarily proposed deferring depreciation to reduce price rises.) City West Water considers the reduction in the WACC will put pressure on its cash interest cover, so it reduced the amount of deferred depreciation from $30 million to $14 million over the third regulatory period. The Commission accepts this proposal.
- Yarra Valley Water proposed to reduce depreciation and the price for customers as it had incorrectly excluded $259 million of land assets from the original Water Plan submission.
- Melbourne Water initially proposed a revised capital expenditure profile in response to the draft decision and therefore a revised depreciation profile. This proposal was later withdrawn by Melbourne Water and it was agreed to revert back to the draft decision depreciation profile.

9.5.3 FINAL DECISION

The Commission has approved the revised depreciation profiles for all businesses.

10 DEMAND

10.1 INTRODUCTION

The greater metropolitan water businesses' demand forecasts directly affect the prices customers will face during the third regulatory period for the following key services:

- water
- sewerage
- trade waste
- recycled water.

The key demand parameters that influence prices and revenue for the greater metropolitan water businesses are the numbers of water and sewerage connections, and the total volume of water sold. Generally, the metropolitan retail businesses generate more than half of their tariff revenue from variable charges. Therefore, forecast revenue will be particularly sensitive to the expected volume of water sold to residential and non-residential customers.

10.2 OVERVIEW OF DRAFT DECISION

The key demand parameters that influence prices and revenue for the metropolitan water businesses are the number of water and sewerage connections and the total volume of water sold.

The Commission engaged Frontier Economics to help review and assess the demand forecasts put forward by the water businesses. The detailed review encompassed water, sewerage, recycled water and trade waste. Key issues in this assessment included the businesses' assumptions about future connections growth and the impact of changing supply conditions. The businesses were given an opportunity to comment on the Frontier Economics' report, which is available on the Commission's website.

The Commission's draft decision generally accepted Frontier Economics' recommendations about the demand forecasts for water and sewerage customer connections, and water and sewage volumes. In most cases, the businesses also accepted Frontier Economics' recommended adjustments.

The Commission considered Frontier Economics' recommended demand forecasts reasonably accounted for expected customer growth and water consumption assumptions. The main differences between the draft decision and the businesses' demand forecasts proposed in their Water Plans included:

- revised residential and non-residential water volumes and revised residential sewage volumes for South East Water to reflect the business's revised water volume forecasts
- revised residential water volumes for Western Water to reflect Intelligent Software Development's (ISD's) alternate forecast
- revised residential and non-residential water volumes and revised residential and non-residential sewage volumes for Yarra Valley Water, to reflect the business's revised water volume forecasts
- revised volumes for Melbourne Water, to reflect City West Water's, South East Water's and Yarra Valley Water's revised volumes.

The Commission also required the businesses to submit updated demand forecasts for 2012-13 and any consequential amendments for the third regulatory period.

The Commission proposed to not adopt City West Water's recycled water volumes in its draft decision and requested City West Water submit revised recycled and potable water forecasts to reflect changes to its approved recycled water expenditure.

Tables 10.1 to 10.4 detail the Commission's draft decision on water connections and volumes.

TABLE 10.1 DRAFT DECISION — WATER CONNECTIONS
residential and non-residential connections, number of connections

	2013-14	2014-15	2015-16	2016-17	2017-18	Average annual growth 2013-14 to 2017-18 *per cent*
City West Water	383 165	394 026	404 500	414 586	424 561	2.6
South East Water	669 075	692 443	715 808	725 710	736 573	2.4
Yarra Valley Water	665 630	676 030	686 580	696 830	706 760	1.5
Western Water	57 219	59 818	62 681	65 779	69 110	4.8

Note: Excludes vacant land, fire services and other standalone fixed charges.

TABLE 10.2 DRAFT DECISION — WATER CONSUMPTION
residential and non-residential volumes, ML

	2013-14	2014-15	2015-16	2016-17	2017-18	Average annual growth 2013-14 to 2017-18 *per cent*
City West Water	87 941	89 665	90 721	89 550	88 028	0.0
South East Water	120 221	119 166	120 089	120 918	121 294	0.2
Yarra Valley Water	125 969	125 646	126 494	126 680	127 045	0.2
Western Water	11 840	12 166	12 486	12 834	13 214	2.8

TABLE 10.3 DRAFT DECISION — SEWERAGE CONNECTIONS
residential and non-residential connections, number of connections

	2013-14	2014-15	2015-16	2016-17	2017-18	Average annual growth 2013-14 to 2017-18 *per cent*
City West Water	380 481	391 342	401 816	411 902	421 877	2.6
South East Water	637 974	649 856	661 720	673 468	685 215	1.8
Yarra Valley Water	640 590	651 140	661 900	672 500	682 840	1.6
Western Water	56 134	58 687	61 499	64 541	67 812	4.8

Note: Excludes vacant land, fire services and other standalone fixed charges.

TABLE 10.4 DRAFT DECISION — SEWAGE VOLUMES
residential and non-residential volumes, ML

	2013-14	2014-15	2015-16	2016-17	2017-18	Average annual growth 2013-14 to 2017-18 *per cent*
City West Water	56 067	57 749	58 973	60 137	61 295	2.3
South East Water	135 714	134 745	135 628	136 464	136 930	0.2
Yarra Valley Water	84 005	84 067	84 600	84 896	85 263	0.4
Western Water	na	na	na	na	na	na

na. Not applicable - Western Water does not charge for volumetric sewage.

10.3 SUBMISSIONS AND COMMISSION'S ASSESSMENT

This section details the water businesses' responses to the draft decision and the Commission's assessment of those responses. Detailed tables containing the Commission's final decision on demand forecasts for each business is set out in annexure A of the determination issued for that business.

Where the Commission adjusted businesses' forecasts in the draft decision, the businesses generally accepted the adjustments and updated their forecasts as discussed by the Commission. However, Western Water did not agree with the draft decision on demand and maintained their Water Plan forecasts.

The remaining businesses put forward alternative forecasts. In most cases, these represented minor changes from the draft decision reflecting updated information, a disagreement with the Commission's draft decision, or to correct an inadvertent error. The businesses' proposed revisions to their demand forecasts are summarised in table 10.5, along with the Commission's decisions on the businesses.

Generally, the Commission accepts the revisions outlined in table 10.5 because they represent either a correction of errors or reasonable revisions to reflect updated information. However, the Commission did not accept some forecasts, and this is discussed below.

TABLE 10.5 RESPONSES TO THE DRAFT DECISION

Response to the draft decision	Final decision
City West Water	
City West Water re-ran its bounce back modeling in response to the draft decision and did not change its bounce back assumptions.	**Accept** — This reflects current information and does not alter the draft decision.
City West Water recalculated its elasticity to reflect the lower prices in its submission.	**Accept** — This reflects more recent pricing information.
City West Water corrected for mistakenly removing its water only customers from its customer forecasts.	**Accept** — This corrects for an inadvertent error.
City West Water proposed to include Department of Human Services properties in its customer numbers for phasing in occupancy-based service charges.	**Accept** — This reflects current information.
In response to the Commission's draft decision, City West Water removed non-residential recycled water volumes for the removal of the Docklands sewer mining project.	**Accept** — This addresses the Commission's request in the draft decision.
South East Water	
South East Water re-ran its bounce back modeling with Deloitte in response to the draft decision and did not change its bounce back assumptions.	**Accept** — This reflects current information and does not alter the draft decision.
South East Water recalculated its elasticity to reflect the lower prices in its submission.	**Accept** — This reflects more recent pricing information.
Western Water	
Western Water did not agree with the Commission's adjustments to its residential water volumes however it proposed to accept them provided the Commission allows more funds for bulk water orders from Melbourne Water.	**Not accept** (see section 10.3.2)
Yarra Valley Water	
Yarra Valley Water re-ran its bounce back modeling in response to the draft decision and did not change its bounce back assumptions.	**Accept** — This reflects current information.
Yarra Valley Water recalculated its elasticity to reflect the lower prices in its submission.	**Accept** — This reflects more recent pricing information

10.3.1 SOUTH EAST WATER

The Commission identified some inconsistencies in South East Water's model and engaged Frontier Economics to undertake further analysis. Frontier Economics recommended revising South East Water's submitted customer numbers for 2014-15 upwards to account for an error in the number of new tenement-based charge customers. The Commission has accepted Frontier Economics' advice on the basis that it reflects more accurate information.

10.3.2 WESTERN WATER

In its draft decision, the Commission adjusted Western Water's forecast residential water volumes upwards following its consultant's review, which identified a number of concerns with Western Water's approach and methodology. The other businesses submitted updated forecasts to account for higher than predicted water consumption after water restrictions were removed, but Western Water did not. Nor did it sufficiently justify its reasons for doing so. Therefore, the Commission engaged ISD to provide an alternate forecast. The Commission adopted ISD's baseline (average) forecast for its draft decision.

In response to the draft decision, Western Water stated that it disagreed with the Commission's draft decision and that the Commission should adopt its Water Plan submission. Nonetheless, Western Water's financial template included the draft decision adjustments. Western Water proposed if the Commission maintained its draft decision, the Commission should allow additional funding for bulk water purchases from Melbourne Water to service the higher level of residential water demand.

The Commission does not consider that Western Water's response to the draft decision addressed its earlier concerns with Western Water's forecasts. The other metropolitan businesses revised their demand upwards to account for higher than expected bounce back in water demand when water restrictions were removed. By contrast, Western Water argued its customer base had a more permanent behaviour change from water restrictions, and its Water Plan forecasts remain the best estimate.

The Commission has further considered Western Water's arguments about the lasting impact of restrictions on its customer base. The Commission also recognises that any error in forecasting demand may impact on Western Water's revenue. The Commission has therefore, adopted the ISD model scenario which best reflected Western Water's argument for a higher level of permanent behavior change (high behavior maintenance in the model).

This scenario corresponds with lower residential volumes for Western Water than the Commission's draft decision but higher than the forecasts in their Water Plan. The Commission has also allowed expenditure for higher bulk water purchases from the Melbourne system to account for this adjustment (see chapter 7).

10.4 FINAL DECISION

The Commission has accepted the revised demand forecasts for City West Water and Yarra Valley Water.

The Commission has accepted South East Water's demand forecasts, except for revising customer numbers to correct for an inadvertent error.

The Commission has not accepted Western Water's proposed residential water volumes. The Commission has adopted ISD's high behaviour maintenance forecast to reflect more conservative assumptions about permanent behaviour change following the drought.

The Commission has accepted Melbourne Water's demand forecasts subject to consequential adjustments to the water businesses' demand.

The following tables set out the benchmark assumptions for customer numbers and forecast demand used for pricing.

TABLE 10.6 FINAL DECISION – WATER CONNECTIONS

residential and non-residential connections, number of connections

	2013-14	2014-15	2015-16	2016-17	2017-18	Average annual growth 2013-14 to 2017-18
						per cent
City West Water	383 165	394 026	404 500	414 586	424 561	2.6
South East Water	669 075	679 596	690 113	700 015	710 878	1.5
Yarra Valley Water	665 630	676 030	686 580	696 830	706 760	1.5
Western Water	57 219	59 818	62 681	65 779	69 110	4.8

TABLE 10.7 FINAL DECISION — WATER CONSUMPTION

residential and non-residential volumes, ML

	2013-14	2014-15	2015-16	2016-17	2017-18	Average annual growth 2013-14 to 2017-18
						per cent
City West Water	87 942	89 665	90 721	89 766	88 361	0.1
South East Water	120 822	120 034	120 790	121 493	121 828	0.2
Yarra Valley Water	126 374	126 224	127 022	127 158	127 482	0.2
Western Water	11 320	11 652	12 006	12 394	12 825	3.2

TABLE 10.8 FINAL DECISION – SEWERAGE CONNECTIONS

residential and non-residential connections, number of connections

	2013-14	2014-15	2015-16	2016-17	2017-18	Average annual growth 2013-14 to 2017-18 *per cent*
City West Water	380 481	391 342	401 816	411 902	421 877	2.6
South East Water	637 974	649 856	661 720	673 468	685 215	1.8
Yarra Valley Water	640 590	651 140	661 900	672 500	682 840	1.6
Western Water	56 134	58 687	61 499	64 541	67 812	4.8

TABLE 10.9 FINAL DECISION — SEWAGE VOLUMES

residential and non-residential volumes, ML

	2013-14	2014-15	2015-16	2016-17	2017-18	Average annual growth 2013-14 to 2017-18 *per cent*
City West Water	56 067	57 749	58 973	60 137	61 295	2.3
South East Water	135 714	134 745	135 628	136 464	136 930	0.2
Yarra Valley Water	84 005	84 067	84 600	84 896	85 263	0.4
Western Water	na	na	na	na	na	na

na Not applicable.

11 FORM OF CONTROL

11.1 INTRODUCTION

Under the Water Industry Regulatory Order (WIRO) water businesses can propose different forms of price control. The various forms of price control have advantages and disadvantages in terms of risk sharing between businesses and their customers, price certainty for customers, and businesses' ability to adjust prices to reflect changed circumstances.

When considering an appropriate form of price control, businesses and the Commission must assess the nature and magnitude of any uncertainties facing a business, the potential impacts of unforeseen events on a business's revenue and financial viability, customer preferences and potential customer impacts, among other factors.

11.2 OVERVIEW OF DRAFT DECISION

In its draft decision, the Commission proposed to maintain the hybrid form of price control for the greater metropolitan water businesses that proposed price caps: City West Water, Western Water, and Melbourne Water. The hybrid form of control provides for price caps with the option to apply for a tariff basket during the third regulatory period.

The Commission proposed to approve price caps for South East Water for the first year of the regulatory period, and approve its proposal for a tariff basket for the remainder of the regulatory period. The Commission proposed to approve South East Water's proposed annual price increase limit of 3 per cent for its tariff basket (with no limit on price decreases).

The Commission proposed to approve Yarra Valley Water's proposal for a revenue cap with a 2 per cent limit on annual increases (with no limit on price decreases) for all tariffs and charges.

In the draft decision, the Commission required the following consultation:

- Where a business proposed to transfer to a hybrid form of price control during the third regulatory period, the Commission proposed to require the business to consult with customers. The determinations would require water businesses to provide evidence of customer consultation and a statement about customer impacts and how the business will address those impacts.
- For South East Water and Yarra Valley Water, where these businesses proposed price changes that result in a material tariff change, the Commission proposed to require the businesses to consult with customers before the annual tariff review. The determinations would require water businesses to provide evidence of customer consultation and a statement about customer impacts and how the businesses will address those impacts.

In the draft decision, the Commission proposed to accept the greater metropolitan water businesses' proposals for a five year regulatory period.

11.3 SUBMISSIONS AND COMMISSION'S ASSESSMENT

City West Water, Melbourne Water, South East Water, Western Water and Yarra Valley Water accepted the Commission's draft decisions on their forms of control. As Yarra Valley Water has moved to a revenue cap price control the Commission has removed its annual allowance for unaccounted for revenue. There is no need to separately allow for unaccounted for revenue as the revenue cap form of control allows a business to recover any revenue shortfalls in subsequent year prices.

The joint submission of customer groups supported the rebalancing constraints on South East Water and Yarra Valley Water.[72] The Commission confirms the draft decision on the form of price control for City West Water, South East Water, Yarra Valley Water and Western Water. The Commission has assessed that their proposals are consistent with the WIRO. The Commission considers that Yarra

[72] Consumer Action Law Centre, Consumer Utilities Advocacy Centre and Victorian Council of Social Services 2013, *Submission to the water price review draft decision 2013-18*, 21 May.

Valley Water's proposed rebalancing constraint in combination with its proposed revenue cap appropriately balances Yarra Valley Water's need for revenue certainty and customer's need for price stability. Chapter 3 explains the Commission's decision to approve a three year regulatory period for Melbourne Water.

11.4 FINAL DECISION

The Commission has approved a hybrid form of price control:

- It approves price caps for City West Water, Western Water, and Melbourne Water.
- These businesses may propose a tariff basket at the time of the annual price review subject to consultation with customers prior to their applications as specified in their determinations.

The Commission has approved a five year regulatory period for City West Water, South East Water, Western Water and Yarra Valley Water. The Commission has approved a three year regulatory period for Melbourne Water (with reasons outlined in chapter 3).

The Commission has approved price caps for South East Water for the first year of the regulatory period, and has approved the business's proposal for a tariff basket for the remainder of the regulatory period. The Commission has approved South East Water's rebalancing constraint of 3 per cent.

The Commission has approved a revenue cap for Yarra Valley Water with a proposed 2 per cent limit on price increases.

12 BULK WATER AND SEWERAGE

12.1 INTRODUCTION

The Water Industry Regulatory Order (WIRO) defines storage operator and bulk water services as services provided in connection with supplying water to a regulated entity. Melbourne Water provides storage operator and bulk water services to City West Water, South East Water, Yarra Valley Water, Western Water and Gippsland Water. It is also available to supply Barwon Water, South Gippsland Water and Westernport Water.

The WIRO defines bulk sewerage services as services that Melbourne Water provides in connection with the conveyance, treatment and disposal of wastewater for a regulated entity. Melbourne Water provides bulk sewerage services to City West Water, South East Water and Yarra Valley Water.

The Commission is required to approve prices for Melbourne Water's storage operator and bulk water, and bulk sewerage services.

12.2 OVERVIEW OF DRAFT DECISION

12.2.1 BULK WATER

In the draft decision, the Commission proposed to approve Melbourne Water's proposed:

- fixed and variable tariff structure for bulk water
- headworks tariff structure for bulk water
- transfer tariff structure for bulk water
- approach to set bulk water prices for regional water businesses.

In the draft decision, Melbourne Water explained that its proposed tariff rates (fixed and variable) provided for the cross-subsidisation of bulk water prices by bulk sewerage prices. The Commission considered that Melbourne Water could make its prices more cost reflective and that given there were proposed amendments to Melbourne Water's maximum allowed revenue in the draft decision, there was an opportunity for Melbourne Water to reconsider its proposed pricing strategy.

12.2.2 BULK SEWERAGE

In the draft decision, the Commission proposed to approve Melbourne Water's proposed:

- fixed and variable tariff structure for bulk sewerage
- different variable sewerage price structure for its eastern and western sewerage systems.

Melbourne Water was required to resubmit a more cost-reflective proposal for its bulk variable sewerage tariff, given that its prices did not reflect its estimates of long run marginal cost (LRMC).

12.2.3 RECYCLED WATER

In the draft decision, the Commission proposed to approve Melbourne Water's proposed prices for recycled water and Melbourne Water's proposed pricing principles for recycled water.

12.3 SUBMISSIONS AND COMMISSION'S ASSESSMENT

12.3.1 BULK WATER AND BULK SEWERAGE

In response to the Commission's adjustments to revenue in the draft decision, Melbourne Water submitted lower tariffs for bulk water and sewerage.

Melbourne Water stated it maintained its proposed tariff structure for bulk water and sewerage because:

- its proposals had regard to the WIRO requirements by transitioning towards cost reflectivity, while taking into account the interests of water-only customers
- it has support for its water and sewerage price path proposal from its customers (the retail water businesses) following extensive consultation on this subject when developing its Water Plan.

Melbourne Water belatedly submitted revised marginal cost calculations (the calculations in its Water Plan were from 2011) which updated its LRMC modelling to account for new capital expenditure and revised timing of projects including:

- The Eastern Treatment Plant estimates were changed following revisions to the timing and the cost of the primary and aeration tank augmentation works.
- The Western Treatment Plant estimates were changed reflecting material revisions to sewage load forecasts and the associated Treatment Capacity Augmentation (Stage Two) works.

Melbourne Water used the Commission's LRMC model for these calculations. Melbourne Water argued its updated variable sewerage prices reflect its updated LRMCs (table 12.1).

TABLE 12.1 MELBOURNE WATER'S VARIABLE SEWERAGE CHARGE AND ITS LONG RUN MARGINAL COST
$2012-13 per ML

	Proposed price in water plan	Proposed price in respond to draft decision	Water plan LRMC	Updated LRMC
Eastern Treatment Plant	648.5	589.2	403	648
Western Treatment Plant	371.6	342.0	119	435

The Commission has approved the expenditure associated with these projects and has reviewed Melbourne Water's LRMC model and is satisfied with the calculations. The Commission considers that Melbourne Water's variable sewerage prices reasonably reflect LRMC and has approved these tariffs.

12.3.2 RECYCLED WATER

Melbourne Water did not comment on the Commission's draft decision to approve its recycled water charges.

12.4 FINAL DECISION

The Commission has approved Melbourne Water's bulk tariff structures.

13 RETAIL WATER SERVICES TARIFFS

13.1 INTRODUCTION

The four greater metropolitan water businesses — City West Water, South East Water, Yarra Valley Water and Western Water — provide retail water services. Retail water services are prescribed services under the Water Industry Regulatory Order (WIRO) and are therefore subject to price regulation by the Commission.

The tariffs proposed by these businesses for the third regulatory period can be broadly classified as two part tariffs. These are tariffs comprising a fixed component that is independent of use and a variable component reflecting metered water use. Two part tariffs may include a single usage charge with a constant price per kilolitre of water for all customers or an inclining block structure, whereby prices increase as successively higher amounts of water are consumed.

13.2 OVERVIEW OF DRAFT DECISION

In its draft decision, the Commission considered the following issues about retail water tariffs: tariff structures, connection based charging, customer choice and variable prices.

13.2.1 TARIFF STRUCTURES

The Commission proposed to approve the following retail water tariff structures for the four greater metropolitan water businesses for the third regulatory period:

- for residential customers — a fixed charge and a three tier inclining block tariff
- for non-residential customers — a fixed charge and a single variable charge.

13.2.2 CONNECTION BASED CHARGING

City West Water, South East Water and Yarra Valley Water charge a fixed water and sewerage tariff based on property title. In their Water Plans, these businesses proposed to introduce fixed charges for water and sewerage services for each connected tenement receiving these services. This means multiple residents on a single title, such as an apartment block, will incur a fixed charge for each connected property, rather than a single charge being applied to the apartment block.

In its draft decision, the Commission proposed to approve City West Water's, South East Water's and Yarra Valley Water's proposals to levy fixed charges on all tenements regardless of their land title status. The Commission proposed to approve the introduction of these charges over two years. However, the Commission proposed not to approve City West Water's proposal to exclude Department of Human Services' (DHS) dwellings from the connection based charges because these charges should be consistently applied to all customers. The Commission considered if City West Water wished to apply this exemption, the business should bear any associated costs, not its customers.

13.2.3 CUSTOMER CHOICE

In its draft decision, the Commission observed Yarra Valley Water was the only water business to propose to trial tariff choice. The Commission requested Yarra Valley Water provide regular updates on the progress of the proposal and make available its findings from the trial.

The Commission also noted the WIRO was amended to require the Commission to be satisfied that prices facilitate choice and innovation, when appropriate. The Commission considered City West Water and South East Water to be large water businesses and for that reason, the Commission required them to consult customers about tariff choice, with a view to undertaking their own customer trials during the third regulatory period.[73]

[73] In the 2013 regional urban water businesses draft decision, the Commission acknowledged implementing customer choice options may increase costs for a small water business, and these costs may outweigh any potential benefits. For this reason, Western Water was not required to submit a proposal to trial tariff choice.

13.2.4 VARIABLE PRICES

In its draft decision, the Commission required South East Water to reconsider the link between the non-residential variable water price and the second tier residential water price. The Commission noted this link may affect large water-only users and may not be cost reflective.

13.3 SUBMISSIONS AND COMMISSION'S ASSESSMENT

The Commission received submissions from customers and customer groups on the structure of retail water tariffs. It also received submissions from the water businesses responding to the draft decision's requirements for further information on water tariffs and trialing customer choice.

13.3.1 CUSTOMER SUBMISSIONS

In their joint submission to the draft decision, the Consumer Action Law Centre, the Consumer Utilities Advocacy Centre and the Victorian Council of Social Services (joint Consumer Action submission) supported Yarra Valley Water's tariff choice trial and also supported South East Water and City West Water undertaking similar trials.[74]

The joint Consumer Action submission recommended the Commission undertake research on how the inclining block tariff structure can be improved, including modeling the impacts of alternative tariff structures and variations in the proportion of fixed and variable charges. At the public forums hosted by the Commission a view was expressed favouring an increase in the variable component in bills to alter customers level of water use. However, a converse view was also expressed — namely that inclining block tariffs do not alter customers' water saving behaviour.

A customer wrote to the Commission concerned that Western Water's customer survey results did not reflect the view of the majority of Western Water's

[74] Consumer Action Law Centre, Consumer Utilities Advocacy Centre and Victorian Council of Social Services 2013, *Submission to the Water Price Review draft decision 2013-18*, 21 May.

customers.[75] A customer from Yarra Valley Water was also concerned about how customer survey results were interpreted and that inclining block tariffs unfairly impact large households.[76]

The joint Consumer Action submission supported connection based charging and suggested water businesses alert customers to any support and payment options that may be available to them to manage this change.

13.4 RESPONSES TO THE DRAFT DECISION

The Commission reviewed the information provided by City West Water, South East Water and Yarra Valley Water and is satisfied they are consistent with the WIRO. The Commission did not require any further information from Western Water about its retail water tariffs.

13.4.1 CITY WEST WATER

In response to the draft decision, City West Water accepted the Commission's requirement to include DHS dwellings for the purposes of tariff pricing. City West Water identified approximately 10 500 relevant DHS occupancies and proposed to add these to the existing 23 000 non-DHS occupancies.

The Commission has accepted City West Water's revised customer numbers.

City West Water also provided more information about implementing a customer choice trial during the third regulatory period. It will consult customers and use the results to decide how to trial and implement appropriate tariff choice options for customers.

The Commission is satisfied with the initial steps proposed by City West Water.

[75] Dance T 2013, *Submission to the Water Price Review draft decision 2013-18*, 13 May.

[76] Name withheld 2013, *Submission to the Water Price Review draft decision 2013-18*, 20 May.

13.4.2 SOUTH EAST WATER

In response to the Commission's concern about the effect on large water-only users and a lack of cost reflectivity of the proposed link between the non-residential variable water price and the second tier residential water price, South East Water proposed a smaller increase in the tier two potable water price. The business stated this will reduce the bill impact for non-residential water-only customers, compared with the initial proposal. Further, South East Water proposed to retain the current linkage on the basis that in the long term it aims to have a single variable charge for residential potable water.

The Commission is satisfied with South East Water's proposal to reduce the second tier potable water price and as a consequence, a lower non-residential variable water price. The Commission encourages South East Water to review its tariff structure in the coming regulatory period.

In response to trialing tariff choice, South East Water proposed to consult with customers to understand their preferences for water and sewerage charges during the third regulatory period. South East Water will use this research to decide how it trials and develops more flexible tariff options for its customers.

The Commission is satisfied with the initial steps proposed by South East Water for trialing tariff choice.

13.4.3 YARRA VALLEY WATER

Yarra Valley Water was the only water business to propose a tariff choice customer trial in its Water Plan. In response to the draft decision, Yarra Valley Water indicated it would share its findings and provide regular updates to the Commission. The business stated it is seeking academic and consulting support to design and implement its trial.

The Commission is satisfied with Yarra Valley Water's response to provide information on its tariff choice trial proposal.

13.5 FINAL DECISION

The Commission has approved the residential and non-residential retail water tariff structures proposed by City West Water, South East Water, Yarra Valley Water and Western Water.

The Commission has approved City West Water's, South East Water's and Yarra Valley Water's proposal to implement a fixed water and sewerage charge per connected property.

14 RETAIL SEWERAGE SERVICES TARIFFS

14.1 INTRODUCTION

The four greater metropolitan water businesses provide reticulated sewerage services within the greater metropolitan Melbourne area. These services involve collecting and treating water-borne waste from households and businesses. Retail sewerage services are prescribed services under the Water Industry Regulatory Order and are subject to price regulation by the Commission.

The greater metropolitan water businesses, except Western Water, apply a two part tariff comprising fixed and variable charges for sewerage services.[77] The fixed component for sewerage services covers access (on-going connection) to the sewerage system and is a single fee levied on each property connected to the sewerage system. The variable sewage charge is calculated by multiplying the variable sewage price by the sewage disposal volume. The sewage disposal volume is unmetered, so charges are typically based on a formula, represented by metered water use multiplied by a discharge factor and a seasonal factor.

14.2 OVERVIEW OF DRAFT DECISION

In its draft decision, the Commission proposed to approve the four greater metropolitan water businesses' retail sewerage tariff proposals for the third regulatory period.

[77] Western Water applies only a fixed sewerage service charge to residential customers.

For residential customers, the Commission proposed to approve:

- City West Water's proposal to increase the residential sewage disposal volume factor from 65 per cent to 75 per cent of metered water consumption.
- South East Water's proposal to remove the current formula for calculating the variable sewage volume factor and to introduce a constant factor for residential customers. The Commission proposed to approve the sewage disposal volume factor of 75 per cent of metered water consumption for houses and 85 per cent for apartments.
- Yarra Valley Water's proposal to maintain the average sewage disposal volume factor of 75 per cent of metered water consumption for houses and 85 per cent for apartments.
- Western Water's proposal to maintain a fixed sewerage tariff.

For non-residential customers, the Commission proposed to approve:

- City West Water's, South East Water's and Yarra Valley Water's proposals to maintain a two part tariff structure for non-residential sewerage tariffs.
- Western Water's proposal to maintain a fixed sewerage tariff.

14.3 SUBMISSIONS AND COMMISSION'S ASSESSMENT

The Commission did not receive any submissions from customers or customer groups about the structure of retail sewerage services. In its draft decision, the Commission did not require any business to submit further information about sewerage tariffs; therefore the Commission has confirmed its draft decision.

14.4 FINAL DECISION

> The Commission has approved City West Water's, South East Water's, Yarra Valley Water's and Western Water's retail sewerage service tariffs.

15 RECYCLED WATER

15.1 INTRODUCTION

Recycled water is sewage treated to the quality required for its intended reuse. Recycled water may be used for non-residential purposes (including watering golf courses and recreational parks) and for residential purposes (including toilet flushing and outdoor use). Recycled water is provided to residential customers via a dual reticulation (or 'third pipe') system.

Retail recycled water services are prescribed services under the Water Industry Regulatory Order (WIRO) and are therefore subject to price regulation by the Commission.

15.2 OVERVIEW OF DRAFT DECISION

In its draft decision, the Commission proposed to approve both the pricing principles and the scheduled prices for recycled water services proposed by the greater metropolitan water businesses. The Commission approved the water businesses' proposals to continue to use the recycled water pricing principles adopted in the 2009 water price decision for non-residential customers.[78]

[78] The Commission developed recycled water pricing principles in the 2008 water price review for regional businesses. These recycled water principles were included in the 2009 water price review for metropolitan water businesses. In the 2008 price review, Western Water was considered a regional water business.

These principles require recycled water prices:

- to have regard to the price of any substitutes and customers' willingness to pay
- to cover the full cost of providing the service (with the exception of services related to specified obligations or maintaining balance of supply and demand) and
- to include a variable component.

In addition to pricing principles, the Commission proposed to approve the following scheduled prices for non-residential customers:[79]

- City West Water's proposal to set the variable recycled water price at 85 per cent of the variable non-residential potable water price
- Yarra Valley Water's and Western Water's proposals to set the variable recycled water charge to the first tier residential potable water price.

For residential customers in third pipe estates, the Commission proposed to approve the following proposed scheduled recycled water charges:

- City West Water's and Western Water's proposals to maintain the variable recycled water price at the first tier potable water price, and a fixed charge.
- South East Water's proposal to set recycled water variable prices at 85 per cent of the first tier potable water price, and a fixed charge. From 2014-15, South East Water proposed to allow prices for recycled water to move according to cost drivers and independently of factors affecting the potable water price.
- Yarra Valley Water's proposal to set the recycled water variable charge at 85 per cent of the first tier potable water price, and a fixed charge.

The Commission considered the proposed scheduled charges for residential and non-residential customers are consistent with its recycled water pricing principles.

15.3 SUBMISSIONS AND COMMISSION'S ASSESSMENT

The Commission received two submissions from customer groups about recycled water.

[79] South East Water did not propose scheduled prices for non-residential customers.

In their joint submission to the draft decision, the Consumer Action Law Centre, the Consumer Utilities Advocacy Centre and the Victorian Council of Social Services were concerned South East Water's residential customers have no pricing certainty for recycled water and the business did not account for its customer research study outcomes.[80]

The Commission notes the recycled water prices proposed by all water businesses are maximum prices and therefore provide pricing certainty to customers.[81] Further, the recycled water price will not be affected by any water ordered from the Victorian Desalination Plant as any water order will only affect potable water prices. Scheduled prices are also publicly available.

South East Water's scheduled recycled water price is currently set at a maximum of 85 per cent of the first tier potable water price. From the second year in the regulatory period, the recycled water price will be a standalone price, independent of the potable water price, with any change in price subject to their rebalancing constraint.

The Commission received a submission from the Purple Pipe Association suggesting the price of recycled water be reduced and decoupled from the potable water price.[82] Responding to feedback from the Purple Pipe Association, Yarra Valley Water proposed to discontinue linking its recycled water tariffs to the potable water price beginning from the second year of the regulatory period. Yarra Valley Water acknowledges cost drivers for potable water prices are different from recycled water prices. The Commission notes that any price change will be subject to their rebalancing constraint.

The Commission considers tariffs should ideally be set to reflect efficient costs because tariffs set arbitrarily too low or too high, may distort consumption and efficient use of resources. The Commission also considers individual water businesses are best placed to design recycled water tariffs that are consistent with the Commission's pricing principles and meet their customer needs. Therefore, the Commission has confirmed its draft decision.

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[80] Consumer Action Law Centre, Consumer Utilities Advocacy Centre and Victorian Council of Social Services 2013, *Submission to the Water Price Review draft decision 2013-18*, 21 May.

[81] Businesses have the opportunity to amend their determinations over the regulatory period. However, the Commission only may approve the amendments if they are consistent with the regulatory principles in the WIRO.

[82] Purple Pipe Association 2013, *Submission to the Water Price Review draft decision 2013-18*, 17 May.

15.4 FINAL DECISION

The Commission has approved the proposed recycled water scheduled charges for City West Water, South East Water, Yarra Valley Water and Western Water.

The Commission has approved the proposed pricing principles for City West Water, South East Water, Yarra Valley Water and Western Water.

16 TRADE WASTE

16.1 INTRODUCTION

Trade waste involves the discharge of waste other than normal domestic sewage into the sewerage system. Customers seeking to discharge trade waste into the sewerage system must first obtain the consent of the relevant water business. The water businesses establish acceptance limits for trade waste, which partly depend on the businesses' treatment plant capabilities. Waste that does not fall within acceptance limits — for example, waste with high concentrations of contaminants (such as heavy metals or toxic substances) — must be pre-treated by customers before they discharge it into the sewer.

Trade waste is subject to charges separate from normal sewerage charges. In addition to fixed and variable charges, trade waste charges include parameters that measure the level of contaminants such as biochemical oxygen demand and suspended solids. The parameters adopted by water businesses differ depending on their trade waste customers. Charges and discharge conditions for trade waste customers with particularly large or unique loads are sometimes determined on a case-by-case basis.

16.2 OVERVIEW OF DRAFT DECISION

The Commission's approach to trade waste pricing is that prices must provide appropriate signals to trade waste customers about the relative merits of discharging waste into the sewerage system compared to alternatives such as waste minimisation and on-site treatment. Cost reflective pricing will strengthen incentives for efficient and sustainable water use and waste discharge, including providing appropriate incentives for investments in changing production methods or extending on-site treatment to reduce trade waste to efficient and sustainable levels.

In its draft decision, the Commission proposed to approve the trade waste tariff schedules proposed by the metropolitan water businesses. They generally proposed small price increases, few major changes to their tariff structures and met the requirements of the WIRO.

The Commission also identified a number of issues and proposed responses:

- Total dissolved solids (TDS) – South East Water did not propose an inorganic total dissolved solids (ITDS) charge and only proposed a TDS charge. The Commission considers the change to an ITDS charge appears to be a more effective method of targeting salinity than the current approach and eliminates issues of double counting. The Commission also recommended South East Water implement an ITDS charge. The Commission required South East Water to provide additional information on why it chose to not implement the ITDS charge to replace the TDS charge.
- 5 per cent price increase – City West Water proposed a 5 per cent price increase in its trade waste tariffs. The Commission did not believe this price increase was justified, especially compared with the changes proposed by the other metropolitan water businesses. The Commission required additional information from City West Water on its reasons for the 5 per cent increase in trade waste tariffs in the first year of the regulatory period.

16.3 SUBMISSIONS AND COMMISSION'S ASSESSMENT

16.3.1 SOUTH EAST WATER

In response to the draft decision, South East Water stated it consulted with customers about introducing an ITDS charge and determined it would not provide sufficient incentive to reduce this type of waste. South East Water also noted ITDS is 'not a critical pollutant and therefore sending a price signal to customers to reduce this waste was not required'.[83] Given this, South East Water chose not to propose a TDS or an ITDS charge for the third regulatory period. The Commission has approved South East Water's trade waste tariff structures.

[83] South East Water 2013, *Submission to the Water Price Review draft decision 2013-18*, 22 May 2013, p. 30.

16.3.2 CITY WEST WATER

In response to the draft decision, City West Water justified its 5 per cent price increase in the first year of the third regulatory period based on the desalination price freeze. In 2009, City West Water intended an approximate 11.4 per cent increase in trade waste charges for 2012-13. However, the desalination price freeze meant the final price increase was not implemented. The proposed increases in price in the first year of the third regulatory period are to reach the price to return the tariffs to their scheduled levels. The Commission considers this is a reasonable justification and has accepted City West Water's trade waste tariff price increase of 5 per cent for the first year of the third regulatory period.

16.4 FINAL DECISION

> The Commission has approved the trade waste tariff structures proposed by the greater metropolitan water businesses.

17 WATERWAYS AND DRAINAGE

17.1 INTRODUCTION

Melbourne Water provides drainage, waterways and floodplain management services in the greater Melbourne metropolitan area and some adjacent river catchment areas. This includes programs to improve the health of rivers and creeks, to improve stormwater quality, and to provide drainage infrastructure to service urban growth and to provide flood protection. Melbourne Water also provides diversion services in connection with managing, extracting or using groundwater or surface water.

The Water Industry Regulatory Order (WIRO) prescribes metropolitan waterways and drainage services, and diversion services, and they are therefore subject to price regulation by the Commission.

17.2 OVERVIEW OF DRAFT DECISION

In the draft decision, the Commission proposed to approve Melbourne Water's proposed residential waterways and drainage charge structures including a fixed charge for residential customers. In the absence of a proposed alternative methodology to price non-residential waterways and drainage services, the Commission proposed to approve Melbourne Water's proposed charge based on property value (with a minimum charge) for non-residential customers. However, this approval was subject to Melbourne Water providing information, prior to the final decision, on how it proposes to improve the cost reflectivity of this charge during the third regulatory period.

In the draft decision, the Commission proposed to allow price increases of 0.5 per cent for waterways and drainage services which was lower than Melbourne Water's proposal to increase prices by 14.1 per cent.

The Commission's draft decision also included the following proposals for Melbourne Water's proposed changes to the waterways and drainage charge:

- The Commission proposed to approve Melbourne Water's proposal to remove farm exemptions (granted in the early 1980s) because the government direction for the waiver of these charges (granted after the Black Saturday bushfires) expires on 1 July 2013. Customers in bushfire affected areas experiencing payment difficulties may be able to access government support and hardship programs.
- The Commission proposed to approve Melbourne Water's proposed changes resulting from the change in the urban growth boundary. Some customers on rural charges will pay higher urban charges following this change.
- The Commission proposed to approve Melbourne Water's proposed precept rate structures for the Koo Wee Rup–Longwarry Flood Protection District. This included transferring rates based on property values to a fixed charge over the third and fourth periods and that a single precept rate would replace multiple rates.
- The Commission supported the process of an independent review of the Patterson Lakes precept area (including the appropriate pricing approach) agreed by Melbourne Water and the Patterson Lakes community. The Commission required Melbourne Water to submit a pricing proposal for Patterson Lakes in response to the draft decision.
- The Commission proposed to approve Melbourne Water's proposed diversion charge structures including the proposed changes to reflect changes in government policy on administering licences and the requirements of operating under the Victorian Water Register.

17.3 SUBMISSIONS AND COMMISSION'S ASSESSMENT

17.3.1 COST REFLECTIVITY OF NON-RESIDENTIAL WATERWAYS AND DRAINAGE CHARGE

In response to the draft decision, Melbourne Water undertook to do the following prior to the fourth regulatory period commencing:

- It will investigate the concept of 'directly connected catchment imperviousness' in terms of its impact, geographic information systems coverage and its relationship to cost and benefits. This is a measure of the proportion of the catchment covered by impervious surfaces (that is roofs and paved surfaces) that are directly connected to the waterways. It is negatively correlated with the condition of stream ecosystems (that is a higher imperviousness indicates a lower condition of stream ecosystem) indicating that both (larger) catchment-scale and (smaller) reach-scale actions are important in managing stormwater impacts.
- Work will occur between Melbourne Water's waterways and drainage group and the Department of Environment and Primary Industries to better understand how pricing can be used to support waterway health objectives. This will also be supported by better understanding of the relationship between impervious area and the impact of stormwater.
- It will develop reform options consistent with government policy, including *Living Victoria* objectives.
- It will work with the Valuer-General Victoria to ensure data gained from general valuations can better facilitate customer impact modelling.

To investigate relevant issues surrounding possible options for changes to the non-residential charge for waterways and drainage services Melbourne Water will:

- establish a working group with appropriate governance
- gain internal and external agreement on key objectives and establish reform principles
- model potential pricing structures
- consult with customers and stakeholders on the modelled pricing structures
- include agreed reform approaches for the fourth regulatory period.

The Commission's final decision is to allow waterways and drainage charges to increase by 4.7 per cent on average over a three year regulatory period, rather than Melbourne Water's proposal of a 14.1 per cent increase over a five year period. The allowed increase in the final decision is higher than the 0.5 per cent proposed in the draft decision and reflects more detailed information submitted by Melbourne Water following the draft decision on the cost of delivering waterways and drainage services. This change has no impact on Melbourne Water's total revenue as there is a corresponding reduction in prices for its water and sewerage services.

Table 17.1 compares Melbourne Water's proposals for specific waterways and drainage charges with the final decision. Melbourne Water proposed to increase the price for residential and non-residential minimum price waterways and drainage services by 13.8 per cent over a five year regulatory period, which is equivalent to a rise of 8.1 per cent over a three year regulatory period. The Commission's final decision is to approve a maximum price increase of 5.0 per cent over a three year regulatory period.

TABLE 17.1 WATERWAYS AND DRAINAGE PRICES PROPOSED BY MELBOURNE WATER COMPARED WITH FINAL DECISION
$2012-13

	2013-2014	2015-2016	Percentage increase
Residential charge			
Proposed in water plan	87.32	91.96	8.1[b]
Draft decision	85.13	85.29	0.3
Final decision	86.96	89.36	5.0
Non-residential charge - minimum [a]			
Proposed in water plan	100.41	105.76	8.1
Draft decision	97.90	98.09	0.3
Final decision	100.01	102.76	5.0
Rural charge			
Proposed in water plan	47.98	50.53	8.1
Draft decision	46.78	46.87	0.3
Final decision	47.79	49.10	5.0

[a] The non-residential charge is calculated by multiplying a rate (in cents) by the net annual value (a measure of property value). [b] This 8.1 per cent rise over three years is the equivalent of Melbourne Water's proposal of 13.8 per cent over five years.

17.3.2 PATTERSON LAKES PRECEPT AREA

In response to the draft decision, Melbourne Water proposed to provide a price submission on the Patterson Lakes precept area to the Commission in July 2013, subject to consultation with the Patterson Lakes community and key stakeholders.

Melbourne Water proposed that until the Commission rules on the price submission the existing precept rate will cease. Customers would still pay the general waterways and drainage charge. The Commission accepts this proposal.

17.4 FINAL DECISION

The Commission has approved Melbourne Water's proposed waterways and drainage charges.

18 NEW CUSTOMER CONTRIBUTIONS

18.1 INTRODUCTION

New customer contributions (NCC) (also known as developer charges) are an upfront payment that a water business may levy when a customer builds or develops a property and connects to that water business's water, sewerage or recycled water network. As part of its role in regulating water prices, the Commission is required to approve the NCC to be paid by developers and property owners or the manner in which NCC are calculated.

Details on the NCC framework, core pricing principles and negotiating framework can be found in the Commission’s draft decision.[84]

The water businesses may also levy a charge (which is based on the NCC pricing principles) when existing property owners in urban areas connect to the businesses’ sewerage networks. These charges are known as Backlog sewerage scheme charges.

This chapter sets out the Commission’s final decision for the greater metropolitan water businesses NCC proposals and South East Water’s and Yarra Valley Water’s backlog sewerage scheme proposals.

18.2 OVERVIEW OF DRAFT DECISION

Based on its analysis of the water business’ NCC proposals, the Commission was generally satisfied City West Water, Western Water and Yarra Valley Water

[84] Essential Services Commission 2013, *Price review 2013: Greater metropolitan water businesses—draft decision, volume I,* April.

calculated Standard NCC in accordance with the core pricing principles. However, the analysis showed there was potential for the businesses to consider more cost-reflective NCC and to improve the transparency about where or when Standard NCC or Negotiated NCC would be levied. The Commission's draft decision proposed to approve the manner in which these three water businesses determined their NCC charges, subject to them completing specific actions:

- assessing how to improve the cost reflectivity of their NCC proposals and presenting options on offering more location specific NCC
- improving the transparency of their NCC proposals by providing maps to show the boundaries around the areas (or towns) within which Standard NCC apply, or by defining any threshold that must be met for an NCC to be levied
- adjusting the modeling assumptions following the Commission's draft decision on other parameters such as demand and expenditure forecasts and the weighted average cost of capital (WACC)
- continuing consultation with stakeholders following the release of the draft decision.

In the draft decision, the Commission proposed not to approve South East Water's NCC proposal, because its costs were limited to distribution asset costs. It excluded incremental operating costs, incremental tax and incremental costs associated with other asset types.

The Commission also required businesses that proposed Standard NCC that were significantly higher than the existing NCC to consult with stakeholders about appropriate transition arrangements.

18.3 NEW CUSTOMER CONTRIBUTIONS

18.3.1 RESPONSES TO DRAFT DECISION

All of the metropolitan water businesses responded to the Commission's draft decision on NCC. The Commission also received two submissions from the public in response to this matter.

Table 18.1 summarises the revised Standard NCC and transition arrangements proposed by the greater metropolitan water businesses.

TABLE 18.1 METROPOLITAN WATER BUSINESSES NCC PROPOSALS
$2012-13 per lot

		2013-14	2014-15	2015-16	2016-17	2017-18
City West Water						
Standard Zone						
All lot sizes	Water	625	625	625	625	625
	Sewerage	625	625	625	625	625
Greek Hill Zone						
<450m^2	Water	625	625	625	625	625
	Sewerage	625	625	625	625	625
	Recycled Water	750	1 250	1 750	2 150	2 150
>=450m^2	Water	625	625	625	625	625
	Sewerage	625	625	625	625	625
	Recycled Water	1 950	2 150	2 150	2 150	2 150
West Werribee Zone						
<450m^2	Water	625	625	625	625	625
	Sewerage	625	625	625	625	625
	Recycled Water	750	1 250	1 750	2 150	2 150
>=450m^2	Water	625	625	625	625	625
	Sewerage	625	625	625	625	625
	Recycled Water	1 950	2 150	2 150	2 150	2 150
Holden Zone						
<450m^2	Water	625	625	625	625	625
	Sewerage	625	625	625	625	625
	Recycled Water	750	1 250	1 750	2 250	2 450
>=450m^2	Water	625	625	625	625	625
	Sewerage	625	625	625	625	625
	Recycled Water	1 950	2 150	2 350	2 450	2 450
South East Water						
Casey	Water	979.26	979.26	979.26	979.26	979.26
	Sewerage	625	625	625	625	625
	Recycled Water	1 411.12	1 411.12	1 411.12	1 411.12	1 411.12
Cardinia	Water	1 379.45	1 379.45	1 379.45	1 379.45	1 379.45
	Sewerage	987.33	987.33	987.33	987.33	987.33
	Recycled Water	911	1 111	1 311	1 511	1 534
Other Area	Water	625	625	625	625	625
	Sewerage	625	625	625	625	625
	Recycled Water	625	625	625	625	625
Western Water						
Infill		1 951.17	1 951.17	1 951.17	1 951.17	1 951.17
Greenfield		3 902.34	3 902.34	3 902.34	3 902.34	3 902.34

		2013-14	2014-15	2015-16	2016-17	2017-18
Yarra Valley Water						
New Urban Growth Boundary						
<450m^2	Water	688	938	1 188	1 438	1 639
	Sewerage	688	938	1 188	1 438	1 639
	Recycled Water	625	625	625	625	625
>=450m^2	Water	1 288	1 388	1 488	1 588	1 639
	Sewerage	1 288	1 388	1 488	1 588	1 639
	Recycled Water	625	625	625	625	625
Greenvale/Mickleham						
<450m^2	Water	688	938	1 188	1 438	1 639
	Sewerage	688	938	1 188	1 438	1 639
	Recycled Water	625	625	625	625	625
>=450m^2	Water	1 288	1 388	1 488	1 588	1 639
	Sewerage	1 288	1 388	1 488	1 588	1 639
	Recycled Water	625	625	625	625	625
Epping North						
<450m^2	Water	688	913	913	913	913
	Sewerage	688	913	913	913	913
	Recycled Water	625	625	625	625	625
>=450m^2	Water	1 088	988	913	913	913
	Sewerage	1 088	988	913	913	913
	Recycled Water	625	625	625	625	625
Standard						
All Lot Sizes	Water	625	625	625	625	625
	Sewerage	625	625	625	625	625
	Recycled Water	625	625	625	625	625

18.4 COMMISSION'S ASSESSMENT

The Commission has assessed the water businesses NCC responses as follows:

- Have businesses confirmed that NCC are calculated in accordance with the core NCC pricing principles?[85]
- Are the revised Standard NCC appropriately cost reflective?
- Have the businesses proposed location specific NCC?
- Have the businesses addressed the actions required in the draft decision?

All of the water businesses met the assessment criteria. However, the following sections contain more detail about South East Water's proposal and transition arrangements. Further information on each business's proposal can be found in appendix D.

18.4.1 SUMMARY OF ASSESSMENT

Table 18.2 summarises the Commission's assessment of each metropolitan water businesses' response to the draft decision.

[85] As described in Essential Services Commission 2012, *New customer contributions — guidance paper*, August.

TABLE18. 2 SUMMARY OF ASSESSMENT

	Have businesses confirmed that NCC are calculated in accordance with the core NCC pricing principles?	Are the revised Standard NCC appropriately cost reflective?	Have the businesses proposed location specific NCC?	Have the businesses addressed the other actions required in the draft decision?
City West Water	Yes	Yes	Yes	Yes
South East Water	Yes	Yes	Yes	Yes
Western Water	Yes	Yes	Yes	Yes
Yarra Valley Water	Yes	Yes	Yes	Yes

18.4.2 SOUTH EAST WATER

The Commission is satisfied that South East Water's revised NCC Standard NCC proposal is based on the core pricing principles and is appropriately cost reflective.

This is because:

- The business has confirmed that it has calculated Standard NCC in accordance with the core pricing principles.
- Review of the calculation model showed that Standard NCC were based on incremental operating costs and revenues.
- The expenditure review that informed the Commission's draft decision showed that the capital forecasts that were included in the NCC calculation were reasonable.
- Revised NCC include adjustments required by the Commission in its draft decision.

18.4.3 TRANSITION ARRANGEMENTS

The Commission received correspondence from the Minister for Water requesting transitional arrangements to apply over the third regulatory period.[86] It outlined that the water businesses were asked to adopt an approach that is consistent with the framework developed by the Commission. This includes a transitional approach during the Water Plan 3 period. Specifically:

> *This transitional approach would apply during the Water Plan 3 period, and would establish NCC as follows:*
>
> - *A combined total of $4,000 per lot for the provision of water, sewerage and recycled water services to greenfields lots; and*

[86] Minister for Water 2013, *Water infrastructure costs in Melbourne's growth areas*, May.

- *A combined total of $2,000 per lot for the provision of water, sewerage and recycled water services to brownfields lots.*

The Commission also received a joint submission from the Urban Development Institute of Australia and the Property Council of Australia about the maximum cap on NCC and the definitions of infill and greenfield.[87] The submission stated:

> *We understand the Government's intention is to apply the cap of $2,000 per dwelling for infill and $4,000 per dwelling for greenfields development as a cap covering the entire regulatory period in nominal terms and we support the capped approach. However, the definitions of 'infill' and 'greenfields' remain outstanding and must be resolved if the implementation of the Government's policy is to be successful. We support the water businesses' proposal to map the applicable areas, however; our concerns remain about the vague approach to defining development.*
>
> *We note that the water businesses have submitted their proposed NCCs in 2012-13 dollars. It is likely that each of the water businesses' proposed NCCs breach the cap in some way when inflation is taken into account.*
>
> *We also note that we expect the caps to be the maximum NCCs, and NCCs should be below this unless the water businesses can justify an NCC equal to the caps.*

The Commission has verified with the water businesses and they have each confirmed that they have revised their latest NCC consistent with the Minister's request, namely that the maximum amounts are fixed in real terms ($2013-14) and then adjusted for inflation in subsequent years.[88] The Commission notes that these arrangements are similar to the Commission's current practice in approving the other tariffs.

[87] Urban Development Institute of Australia and Property Council of Australia 2013, *Submission to the water price review 2013–18*, 12 June.

[88] Minister for Water 2013, *Water infrastructure costs in Melbourne's growth areas,* June.

The Commission's assessment showed that all metropolitan water businesses have considered these transitional arrangements accordingly.

The Commission's review found that the metropolitan water businesses have addressed issues relating to providing greater clarity about where Standard NCC are to be levied. City West Water, South East Water and Yarra Valley Water have prepared maps showing the areas where each Standard NCC is applicable. For the purpose of levying NCC, Western Water has defined the terms 'greenfield' and 'infill'.

The Commission is satisfied Western Water's Standard NCC ($4000 per lot for greenfields developments and $2000 per lot for brownfields developments) reflect the business's approach to transitioning from its original higher NCC, subject to the cap for the 5 year period.

During the third regulatory period the Commission will monitor the effectiveness of the businesses' arrangements in implementing the NCC framework.

18.5 FINAL DECISION – NCC STANDARD CHARGES

Core pricing principles

The Commission has approved the core pricing principles as the methodology to be adopted by all regional water businesses for determining NCC, as set out below.

Standard and Negotiated NCC will:

- have regard to the incremental infrastructure and associated costs in one or more of the statutory cost categories attributable to a given connection
- have regard to the incremental future revenues that will be earned from customers at that connection
- be greater than the avoidable cost of that connection and less than the standalone cost of that connection.

Notes:

1. Given that NCC are to be based on the net incremental cost of connection (for example, incremental costs net of incremental benefits), in this context, the costs referred to in the efficient pricing bound are the net costs, specifically the avoidable net cost of connection and standalone net cost of connection.
2. Where the connection arrangement requires assets to be gifted, the value of gifted assets will be excluded for the purposes of calculating net costs.
3. Incremental costs may include financing costs associated with constructing an asset sooner than planned. Refer to section 18.5.1.

Standard NCC

The Commission has approved the Standard NCC for City West Water, South East Water, Western Water and Yarra Valley Water, as shown in table 18.1.

Transition arrangements

The Commission has approved the transition arrangements for City West Water, South East Water, Western Water and Yarra Valley Water as shown in table 18.1.

18.5.1 OTHER ELEMENTS OF FINAL DECISION - NCC

Incremental financing costs

The Commission has approved the following formula as the method to calculate incremental financing costs.

All water businesses should calculate incremental financing costs (IFC) using this formula:

> IFC = $(1 - [1/ (1+r)^{n}])$ x cost of capital being provided sooner than planned
>
> where:
>
> r = estimated pre-tax WACC
>
> n = the number of years the asset is required sooner than planned.

The Commission expects that water businesses will review their capital works programs annually and update their development servicing plans (DSPs) accordingly. DSPs show the timing of a logically sequenced expansion of a business's water, sewerage and recycled water networks. They help the businesses explain to developers the basis for recovering incremental financing costs. The Commission expects the water businesses to make these DSPs publicly available.

Under the new framework, the developer who makes the incremental financing cost payment may negotiate with the water business to be reimbursed (a portion of the financing costs) when other developers connect (to the asset that was provided sooner than planned). Refer to appendix D for further discussion on this issue.

The Commission received a joint submission from the Urban Development Institute of Australia and the Property Council of Australia in relation to levying bring forward charges (recovering the incremental financing costs of providing an asset sooner than planned).[89] The submission stated:

> *The resounding view of the development industry is that any site that is covered by a Precinct Structure Plan (PSP) should not be subject to a bring forward charge as it has been declared to be development ready within the planning system. This would be consistent with a whole of government approach to urban development.*

This issue was discussed in the draft decision and the Commission's view remains[90]. The water businesses face additional financing costs whenever an asset is provided sooner than planned, regardless of whether development is in an area covered by a precinct structure plan. Thus the Commission considers water businesses should not be prevented from levying bring forward charges on developments where a precinct structure plan exists.

The Commission will examine this issue more fully as it develops the NCC guideline.[91]

[89] Urban Development Institute of Australia and Property Council of Australia 2013, *Submission to the water price review 2013–18*, 12 June.

[90] Essential Services Commission 2013, *Price review 2013: Greater metropolitan water businesses—draft decision, volume I,* March.

[91] Under section13 of the *Essential Services Commission Act* 2001 the Commission may publish guidelines.

Gifted Assets

The Commission has approved the following treatment of gifted assets.

The Commission considers that under the NCC framework it is acceptable for a water business to require developers to provide and gift to the water business specified assets as a condition of connection provided that the water business:

- makes clear to potential developers which assets a developer will be responsible for providing and gifting, and which will be provided by the water business
- confirms that negotiation of any non-standard connection and associated charges will be undertaken in accordance with the water business's published negotiating framework
- where the connection arrangement requires assets to be gifted, the value of gifted assets will be excluded for the purposes of calculating net costs.

Note: Refer to appendix D for more details on gifted assets.

The Commission will monitor the gifting arrangements imposed by the water businesses. If stakeholders raise concerns, the Commission will consider developing binding principles to guide the classification of gifted assets.

Standard NCC Charging Units

The Commission confirms its view as in its draft decision, namely the water businesses should have the flexibility to choose the most appropriate charging units for NCC. As a guide water businesses should consider charging units that act as proxies for the amount of capacity needed to service the connection.

City West Water, South East Water and Yarra Valley Water responded by proposing charging units based on a 20 mm connection as a standard charge. The Commission considers that the standard charging unit should be unambiguous and on this basis has accepted the businesses' proposals.

Standard NCC Charging Units

The Commission has accepted the water businesses proposal to have the charging units based on a 20 mm meter for a Standard NCC.

Melbourne Water developer charges

The Commission notes that Melbourne Water has proposed to continue with the existing arrangements that apply to developer service drainage scheme charges and stormwater quality offset charges.

The Commission recognizes that the basis for Melbourne Water's developer charges is different from the other urban water businesses, and it is not intended that the new NCC framework will apply to Melbourne Water.

On this basis, the Commission has accepted that the arrangements that apply to Melbourne Water's developer service drainage scheme charges and stormwater quality offset charges continues.

18.6 BACKLOG SEWERAGE SCHEME CHARGES

18.6.1 BACKGROUND

The water businesses' Statement of Obligations require them to participate with local councils to develop waste water management plans. Previously, the Government imposed a $500 cap on the price of connection in the backlog sewerage scheme areas. In 2012, the Minister for Water wrote to the water businesses stating that the $500 customer contribution was no longer Government policy.

The Minister also advised the businesses that backlog sewerage scheme charges were to be calculated using the same principles as those used in calculating a NCC for a sewerage connection in a new development and that consideration should be given to broader factors by the water businesses:

- the efficiency of the scheme and the impact of the proposed customer contribution on the rate of connection to the sewer
- the customer impacts of the contribution, both for the connecting customers (including vulnerable customers) and the broader customer base (the latter with regard to the level of cross-subsidy) and
- the environmental and public health benefits of the scheme

In accordance with the Statement of Obligations, property owners must be given the option to pay the contribution in installments over 20 years as an annuity calculated by reference to the 20 year market annuity rate, as determined by the Treasury Corporation of Victoria.

18.6.2 SOUTH EAST WATER PROPOSAL AND COMMISSION ASSESSMENT

South East Water confirmed it based its backlog sewerage scheme charge on the core NCC pricing principles, and after considering the broader factors, it proposed a standard backlog sewerage scheme charge of $1500 per lot. This total amount can be paid in installments over 20 years.[92] The Commission notes that South East Water will offer customers a reduced charge of $525 per lot if they connect within 2 years of the service becoming available.

The Commission is satisfied that South East Water has considered the core NCC pricing principles to calculate a backlog sewerage scheme charge.

South East Water is also proposing an accelerated rollout of the backlog sewerage scheme on the Mornington Peninsula. South East Water advises that this approach will generate efficiencies in the delivery of the capital rather than delivering the infrastructure in an incremental manner over a longer period of time.

South East Water is proposing to levy a charge that reflects the financing costs of the scheme on those customers who choose to connect earlier than scheduled.

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[92] Using the core NCC pricing principles South East Water calculated a backlog sewerage scheme charge of $28 498 per lot.

The charge will be calculated using the incremental financing cost method described in section 18.5.1.[93] Charges will be based on the average costs of connection rather than having the initial customer paying a very high charge and later customers paying a substantially lower amount in later years. The Commission notes that there is no compulsion to connect earlier than scheduled. Customers who choose to connect at the scheduled time will continue to pay the standard charge; $1500 per lot.

The Commission considers in principle that South East Water should be able to levy a charge to recover the incremental financing costs of providing an asset sooner than planned. However, South East Water's submission lacked details to fully understand the calculation of charge that applies to customers who choose to connect earlier than scheduled. The Commission requires South East Water to provide greater details and transparency on the calculation to potential customers. In addition the Commission requires South East Water to publish maps showing the areas covered by the accelerated backlog sewerage scheme. Therefore, the Commission will approve the *manner* in which South East Water determines backlog sewerage scheme charges for customers in the accelerated backlog sewerage scheme area who require connection sooner than scheduled.

18.6.3 YARRA VALLEY WATER PROPOSAL

Yarra Valley Water confirmed it based its backlog sewerage scheme charge on the core NCC pricing principles, and after considering the broader factors, it proposed a standard backlog sewerage scheme charge of $1500 per lot. This total amount can be paid in installments over 20 years.[94] The Commission notes that Yarra Valley Water will waive the charge if customers connect within 1 year of the service becoming available.

The Commission is satisfied that Yarra Valley Water has considered the core NCC pricing principles to calculate a backlog sewerage scheme charge.

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[93] Incremental financing costs take into account the number of years the asset is being brought forward sooner than planned and the capital costs to connect the customer. In this case South East Water proposed to use an average cost per customer of $28 498 per lot as the basis of the capital cost for inclusion in the calculation.

[94] Using the core NCC pricing principles Yarra Valley Water calculated a backlog sewerage scheme charge of $25 000 per lot.

18.6.4 FINAL DECISION – BACKLOG SEWERAGE CHARGES

The Commission has approved the Standard backlog sewerage charge for South East Water of $1500 per lot.

The Commission has approved the *manner* in which South East Water determines backlog sewerage charges for customers in the area covered by the accelerated program. Subject to it:

- Providing greater details and transparency on the calculation of the charge to potential customers who may choose to connect earlier than scheduled.
- Publishing maps showing the areas covered by the accelerated backlog sewerage scheme.

Noting customers will have the choice to opt out of earlier connection.

The Commission has approved the Standard backlog sewerage charge for Yarra Valley Water of $1500 per lot.

18.7 FURTHER ACTIONS IN THE THIRD REGULATORY PERIOD

Over the third regulatory period, the Commission will work with stakeholders to bed down the NCC framework. The Commission will issue a guideline in 2013-14 to provide greater clarity and consistency in the application of all the elements of the NCC framework.

In addition, the Commission will:

- Undertake a review in 2015-16 on how the NCC framework sits within broader *Living Melbourne, Living Victoria* and other Government policies on infrastructure provision and of any practical issues businesses and developers have encountered since its implementation. The findings will inform the need for any refinements to the framework for the fourth regulatory period or further guidance on its operation.
- Provide non-binding advice to water businesses and developers in the event of potential dispute.
- Undertake annual audits of each water business to ensure that the framework is working as intended.
- Monitor the gifting arrangements prescribed by the water businesses. If concerns are raised by stakeholders, the Commission will consider developing binding principles to guide the classification of gifted assets.

19 MISCELLANEOUS SERVICES

19.1 INTRODUCTION

As well as providing water, sewerage and other primary services, greater metropolitan water businesses provide miscellaneous services. These may include providing services such as new connections, special meter reads and meter testing, providing property information statements and reviewing applications to build over easements. Miscellaneous services are prescribed services under the *Water Industry Regulatory Order* (WIRO) and are therefore subject to price regulation by the Commission.

The Commission requires each business to identify a core set of miscellaneous services. This core set should include businesses' most important miscellaneous services, including those expected to generate a significant proportion of total miscellaneous services revenue. Examples of core miscellaneous services include meter reading, the provision of information statements and the installation of new meters. Businesses are required to include their core miscellaneous services in their price schedules and they are part of the Commission's approved price determinations. Core miscellaneous services should be priced according to pricing principles that comply with the WIRO.

Water businesses can either set a standard price for miscellaneous services based on the approved pricing principles and list prices in their pricing schedules, or apply the principle of actual cost on a case-by-case basis when charging for noncore miscellaneous services. For many services (for example, a meter accuracy test), businesses could set a standard price and review it annually to ensure it was cost reflective. In other cases, especially for services provided infrequently (such as larger meter installations), businesses could apply actual cost on a case-by-case basis.

19.2 OVERVIEW OF DRAFT DECISION

Most metropolitan water businesses proposed miscellaneous services and pricing principles for miscellaneous services in their Water Plans that are consistent with the current arrangements and the WIRO. The Commission proposed to approve the miscellaneous services proposed by South East Water, Melbourne Water, and Yarra Valley Water.

The Commission proposed not to approve City West Water's proposed increases to its miscellaneous services charges. The Commission considers the business did not adequately justify the increases and required additional information from City West Water.

The Commission proposed to approve the miscellaneous services fees and charges proposed by Western Water, subject to the business submitting more detailed definitions of its core miscellaneous services.

The Commission considered water businesses should not have miscellaneous services charges related to administration fees for development outside the New Customer Contributions (NCC) framework (for example, a miscellaneous charge for the application for a new development). There is a newly established NCC framework and the Commission required all greater metropolitan water businesses to define and specify any miscellaneous services fees relating to developers. The Commission wants to prevent a transfer of costs from NCC related charges to miscellaneous services charges.

19.3 SUBMISSIONS AND COMMISSION'S ASSESSMENT

19.3.1 CITY WEST WATER

In response to the draft decision, City West Water accepted the Commission's decision to only increase core miscellaneous charges by inflation after 2013-14. The Commission has approved City West Water's miscellaneous services charges.

19.3.2 WESTERN WATER

In response to the draft decision, Western Water provided more detailed definitions of its miscellaneous services. These definitions are available in Western Water's price determination. The Commission has approved these definitions.

19.3.3 YARRA VALLEY WATER

In response to the draft decision, Yarra Valley Water provided some minor revisions to its miscellaneous services charges. These changes have been approved and are reflected in Yarra Valley Water's determination.

19.3.4 NEW CUSTOMER CONTRIBUTIONS

The Commission considers water businesses should not have additional miscellaneous charges related to the New Customer Contributions (NCC) framework, for example, a miscellaneous service charge for the application for a new development. As there is a newly established NCC framework, the Commission required all greater metropolitan water businesses to clearly define and specify any additional service fees relating to developers. The aim is to prevent a transfer of costs from NCC to miscellaneous services charges.

Yarra Valley Water and Western Water did not identify any miscellaneous services relating to NCCs in response to the draft decision.

The Commission will not approve any new miscellaneous services charges relating to NCCs over the third regulatory period. The Commission will review the NCC framework during the third regulatory period. At the time of the review, the Commission will also review any new miscellaneous services charges relating to NCCs to ensure they are appropriate.

19.4 FINAL DECISION

The Commission has approved the miscellaneous fees and charges proposed by City West Water, South East Water, Melbourne Water, Yarra Valley Water and Western Water.

20 ADJUSTING PRICES

20.1 INTRODUCTION

In the water industry, businesses' forecasts of future demand for their services and the cost of delivering those services can be a significant source of uncertainty. Despite this uncertainty, these forecasts are essential to determining each business's revenue requirements and price paths. The regulatory framework that governs these determinations is based on the assumption that, in most instances, the water businesses are better placed to manage this uncertainty than their customers and that one of their major roles is to manage this uncertainty on behalf of their customers.

Typically, regulators do not allow price adjustments within a regulatory period to reflect differences between the actual and forecast costs, demand or revenue (irrespective of whether these differences are to the detriment or the benefit of the water business) in the interests of ensuring customers can have confidence in the predictability of prices to be charged. Instead, the regulatory framework administered by the Commission seeks to provide the water businesses appropriate incentives to operate efficiently in managing uncertainty.

There may, however, be circumstances that are beyond the scope of the water business to manage within the prices approved at the start of a regulatory period. In circumstances where fluctuations and financial impacts of an event are large such that businesses are unable to manage those risks without jeopardising their service delivery obligations, the Commission approves an uncertain and unforeseen events mechanism. This mechanism sets out a process for applying for a re-opening of the Commission's price determination, either during or at the end of the regulatory period, to account for events that were uncertain or unforeseen at the time of the price review process.

20.2 REOPENING PRICE DETERMINATIONS

20.2.1 OVERVIEW OF DRAFT DECISION

The Commission proposed to approve an uncertain and unforeseen events mechanism that sets out a process for businesses or the Commission to reopen price determinations to account for events that were uncertain or unforeseen at the time of the price review, such as:

- unsustainable or unwarranted differences between actual and forecast demand
- changes in legislative and other government imposed obligations
- catastrophic events (such as fire, earthquake or acts of terrorism).

The Commission proposed to only consider applications for events listed above that the business cannot control or efficiently manage without undermining its delivery of services to customers. The Commission approved an uncertain and unforeseen events mechanism in the 2009 water price review.

In its draft decision, the Commission proposed the mechanism will include new provisions that in certain cases — only those where an uncertain and unforeseen event is material, and its effects on a business's costs and revenues can be isolated from broader operational considerations — allows it to limit a re-opening of determinations to the single event. The Commission also considered it appropriate to allow for price changes arising from re-opening a price determination to take effect at any time within the regulatory period.

The Commission considered a key threshold in deciding whether to approve a mid-period price adjustment is whether the business can absorb the impacts of any event that affects the costs or revenues. The Commission places particular emphasis on financial viability ratios in assessing the appropriateness of a mid-period price adjustment. The Commission expects businesses to demonstrate they have exercised appropriate risk management processes to mitigate and to plan for such events wherever possible.

20.3 SUBMISSIONS AND COMMMISSION'S ASSSESSMENT

Melbourne Water suggested that the Commission '…[provide] for any unsustainable increases in the cost of debt to be managed via the uncertain and unforeseen events mechanism'.[95]

The Commission decided not to include a specific reference to changes in the cost of debt in the uncertain and unforeseen events mechanism. However, the Commission considers the uncertain and unforeseen events mechanism remains sufficiently broad to allow a business to apply for a re-opening based on *any* event that was uncertain or unforeseen at the time of review, and which the business cannot control or efficiently manage without undermining its delivery of services.

The other metropolitan water businesses did not comment on the Commission's proposed revision of the uncertain and unforeseen events mechanism.

A joint submission by the Consumer Action Law Centre (CALC), Consumer Utilities Advocacy Centre (CUAC) and the Victorian Council of Social Service (VCOSS) expressed strong support for the increased flexibility in the Commission's proposed uncertain and unforeseen events mechanism.

The Commission has set a three year regulatory period for Melbourne Water (see chapter 3). This may result in different base assumptions for retail water pricing in 2016-17 to 2017-18 than those underlying the final decision for the three metropolitan water retailers and Western Water. The Commission has included a clause in each of the affected businesses' determinations that allows for a pass through to deal with this.

[95] Melbourne Water (2013), *Submission to the Water Price Review draft decision 2013-18*, May, p. 2.

20.4 FINAL DECISION

The Commission has approved an uncertain and unforeseen events mechanism that sets out a process for a water business or the Commission to reopen price determinations to account for events that were uncertain or unforeseen at the time of the price review.

The mechanism will include new provisions that in certain cases (only for those where an uncertain and unforeseen event is material, and the effects of which on a business's costs and revenues can be isolated from broader operational considerations) the Commission has adopted the discretion to limit a reopening of determinations to the single event, rather than the full suite of factors influencing business costs and revenues (as applies under the general re-opener provision).

The Commission has allowed for price changes arising from re-opening a price determination to take effect at any time within the regulatory period. Details on the mechanism are specified in the determinations for each water business.

The Commission has adopted a mechanism for the four greater metropolitan water businesses to pass through changes to Melbourne Water's prices in the fourth and fifth years of their five-year regulatory period.

20.5 DESALINATION COST PASS-THROUGHS

20.5.1 OVERVIEW OF DRAFT DECISION

Melbourne Water may need to adjust bulk water charges for City West Water, South East Water, Western Water and Yarra Valley Water if it needs to order desalination water or if there are any adjustments to the desalination security charge. The Water Industry Regulatory Order (WIRO) specifies the water businesses must pass any additional desalination related costs or savings onto customers.

Melbourne Water proposed price mechanisms to deal with two possible cost changes arising from the desalination plant:

- changes in the security payment — that is, changes in the annual costs associated with a zero gigalitre water order over the life of the contract
- changes in water order costs — that is, an annual adjustment to prices if desalinated water is ordered during the third regulatory period.

The Commission's draft decision recognised that Melbourne Water's proposed adjustment factors were appropriate given a full pass through of desalination security payments. The Commission's draft decision requested Melbourne Water consider alternative approaches to recovering its desalination security payments. Therefore, the Commission considered it appropriate for Melbourne Water to review its proposed approach to passing through desalination costs, accounting for any alternative approach to recovering its desalination security payments.

City West Water, South East Water and Yarra Valley Water proposed different approaches to adjusting prices to account for changes to desalination security payments and water order costs.

The Commission proposed not to approve City West Water's, South East Water's and Yarra Valley Water's proposed desalination adjustment factors because they did not adequately meet WIRO requirements.

The approaches proposed by these businesses ensured they did not over-recover or under-recover funds for desalination purposes, but the Commission considered City West Water and Yarra Valley Water should only apply the adjustment factors for water order costs to variable potable water charges. It also expected the businesses to propose a consistent approach to applying these adjustments and adjustments for changes to desalination security payments.

The Commission requested City West Water, South East Water and Yarra Valley Water propose a water order adjustment factor on a per kilolitre basis, and provide the Commission and customers with a table of the prices that would apply if any desalination water is ordered.

Western Water did not propose to order significant quantities of bulk water from Melbourne Water over the third regulatory period. However, the Commission asked it to propose how it would apply adjustment factors for desalination water orders and changes to desalination security payments.

20.6 SUBMISSIONS AND COMMISSION'S ASSESSMENT

In response to the draft decision, Melbourne Water did not significantly alter its mechanism for passing on changes to desalination costs to customers should capitalisation occur. It noted:

> *… as the actual contract costs are treated as a change, Melbourne Water does not propose to alter the mechanism if desalination capitalisation was to occur.*[96]

However, Melbourne Water did make minor refinements to its approach and associated formulas for passing through changes to desalination costs to assist the metropolitan businesses with developing their pass through formulas and to provide indicative cents per kilolitre adjustments for each water order.[97]

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[96] Melbourne Water 2013, *Submission to the Water Price Review draft decision 2013–18*, May, p. 21.

[97] Melbourne Water 2013, *Submission to the Water Price Review draft decision 2013–18*, May, p. 53.

The water businesses proposed the following in response to the draft decision:

- City West Water, South East Water and Yarra Valley Water provided indicative cents per kilolitre adjustments for each water order increment (see appendix E).[98]
- All metropolitan businesses specified water order adjustments would only apply to potable water charges.
- City West Water, South East Water and Yarra Valley Water updated their formulas for passing through changes in desalination water order and security costs.
- Western Water proposed adjustment mechanisms for passing through changes in desalination water order and security costs.

The Commission considers that City West Water, South East Water, Western Water and Yarra Valley Water's revised proposals to pass through desalination water order and security cost changes through adjustment factors for changes in fixed and variable bulk water costs provide that they do not over- or under-recover funds for desalination purposes. They also allow customers to readily understand the prices that will apply if desalinated water is ordered.

20.7 FINAL DECISION

> The Commission has accepted the desalination cost pass through mechanisms for desalination security costs and desalination water order costs proposed by Melbourne Water, City West Water, South East Water, Western Water and Yarra Valley Water.

[98] City West Water 2013, *Submission to the Water Price Review draft decision 2013–18*, attachment 2, p. 25.

South East Water 2013, *Submission to the Water Price Review draft decision 2013–18*, May, p. 24.

Western Water 2013, *Submission to the Water Price Review draft decision 2013–18*, May p. 6.

Yarra Valley Water 2013, *Submission to the Water Price Review draft decision 2013–18*, May p. 41.

APPENDIX A – SUBMISSIONS

TABLE A.1 SUBMISSIONS TO THE METROPOLITAN FINAL DECISION

Submission	Date
Andrew Brion	22 May 2013
Anonymous Developer	20 May 2013
CALC, CUAC and VCOSS	21 May 2013
Child Care Victoria	13 June 2013
EWOV	16 May 2013
Jen McLeod	1 May 2013
Lend Lease	20 May 2013
Mobil	14 May 2013
Property Council of Australia & Urban Development Institute of Australia	12 June 2013
Purple Pipe	17 May 2013
Richard Edwards	30 April 2013
Sanctuary Lakes Club	23 May 2013
Tim Armytage	21 April 2013
Trevor Dance	13 May 2013
Victoria Wool Processors	20 May 2013

APPENDIX B – DOCUMENTS ATTACHED

TABLE B.1 DOCUMENTS ATTACHED

Document
Deloitte 2013 – *Desalination Capitalisation Scenarios*, June.
Deloitte 2013 – *Melbourne Water's Energy Costs*, June.
Intelligent Software Development 2013 – *Western Water Forecast,* January.
PricewaterhouseCoopers 2013 – *Essential Services Commission: Responses to metropolitan Melbourne's water companies' responses to the ESC draft decision*, June.
PricewaterhouseCoopers 2013 – *Estimating a debt risk premium*, June.

Note: documents attached are available on the Commission's website at www.esc.vic.gov.au

APPENDIX C – PRICE FREEZE

C.1 EFFECT OF PRICE FREEZE ON PRICES FOR THE NEXT REGULATORY PERIOD

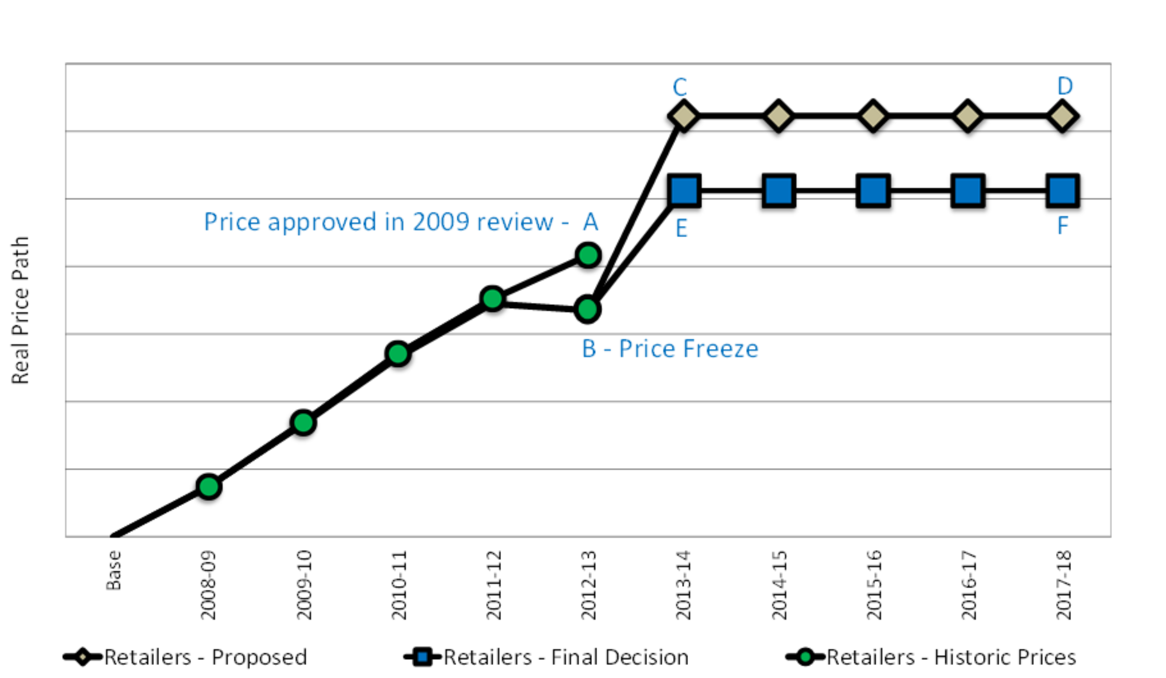
In its 2009 water price review, the Commission authorised the maximum prices water businesses could charge between 1 July 2009 and 30 June 2013. These prices included a component for the costs associated with the Victorian desalination plant. Because construction delays deferred the completion date of the plant, the revenue required over this period was substantially less than the water businesses were scheduled to collect. Consequently, in June 2012 the Government announced that prices would be frozen in 2012-13 at the previous year's level.

From 1 July 2012 a price freeze started to return unrequired payments to customers. From early 2013 water businesses began rebating customer bills to speed the return of funds to customers.

Figure C.1 indicates the effect of the freeze on prices:

- Point A shows the maximum allowable prices for 2012-13 approved for the retailers in the Commission's 2009 water price review.
- Point B shows the effect of the price freeze in 2012-13, which is below the approved prices.
- The price freeze means the proposed increase in prices for 2013-14 (when compared in percentage terms) are higher than it would have been without the price freeze.

FIGURE C.1 INDICATIVE AVERAGE RETAILER PRICE PATH (CWW, SEW, YVW, WW)



A is the average retailer price without the price freeze. **B** is the average retailer price with the price freeze (around 10 per cent lower than point A). **C to D** is the average retailer price path proposed by businesses (around 34 per cent above the retailer price with the price freeze). **E to F** is the average retailer price path based on the Commission’s final decision (around 24 per cent increase from point B).

APPENDIX D - NEW CUSTOMER CONTRIBUTIONS

D.1 COMMISSION'S ASSESSMENT

The Commission has assessed the water businesses NCC responses as follows:

- Have businesses confirmed that NCC are calculated in accordance with the core NCC pricing principles?[99]
- Are the revised Standard NCC appropriately cost reflective?
- Have the businesses proposed location specific NCC?
- Have the businesses addressed the actions required in the draft decision?

D.1.1 ASSESSMENT AGAINST CORE PRICING PRINCIPLES

The core NCC pricing principles (box D.1) were set out in the Commission's guidance paper which noted that the principles represent the minimum requirements that the Commission would expect of an NCC for the charge to be fair and reasonable as required by the *Water Act* 1989.

Core pricing principles

The Commission approves the core pricing principles as the method for calculating NCC. The core pricing principles will be included in each metropolitan business's water price determination.

[99] Essential Services Commission 2012, *New customer contributions — guidance paper*, August.

BOX D.1 CORE NCC PRICING PRINCIPLES

Standard and Negotiated NCC charges will:

- have regard to the incremental infrastructure and associated costs in one or more of the statutory cost categories attributable to a given connection
- have regard to the incremental future revenues that will be earned from customers at that connection
- be greater than the avoidable cost of that connection and less than the standalone cost of that connection.

Interpretation and application of core NCC pricing principles

The Commission's 2012 NCC guidance paper and the associated NCC estimation model included notes on interpreting and applying the core NCC pricing principles in calculating charges. The Commission considers the principles must be applied consistently across the water businesses. Accordingly, it notes the following points of clarification and definition:

- **Costs in efficient pricing bound:** Given NCC are to be based on the net incremental cost of connection (for example, incremental costs net of incremental benefits), the costs referred to in applying the efficient pricing bound are the net costs; specifically, the avoidable net cost of connection and standalone net cost of connection.
- **Gifted assets**: Gifted assets are discussed in section 18.5.1, where the connection arrangement requires assets to be gifted; the value of these gifted assets will be excluded for the purposes of calculating the net costs.
- **Incremental financing and bring forward costs**: Financing or bring forward costs are discussed in section 18.5.1. Incremental costs may include financing costs associated with constructing an asset sooner than planned.

How the Commission assessed the metropolitan water businesses' proposals

The Commission assessed each metropolitan water business to ensure, during the third regulatory period:

- businesses confirmed NCC were calculated in accordance with the core pricing principles
- proposed Standard NCC were based on the core pricing principles
- the negotiating framework contains the core pricing principles.

Confirmation by businesses

In the draft decision, the Commission sought confirmation from each metropolitan water business that it would calculate Negotiated NCC in accordance with the core pricing principles. All metropolitan water businesses confirmed any Negotiated NCC will be calculated in accordance with the core pricing principles.

Standard NCC

The Commission reviewed the models to calculate Standard NCC to assess whether each water business's model accounted for relevant costs and revenues. The review found all metropolitan water businesses based their calculations of Standard NCC on the core pricing principles.

Negotiating framework

The negotiating framework sets out the procedural and information requirements that are relevant to applying NCC. It applies to both Standard and Negotiated NCC.

The Commission analysed each business's framework for the draft decision and found all businesses except South East Water prepared a negotiating framework that included the core pricing principles. South East Water revised its negotiating framework to include the core pricing principles following the draft decision.

The Commission is satisfied each metropolitan water business has a negotiating framework that incorporates the core pricing principles.

Summary

Based on the findings above, the Commission is satisfied the metropolitan water businesses developed their Standard NCC and/or will apply any Negotiated NCC based on the core NCC pricing principles. The Commission considers the core NCC pricing principles represent the minimum requirements for a charge to be fair and reasonable as required by the Water Act. Therefore, the Commission approves the following manner for calculating NCC for third regulatory period.

BOX D.2 CORE PRICING PRINCIPLES

NCC, including Standard or Negotiated NCC, will be calculated by applying the following core NCC pricing principles:

Standard and Negotiated NCC will:

- have regard to the incremental infrastructure and associated costs in one or more of the statutory cost categories attributable to a given connection
- have regard to the incremental future revenues that will be earned from customers at that connection
- be greater than the avoidable cost of that connection and less than the standalone cost of that connection.

Notes:

1. Given that NCC are to be based on the net incremental cost of connection (for example incremental costs net of incremental benefits), in this context, the costs referred to in the efficient pricing bound are the net costs, specifically the avoidable net cost of connection and standalone net cost of connection.

2. Where the connection arrangement requires assets to be gifted, the value of gifted assets will be excluded for the purposes of calculating net costs.

3. Incremental costs may include financing costs associated with constructing an asset sooner than planned. Refer to section 18.5.1

D.1.2 ARE THE REVISED STANDARD NCC APPROPRIATELY COST REFLECTIVE?

Each water business's NCC proposals must satisfy the Water Industry Regulatory Order (WIRO) principle:

- clause 14(1)(a)(v) provides appropriate incentives and signals to customers or potential customers about:

  (A) the sustainable use of Victoria's water resources by reference to the costs of providing prescribed services to customers (either collectively or to an individual customer or class of customers), including costs associated with balancing supply and demand

  (B) the costs associated with servicing a new development in a particular location.

The Commission considers two conditions must be met for (Standard and Negotiated) NCC to satisfy the WIRO requirement. These are:

- NCC are calculated in accordance with the core pricing principles
- NCC are based on prudent and efficient costs.

Core pricing principles

As discussed above, the Commission is satisfied the metropolitan water businesses based their NCC proposals on the core pricing principles.

Prudent and efficient costs

The Commission assessed the reasonableness of the operating and capital expenditure forecasts underpinning the water businesses' NCC proposals. For the draft decision the Commission, engaged Sinclair Knight Merz (SKM) to review the four metropolitan water businesses' expenditure forecasts. SKM found City West Water's, Western Water's and Yarra Valley Water's capital and operating expenditure forecasts to be reasonable in the context of the NCC methodology. SKM reviewed South East Water's capital expenditure forecasts only and found them to be reasonable. SKM did not review South East Water's operating expenditure because the business did not include this cost in its NCC calculation. The Commission considered SKM's approach and analysis to be satisfactory.

The Commission required the water businesses to update their NCC models to reflect the draft decision on expenditure. Given this, the Commission is satisfied South East Water's estimate of operating costs is reasonable.

During the third regulatory period, the Commission will audit the actual costs and revenues included in each metropolitan water business's NCC calculation, to ensure they are consistent with the core pricing principles.

Review of spreadsheet models — modeling adjustments

The Commission reviewed the spreadsheet models the water businesses used to calculate Standard NCC, to assess whether there were any obvious modeling errors. The review did not find any modeling errors.

D.1.3 LOCATION SPECIFIC STANDARD NCC

All metropolitan water businesses considered how they could improve the cost reflectivity of their Standard NCC proposals. Each water business proposed Standard NCC to apply in more than one area within its service region:

- City West Water proposed to levy Standard NCC for water and sewerage services in the Standard zone. It also proposed to levy location specific Standard NCC for water, sewerage and recycled water in three zones — Greek Hill, Holden and West Werribee.
- Yarra Valley Water proposed to levy location specific Standard NCC in three special charge areas — Epping North, Greenvale and New Urban Growth Boundary (UGB) (which is bordered by the old and new urban growth boundaries north of Craigieburn). All other areas within Yarra Valley Water's service region will attract a Standard NCC (the standard charge).
- South East Water proposed location specific Standard NCC across two areas — Casey and Cardinia. All other areas within South East Water's service region will attract a Standard NCC.
- Western Water proposed location specific Standard NCC in two areas — Infill and Greenfields. The total NCC for water, recycled and sewerage in the Greenfields area is $4000 per lot ($2013-14). The total NCC for water, sewerage and recycled water in the Infill areas is $2000 per lot ($2013-14).

D.1.4 DRAFT DECISION – OTHER ISSUES

In the draft decision, the Commission required the metropolitan water businesses to complete the following actions:

- improve the transparency of their NCC proposals
- describe the circumstances for negotiating NCC
- consult with other water businesses to propose a common timeframe to estimate incremental costs and revenues
- consult with stakeholders following the draft decision
- make other modeling adjustments.

The Commission is satisfied the metropolitan water businesses completed the key actions.

D.2 GIFTED ASSETS

South East Water and Yarra Valley Water proposed definitions for gifted (also known as reticulation) assets. The businesses proposed:

- Water pipes 150 mm or less and associated assets are classified as reticulation assets
- Sewerage pipes 225 mm or less and associated assets are classified as reticulation assets

The Commission received a joint submission from the Urban Development Institute of Australia and the Property Council of Australia in relation to the definition of reticulation (gifted assets).[100]

> *The UDIA and Property Council support a definition of reticulation and shared assets based on pipe size, subject to new water infrastructure being delivered at the lowest overall community cost. We consider it reasonable that pipes of*

[100] Urban Development Institute of Australia and Property Council of Australia 2013, *Submission to the water price review 2013–18*, 12 June.

150 mm or less for water and 225 mm or less for sewer should be classified as reticulation assets and anything above these sizes should be treated as shared assets. The ESC should monitor the water businesses to ensure that water infrastructure is being installed at the lowest community cost and that the water businesses are not engaging in 'gaming'.

The Commission also received an anonymous submission in relation to defining reticulation assets or gifted assets. The submission stated:

> *Clear, unambiguous and consistent definition of gifted "reticulated" assets is required. The draft decision (Volume 1) addresses this in the Glossary but the document then references a previous May 2011 definition. This needs to be fixed and the definition needs to carry through the entire ESC 2013 Final Decision & Water Company plans;*
>
> *The ESC needs to adopt a consistent and clear approach on what NCC's include and exactly what assets are to be gifted and ensure that Water Company plans are compliant with this. Assets beyond "reticulation" as defined above (point 1) need to be accounted for and included in NCC's and reimbursed back to developers when these assets are delivered;*
>
> *The concept of "basic size (& depth)" needs to be included in the ESC Final Decision. Developers cannot be expected to fund reticulation that is upsized or deepened in order to provide a service or benefit to any adjoining land or external catchments. 2013-2018 Water Plans need to exactly reflect this approach;*
>
> *Negotiated outcomes need to be an option of last resort and only when Water Company can be reasonably demonstrate that assets were not planned;*

These issues are discussed below and in section D.1.2.

The 2008–13 water price determinations required developers to provide reticulation assets to serve their development and connect to the water business networks.

However, the Commission recognises it does not have the power to require developers to provide assets to water businesses. This power may be derived by the water businesses from general provisions in the Water Act, which may form the foundation of developers 'gifting' assets to water businesses. The following provisions are examples:

- A water business has power to do all things that are necessary or convenient to be done for or in connection with, or as incidental to, the performance of its functions, including any function delegated to it (s123):
  - It is a function of a water business to supply water from its works to any person by agreement (s124(7)).
  - The water businesses are given control over connections to their works and may consent to connections being made subject to any terms and conditions they think fit (s145).
  - A water business may require property owners to 'meet or contribute to the present day cost of any works' to service their properties in certain circumstances (ss 268–270).

Thus, the Commission considers water businesses should have the discretion to determine which assets are to be gifted, and to characterise the gifting as a condition of connection to the water business's works. Where applicable, developers may appeal to the Victorian Civil and Administrative Tribunal on the grounds described in section 271(3) of the Water Act.

However, the Commission expects the greater metropolitan water businesses to consult among themselves and with the development industry to establish a common basis for gifting assets. That approach could be included in the negotiating frameworks, to minimise disputes arising from this matter.

In summary, the Commission considers it is acceptable for a water business to require developers to provide and gift to the water business specified assets as a condition of connection, provided the water business:

- makes clear to potential developers which assets a developer will be responsible for providing and gifting, and which will be provided by the water business
- confirms any Negotiated NCC will be undertaken in accordance with the water business's published negotiating framework
- where the connection arrangement requires assets to be gifted, the value of gifted assets will be excluded for the purposes of calculating net costs.

The Commission will monitor the gifting arrangements imposed by the water businesses. If stakeholders raise concerns, the Commission will consider developing principles to guide the classification of gifted assets.

D.2.1 PIONEER DEVELOPER ISSUE

The draft decision for the metropolitan water businesses discussed the pioneer developer issue. This arises when a pioneer developer pays incremental financing costs to bring forward an asset earlier than planned and then other developers connect to the asset soon after without contributing to the financing costs. Under the new framework, the developer who makes the incremental financing cost payment may negotiate with the water business to be reimbursed (a portion of the financing costs) when other developers connect (to the asset that was brought forward).

Another related situation that may arise is when a pioneer developer is required to provide an asset that was designed with excess capacity to service later developments. In this situation, the water business has two options to ensure the asset's costs are shared across those who connect to it:

- the regulatory asset base option, whereby:
  - the initial connection applicant pays their required capacity share of the asset through their NCC
  - any remaining share of the asset's costs (when the asset has been efficiently pre-built to service future growth) would default to recovery through the regulatory asset base (RAB) and prescribed retail tariffs
  - the NCC calculation for any subsequent connections would include the applicant's capacity share of the asset's cost, and the resulting NCC revenue would be deducted from the water business's RAB
- the reimbursement option, which involves the water business charging foundation connection(s) an upfront NCC to recover the full asset cost, with provision to reimburse those connections when subsequent connections start to use the asset.

The Commission considers the water businesses should negotiate with developers about the most appropriate way to address any 'pioneer' developer issue when the situation arises. The Commission will audit water business records to ensure any reimbursement scheme is duly applied during the third regulatory period.

APPENDIX E – INDICATIVE DESALINATION WATER ORDER ADJUSTMENTS

TABLE E.1 INDICATIVE DESALINATION WATER ORDER ADJUSTMENTS – CENTS PER KILOLITRE
$2012-13

Desalination water order *GL*	2013-14	2014-15	2015-16	2016-17	2017-18
City West Water					
0	0	0	0	0	0
50	7	7	7	7	7
75	11	11	11	11	11
100	17	17	17	17	17
125	24	24	24	24	24
150	31	31	31	31	31
Yarra Valley Water					
0	0	0	0	0	0
50	8	8	8	9	9
75	12	12	12	13	14
100	18	19	19	20	21
125	26	26	27	28	29
150	33	34	35	36	37

Desalination water order *GL*	2013-14	2014-15	2015-16	2016-17	2017-18
South East Water					
0	0	0	0	0	0
50	na	9	9	9	9
75	na	15	14	14	14
100	na	22	22	22	22
125	na	30	30	30	30
150	na	40	40	39	39

na. South East water did not provide indicative adjustments for 2013-14 because no water has been ordered for 2013-14

Source: Metropolitan water businesses.[101]

[101] City West Water 2013, *Submission to the Water Price Review draft decision 2013–18*, attachment 2, p. 25.

South East Water 2013, *Submission to the Water Price Review draft decision 2013–18*, May, p. 24.

Western Water 2013, *Submission to the Water Price Review draft decision 2013–18*, May p. 6.

Yarra Valley Water 2013, *Submission to the Water Price Review draft decision 2013–18*, May p. 41.

APPENDIX F – DRAFT DECISION BILLS

TABLE F.1 INDICATIVE ANNUAL RESIDENTIAL OWNER-OCCUPIER BILLS

$2012-13

	Current bill	Bills based on businesses' proposals		Bills based on draft decision	
	2012-13	*2013-14*	*2017-18*	*2013-14*	*2017-18*
City West Water	848	1 091	1 091	994	994
South East Water	863	1 166	1 166	1 078	1 078
Yarra Valley Water[a]	949	1 272	1 272	1 177	1 177
Western Water	975	1 035	1 330	982	1 014

Note: Bills based on 2013-14 business proposed estimated consumption. Bills are based on average consumption of: City West Water (150 kL per year), South East Water (150 kL per year), Yarra Valley Water (155 kL per year), Western Water (180 kL per year). [a] Bills shown for Yarra Valley Water are indicative because the business proposed a revenue cap form of price control, so prices may vary slightly during the regulatory period.

TABLE F.2 INDICATIVE ANNUAL RESIDENTIAL TENANT BILLS

$2012-13

	Current bill	Bills based on businesses' proposals		Bills based on draft decision	
	2012-13	*2013-14*	*2017-18*	*2013-14*	*2017-18*
City West Water	461	600	600	547	547
South East Water	445	625	625	577	577
Yarra Valley Water[a]	508	698	698	646	646
Western Water	264	287	410	272	309

Note: Bills based on 2013-14 business proposed estimated consumption. Bills are based on average consumption of: City West Water (150 kL per year), South East Water (150 kL per year), Yarra Valley Water (155 kL per year), Western Water (180 kL per year). [a] Bills shown for Yarra Valley Water are indicative because the business proposed a revenue cap form of price control, so prices may vary slightly during the regulatory period.