



# Central Highlands Water draft decision

2023 Water Price Review

12 April 2023



## Acknowledgement

We acknowledge the Traditional Owners of the lands and waterways on which we work and live.

We acknowledge all Aboriginal and Torres Strait Islander communities, and pay our respects to Elders past and present.

As the First Peoples of this land, belonging to the world's oldest living cultures, we recognise and value their knowledge, and ongoing role in shaping and enriching the story of Victoria.

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# Summary

## **Our draft decision considers Central Highlands Water’s proposed prices for a 5-year period starting 1 July 2023**

This draft decision sets out our preliminary views on Central Highlands Water’s price submission.<sup>1</sup> Our draft decision should be read together with Central Highlands Water’s price submission.



We invite interested parties to comment on our preliminary views in this draft decision before we make a final decision and issue a price determination in June 2023. For details of how to provide feedback, see our dedicated Engage Victoria page: <https://engage.vic.gov.au/water-price-review-2023>.

## **Central Highlands Water has committed to delivering outcomes that reflect customer priorities**

Central Highlands Water plans to deliver the following outcomes for customers:

- customer care
- equity
- sustainability.<sup>2</sup>

Among the key initiatives to deliver on its commitments, Central Highlands Water has proposed to enhance its support for customers experiencing vulnerability, and further develop partnerships with Traditional Owners. Its capital program is being driven by accelerated and sustained population growth, renewing assets to secure reliable services, and responding to climate change.

## **Our draft decision adopts a lower revenue requirement than proposed by Central Highlands Water**

Our draft decision is to adopt a revenue requirement that will allow Central Highlands Water to deliver on its customer service commitments, government policy, statements of obligations, and obligations monitored by the Environment Protection Authority Victoria and the Department of Health.

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<sup>1</sup> Clause 16 of the Water Industry Regulatory Order 2014 requires the Essential Services Commission to issue a draft decision; Central Highlands Water’s price submission is available on our website at [www.esc.vic.gov.au](http://www.esc.vic.gov.au).

<sup>2</sup> Central Highlands Water, 2023 water price submission, September 2022, pp. 50–55.

Central Highlands Water proposed a revenue requirement of \$549.2 million over a 5-year period starting 1 July 2023. Our draft decision adopts a revenue requirement of \$528.9 million. The main reason for the lower figure adopted in our draft decision relates to our review of Central Highlands Water's forecast operating expenditure (see Section 4.1.1).

In its response to our draft decision, Central Highlands Water must reflect our proposed adjustment to its forecast operating expenditure, and other adjustments proposed in our draft decision, in its proposed revenue requirement and prices.

## **In response to our draft decision, Central Highlands Water must consider the inflation environment and the impact on customer prices and bills**

Central Highlands Water, unlike some other water businesses, proposes to increase prices in real terms over the 2023–28 regulatory period. Under its proposal, prices would remain flat in real terms in 2022-23, and rise by 1 per cent per year more than inflation in the following 4 years.

Given this and given that since lodgement of its price submission it has become increasingly likely that a relatively high inflation adjustment will be incorporated into 2023-24 prices, Central Highlands Water must provide us with further information illustrating how it intends to address the impacts of relatively high inflation on its proposed prices and customer bills.<sup>3</sup>

Prices and estimated bills will also change following our draft decision to reflect updates for inflation and the cost of debt. The March Quarter 2023 annual outcome for the consumer price index due for release in late April 2023, will be added to 2023-24 real prices.<sup>4</sup>

Based on recent inflation outcomes and market expectations, the annual outcome for the March Quarter 2023 consumer price index is likely to be relatively high, noting the rate is expected to fall through 2023 and 2024.<sup>5</sup> For the 2023–28 regulatory period, we have assumed an inflation rate of 3 per cent per year, which is significantly lower than near-term inflation expectations.<sup>6</sup>

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<sup>3</sup> This is relevant to clause 11(d)(ii) of the Water Industry Regulatory Order 2014 which states that when making a price determination, the commission, in considering the manner in which a regulated entity's prices are to be calculated, determined or otherwise regulated, must have regard to whether prices provide signals about the efficient costs of providing prescribed services to customers (either collectively or to an individual customer or class of customers) while avoiding price shocks where possible.

<sup>4</sup> Published by the Australian Bureau of Statistics (All Groups – Australia)

<sup>5</sup> The latest (February 2023) Reserve Bank of Australia Quarterly Statement on Monetary Policy forecast the consumer price index to change (over the year) fall to around 4.8 per cent by December 2023 and 3.2 per cent by December 2024.

<sup>6</sup> The pricing model issued by the commission includes a forecast for inflation for the full 2023–28 regulatory period (currently 3 per cent). This assumption is used by businesses to enter expenditure values and prices in our pricing model in real terms.

Many of the drivers of higher inflation (such as fuel, food and travel) are not major cost items for water businesses. Some high-cost growth areas specific to the water sector such as insurance and chemicals have been accounted for in uplifts to their opening base costs for the 2023–28 regulatory period. Accordingly, it may be the case that the inflation that is added to prices in 2023-24 provides an uplift in revenue that is well above a business’s actual costs for the year.

## **Tariff structures will remain the same**

For water services, Central Highlands Water proposed a two-part tariff with a fixed water service charge and a two-tier inclining block variable usage component that depends on water use. For residential sewerage services, Central Highlands Water proposed a fixed charge only. For non-residential sewerage services Central Highlands Water proposed a two-part tariff with a fixed service charge and a single variable charge. For non-residential sewerage services, a fixed service charge and a variable usage component was proposed.

Our draft decision is to accept Central Highlands Water’s proposed tariff structures, on the basis that they are a continuation of Central Highlands Water’s current approach and are generally supported by its customers. Specifically, the tariff structures ensure a sustainable revenue stream and are simple to understand.

Our draft decision is to accept Central Highlands Water’s proposed form of price control, in part because it is the same as its current approach, which we have previously approved.

## **Our draft decision rates Central Highlands Water’s price submission as ‘Standard’ under the PREMO framework**

Our draft decision is to rate Central Highlands Water’s price submission as ‘Standard’ under the PREMO framework (Table A). This is the same as the business’s self-rating of its price submission.

Key factors supporting this PREMO rating include:

- We agree with Central Highlands Water that it has generally met its outcome commitments in the current regulatory period. At the 2018 review, we considered Central Highlands Water generally had more ambitious targets than other businesses. And during the regulatory period it reset some targets to be more ambitious compared to these initial targets – we consider this demonstrates a commitment to improving customer value.
- Central Highlands Water has doubled the payable amounts for not meeting two of its existing guaranteed service levels, and also proposed changes to reflect customer priorities.
- The overall suitability of the engagement methods used by Central Highlands Water, which supported inclusion and effective participation in its engagement process, including customers experiencing vulnerability and its First Nations customers.


- Central Highlands Water’s efforts to tailor methods and materials to the circumstances of its customers, which had the result of ensuring customers experiencing vulnerability had a reasonable and fair opportunity to influence the issues that affected them.
- Outcome measures and targets were developed by Central Highlands Water in consultation with its customers, and they are supported by customers – it used a deliberative assembly to provide validation of its proposed outcomes and targets.
- Our preliminary view is that the targets adopted by Central Highlands Water reflect an overall improvement in service levels for its customers.

Our draft decision proposes to not accept Central Highlands Water’s self-rating of its price submission as ‘Standard’ for the Management element of PREMO. We found Central Highlands Water’s financial model (lodged with its price submission) contained a number of errors and included changes to some formulas that we embedded in the model.

Also, substantive corrections were needed to its financial model, with the corrections both greater in number and more complex to resolve than other businesses. The formula changes Central Highlands Water made to the financial model also impeded our review process.

Central Highlands Water’s price submission received an overall rating of ‘Advanced’ at the 2018 water price review.

See Section 1.4 and Chapter 7 for an explanation of the PREMO framework.



Our PREMO rating is an assessment of the water business’s price submission and its ambition to deliver outcomes valued by its customers. It is not an assessment of the water business itself.

**Table A**      **PREMO rating**

	Overall PREMO rating	Performance	Risk	Engagement	Management	Outcomes
Central Highlands Water’s self-rating	Standard	Standard	Standard	Advanced	Standard	Advanced
Commission’s rating	Standard	Standard	Standard	Advanced	Basic	Advanced

Among the 14 draft decisions in the 2023 price review, Central Highlands Water is one of 9 businesses for which we propose to approve a ‘Standard’ rating (Table B).

**Table B** Draft decision on PREMO — overall rating

Leading	Advanced	Standard	Basic
	Barwon Water Gippsland Water GWMWater South East Water Yarra Valley Water	Central Highlands Water Coliban Water East Gippsland Water Goulburn Valley Water Lower Murray Water South Gippsland Water Southern Rural Water Wannon Water Westernport Water	

## We invite feedback on our draft decision

We invite feedback from stakeholders on our draft decision before we make a final decision and price determination. We expect to release our final decision and price determination in June 2023.

Stakeholders may comment on any aspect of our draft decision, including:

- the information we have relied upon in our assessment (such as Central Highlands Water's price submission):
- additional matters or issues we should consider before making our final decision
- whether our draft decision on Central Highlands Water's price submission has adequate regard to the matters in clause 11 of the Water Industry Regulatory Order 2014 and our guidance.

Table C lists specific issues we are seeking feedback on to inform our final decision and price determination for Central Highlands Water.

**Table C** Specific topics we are particularly interested in stakeholder feedback on

Topic	Specific issue	Draft report reference
Guaranteed service levels	Central Highlands Water's proposed guaranteed service levels and rebates	Section 3.4
New customer contributions	Feedback from developers and other customers about Central Highlands Water's proposed new customer contributions	Section 5.4

## How to provide feedback and stay up to date

You can stay up to date with our review via the dedicated Engage Victoria website:

<https://engage.vic.gov.au/water-price-review-2023>



You can provide feedback by:

- taking part in a public forum
- providing written comments or submissions.

### **Taking part in a public forum**

We plan to hold a public forum on 28 April 2023. Forums provide an opportunity for interested parties to discuss key features of our draft decisions. Details of our public forums will be published on the Engage Victoria website.

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

Written comments or submissions in response to this draft decision will be due by 12 May 2023.

We require submissions by this date so that we have time to fully consider submissions for our final decision. Comments or submissions received after this date may not be afforded the same weight as submissions received by the due date.

We would prefer to receive comments and submissions via the dedicated [Engage Victoria website](#).

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

2023 Water Price Review  
Essential Services Commission  
Level 8, 570 Bourke Street  
Melbourne VIC 3000

### **Submission and privacy statement**

We encourage transparency in our review processes. It is our policy to publish all submissions to the 2023 water price review on the Essential Services Commission website unless the submitter has requested confidentiality. When we publish a submission, we will also include some details about the submitter (your name, not your address) unless the submitter has requested anonymity (does not want to be identified).

You can request confidentiality in relation to your submission. Requesting this may affect the weight we can give to your submission. You may also request anonymity.

## Next steps

Activity	Indicative date
Public forum	28 April 2023
Closing date for submissions on our draft decision	12 May 2023
Release date for our final decision and price determination	June 2023

# 1. Our role and approach to water pricing

## 1.1 We are Victoria's independent economic regulator

Our role in the water industry is based on the Water Industry Regulatory Order 2014 (WIRO), which is made under the *Water Industry Act 1994* (WI Act) and sits within the broader context of the *Essential Services Commission Act 2001* (ESC Act). Our role under the WIRO includes regulating the prices and monitoring service standards of the 18 water businesses operating in Victoria.

## 1.2 We are reviewing the proposed prices of 14 water businesses

Our review is of the prices that the 14 water businesses propose to charge customers for prescribed services from 1 July 2023.<sup>7</sup> The prescribed services include retail water and sewerage services, and bulk water and sewerage services delivered by the water businesses.<sup>8</sup>

Central Highlands Water provided a submission to us proposing prices for a 5-year period starting 1 July 2023. Our task is to assess the price submission using the legal framework and make a price determination that takes effect from 1 July 2023. The price determination will specify the maximum prices Central Highlands Water may charge for prescribed services, or the manner in which prices are to be calculated, determined or otherwise regulated. We will also issue a final decision that explains the reasons for our price determination.

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

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

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

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<sup>7</sup> The review excludes Melbourne Water, Goulburn-Murray Water, North East Water and Greater Western Water. In 2021 we approved prices for Melbourne Water to 30 June 2026 and in 2020 we approved prices for Goulburn-Murray Water to 30 June 2024. In 2018, we approved prices for North East Water to 30 June 2026. We have approved an extension to the regulatory period for Greater Western Water to 30 June 2024.

<sup>8</sup> The prescribed services are listed at clause 7(b) of the WIRO.

- the matters set out in section 33(3) of the ESC Act, which include the return on assets, relevant benchmarking and any other matters that the ESC considers relevant
- the matters specified in our guidance<sup>9</sup>
- the principle that prices should be easily understood by customers and provide signals about the efficient costs of providing services, while avoiding price shocks where possible
- the principle that prices should take into account the interests of customers of the regulated entity, including low income and vulnerable customers.

Appendix B lists the specific objectives and the various matters we must have regard to when making a price determination and provides a guide to where we have done so in this draft decision. Table 1.1 summarises the matters we must have regard to and groups them into themes.

In October 2021, we issued guidance to Central Highlands Water to inform its price submission. The guidance set out how we would assess Central Highlands Water's submission against the matters we must consider under clause 11 of the WIRO. It also outlined our expectation that Central Highlands Water would comply with certain requirements and specified information that Central Highlands Water must provide to us when submitting its price submission.

If we consider the price submission has adequate regard for the matters in clause 11 of the WIRO and complies with our guidance, we must approve Central Highlands Water's proposed prices.<sup>10</sup>

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

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<sup>9</sup> Essential Services Commission, *2023 water price review: Guidance paper*, 26 October 2021.

<sup>10</sup> This is a requirement of the WIRO, clause 14(b).

<sup>11</sup> This is provided for under the WIRO, clause 14(b)(i).

**Table 1.1 Matters businesses and the commission must have regard to**

Economic efficiency and viability matters	Industry/business specific matters	Customer matters
<ul style="list-style-type: none"> <li>• promotion of efficient use of prescribed services by customers [cl 8(b)(i), WIRO]</li> <li>• promotion of efficiency in regulated entities as well as efficiency in, and the financial viability of, the regulated water industry [cl 8(b)(ii), WIRO]</li> <li>• provision to regulated entities of incentives to pursue efficiency improvements [cl 8(b)(iii), WIRO]</li> <li>• efficiency in the industry and incentives for long term investment [s. 8A(1)(a), ESC Act]</li> <li>• efficient costs of producing or supplying regulated goods or services and of complying with relevant legislation and relevant health, safety, environmental and social legislation applying to the regulated industry [s. 33(3)(b), ESC Act]</li> <li>• financial viability of the industry [s. 8A(b)(1), ESC Act]</li> </ul>	<ul style="list-style-type: none"> <li>• particular circumstances of the regulated industry and the prescribed goods and services for which the determination is being made [s. 33(3)(a), ESC Act]</li> <li>• return on assets in the regulated industry [s. 33(3)(c), ESC Act]</li> <li>• ensure that regulatory decision making and regulatory processes have regard to any differences between the operating environments of regulated entities [s. 4C(b), WI Act]</li> </ul>	<ul style="list-style-type: none"> <li>• in performing its functions and exercising its powers, the objective of the Commission is to promote the long term interests of Victorian consumers [s. 8(1), ESC Act] without derogating from that objective. The Commission must in seeking to achieve the objective have regard to the price, quality and reliability of essential services [s. 8(2), ESC Act]</li> <li>• enable customers or potential customers of the regulated entity to easily understand the prices charged by the regulated entity for prescribed services or the manner in which such prices are calculated, determined or otherwise regulated [cl 11(d)(i), WIRO]</li> <li>• provide signals about the efficient costs of providing prescribed services to customers (either collectively or to an individual customer or class of customers) while avoiding price shocks where possible [cl 11(d)(ii), WIRO]</li> <li>• take into account the interests of customers of the regulated entity, including low income and vulnerable customers [cl 11(d)(iii), WIRO]</li> </ul>

Continued next page

**Table 1.1 (continued)**

Benchmarking	Health, safety and social obligations	Other
<ul style="list-style-type: none"> <li>any relevant interstate and international benchmarks for prices, costs and return on assets in comparable industries [s. 33(3)(d), ESC Act]</li> </ul>	<ul style="list-style-type: none"> <li>the relevant health, safety, environmental and social legislation applying to the industry [s 8A(1)(d), ESC Act]</li> <li>to ensure that regulatory decision making has regard to the health, safety, environmental sustainability (including water conservation) and social obligations of regulated entities [s. 4C(c), WI Act]</li> </ul>	<ul style="list-style-type: none"> <li>the degree of, and scope for, competition within the industry, including countervailing market power and information asymmetries [s. 8A(1)(c), ESC Act]</li> <li>consistency in regulation between States and on a national basis [s. 8A(1)(f), ESC Act]</li> <li>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 [s. 8A(1)(e), ESC Act]</li> <li>wherever possible, to ensure that the costs of regulation do not exceed the benefits [s. 4C(a), WI Act]</li> </ul>

**Note:** References in the table are to the Water Industry Regulatory Order 2014 (WIRO), the Essential Services Commission Act 2001 (ESC Act), and the Water Industry Act 1995 (WI Act).

## 1.4 PREMO

PREMO stands for **P**erformance, **R**isk, **E**ngagement, **M**anagement, and **O**utcomes. Each element of PREMO is summarised in Box 1.1.

### Box 1.1 PREMO

Water businesses must demonstrate their level of ambition in delivering value for money for customers in their price submissions across the five PREMO elements:

- Performance — have the performance outcomes to which the business committed in the previous regulatory period been met or exceeded?
- Risk — has the business sought to allocate risk to the party best positioned to manage that risk? To what extent has the business accepted risk on behalf of its customers?
- Engagement — how effective was the business's customer engagement to inform its price submission?
- Management — is there a strong focus on efficiency? Are controllable costs increasing, staying the same, or decreasing? Is the price submission succinct and free of material errors?
- Outcomes — do proposed service outcomes represent an improvement, the status quo, or a reduction of service standards?

First introduced at our 2018 water price review, the purpose of PREMO is to provide incentives for water businesses to deliver outcomes most valued by customers. PREMO includes reputation incentives, via the rating of price submissions as Leading (the highest available rating), Advanced, Standard or Basic, depending on the level of ambition expressed by a water business in its price submission. Financial incentives are provided by linking the return on equity to the PREMO rating.

A key priority under PREMO is to provide incentives for a water business to engage with customers to understand their priorities and concerns and take these into account in forming its proposals, as outlined in its price submission. These should be evidenced in price submissions by linking the outcomes proposed with findings from a business's engagement.

Our guidance specifies the way in which we expect water businesses to assess themselves by reference to the PREMO elements.

Our PREMO framework rewards stronger customer value propositions in price submissions, and an early draft decision is available for price submissions we can assess in a short timeframe.<sup>12</sup>

For the 2023 water price review, a water business's ambition in terms of delivering customer value is being assessed against all five elements of PREMO — Performance, Risk, Engagement, Management and Outcomes. This is the first water price review where we are assessing the Performance element of the PREMO framework. The Performance element assesses businesses against their Outcomes and proposals from the previous price review (for our 2023 review, this means proposals at the 2018 water price review). We did not assess the Performance element in 2018 because it was the first time that we had applied the PREMO framework and so we did not have a set of approved Outcomes to inform our assessment.

Taking into account all five elements of PREMO, a water business must self-assess and propose a rating for its price submission as 'Leading', 'Advanced', 'Standard' or 'Basic'. Its proposed return on equity will then reflect its proposed PREMO rating. A 'Leading' submission has the highest return on equity, and a 'Basic' submission the lowest. We assess the self-rating and also assess the price submission more broadly, including the water business's justification for the proposed PREMO rating, and form our own view of the appropriate rating. This process determines the PREMO rating adopted and the return on equity reflected in the revenue requirement.<sup>13</sup>

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<sup>12</sup> In December 2022, we issued early draft decisions for Yarra Valley Water and Westernport Water.

<sup>13</sup> Essential Services Commission, *2023 water price review: Guidance paper*, pp. 41–46.



## 2. Our assessment of Central Highlands Water's price submission

We have made our draft decision on Central Highlands Water's price submission after considering:

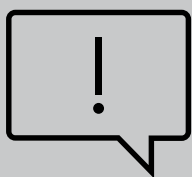
- Central Highlands Water's price submission
- Central Highlands Water's responses to our queries
- our consultants' reports
- written submissions from interested parties (a list of submissions is provided in Appendix A).

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

Our guidance included matters water businesses must address in their price submissions. Central Highlands Water's price submission addressed each of these matters. Our preliminary assessment of these matters is provided in this draft decision.

We found Central Highlands Water's price submission provided evidence that its engagement sought to capture the main priorities and concerns of customers, and that it has taken this feedback into account (see Section 3.1 on customer engagement).

Unless otherwise noted, all financial values referred to in this draft decision paper are in \$2022-23, which means inflation is excluded.



Central Highlands Water must submit a response to our draft decision and provide an updated financial model by 12 May 2023 (via email to [water@esc.vic.gov.au](mailto:water@esc.vic.gov.au)). The response will be published on our website. We also invite other interested parties to make a submission.

We intend to make a price determination for Central Highlands Water in June 2023.

### 2.1 Draft decision paper outline

This decision paper is structured around the steps we take to arrive at our price determination. In summary, these steps are:

- Determine the regulatory period (Section 2.2).
- Confirm the customer outcomes and service levels that Central Highlands Water has committed to over the regulatory period (Chapter 3).

Our assessment of Central Highlands Water's price submission

- Establish Central Highlands Water’s revenue requirement using a building block methodology (Chapter 4).
- Use demand forecasts and the form of price control to convert the revenue requirement to tariffs and prices (Chapter 5).

Chapter 6 outlines our consideration of Central Highlands Water’s financial position, which we have also had regard to.

Chapter 7 outlines our assessment of Central Highlands Water’s price submission under the PREMO framework.

## 2.2 Regulatory period

Our draft decision is to approve a regulatory period of 5 years from 1 July 2023.

We are required to set the term of the regulatory period over which a water business’s price determination will apply.<sup>14</sup> Our guidance proposed that we set a 5-year regulatory period, but also noted we were open to justified alternatives proposed in a price submission.<sup>15</sup>

Central Highlands Water proposed a regulatory period of 5 years. Accordingly, consistent with the reasons outlined in our guidance, our draft decision proposes to set a regulatory period of 5 years.

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

<sup>15</sup> For detail on the reasons for using five years as the default regulatory period, see: Essential Services Commission, *2023 water price review: Guidance paper*, p. 18.

## 3. Customer outcomes

The customer outcomes Central Highlands Water plans to deliver over the regulatory period are a key component of its price submission – confirming its commitments to customers, underpinning its revenue requirement, and feeding in to its PREMO assessment.

This chapter:

- examines Central Highlands Water’s engagement with its customers in preparing its price submission
- reviews whether Central Highlands Water has delivered on the outcomes it committed to for the current regulatory period (2018–23) and examines the customer outcomes Central Highlands Water is committing to for the next regulatory period
- outlines Central Highlands Water’s proposed service standards
- outlines Central Highlands Water’s proposed guaranteed service levels.

### 3.1 Customer engagement

Our guidance required Central Highlands Water to engage with customers to inform its price submission. Our guidance also identified principles to guide Central Highlands Water’s engagement.<sup>16</sup>

We consider Central Highlands Water’s engagement aligned with these principles in a number of ways. Central Highlands Water:

- was informed by ongoing engagement activities since 2018, with targeted engagement taking place between November 2021 and June 2022
- used a wide range of online and in person methods to support effective participation including surveys, pop up conversation caravans, anonymous online discussions, gamification, cue cards with images, a customer advisory panel and a 3-day deliberative assembly
- used inclusive engagement methods suitable to its context and the issues it was seeking to engage on to hear directly from its First Nations customers, customers more likely to experience vulnerability and its Careflow advisory group (made up of local welfare support organisations)
- engaged on matters that influence services and prices such as support for customers experiencing vulnerability, adaptation to climate change impacts, water quality, drinkable town water priority areas and guaranteed service levels

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<sup>16</sup> Essential Services Commission, *2023 water price review: Guidance paper*, p. 20.

More detail on Central Highlands Water's engagement is available in its price submission.<sup>17</sup>

Actions proposed to be taken by Central Highlands Water in response to feedback from its customers and stakeholders provides evidence that its engagement influenced its proposals. For example, in its price submission, Central Highlands Water proposed:

- incorporating the views of its deliberative assembly into its customer outcomes and outputs including water and energy efficiencies, water quality projects, approach to tariff structures and improved water quality for towns without access to potable water<sup>18</sup>
- an additional billing cycle for the first 2 years of the pricing period, in response to recommendations from its deliberative assembly, customer advisory panel and a local welfare advisory group on measures to reduce bill shock and support customer affordability<sup>19</sup>
- doubling its current commitment in financial support for customers experiencing vulnerability to assist those customers who may be affected by the proposed price increase in response to supportive feedback across all its engagement stages on increasing support to customer affordability<sup>20</sup>
- an increase to all its guaranteed service level payments to be made if Central Highlands Water fails to meet its service levels<sup>21</sup>
- to increase the current financial commitment for partnerships with Traditional Owners from \$25,000 to \$100,000 each year with support from its customer panel.<sup>22</sup>

The influence of Central Highlands Water's engagement on its proposals supports the objectives in our pricing framework relating to efficiency and the interests of consumers.

Overall, our preliminary view is that Central Highlands Water has designed and delivered a sound engagement program with strong customer and stakeholder influence on the proposals in its submission.

Central Highlands Water's engagement on its price submission was informed by customer insights gathered through its established forms of engagement that include its quarterly customer advisory panel meetings, twice yearly meeting of its Careflow forum, and a yearly customer survey. Early findings informed the content and method of future engagement, including a comprehensive deliberative process carried out later in its process.

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<sup>17</sup> Central Highlands Water's price submission is available on our website at [www.esc.vic.gov.au](http://www.esc.vic.gov.au).

<sup>18</sup> Central Highlands Water, 2023–28 Price Submission, September 2022, p. 39 and p. 40.

<sup>19</sup> Central Highlands Water, 2023–28 Price Submission, September 2022, p. 34.

<sup>20</sup> Central Highlands Water, 2023–28 Price Submission, September 2022, p. 7.

<sup>21</sup> Central Highlands Water, 2023–28 Price Submission, September 2022, p. 58.

<sup>22</sup> Central Highlands Water, 2023–28 Price Submission, September 2022, p. 51.

We consider that Central Highlands Water designed engagement methods and materials that were overall well suited to the circumstances of its customers. For example, to gather views on service priorities from a breadth of customers across its communities, it used gamification to achieve wider participation, and cue cards to support customers in their decision making. We also note that Central Highlands Water introduced innovative technology to host anonymous conversations and deep exploration of issues in a safe environment including for its Careflow advisory group and its customer advisory panel.

However, our preliminary view is that Central Highlands Water did not achieve this same standard when engaging on its new customer contribution pricing methodology, as we identified minimal information provided to stakeholders on key aspects of the methodology. We address this further in Section 5.4.4 of this draft decision.

Central Highlands Water's engagement methods supported participation from people experiencing vulnerability as it tailored its engagement to suit customer circumstances, including by attending towns with known vulnerable populations and providing laptop access in its main office for participants of the deliberative assembly who did not have access to appropriate technology. The workshop with the Careflow advisory group and the makeup of its deliberative assembly with 50 per cent of people experiencing vulnerability, ensured these customers' views were considered, consistent with the expectations set in our guidance.

In forming our preliminary view about the level of inclusivity Central Highlands Water was able to achieve in relation to customers experiencing vulnerability, we considered:

- its recruitment effort for its deliberative assembly
- the broad demographic representation of customers contributing to the assembly including a First Nations customer, people who identify as LGBTQI+, multicultural community members, and people with a disability,
- the overall opportunities for all customers to participate in its price review process.

A submission by the Consumer Action Law Centre commented positively on Central Highlands Water's transparency regarding the make-up of its deliberative assembly. We consider that Central Highlands Water's engagement methods allowed for quality of participation from its diverse customer base.

We consider that Central Highlands Water's engagement achieved an overall high level of influence on the submission, as evidenced by feedback from its deliberative assembly members and customer advisory panel members. Participants commented favourably on the alignment between their priorities and the business's outcomes proposals and the quality of the engagement, and provided overall endorsement of the submission.

Our preliminary view is that we accept Central Highlands Water’s self-rating of ‘Advanced’ for its price submission engagement. See Chapter 7 for our PREMO assessment of Central Highlands Water’s price submission.

## **3.2 Outcomes**

### **3.2.1 Performance against outcome commitments 2018–23**

As part of our 2018 water price review, Central Highlands Water established ‘outcomes’ it would deliver customers over the following 5 years. These outcomes were reflected in the prices we approved for the period 1 July 2018 to 30 June 2023. Progress against these outcome commitments can indicate whether customers got what they paid for.

A business’s price submission should account for its actual performance against its outcome commitments for the current period, from 1 July 2018 to 30 June 2023.<sup>23</sup>

We consider Central Highlands Water accounted for its annual performance for each measure in its price submission. Table 3.1 lists Central Highlands Water’s outcome commitments and includes its annual performance results as reported in its price submission. The information in this table informs our assessment under the Performance element of PREMO, which is discussed in Chapter 7.

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<sup>23</sup> Essential Services Commission, 2023 water price review: Guidance paper, 26 October 2021, p. 23.

**Table 3.1 Business self-assessment of performance against Outcome commitments**

Outcome	2018-19	2019-20	2020-21	2021-22	Period to date <sup>a</sup>
1. Better customer experience	Amber	Red	Amber	Amber	Amber
2. Safe, clean drinking water that tastes great	Green	Green	Green	Green	Green
3. Reliable and sustainable water and sewer systems	Amber	Amber	Amber	Amber	Amber
4. More efficient water use	Green	Green	Amber	Green	Green
5. Increased value for money	Green	Green	Green	Green	Green

**Note:** Green = achieved target; Amber = close to achieving target; Red = failed to meet target. <sup>a</sup> This is Central Highlands Water’s self-assessment of its performance across the first 4 years of the current regulatory period. Central Highlands Water’s performance against Outcome commitments in the final year of the current regulatory period (2022-23) will be published in our 2022-23 Outcomes Report.

In its 2021-22 outcomes report, Central Highlands Water reported it had achieved or exceeded its targets for 88 (78 per cent) of its 113 reported measures over the first 4 years of the current regulatory period. Of these 113 performance measures, 14 (12 per cent) have been rated as amber ‘close to achieving target’ and 11 (10 per cent) as red ‘failed to meet target’ in the period to date.<sup>24</sup>

Central Highlands Water was close to achieving its ‘better customer experience’ outcome commitment for the period to date. In its price submission, Central Highlands Water noted that it set overly optimistic targets for its ‘accounts using direct debit’ measure, resulting in it failing to meet its annual targets for this measure. Additionally, its ‘online platform customer satisfaction’ measure included a small number of respondents, which skewed its results.<sup>25</sup>

Central Highlands Water was also close to achieving its ‘reliable and sustainable water and sewer systems’ outcome commitment for the period to date. In its price submission, Central Highlands Water noted that it had set overly optimistic targets for its ‘sewer spills inside a customer’s house’ measure, resulting in it failing to meet its annual targets for this measure. Additionally, it was close to achieving its annual targets for its ‘unplanned water supply interruptions restored within 5 hours’

<sup>24</sup> Essential Services Commission, Central Highlands Water’s outcomes performance 2021-22, October 2022.

<sup>25</sup> Central Highlands Water, 2023 water price submission, September 2022, p. 13-14.

measure, ultimately resulting in it almost achieving this outcome commitment for the period to date.<sup>26</sup>

Central Highlands Water revised its measures and targets in consultation with its customer advisory panel and with us in 2019-20, resulting in adjustments to some of its measures and targets that applied from 1 July 2020. Some of its revised targets are more ambitious than its previous targets and, considering its higher benchmark, demonstrate its commitment to improving customer value. We commend businesses that continue to refine their outcome measures and targets during the regulatory period in consultation with their customers.<sup>27</sup>

Central Highlands Water reported its performance by publishing its annual report on its website and through its social media and other channels. It sought the views of its customer committees before finalising its traffic light ratings.

Our draft decision is that we agree with Central Highlands Water's self-assessment that it has, overall, met its outcome commitments for the period to date.

### **3.2.2 Outcome commitments for 2023–28**

Central Highlands Water engaged with its customers to refine its outcomes for the period from 1 July 2023 to 30 June 2028. It has established three customer outcomes it proposes to deliver:

- customer care
- equity
- sustainability.<sup>28</sup>

Among the key initiatives to deliver on its commitments, Central Highlands Water has proposed to enhance its support for customers experiencing vulnerability, and further develop partnerships with Traditional Owners. Its capital program is being driven by accelerated and sustained population growth, renewing assets to secure reliable services, and responding to climate change.

### **3.2.3 Our assessment of measures and targets**

Central Highlands Water proposed a set of 16 measures and targets that it will use to report on performance across the 3 outcomes. These are set out on pages 50 to 55 of its price submission. Performance against these measures will inform our assessment during future price reviews.

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<sup>26</sup> Central Highlands Water, 2023 water price submission, September 2022, p. 13-14; Essential Services Commission, Central Highlands Water's outcomes performance 2021-22, October 2022.

<sup>27</sup> Essential Services Commission, Central Highlands Water's outcomes performance, 2021-22, October 2022.

<sup>28</sup> Central Highlands Water, 2023 water price submission, September 2022, p. 50–55.



We have assessed Central Highlands Water’s proposed measures against the criteria set out in our guidance which states that proposed output measures for each outcome must:

- be relevant to, or be a reasonable proxy for, the delivery of the outcome they represent
- be measurable
- be clearly defined and unambiguous
- be easy for customers to understand
- have performance targets listed for each year of the regulatory period.<sup>29</sup>

Evidence provided by Central Highlands Water demonstrates that these measures and targets were developed in consultation with its customers, and that they are supported by its customers. In its price submission, Central Highlands Water notes that it developed a range of outputs to address key customer priorities, based on suggestions from its deliberative assembly. The deliberative assembly reviewed these outcomes in small groups, and following this consultative assembly, customers were asked to rate their support of the outcomes under each theme with a score between 0 and 5. The result of this rating process showed strong support for Central Highlands Water’s proposed outcomes and outputs.<sup>30</sup>

We consider some of Central Highlands Water’s measures have not been well presented in its submission and will require considerable reworking to meet our requirements. The broad scope afforded by each of Central Highlands Water’s three new outcomes suggests a wide range of performance measures could apply. However, we consider that some measures put forward may not be the best proxy for the outcome they represent, and Central Highlands Water may not be able to meaningfully report on its performance against its outcome commitments to its customers.

We note Central Highlands Water has dropped its previous measure for full compliance with the Safe Drinking Water Regulations, which we had asked all businesses to include at the 2018 price review. It has also dropped previous performance measures for water quality satisfaction, water quality complaints, and water and sewerage reliability. It does not have a measure for compliance with environmental licences, which many other businesses have included.

We will provide Central Highlands Water with our standard Outcomes Reporting Template to complete and submit with its response to this draft decision. We will work with the business to ensure the final set of measures addresses the above matters and complies with our guidance requirements.

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<sup>29</sup> Essential Services Commission, 2023 water price review: Guidance paper, 26 October 2021, p. 23.

<sup>30</sup> Central Highlands Water, 2023–28 Price Submission, September 2022, p. 39–43.

Central Highlands Water's proposed targets for some of its outcome measures suggest an overall improvement in customer value, however this was not clear for all measures.

Central Highlands Water will continue to report its performance to its customers on a 6-monthly basis through a range of communication channels, including engagement with its community engagement panel, as well as annually through the established outcomes reporting process.<sup>31</sup>

Overall, we consider Central Highlands Water's proposed set of measures and targets to be less robust than its current set for the 2018–23 regulatory period, and we cannot ascertain whether it demonstrates a clear improvement in customer value. For the purpose of our draft decision, we accept Central Highlands Water's self-assessment of 'Advanced' for the Outcomes element of PREMO, which is discussed further in Chapter 7. However, Central Highlands Water's response to this draft decision must provide sufficient clarity to demonstrate its proposal does reflect customer value consistent with an 'Advanced' rating.

### **3.3 Service Standards related to service reliability and faults**

Service standards are a common set of services applicable to all Victorian consumers required under Clause 18.2 of the *Water Industry Standard – Urban Customer Service* (Water Industry Standard). Each water business must specify its own service levels against each of these service standards. Rather than performance measures, these service standards and corresponding service levels are the minimum level of service customers can expect to receive.

Central Highlands Water's proposed service standards relating to reliability and faults can be found on page 57 of its price submission.

The service standards proposed by Central Highlands Water are the same as its service standards for the current regulatory period (with some wording changes to align with the updated Water Industry Standard). The service levels proposed are the same or in some cases an improvement on service levels for the current regulatory period. Central Highlands Water has also specified minimum flow rates as required by the Water Industry Standard.

On the basis of the above, our preliminary assessment is that the service standards relating to reliability and faults proposed by Central Highlands Water comply with the requirements of the Water Industry Standard.

Service standards are approved in our Water Industry Standard. Accordingly, in early 2023-24, we will update the Water Industry Standard to reflect approved service standards.

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<sup>31</sup> Central Highlands Water, 2023 water price submission, September 2022, p. 51 and p. 56.

### 3.4 Guaranteed service levels

Our draft decision is to accept Central Highlands Water's proposed guaranteed service levels.

Guaranteed service levels define a water business's commitment to deliver a specified level of service. For each guaranteed service level, typically a water business commits to a payment or a rebate on bills to those who have received a level of service below the guaranteed level.

Central Highlands Water's proposed guaranteed service levels are set out on page 58 of its price submission. It has proposed to make no changes to the guaranteed service levels that apply in the current regulatory period. In its consultation, its customers identified two guaranteed service levels as priorities – those relating to a failure to restore clean drinking water and a failure to repair a leaking water service. In recognition of this, Central Highlands Water proposed to double the rebate associated with both of these guaranteed service levels to \$200.<sup>32</sup> It has also increased the rebate for all other guaranteed service levels by 50 per cent.

We propose to accept Central Highlands Water's proposed guaranteed service levels, on the basis that they have been developed with customers during its engagement. Final guaranteed service levels and rebates will be subject to our consideration of any feedback following the release of our draft decision.

Guaranteed service levels are approved in our water industry standards. Accordingly, in early 2023-24, we will update the standards to reflect the guaranteed service levels published in our final decision.

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<sup>32</sup> This amount is in nominal terms, that is, it will not increase further with inflation.

## 4. Revenue requirement

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

We have used a building block methodology to establish the revenue requirement. This chapter outlines our assessment of Central Highlands Water's revenue requirement based on the following steps:

- establish an efficient benchmark level of forecast operating expenditure for the next regulatory period (Section 4.1)
- establish an efficient benchmark level of forecast capital expenditure for the next regulatory period (Section 4.2)
- roll-forward the regulatory asset base (Section 4.3)
- apply a rate of return to the regulatory asset base, calculated using:
  - a benchmark cost of debt estimated using a 10-year trailing average approach (Section 4.4.1)
  - a benchmark return on equity value determined by Central Highlands Water's PREMO rating (Section 4.4.2)
- establish a return of capital through a regulatory depreciation allowance (Section 4.5)
- establish a benchmark tax allowance (Section 4.6).

Our draft decision is to not approve the revenue requirement of \$549.2 million proposed by Central Highlands Water in its price submission, and instead approve a revenue requirement of \$528.9 million, 3.7 per cent lower than proposed by Central Highlands Water.

Central Highlands Water proposed a revenue requirement of \$549.2 million over a 5-year period starting 1 July 2023. Our draft decision approves a revenue requirement of \$528.9 million (Table 4.1).

**Table 4.1 Draft decision on Central Highlands Water’s revenue requirement**  
\$ million 2022-23

	2023-24	2024-25	2025-26	2026-27	2027-28	Total
Operating expenditure	70.1	70.7	71.7	71.7	72.4	356.5
Return on assets	11.0	10.6	10.5	10.5	10.6	53.1
Regulatory depreciation	20.9	21.8	22.7	23.6	24.5	113.4
Tax allowance	0.0	0.0	0.0	0.0	5.9	5.9
<b>Draft decision – revenue requirement</b>	<b>101.9</b>	<b>103.1</b>	<b>104.9</b>	<b>105.7</b>	<b>113.4</b>	<b>528.9</b>

**Note:** Numbers have been rounded.

Table 4.2 summarises how our draft decision on Central Highlands Water’s revenue requirement (row E) differs to the revenue requirement proposed by Central Highlands Water in its price submission (row A). Where our draft decision differs from Central Highlands Water’s price submission in relation to a component of the revenue requirement, the adjustment we propose is shown in rows B to D of Table 4.2.

The adjustments mainly reflect our preliminary views on Central Highlands Water’s forecast operating expenditure (Section 4.1.1). We also propose smaller adjustments to regulatory depreciation and the return on assets to reflect our review of Central Highlands Water’s proposed capital expenditure (Section 4.2.2).

Our final decision on Central Highlands Water’s revenue requirement will be based on the latest available information. Accordingly, as well as responding to our draft decision and providing an updated price schedule, Central Highlands Water must update its revenue requirement and prices to reflect our updates to estimates for the cost of debt and inflation, which we will advise in April 2023.

There may be changes in laws or government policy before we make a price determination. If any such changes occur between the draft decision and the price determination that impact on its forecast costs and the revenue requirement, Central Highlands Water should update its price submission and provide us with an updated financial model. It also should notify us of any material changes that impact its forecast costs, revenue requirement or prices (including demand). Any updates to its submission or pricing model will be made publicly available on our website.

**Table 4.2 Our proposed adjustments to Central Highlands Water’s proposed revenue requirement**  
\$ million 2022-23

	2023-24	2024-25	2025-26	2026-27	2027-28	Total
<b>A. Central Highlands Water’s proposed revenue requirement</b>	<b>104.1</b>	<b>106.9</b>	<b>109.2</b>	<b>110.4</b>	<b>118.6</b>	<b>549.2</b>
B. Operating expenditure	-2.1	-3.7	-4.0	-4.3	-4.6	-18.8
C. Return on assets	-0.0	-0.1	-0.1	-0.1	-0.2	-0.6
D. Regulatory depreciation	0.0	-0.1	-0.2	-0.3	-0.4	-0.9
<b>E. Draft decision – revenue requirement (A+B+ C+D)</b>	<b>101.9</b>	<b>103.1</b>	<b>104.9</b>	<b>105.7</b>	<b>113.4</b>	<b>528.9</b>

**Notes:** Our proposed adjustments are the differences between our draft decision and what Central Highlands Water proposed in its price submission. Row A shows the total revenue requirement proposed by Central Highlands Water in its price submission. We have arrived at our draft decision (row E) by proposing the relevant adjustments to the components of the revenue requirement shown in rows B to D. Numbers have been rounded.

## 4.1 Operating expenditure

Our draft decision is to adopt a forecast operating expenditure of \$356.50 million, which is \$18.75 million or 5.0 per cent lower than proposed by Central Highlands Water.

Operating expenditure is a component of the revenue requirement. Central Highlands Water’s price submission provides detail on its forecast operating expenditure from pages 67 to 73.

We assess both:

- controllable operating expenditure – comprising all costs that can be directly or indirectly influenced by a water business’s decisions
- non-controllable operating expenditure – comprising all costs that cannot be directly or indirectly influenced by a water business’s decisions.

We engaged FTI Consulting to provide expert advice to inform our assessment of controllable operating expenditure. FTI Consulting’s report on its assessment of Central Highlands Water’s expenditure forecast is available on our website.<sup>33</sup>

<sup>33</sup> FTI Consulting, *Central Highlands Water – Expenditure Review for 2023 water price review*, February 2023.

Since lodging its price submission with us, we identified that Central Highlands Water’s 2021-22 Regulatory Account Statement figure for total prescribed operating expenditure is \$4.0 million lower than the figure provided in its financial model for the price review. Further investigation to reconcile this with Central Highlands Water and our auditor has confirmed an error in the 2021-22 regulatory accounts. Correcting for this increases the 2021-22 figure by \$2.9 million, and we accept this adjustment to the total operating expenditure figure, noting it is \$1.16 million lower than the figure initially proposed by Central Highlands Water in its price submission.

Table 4.3 sets out our draft decision on Central Highlands Water’s forecast operating expenditure, for the purpose of establishing the revenue requirement outlined in Table 4.1.

**Table 4.3 Draft decision – operating expenditure**  
\$ million 2022-23

	2023-24	2024-25	2025-26	2026-27	2027-28	Total
<b>Controllable operating expenditure</b>	<b>64.55</b>	<b>65.31</b>	<b>66.38</b>	<b>66.50</b>	<b>67.29</b>	<b>330.03</b>
<b>Non-controllable operating expenditure</b>	<b>5.50</b>	<b>5.40</b>	<b>5.30</b>	<b>5.19</b>	<b>5.09</b>	<b>26.47</b>
Bulk services <sup>a</sup>	0.65	0.66	0.67	0.68	0.69	3.34
Environmental contribution <sup>b</sup>	4.34	4.22	4.09	3.97	3.86	20.48
Licence fees – Essential Services Commission <sup>c</sup>	0.08	0.08	0.08	0.08	0.08	0.39
Licence fees – Department of Health <sup>c</sup>	0.04	0.04	0.04	0.04	0.04	0.21
Licence fees – Environmental Protection Authority <sup>c</sup>	0.24	0.24	0.25	0.25	0.25	1.23
Temporary water purchases	0.16	0.16	0.17	0.17	0.17	0.82
<b>Draft decision – operating expenditure</b>	<b>70.05</b>	<b>70.71</b>	<b>71.68</b>	<b>71.68</b>	<b>72.37</b>	<b>356.50</b>

**Notes:** Numbers have been rounded. <sup>a</sup> Bulk services covers the supply of bulk water and sewerage services.

<sup>b</sup> Environmental contributions are funds collected from water businesses under the *Water Industry Act 1994*. <sup>c</sup> Licence fees are paid to cover costs incurred by the Department of Health, the Environment Protection Authority Victoria, and the Essential Services Commission in their regulatory activities related to the water business.

Table 4.4 summarises how our draft decision on Central Highlands Water’s operating expenditure (row D) and its two components differ from the operating expenditure proposed by Central Highlands Water in its price submission (row A). Rows B and C of the table summarise our

proposed adjustments to Central Highlands Water’s proposed controllable and non-controllable operating expenditure.

Details of our assessment and reasons for our proposed adjustments to Central Highlands Water’s proposal are included in Section 4.1.1 (controllable operating expenditure) and Section 4.1.2 (non-controllable operating expenditure).

**Table 4.4 Our proposed adjustments to Central Highlands Water’s proposed operating expenditure**  
\$ million 2022-23

	2023-24	2024-25	2025-26	2026-27	2027-28	Total
<b>A. Central Highlands Water’s proposed total operating expenditure</b>	<b>72.17</b>	<b>74.40</b>	<b>75.69</b>	<b>75.98</b>	<b>77.01</b>	<b>375.25</b>
<b>B. Our total proposed adjustments to controllable operating costs (B1 + B2 + B3)</b>	<b>-1.53</b>	<b>-1.84</b>	<b>-2.10</b>	<b>-2.42</b>	<b>-2.73</b>	<b>-10.63</b>
B1 – Regulatory accounts reconciliation	-1.18	-1.19	-1.20	-1.22	-1.23	-6.03
B2 – Additional FTEs	-0.30	-0.60	-0.90	-1.20	-1.50	-4.50
B3 – More frequent billing	-0.05	-0.05	0.00	0.00	0.00	-0.10
<b>C. Our total proposed adjustments to non-controllable operating costs (C1)</b>	<b>-0.59</b>	<b>-1.85</b>	<b>-1.90</b>	<b>-1.87</b>	<b>-1.90</b>	<b>-8.11</b>
C1 – Environmental contribution	-0.59	-1.85	-1.90	-1.87	-1.90	-8.11
<b>D. Draft decision – total operating expenditure (D = A + B + C)</b>	<b>70.05</b>	<b>70.71</b>	<b>71.68</b>	<b>71.68</b>	<b>72.37</b>	<b>356.50</b>

**Notes:** Our proposed adjustments are the differences between our draft decision and what Central Highlands Water proposed in its price submission. Row A shows the total operating expenditure proposed by Central Highlands Water in its price submission. We have arrived at our draft decision (row D) by proposing the relevant adjustments to controllable operating costs and non-controllable operating costs shown in rows B and C (and itemised in rows B1 to B3 and C1). Numbers have been rounded.

We consider the operating expenditure proposed in our draft decision reflects the expenditure that a prudent service provider would incur when acting efficiently to achieve the lowest cost in delivering the outcomes specified in Central Highlands Water’s price submission.



The operating expenditure that we propose to adopt for Central Highlands Water does not represent the amount that Central Highlands Water is required to spend or allocate to particular operational, maintenance and administrative activities. Rather, it is a benchmark that represents assumptions about the overall level of operating expenditure (to be recovered through prices) that we consider sufficient to operate the business efficiently and to maintain services over the regulatory period.

#### **4.1.1 Controllable operating expenditure**

Central Highlands Water proposed a total forecast controllable operating expenditure of \$340.65 million over a 5-year regulatory period. For the reasons set out below, we propose to adopt a forecast operating expenditure of \$330.03 million for the 2023–28 regulatory period, which is \$10.6 million or 3.1 per cent lower than proposed by Central Highlands Water.

Central Highlands Water’s forecast controllable operating expenditure for the period from 1 July 2023 is estimated through a series of steps:

1. Establish a controllable operating expenditure baseline – the baseline comprises the efficient recurring costs from the last full year of data (2021-22) after non-controllable expenditure, one-off items are removed or normally occurring items are added in.
2. Apply a growth rate for operating expenditure for the regulatory period – assumed by Central Highlands Water to be 2.2 per cent per year.
3. Apply an annual cost efficiency improvement rate – assumed by Central Highlands Water to be 1.0 per cent per year.
4. Make adjustments for additional costs or cost saving expected in future years.

##### **4.1.1.1 Baseline controllable operating expenditure**

Central Highlands Water has proposed a controllable operating expenditure baseline of \$63.3 million, after removing \$1.6 million in non-recurring operating expenditure that occurred in 2021-22. Central Highlands Water’s proposed baseline is \$6.2 million (or 11 per cent) higher than the benchmark figure of \$57.1 million of controllable operating expenditure for 2021-22 used for our 2018 price determination.

After the regulatory account adjustment described above, the baseline drops by \$1.16 million to \$62.15 million, which is \$5.0 million (or 9 per cent) higher than the \$57.1 million benchmark.

Our expenditure consultant requested substantiation of Central Highlands Water's proposed increase to its baseline year operating expenditure benchmark.<sup>34</sup> Central Highlands Water explained the increase was due to a number of factors including:

- \$0.1 million for compliance costs for new or amended obligations
- \$0.4 million to meet the comprehensive compliance requirements of the Victorian Protective Data Security Standards
- \$1.3 million for occupational health and safety to ensure Central Highlands Water continues to provide a safe environment for staff, contractors, customers and the community
- \$0.3 million for additional compliance activities which have required staffing resources
- \$1.1 million to accommodate higher than expected growth and supply chain impacts to costs
- \$1.5 million in coronavirus pandemic related costs and ongoing costs associated with moving to a digital workplace
- \$0.3 million for insurance costs which have increased significantly in recent years
- \$1.2 million for other additional staffing and associated costs.

Several of these factors were common across all water businesses with an increase in costs for labour, insurance, IT and coronavirus pandemic related impacts. For Central Highlands Water, this also included significantly higher than forecast growth in connections over the current regulatory period. Total customer connections at the end of the 2021-22 baseline year are 4.1 per cent higher than the forecast for that year in the 2018 price submission.

Our expenditure consultant verified these additional costs were recurring and found Central Highlands Water's substantiation of these costs to be reasonable. Accordingly, it recommended accepting Central Highlands Water's proposed baseline increase with no adjustments required. We reviewed Central Highlands Water's proposal and the advice from our expenditure consultant.

Given the above, we consider \$62.15 million reflects an efficient baseline cost to forecast annual operating expenditure for the purpose of our draft decision.

#### **4.1.1.2 Efficiency improvement and growth rate**

Central Highlands Water proposed an average efficiency improvement rate on its controllable operating costs of 1.0 per cent per annum, which is below the average of businesses in the current price review (around 1.3 per cent per annum).

Central Highlands Water proposes to achieve the efficiency improvement rate through a series of initiatives including digitisation of systems to drive efficiency savings, continuing to identify and participate in joint procurement opportunities, participating in VicWater working groups to enable

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<sup>34</sup> FTI Consulting, *Central Highlands Water – Expenditure Review for 2023 water price review*, February 2023, pp. 16-23.

collaboration across the water sector and shared benefits, and through the establishment of an enterprise program management office and innovation hub to identify and deliver on initiatives that will drive efficiencies.

The efficiency improvement rate is also lower than Central Highlands Water's proposed average cost growth rate of 2.2 per cent per annum, effectively delivering a net annual increase to its controllable annual baseline operating costs in each year of the regulatory period due to high growth.

Central Highlands Water has proposed the high average cost growth rate due to growth in new development zones for Ballarat, and to support regional growth and new growth areas. Given the cost pressures associated with growth, Central Highlands Water has committed to delivering its operational efficiency program to reduce the overall net annual increase in its controllable annual baseline operating costs.

#### **4.1.1.3 Cost adjustments**

Central Highlands Water has proposed additional forecast operating expenditure above the annual baseline, including:

- \$1.25 million to double support for customers experiencing vulnerability from \$250,000 per year to \$500,000
- \$0.38 million for a four-fold increase for the Traditional Owners partnership program
- \$0.40 million for more frequent billing (including digital metering) to provide for quarterly billing, including additional meter reads until full digital meter rollout is completed
- \$0.15 million for the Rainwater Tank Maintenance Program for customer rebates in the non-potable systems of Raglan, Amphitheatre and Redbank
- \$1.07 million for the additional pumping at White Swan Dam to allow for the White Swan Dam Safety Improvement capital project
- \$1.00 million to move an old stockpile of biosolids to comply with EPA obligations
- \$1.97 million for sewerage treatment plant lagoon biosolids remediation
- \$4.50 million for two additional employee positions per year, to meet service commitments.

The above costs represent an additional \$10.72 million over the regulatory period, or an average of \$2.14 million per annum.

Our expenditure consultant reviewed each of the proposed forecast variations above the baseline and requested further information from Central Highlands Water, including a further breakdown by individual cost item where required, along with documentation that supported the prudence and efficiency of each cost item.

Our expenditure consultant assessed each forecast variation against criteria for prudent and efficient operating expenditure and was mostly satisfied each item was appropriately costed and

supported by internal documentation, which included evidence of its prudence and efficiency. It therefore considered that Central Highlands Water's proposed additions were reasonable and only recommend changes to the more frequent billing step change and the two additional staff positions step change listed above.

The \$0.40 million for more frequent billing, which consists of \$0.20 million per year for 2023-24 and 2024-25, will allow for Central Highlands Water to introduce an additional meter read and a transition to quarterly billing until digital metering is implemented. This will smooth billing for customers and in turn reduce bad debt risk for Central Highlands Water. After discussions with our expenditure consultant, Central Highlands Water has subsequently revised its forecast for this work to \$0.15 million per year for 2023-24 and 2024-25. Given the level of customer support, our consultant was satisfied with the justification for the step change and also recommended adopting the revised lower figure of \$0.30 million. We accept the lower figure and have removed \$0.1 million from the forecast for this item.

However, it is not clear to us how Central Highlands Water has captured the benefits of the more frequent cashflows it will receive through more frequent billing in the period.

Further, we note that Central Highlands Water has not specifically identified any decrease in its operating costs following its roll out of digital meters. It is not immediately clear to us where the associated operating cost savings that justified this investment (avoided manual meter readings, for example) are presented in its financial model, or how they are being passed through to customers. We do not consider that these savings would be captured through Central Highlands Water's proposed efficiency rate of 1 per cent, given the efficiency rate is intended to reflect the business performing 'business as usual' activities more efficiently over time. Rather, we expect that the cost savings delivered by a digital metering rollout would be reflected in decreases to the business's operating expenditure benchmarks.

We request that in its response to our draft decision, Central Highlands Water quantify the cost savings to customers to be delivered through digital metering, and demonstrate how these savings are reflected in its financial model and passed through to customers. We also request the business explain any benefits associated with its move to quarterly billing, such as the more frequent collection of revenues, and how this may benefit customers.

For the \$4.5 million for two additional full time equivalent staff positions to meet service commitments across capital delivery, ICT and digital, and customer service, our expenditure consultant was not satisfied that sufficient justification or level of detail were provided to justify this step change. Our consultant noted that Central Highlands Water already had \$0.4 million for increased customer service roles in its operating baseline, and that while Central Highlands Water is preparing an overarching ICT and digital strategy, this is yet to be finalised. Further, our

consultant has recommended a corresponding reduction in the forecast allowance for capital expenditure on the ICT Business Solutions Enhancements from \$14.9 million to \$10 million.

Central Highlands Water also had the highest proposed average net cost growth rate of 1.2 per cent per annum when compared to other businesses in the current price review, which could be expected to cover increases in staff numbers. Our expenditure consultant has recommended the removal of this step change component because Central Highlands Water had not provided sufficient justification for such a large step change.

We note Central Highlands Water's price submission showed 198 full time equivalent staff positions in 2021-22, and its 2.2 per cent per annum operating expenditure growth allowance effectively provides for at least 4 additional staff positions each year. We consider Central Highlands Water has not effectively identified why these positions cannot be funded through its forecast growth rate of 2.2 per cent per annum.

We have reviewed Central Highlands Water's proposal and our consultant's advice and given the above, our draft decision is to not accept the step change for two additional employee positions per annum.

For the \$1 million (\$0.2 million per annum) in proposed operating expenditure to move a stockpile of contaminated biosolids and the \$1.97 million (\$0.39 million per annum) to complete lagoon desludging work, we accept our consultant's advice that these are prudent activities for the business to conduct. However, we note that these works address the movement and long-term storage of biosolids and lagoon desludging of accumulated biosolids, which are usually periodic rather than annual activities (for example, once every 10 years). Central Highlands Water has presented these costs in its financial model as steady across all 5 years of the regulatory period, seemingly to smooth the pricing impact. We ask Central Highlands Water to consider whether it might be more appropriate to capitalise these associated costs, for recovery over a suitable longer time period, and quantify the customer pricing benefits of its chosen approach.

We have considered the advice from our expenditure consultant, and Central Highlands Water's proposal. We consider Central Highlands Water's approach to forecasting its operating expenditure is mostly consistent with the requirements of our guidance, with the exception of the \$4.5 million for additional employees, which we consider are accounted for through the business's forecast average cost growth rate of 2.2 per cent. Our preliminary position is that we are satisfied that its proposed forecast represents efficient controllable operating expenditure after removing \$4.6 million relating to step changes for more frequent billing and the two additional staff positions each year (Table 4.4). There is evidence that Central Highlands Water has significantly tested its controllable expenditure requirements, resulting in a forecast overall decline (excluding inflation) in controllable operating expenditure per customer connection across the 2023–28 regulatory period.

### 4.1.2 Non-controllable operating expenditure

Our process for establishing non-controllable operating expenditure involves:

- obtaining the most recent information from the relevant regulatory authorities on their licence fees and the environmental contribution
- adjusting the forecasts proposed by Central Highlands Water where required.

The values we have adopted for our draft decision are set out above in Table 4.3.

Central Highlands Water has proposed \$34.58 million in non-controllable operating expenditure over the 2023–28 regulatory period. This is an increase of \$6.63 million compared to the 2018–23 regulatory period, driven by a \$0.23 million increase in external bulk charges, an increase of \$5.87 million due to forecast increases in the real value of the environmental contribution, and a \$0.43 million increase in external licence fees.

Our guidance paper sets out our approach for businesses to forecast their non-controllable operating costs. We consider businesses should forecast licence fees for the Department of Health, the Environment Protection Authority Victoria and the Essential Services Commission to remain flat in real terms, and for the environmental contribution to remain flat in nominal terms (decline in real terms) across the 2023–28 regulatory period. Central Highlands Water has partially followed this approach in its price submission but has forecast minor non-material but stable increases for external licence fees, and an increased environmental contribution in 2023-24 followed by a material increase in 2024-25 before declining in real terms.

Our draft decision proposes to reduce Central Highlands Water’s forecast non-controllable operating expenditure by \$8.11 million across the 2023–28 period, resulting from our adjustments to the environmental contribution to reflect a flat rate in nominal terms based on the actual figure from 2021-22.

For the purpose of calculating the revenue requirement for our draft decision, we have accepted Central Highlands Water’s proposed non-controllable operating expenditure after adjusting for a \$8.11 million reduction to the environmental contribution. We have reviewed Central Highlands Water’s forecast bulk charges with Goulburn-Murray Water’s 2022-23 approved tariffs and request that Central Highlands Water respond to our draft decision by:

- updating its forecast bulk charges for the period 2022-23 to 2027-28 by using the approved prices for Goulburn-Murray Water in 2022-23
- maintaining the forecast bulk charges at a flat rate in real terms (using a price path of 0 per cent and not applying the consumer price index) during the next regulatory period
- submitting an updated financial model which takes into account these changes.

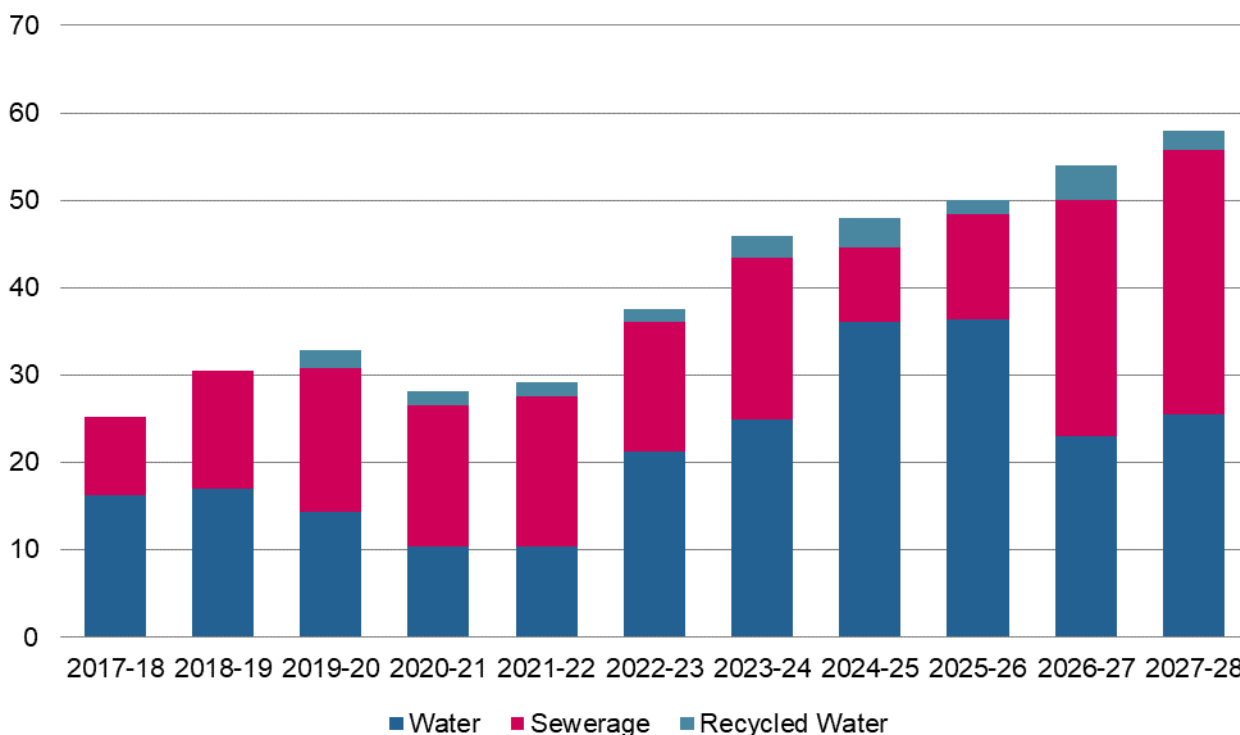
Prior to making our final decision, we will update the forecast licence fee and environmental contribution values with the relevant regulatory bodies and adjust where necessary for the latest inflation and external bulk charges data.

## 4.2 Capital expenditure

Our draft decision is to adopt a forecast capital expenditure of \$244.7 million, which is \$11.34 million or 4.4 per cent lower than proposed by Central Highlands Water.

Capital expenditure is an input to estimating the regulatory asset base, which is an input to the revenue requirement. Central Highlands Water’s forecast capital expenditure and supporting information is provided at pages 74 to 87 of its price submission. Figure 4.1 shows Central Highlands Water’s actual gross capital expenditure for 2017-18 and the first 4 years of the current regulatory period (2018-19 to 2021-22) and forecast gross capital expenditure from 2022-23 to 2027-28. The first 5 years of actual expenditure shown in Figure 4.1 (2017-18 to 2021-22) is relevant to the calculation of the closing regulatory asset base discussed in Section 4.3.1.

**Figure 4.1** Gross capital expenditure by service category  
\$ million 2022-23



**Note:** This graph shows actual figures for 2017-18 to 2021-22, and Central Highlands Water’s forecasts for 2022-23 to 2027-28.

We engaged FTI Consulting to provide expert advice to inform our assessment of capital expenditure. FTI Consulting's report on its assessment of Central Highlands Water's expenditure forecast is available on our website.<sup>35</sup>

#### 4.2.1 Actual capital expenditure

The PREMO framework involves reviewing a business's actual performance over the current regulatory period, against its proposals and commitments made to its customers in its previous price submission. This includes a comparison of its actual capital expenditure against the approved expenditure forecasts for the current regulatory period.

Central Highlands Water will incur \$145.7 million in actual gross capital expenditure over the period from 2017-18 to 2021-22, which is \$3.3 million or 2.2 per cent lower than forecast. For 2022-23, it has forecast expenditure of \$37.5 million, which is higher than the \$23.8 million benchmark adopted in its 2018 price determination. In net terms, Central Highlands Water will incur \$129.8 million in capital expenditure, \$10.5 million or 7.5 per cent lower than the benchmarks adopted in its 2018 price determination.

In a response to our request for further information, Central Highlands Water stated the drivers of its updated gross capital expenditure forecast of \$37.5 million for 2022-23 are material increases in construction costs above inflation and the need to bring forward significant capital expenditure projects (such as Ballarat North Sewer planning and design works, water main renewals, Cherry Flat Road Pump Station works, and water and sewer main upsizing works) in response to emerging growth and development requirements.<sup>36</sup>

Central Highlands Water's price submission provided an updated summary on the status of its top 10 major capital projects. As at September 2022, Central Highlands Water reported that of the top 10 major projects proposed for the 2018–23 regulatory period, 7 have been completed and the completion of the following 3 projects are delayed:

- Daylesford water supply upgrade is delayed due to the external approvals process. It is now expected to be completed in the early years of the 2023–28 regulatory period.
- Ballarat South outfall sewer duplication is delayed to prioritise the Ballarat East sewer duplication and flow storage project as per local council preference. It is expected to be completed in the early years of the 2023–28 regulatory period.
- Maryborough wastewater reuse scheme improvements are partially complete with further works transitioning into 2023–28.

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<sup>35</sup> FTI Consulting, *Central Highlands Water: Review of expenditure forecasts - 2023 Water Price Review*, February 2023.

<sup>36</sup> Central Highlands Water, Response to request for information, 16 January 2023.



Central Highlands Water’s price submission notes that the underspend on these delayed major projects and programs has been offset via project reprioritisation.

#### 4.2.2 Forecast Capital Expenditure

For the reasons set out below, our draft decision is to adopt a forecast capital expenditure of \$244.7 million, \$11.4 million (or 4.4 per cent) lower than the \$256.0 million forecast proposed by Central Highlands Water for the purpose of calculating its revenue requirement (Table 4.5).

**Table 4.5 Our proposed adjustments to Central Highlands Water’s proposed total forecast capital expenditure**  
\$ million 2022-23

	2023-24	2024-25	2025-26	2026-27	2027-28	Total
<b>Central Highlands Water’s proposed total forecast capital expenditure</b>	<b>45.99</b>	<b>48.00</b>	<b>50.01</b>	<b>54.01</b>	<b>57.99</b>	<b>256.00</b>
Adjustment – Ballarat Water Growth Project – Western and North-Western growth area	0.00	0.00	0.00	0.00	-0.43	-0.43
Adjustment – Ballarat Sewer Growth Project – Western and North-Western growth area	0.00	0.00	0.00	-0.35	-0.77	-1.12
Adjustment – Growth and Development Upsizing and Efficiency Program	-1.30	-0.90	-0.90	-0.90	-0.90	-4.90
Adjustment – ICT Business Solutions Enhancements	-1.13	-1.00	-0.63	-1.26	-0.87	-4.90
<b>Draft decision - total forecast capital expenditure</b>	<b>43.56</b>	<b>46.10</b>	<b>48.48</b>	<b>51.50</b>	<b>55.02</b>	<b>244.66</b>

**Note:** Numbers have been rounded.

Central Highlands Water’s price submission provided evidence that a large majority of its forecasts for capital expenditure are prudent and efficient. Its total proposed capital expenditure is \$98 million (62 per cent) higher than actual capital expenditure in the current 2018–23 period, and 55 per cent higher than the capital expenditure forecast for 2023–28 that the business provided in its 2018 price submission. This is due to an increase in expenditure to address the impacts of historic and future growth and deliver required increases in capacity, along with an increase in ‘improvement and compliance’ driven expenditure.

Our expenditure consultant requested selected documents from Central Highlands Water as a representative sample to demonstrate its asset management processes and justification for its

capital expenditure program. Based on the sample of documents reviewed, our consultant's workshop with the business and Central Highlands Water's responses to further questions, our consultant found that Central Highlands Water has an appropriate and fit for purpose approach for developing project scope, the timing of works and cost estimates.<sup>37</sup> However, our consultant recommended adjustments to address some timing and scope uncertainty for some growth driven projects.

Central Highlands Water has forecast \$116.2 million of capital expenditure on its top 10 major projects, this is 45.4 per cent of its total forecast capital expenditure. Given this, our consultant reviewed business cases and supporting information for all of Central Highlands Water's proposed top 10 major projects. Our consultant found that the information provided on each project was appropriately detailed and provided strong justification for the projects and associated expenditures. Our consultant recommended no adjustments to Central Highlands Water's forecast capital expenditure for its top 10 major projects.<sup>38</sup> We have reviewed our consultant's advice and Central Highlands Water's draft decision and we consider that, for the purposes of our draft decision, the prudence and efficiency of the expenditure has been justified, consistent with our guidance.

However, our consultant recommended adjustments to two projects outside of the top 10 major projects where there remains timing uncertainty with regards to the rezoning of required land.<sup>39</sup> These projects are:

- Ballarat Sewer Growth Project – Western and North-Western growth area (\$1.12 million over the 2023–28 regulatory period)
- Ballarat Water Growth Project – Western and North-Western growth area (\$0.43 million over the 2023–28 regulatory period)

Our consultant considered that as the required land is not yet subject to a rezoning application, the expenditure included in Central Highlands Water's forecast for the next regulatory period should be reallocated into the 2028–33 regulatory period, alongside the remainder of the relevant projects' expenditure. We agree with our consultant's view, noting this is an appropriate approach to address timing risk on behalf of customers.

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<sup>37</sup> FTI Consulting, *Central Highlands Water: Review of expenditure forecasts - 2023 Water Price Review*, February 2023, pp. 41–42.

<sup>38</sup> FTI Consulting, *Central Highlands Water: Review of expenditure forecasts - 2023 Water Price Review*, February 2023, p. 46.

<sup>39</sup> FTI Consulting, *Central Highlands Water: Review of expenditure forecasts - 2023 Water Price Review*, February 2023, pp. 44–45.

Our consultant also reviewed 5 of Central Highlands Water's major capital programs:

- Our consultant's view was that the project justification reports and supporting documentation on the Water Main Renewals program, Clear Water Storage Tank Rehabilitation program and the Sewer Gravity Main Renewals program provided strong and robust justification for the programs and the related expenditure. Our consultant did not recommend any adjustment to these three programs.<sup>40</sup>
- However, our consultant recommended adjustments to both the Growth and Development Upsizing and Efficiency program and the ICT Business Solutions Enhancements program to address timing, scope or cost uncertainty.
  - Our consultant identified the forecast expenditure for the Growth and Development Upsizing and Efficiency program was derived using the actual costs of projects delivered in the current regulatory period, which included two high-cost projects, along with a contingency allowance of \$0.5 million per year. While noting that the drivers for this program were appropriate and justified the need for the program, given the timing uncertainty around the growth drivers for this work and uncertainty in the scope of works to occur, our consultant recommended reducing the annual allowance for this program to \$1.5 million, with an overall adjustment of \$4.9 million across the period.
  - Our consultant identified the justification and expenditure associated with several specific initiatives within the ICT Business Solutions Enhancements program were well justified and appropriate but considered the scope and associated benefits of other works to be delivered through the program were still in development and required further refinement. Our consultant also noted Central Highlands Water is still preparing its overarching ICT and digital strategy connected with this program. Given this, our consultant recommended \$4.9 million of expenditure connected to this program be deferred to the 2023–28 regulatory period.
- We have reviewed Central Highlands Water's proposals and advice from FTI Consulting, and our preliminary view is that these adjustments constitute an appropriate approach to address the risks identified by our expenditure consultant in the next regulatory period.

Our preliminary view is that while the planned capital expenditure program is larger than the program delivered across 2018–23, it is driven by prudent and efficient forecast expenditure and Central Highlands Water has a positive track record of delivering its capital expenditure program. Over the current 2018–23 regulatory period, Central Highlands Water has completed 7 of its top 10 major projects, and expects to deliver the remaining 3 major projects early in the next regulatory

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<sup>40</sup> FTI Consulting, *Central Highlands Water: Review of expenditure forecasts - 2023 Water Price Review*, February 2023, p. 46.

period.<sup>41</sup> Our expenditure consultant also reviewed the business's capacity to deliver on its large forecast capital program and noted the business has taken a number of actions to enhance its delivery capability.<sup>42</sup>

Central Highlands Water has deferred or excluded approximately \$144 million of capital expenditure through its capital prioritisation process framework, but it has not specifically identified the project costs it has excluded due to uncertainty in timing, cost, scope and benefits of this capital expenditure.<sup>43</sup> Our draft decision is to accept Central Highlands Water's proposal for addressing uncertainty, noting the following:

- Central Highlands Water will need to demonstrate the prudence and efficiency of any additional costs during the 2023–28 regulatory period if it seeks to include them in the regulatory asset base for the 2028–33 price review.
- Deviations from forecasted capital expenditure during the 2023–28 regulatory period will form a key part of our assessment of the Performance element of PREMO at the next price review.

We have reviewed Central Highlands Water's proposals and advice from FTI Consulting. Our preliminary view is that Central Highlands Water's approach to forecasting its capital expenditure is largely consistent with the requirements of our guidance, noting our proposed downward adjustment of \$11.5 million, and the principles in the Water Industry Regulatory Order 2014.<sup>44</sup>

On this basis, our draft decision for total gross capital expenditure is to not accept Central Highlands Water's proposed benchmark. We propose to adopt a benchmark of \$244.7 million for the purpose of setting a revenue requirement, reflecting our proposed adjustment of \$11.5 million. The benchmark we propose to adopt is set out in Table 4.6.

The benchmark that we propose to adopt for Central Highlands Water does not represent the amount that Central Highlands Water is required to spend or allocate to particular projects. Rather, it represents assumptions about the overall level of expenditure (to be recovered through prices) that we consider sufficient to operate the business and to maintain or improve services over the regulatory period. Where we have made an adjustment to exclude a project's capital expenditure from Central Highlands Water's revenue requirement, we are not requiring the business to remove that project. Central Highlands Water determines how to best manage the allocation of its revenue and priority of its expenditure within a regulatory period.

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<sup>41</sup> Central Highlands Water, 2023 water price submission, September 2022, pp. 17–18.

<sup>42</sup> FTI Consulting, *Central Highlands Water: Review of expenditure forecasts - 2023 Water Price Review*, February 2023, pp. 42–43.

<sup>43</sup> Central Highlands Water, 2023 water price submission, September 2022, pp. 85–86.

<sup>44</sup> Essential Services Commission, *2023 water price review: Guidance paper*, pp. 32–37.

## 4.3 Regulatory asset base

A water business's regulatory asset base is the value of the business's assets for regulatory purposes.<sup>45</sup> The regulatory asset base is used to estimate the return on assets (discussed in Section 4.4), and regulatory depreciation (discussed in Section 4.5). Both the return on assets and regulatory depreciation are components of the revenue requirement.

Our guidance required Central Highlands Water to propose:

- the closing value of its regulatory asset base at 30 June 2022 (using actual data)
- the opening value of its regulatory asset base at 1 July 2023 (calculated according to the criteria outlined in the guidance)
- the forecast value of its regulatory asset base for each year of the regulatory period (2023-24 to 2027-28), in accordance with the prudence criteria outlined in the guidance.

### 4.3.1 Closing regulatory asset base

Our draft decision is to accept Central Highlands Water's closing regulatory asset base.

We update the regulatory asset base to reflect actual gross capital expenditure, less government and customer contributions, and asset disposals for the period from 2017-18 to 2021-22.<sup>46</sup> This helps to ensure prices reflect the actual net expenditure of a water business.<sup>47</sup>

Central Highlands Water's proposed closing asset base at 30 June 2022 is provided at page 88 of its price submission.<sup>48</sup>

We compared Central Highlands Water's actual net capital expenditure for 2017-18 to 2021-22 with the forecast used to approve maximum prices for the period from 1 July 2018. Typically, if a water business's net capital expenditure was more than 10 per cent above the forecast, we consider the business's justification for the additional expenditure before including it in the closing regulatory asset base. We consider this approach is reasonable given capital expenditure can be 'lumpy' in nature.

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<sup>45</sup> These values were set initially for the water businesses by the Minister for Water and are adjusted on an ongoing basis to account for new investments, asset disposals, depreciation and inflation.

<sup>46</sup> See Section 4.2 for a discussion of Central Highlands Water's capital expenditure.

<sup>47</sup> Net capital expenditure is calculated by deducting government and customer contributions from gross capital expenditure. Customer contributions reflect revenue earned from new connections made to the water business's water, sewerage or recycled water networks.

<sup>48</sup> Available at [www.esc.vic.gov.au](http://www.esc.vic.gov.au).

Central Highlands Water’s net capital expenditure over the period from 2017-18 to 2021-22 was \$129.8 million. This is \$10.5 million or 7.5 per cent lower than the forecast used to approve maximum prices for the period from 1 July 2018. This is well below the 10 per cent threshold identified above, so we propose to adopt this amount for the purpose of calculating Central Highlands Water’s closing regulatory asset base at 30 June 2022.

Table 4.6 sets out our draft decision on Central Highlands Water’s closing regulatory asset base at 30 June 2022.

**Table 4.6 Draft decision – closing regulatory asset base (RAB)**  
\$ million 2022-23

	2017-18	2018-19	2019-20	2020-21	2021-22
<b>Opening RAB 1 July</b>	<b>375.6</b>	<b>381.8</b>	<b>391.4</b>	<b>401.7</b>	<b>405.6</b>
Plus gross capital expenditure	25.2	30.4	32.9	28.1	29.1
Less government contributions	0.0	0.0	0.0	0.4	0.4
Less customer contributions	1.9	2.0	3.3	3.7	4.1
Less proceeds from disposals	0.3	0.6	0.2	0.6	0.6
Less regulatory depreciation	16.8	18.2	19.0	19.5	20.2
<b>Closing RAB 30 June</b>	<b>381.8</b>	<b>391.4</b>	<b>401.7</b>	<b>405.6</b>	<b>409.4</b>

**Note:** Numbers have been rounded.

### 4.3.2 Forecast regulatory asset base

Our draft decision is to not accept Central Highlands Water’s proposed forecast regulatory asset base.

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

Reflecting our preliminary views on Central Highlands Water’s forecast capital expenditure and our draft decision to not approve its forecast customer contributions, our draft decision is to not accept Central Highlands Water’s forecast regulatory asset base.

Our guidance specifies that the amount reflected for 2022-23 in the forecast regulatory asset base is to be calculated based on the forecast for gross capital expenditure adopted in the 2018 price determination less any contributions (net capital expenditure).<sup>49</sup>

This is intended to provide an incentive for businesses not to defer capital expenditure, noting they recover financing costs on projects included in capital expenditure benchmarks in earlier years.

As noted in Section 4.2.1, Central Highlands Water has proposed to roll in a higher amount to reflect increases in construction costs and the need to bring forward projects in response to emerging growth and development requirements. While we have included the higher expenditure amounts for 2022-23 for our draft decision, we require further information from Central Highlands Water to inform our final decision, namely:

- for each project contributing to the higher amount, estimated costs in gross and net capital expenditure terms
- noting some of the additional costs appear to be related to growth, an explanation as to why Central Highlands Water is not proposing to reflect these costs in its new customer contributions charges that it proposes to apply from 1 July 2023.

We also require Central Highlands Water to update its forecast customer contributions in response to our draft decision. For the purpose of our draft decision, we have adopted the forecasts provided by Central Highlands Water noting these will be reviewed for our final decision.

Table 4.7 sets out our draft decision on Central Highlands Water's forecast regulatory asset base from 1 July 2023. Our assessments of the components of the forecast regulatory asset base are outlined in different sections of this draft decision paper as follows:

- Section 4.2 (capital expenditure)
- Section 4.3.2.1 (customer contributions)
- Section 4.5 (regulatory depreciation).

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<sup>49</sup> Our guidance required water businesses to provide an estimate of the components of their regulatory asset base for 2022-23. This was so we could assess the opening asset base for 1 July 2023. Our guidance noted that where the 2022-23 forecasts for net capital expenditure (gross capital expenditure less government and customer contributions) is lower than the forecast benchmark for that year in its 2018 price determination, the lower amount must be used. The estimates for 2022-23 will be confirmed at the price review following the 2023 water price review. Essential Services Commission, *2023 water price review: Guidance paper*, p. 38.

**Table 4.7 Draft decision – forecast regulatory asset base (RAB)**  
\$ million 2022-23

	2022-23	2023-24	2024-25	2025-26	2026-27	2027-28
<b>Opening RAB 1 July</b>	<b>409.4</b>	<b>421.1</b>	<b>438.9</b>	<b>456.7</b>	<b>474.2</b>	<b>491.8</b>
Plus gross capital expenditure	37.5	43.6	46.1	48.5	51.5	55.0
Less government contributions	0.4	0.0	0.0	0.0	0.0	0.0
Less customer contributions	4.1	4.5	6.2	7.9	9.9	12.2
Less proceeds from disposals	0.6	0.4	0.4	0.4	0.4	0.4
Less regulatory depreciation	20.5	20.9	21.8	22.7	23.6	24.5
<b>Closing RAB 30 June</b>	<b>421.1</b>	<b>438.9</b>	<b>456.7</b>	<b>474.2</b>	<b>491.8</b>	<b>509.7</b>

**Note:** Numbers have been rounded.

#### 4.3.2.1 Customer contributions

Our draft decision is to not accept Central Highlands Water’s forecasts for revenue from customer contributions.

Revenue from customer contributions is deducted from gross capital expenditure so it is not included in the regulatory asset base.<sup>50</sup>

New customer contributions are a key input to revenue from customer contributions. Since our draft decision is to not accept Central Highlands Water’s new customer contributions, our draft decision is to not accept Central Highlands Water’s forecasts for customer contributions.

Further, Central Highlands Water’s forecasts for customer contributions in the financial model and the new customer contributions model do not match (Section 5.4).

For the purposes of calculating the regulatory asset base and revenue requirement in our draft decision, we have adopted Central Highlands Water’s proposed customer contributions forecasts. However, Central Highlands Water must update its customer contribution forecasts in response to

<sup>50</sup> Revenue from new customer contributions reflects revenue earned from new connections made to the water business’s water, sewerage or recycled water networks.



our draft decision and must ensure that the forecast customer contributions in the financial model and new customer contributions model reconcile.

## 4.4 Rate of return

In establishing the return on assets component of Central Highlands Water’s revenue requirement, we have applied a rate of return to Central Highlands Water’s regulatory asset base. The rate of return is calculated using a benchmark cost of debt (discussed in Section 4.4.1) and a benchmark return on equity value (discussed in Section 4.4.2).

### 4.4.1 Cost of debt

Our draft decision is to accept the cost of debt proposed by Central Highlands Water.

Our guidance required Central Highlands Water to use estimates of the cost of debt provided by the commission to estimate its revenue requirement. Central Highlands Water used the cost of debt values we specified to calculate its revenue requirement. For this reason, as set out in Table 4.8, our draft decision is to accept the cost of debt proposed by Central Highlands Water, noting that the cost of debt estimates will be updated following the release of the Australian Bureau of Statistics March Quarter 2023 consumer price index.

**Table 4.8 Draft decision – cost of debt**

	2013-14	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20	2020-21	2021-22	2022-23
Cost of debt (nominal)	7.05%	5.36%	5.27%	4.91%	4.53%	4.61%	3.31%	3.05%	3.75%	3.75% <sup>a</sup>

**Note:** Numbers have been rounded. <sup>a</sup> Estimated cost of debt – we will update the 2022-23 figure before the final decision and price determination.

### 4.4.2 Return on equity

Our draft decision is to adopt a return on equity of 4.1 per cent, which reflects Central Highlands Water’s PREMO self-rating.

Under our PREMO incentive mechanism, which we have applied since 2018, the return on equity we adopt to calculate the revenue requirement is linked to a business’s PREMO rating. See Chapter 7 for an explanation of PREMO and our assessment of Central Highlands Water’s PREMO rating. As outlined in our guidance, the return on equity we adopt depends on a water business’s self-rating and whether we accept that rating.

Our guidance included a matrix proposing the return on equity we would adopt, based on the combination of the business's self-rating and our rating.<sup>51</sup> We reviewed the return on equity values in the matrix in mid-2022 given the change in market conditions that has occurred since we published our guidance in October 2021. We consider that the values in our matrix reflect the medium-term real rates of return.<sup>52</sup>

Central Highlands Water rated its price submission as 'Standard'. Based on this PREMO self-rating, Central Highlands Water proposed a return on equity of 4.1 per cent per annum. This reflects the maximum return rate allowed in our guidance for a price submission rated as 'Standard'.<sup>53</sup>

As outlined in Chapter 7, our draft decision is to agree with Central Highlands Water's PREMO self-rating and therefore to adopt its proposed return on equity.

## 4.5 Regulatory depreciation

Our draft decision is to not accept Central Highlands Water's forecast regulatory depreciation.

Regulatory depreciation is a component of Central Highlands Water's revenue requirement and is also an input to calculating the regulatory asset base.

Central Highlands Water's forecast regulatory depreciation was calculated using a straight-line depreciation profile.<sup>54</sup> We noted in our guidance that we prefer this approach.<sup>55</sup>

However, given our draft decision to adopt a different forecast regulatory asset base than proposed by Central Highlands Water, we require it to recalculate its depreciation in its response to our draft decision. As it used the deprecation override function in our financial model, Central Highlands Water must also explain its approach to calculating depreciation and how it complies with our

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<sup>51</sup> Essential Services Commission, *2023 water price review: Guidance paper*, pp. 42–43.

<sup>52</sup> We will continue to monitor market conditions and may amend the return on equity matrix values to reflect any changes to the medium-term outlook prior to releasing our final decision. We have had regard to the return on equity adopted by interstate regulators in the following publications: Independent Pricing and Regulatory Tribunal NSW, *Final Report - Review of WaterNSW's rural bulk water prices*, 9 September 2021; Independent Pricing and Regulatory Tribunal NSW, *Final Report - Review of prices for Sydney Water*, June 2020; Essential Services Commission of South Australia, *SA Water's water and sewerage retail services: 1 July 2020 - 30 June 2024*, Price Determination, 1 July 2020; Queensland Competition Authority, *Final report - Seqwater bulk water price review 2022–26*, March 2022; Queensland Competition Authority (QCA), *Final report - Rural irrigation price review 2020–24, Part A: Overview*, January 2020; Office of the Tasmanian Economic Regulator, *Final report - Investigation into TasWater's prices and services for the period 1 July 2022 to 30 June 2026*, May 2022.

<sup>53</sup> Essential Services Commission, *2023 water price review: Guidance paper*, p. 42.

<sup>54</sup> For the period from 2022-23 to 2027-28, Central Highlands Water proposed a regulatory depreciation of \$134.9 million.

<sup>55</sup> Essential Services Commission, *2023 water price review: Guidance paper*, p. 39.

guidance. For the purpose of our draft decision, we have adopted the forecasts provided by Central Highlands Water noting these will be reviewed for our final decision.

See Table 4.7 in Section 4.3.2 for the estimates we have adopted for regulatory depreciation.

## 4.6 Tax allowance

Our draft decision is to not accept Central Highlands Water's proposed tax forecast for the 2023–28 regulatory period.

The tax allowance is a component of the revenue requirement. Central Highlands Water has proposed a tax allowance of \$5.9 million in its revenue requirement for the 2023–28 regulatory period. While we have used this amount for the purpose of calculating the revenue requirement in our draft decision (Table 4.1 in Section 4), the business must provide an updated estimate in response to our draft decision as our draft decision proposes adjustments to its revenue requirement.<sup>56</sup>

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<sup>56</sup> Essential Services Commission, *2023 water price review: Guidance paper*, pp. 47–48.

## 5. Demand, tariffs and prices

Once Central Highlands Water's revenue requirement is established, demand forecasts and the form of price control are used to translate the revenue requirement into tariffs and prices.

### 5.1 Demand

Our draft decision is to accept Central Highlands Water's demand forecasts.

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

Central Highlands Water's demand forecasts are set out at pages 59 to 64 of its price submission and are also included in its financial model.

Our draft decision is to accept Central Highlands Water's demand forecasts for the purpose of approving maximum prices, because they were developed consistently with the requirements of our guidance. However, since lodgement of its price submission, updated Victorian Government population and dwelling growth estimates have been made available to water businesses.

In its response to our draft decision, Central Highlands Water must demonstrate how it has considered these updated estimates and if required, identify and justify any changes to its demand forecasts (any updates must also be included in its pricing model submitted in response to our draft decision).

### 5.2 Form of price control

Our draft decision is to accept Central Highlands Water's proposed tariff basket form of price control.

Our guidance indicated we would have particular regard to whether a business proposed to continue its existing form of price control or introduce a new form of price control.<sup>57</sup>

Central Highlands Water proposed a tariff basket form of price control as set out on page 93 of its price submission. This is the same as its current approach. Under the tariff basket form of price control, a weighted average price cap is applied to a basket of services, with the weighted average price following a predetermined price path. Adjustments to account for movements in inflation (measured by the consumer price index published by the Australian Bureau of Statistics), return on assets and any approved pass-through mechanisms will be made during the regulatory period. We

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<sup>57</sup> Essential Services Commission, *2023 water price review: Guidance paper*, p. 50.

note that Central Highlands Water made use of the tariff basket form or price control during the current regulatory period to implement changes to its tariff structures.

Our draft decision is to accept Central Highlands Water's proposed form of price control because:

- it is the same as its current approach, which we have previously approved
- under the tariff basket approach, Central Highlands Water carries most of the demand risk, and demand risk is more efficiently managed by Central Highlands Water, rather than its customers
- it is otherwise consistent with the requirements of our guidance.

### 5.3 Tariff structures and prices

Our draft decision is to accept Central Highlands Water's proposed tariff structures.

Central Highlands Water's proposed tariffs are set out at pages 94 to 99 of its price submission.

Our draft decision does not approve prices for each tariff. Prices will need to be updated by Central Highlands Water to reflect our updates to inflation and cost of debt estimates prior to our final decision, as well as our draft decision views on its revenue requirement. Our draft decision considers proposals related to tariff structures, the price path proposed, and any submissions on the level of prices or bills.

#### 5.3.1 Tariff structures

As outlined in our guidance, we have provided the water businesses with a large degree of discretion to decide on individual tariff structures.<sup>58</sup> This recognises water businesses are often best placed to consider the interests of customers in designing tariffs, and that existing tariff structures have been developed over time to deal with a variety of local circumstances.

Central Highlands Water proposed to maintain its existing tariff structures, comprising:

- For residential water services – a two-part tariff with a fixed water service charge and a two-tier inclining block variable usage component that depends on water use, where price increases in the second block.
- For residential sewerage services – a fixed service charge only.
- For non-residential water services – a two-part tariff with a fixed service charge and a variable usage component that depends on water use.
- For non-residential sewerage services – a fixed service charge and a variable usage component.

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<sup>58</sup> Essential Services Commission, *2023 water price review: Guidance paper*, p. 51.

The Consumer Action Law Centre stated, in its submission on Central Highlands Water's proposal, that it was pleased to see businesses responding to customer feedback regarding tariffs. It referenced Central Highlands Water's decision to keep tariff structures unchanged due to equity concerns raised by its deliberative assembly about volumetric price increases.<sup>59</sup> The Concerned Waterways Alliance considered all water businesses should adopt tiered water use structures, which Central Highlands Water has proposed for its tariff structure.<sup>60</sup>

Our draft decision is to accept Central Highlands Water's proposed tariff structures, on the basis that they are generally a continuation of Central Highlands Water's current approach and are generally supported by its customers.

Our preliminary view is that the two-part tariff structure proposed by Central Highlands Water for its water services will promote the efficient use of services. It also sends customers a signal about the costs of their water use and is an approach that is commonly applied in other states and territories.<sup>61</sup> We also consider two-part tariff structures are easy to understand.

For sewerage services, we consider Central Highlands Water's proposed fixed charge for residential customers is easy to understand. A two-part tariff for non-residential customers sends these customers signals about efficient costs.<sup>62</sup>

### 5.3.2 Prices

The prices proposed by Central Highlands Water for water and sewerage services are set out on pages 94 to 96 of its price submission.

Under Central Highlands Water's proposal, generally prices (excluding inflation) will be slightly higher. Excluding inflation, prices will remain steady in 2023-24, and then increase by 1 per cent per year in 2024-25 to 2027-28.

In terms of submissions we received, one considered Central Highlands Water's proposed prices are reasonable.<sup>63</sup>

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<sup>59</sup> Consumer Action Law Centre, Initial Feedback: 2023-28 Water Price Review, Essential Services Commission, 30 November 2022.

<sup>60</sup> Concerned Waterways Alliance, Concerned Waterways Alliance submission to the Essential Services Commission Water Price Review 2023, 1 December 2022.

<sup>61</sup> Includes the tariffs of Icon Water, Sydney Water, Hunter Water, Central Coast Council, Power and Water Corp, Urban Utilities, Unity Water, SA Water and TasWater.

<sup>62</sup> Our reasons are outlined in our 2013 draft decisions on price review 2013-14 to 2017-18.

<sup>63</sup> Anonymous, submission to the Essential Services Commission on Central Highlands Water's 2023 price submission, 7 October 2022.

In May 2023, we intend to determine prices for Central Highlands Water in \$2023-24 terms. This means we will add the annual change in the March Quarter 2023 consumer price index (published by the Australian Bureau of Statistics) to its 2023-24 prices, which will also flow through to customer bills.

Based on recent inflation outcomes and market expectations, the annual outcome for the March Quarter 2023 consumer price index is likely to be relatively high.<sup>64</sup> For the 2023–28 regulatory period, we have assumed an inflation rate of 3 per cent per year, which is significantly lower than near-term inflation expectations.

Many of the drivers of higher inflation (such as fuel, food and travel) are not major cost items for water businesses. Some high-cost growth areas specific to the water sector such as insurance and chemicals have been accounted for in uplifts to their opening base costs for the 2023–28 regulatory period. Considering this, and Central Highlands Water’s proposal for increasing prices in real terms over the 2023–28 regulatory period, we are seeking further information from Central Highlands Water in response to our draft decision on how it intends to address the impacts of relatively high inflation on its proposed prices and customer bills for 2023-24.<sup>65</sup>

As part of its response to our draft decision, Central Highlands Water must demonstrate how it has considered the impacts of inflation on its forecast expenditure in 2023-24, and whether these are reasonable taking into account that some of its key costs (such as labour) are unlikely to increase as much as near-term inflation.

Central Highlands Water’s prices will also be affected by our draft decision on the revenue requirement, which is outlined in Chapter 4. In response to our draft decision, Central Highlands Water will need to propose updated prices that reflect our draft decision and any updates to its revenue requirement.

### 5.3.3 Addressing the interests of low income and vulnerable customers

In making our price determination, we must have regard to whether Central Highlands Water’s prices take into account the interests of customers, including low income and vulnerable customers.<sup>66</sup>

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<sup>64</sup> The latest (February 2023) Reserve Bank of Australia Quarterly Statement on Monetary Policy forecast the consumer price index to change (over the year) fall to around 4.8 per cent by December 2023 and 3.2 per cent by December 2024.

<sup>65</sup> This is relevant to clause 11(d)(ii) of the Water Industry Regulatory Order 2014 which states that when making a price determination, the commission must have regard to principles that the manner in which a regulated entity’s prices are to be calculated, determined or otherwise regulated, should provide signals about the efficient costs of providing prescribed services to customers (either collectively or to an individual customer or class of customers) while avoiding price shocks where possible.

<sup>66</sup> Water Industry Regulatory Order 2014 clause 11(d)(iii).

There is evidence that Central Highlands Water has sought to address the interests of low income and vulnerable customers because Central Highlands Water proposed:

- a price path that keeps prices stable in the first year of the regulatory period and then increases by 1 per cent per year in 2024-25 to 2027-28, which was supported by its deliberative assembly customer group
- doubling its support for vulnerable customers to \$2.5 million over the regulatory period in order to assist those customers who may be affected by its proposed price increases
- an additional billing cycle for the first 2 years of the pricing period to avoid potential bill shock and support customer affordability.<sup>67</sup>

As noted in Section 3.1, Central Highlands Water's price submission was informed by engagement that was inclusive for customers more likely to experience vulnerability, including its ongoing engagement with local welfare support organisations via its Careflow advisory group. We received a positive submission from the Consumer Action Law Centre regarding Central Highlands Water's commitment to hardship assistance.<sup>68</sup>

#### 5.3.4 Unique services

Central Highlands Water has confirmed that its proposed tariffs for trade waste and miscellaneous services are calculated in accordance with the pricing principles referenced in our guidance.

### 5.4 New customer contributions

Our draft decision is to not accept Central Highlands Water's proposed standard new customer contributions or negotiated new customer contributions framework.

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

Central Highlands Water's proposed new customer contributions are set out at pages 98 and 100 to 109 of its price submission. Central Highlands Water proposed using a model based on average

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<sup>67</sup> Central Highlands Water, 2023–28 Price Submission, September 2022, p. 34

<sup>68</sup> Consumer Action Law Centre, Initial Feedback: 2023-28 Water Price Review, 1 December 2022, p. 9



incremental cost to estimate its new customer contributions, rather than the net incremental cost approach we suggested.<sup>69</sup>

Central Highlands Water proposed to:

- increase its new customer contribution for water services in the new growth zones from \$1,504 to a capped \$4,000 per lot and introduce a new customer contribution for sewer services to be set at \$4,000 (capped)
- phase in the new customer contributions until it reaches the \$4,000 cap per lot in year 3 of the regulatory period (2025-26)<sup>70</sup>
- introduce differential new customer contributions for existing growth zones/infill to be initially charged at 43 per cent of the new growth zones new customer contributions, rising to 65 per cent in year 5 (2027-28)
- increase new customer contributions by 1 per cent annually from 2024-25 to 2027-28
- exclude tax liability based on the assumption that under an anticipated Australian Taxation Office ruling, gifted assets will not be categorised as taxable income, and bear the financial risk if this ruling does not eventuate.

Central Highlands Water put forward three reasons for using the average incremental cost approach, namely that it will:

- address the risks associated with the recent development boom in its service area by enabling clear signals to be sent to developers regarding pricing
- incentivise efficient locational timing decisions
- be easier to understand and address as Central Highlands Water considers there is a perceived lack of transparency in the rationale and calculation of existing new customer contributions.<sup>71</sup>

We consider the net incremental cost approach outlined in our guidance, and previously adopted by Central Highlands Water, also enables water businesses to address the risks associated with changes in development, allows for cost reflectivity and is transparent, and that these issues can be flexibly dealt with by applying that approach.<sup>72</sup> Further, water businesses have the flexibility to

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<sup>69</sup> The average incremental cost approach calculates the new customer contribution charge by dividing the capital and operating cost of a growth area by the number of connections in that area. The net incremental cost approach applies the incremental revenue less incremental cost to estimate the new customer contribution charge.

<sup>70</sup> New customer contributions for new growth zones will commence at \$3,000 in year 1 (75 per cent of the cap).

<sup>71</sup> Central Highlands Water, 2023–28 Price Submission, September 2022, p. 105.

<sup>72</sup> Essential Services Commission, *2023 water price review: Guidance paper*, 26 October 2021, pp. 59-60.

negotiate different charges for different developments or growth areas as circumstances may require.

We reviewed the average incremental cost methodology and consider it may be capable of meeting our new customer contribution pricing principles and the relevant requirements of the Water Act 1989 (refer to Appendix C in relation to the Water Act 1989). Relevantly, and as set out in Sections 5.4.2, 5.4.3 and 5.4.4 below, the guidance requires that new customer contributions must:

- 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.

However, our draft decision is to not accept Central Highlands Water's proposed new customer contributions as Central Highlands Water has not provided us with adequate information or justification for us to assess that its approach complies with our guidance requirements. Our reasons are explained below.

#### **5.4.1 Fair and reasonable costs**

Section 268(3) of the Water Act 1989 requires that:

*The amount of payment required from an owner must be assessed by the Authority to be fair and reasonable, taking into account the benefit to that property relative to the benefit to other properties.*

As set out in Appendix C, our preliminary view is that the proposed average incremental cost methodology can comply with this requirement if growth related costs have been appropriately attributed between new customer contributions and ongoing charges, and if new customer contribution revenues have been accounted for when setting the regulatory asset base for ongoing charges.

We have undertaken a preliminary assessment of Central Highlands Water's capital expenditure. Our preliminary view is that Central Highlands Water has not undertaken an assessment to determine the actual incremental increase in cost of any upgrade. We also consider that Central Highlands Water's methodology to allocate costs to new customer contributions is unclear. Central Highlands Water has not provided us with sufficient information to enable us to be satisfied that it has implemented the average incremental cost approach according to the Water Act section 268(3).

## 5.4.2 Incremental infrastructure and associated costs

Our preliminary view is that Central Highlands Water's proposed standard new customer contributions do not meet the new customer contributions pricing principle set out in our guidance that requires having regard to the incremental infrastructure and associated costs, for the reasons set out below.

We have reviewed Central Highlands Water's proposed standard new customer contributions charges and compared them to the charges calculated in its new customer contributions pricing model. Central Highlands Water did not use the modelled new customer contributions by service and system to set its proposed new customer contributions.<sup>73</sup> Instead of the six system-level charges it modelled, based on developer feedback during Central Highlands Water's customer engagement, it has proposed:

- two charge segments: new growth zones and existing growth zones/infill
- capped new customer contributions of \$4,000 each for water and sewer services with phased implementation.<sup>74</sup>

### 5.4.2.1 Justification of proposed transition to cost reflective pricing

Central Highlands Water proposed new customer contributions charges that are below the calculated average incremental cost to minimise price increases for developers and new customers. Central Highlands Water estimated the gap between the modelled and proposed new customer contributions translates to a cross subsidy of about \$0.03 per existing customer per new developed lot. Central Highlands Water considers the cross-subsidy 'immaterial and better than the cross-subsidy implied by the existing new customer contribution charge of \$1,504'.<sup>75</sup> Central Highlands Water did not state its intent to transition to the modelled/system-based new customer contributions in the future.

The submission we received from the Consumer Action Law Centre sought closer scrutiny of those price submissions that do not address decreasing cross subsidies, and said that it wants to see all users, particularly builders and developers, paying the full costs of their water use.<sup>76</sup> On the other hand, a development consultant and a land developer, considered Central Highlands Water's

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<sup>73</sup> Central Highlands Water calculated the new customer contributions for water and sewer services for each of the Ballarat, Avoca, Beaufort, Daylesford, Maryborough and other systems.

<sup>74</sup> The model calculated the new customer contributions attributed to each of the Ballarat, Avoca, Beaufort, Daylesford, Maryborough and other systems. Central Highlands Water estimated the weighted average new customer contributions for water services to be \$4,789 and \$5,339 for sewer services (with a combined total of \$10,128). The gap between the proposed new customer contributions and the weighted average new customer contributions is \$2,128 (that is \$10,128 less \$8,000).

<sup>75</sup> Central Highlands Water, Response to request for information, 21 December 2022.

<sup>76</sup> Consumer Action Law Centre, Initial Feedback: 2023-28 Water Price Review, 30 November 2022, p. 5.

proposed new customer contributions in new growth areas to be reasonable, clearer and equitable.<sup>77</sup> Builders and developers generally recover the new customer contributions from home buyers, hence buyers will face the higher charges. Existing customers may partly benefit from developments funded by new customer contributions too.<sup>78</sup>

Central Highlands Water did not provide a separate cost modelling for the proposed new customer contributions for existing growth zones/infill. However, we do not consider that the broader customer base should be required to fund revenue shortfalls from new customer contributions.<sup>79</sup>

It is not clear to us whether the proposed new customer contributions for existing growth zones/infill are cost reflective or below the avoidable cost of these connections and, if the latter, Central Highlands Water's transition plan towards achieving full cost reflectivity for existing growth zones/infill is not clear.<sup>80</sup>

We cannot verify if Central Highlands Water's capital expenditure is reasonably attributed between multiple drivers and catchments.

A land developer considered the implementation of new customer contributions for existing growth areas/infill is inequitable noting that the final stages of the currently zoned land will pay new customer contributions towards infrastructure that was supposed to be delivered in the 2018–23 water plan.<sup>81</sup>

We also received submissions from a number of stakeholders which recommend the inclusion or prioritisation of various growth areas in Central Highlands Water's new customer contributions proposal.<sup>82</sup> Two stakeholders noted that the Victorian Planning Authority is undertaking a review of

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<sup>77</sup> Beveridge Williams, submission to the Essential Services Commission Water Price Review 2023, 28 November 2022; Integra, submission to the Essential Services Commission Water Price Review 2023, 1 December 2022.

<sup>78</sup> Historically, customers have never fully paid for the regulatory asset base as it was originally set below cost for pricing purposes. Hence, existing customers have benefitted from a cross-subsidy of the total cost of the regulatory asset base. Developer contributions reduce the regulatory asset base and therefore the prices of water and sewerage services paid for by the general customer base.

<sup>79</sup> As noted earlier, water and sewerage customers will make up for any revenue shortfall from developer contributions.

<sup>80</sup> One of the new customer contributions pricing principles is that the new customer contributions should be greater than the avoidable cost of that connection and less than the standalone cost of that connection.

<sup>81</sup> Integra, submission to the Essential Services Commission Water Price Review 2023, 1 December 2022.

<sup>82</sup> Michael Heinz, submission to the Essential Services Commission Water Price Review 2023, 16 November 2022; Anonymous, submission to the Essential Services Commission Water Price Review 2023, 16 November 2022; Noel Coxall, submission to the Essential Services Commission Water Price Review 2023, 25 November 2022; Anonymous, submission to the Essential Services Commission Water Price Review 2023, 29 November 2022; Loreto Ballarat Ltd, submission to the Essential Services Commission Water Price Review 2023, 30 November 2022; Kaufmann Property Consultants, submission to the Essential Services Commission Water Price Review 2023, 28 November 2022; Beveridge Williams, submission to the Essential Services Commission Water Price Review 2023, 28 November 2022; Integra, submission to the Essential Services Commission Water Price Review 2023, 1 December 2022.

the sequencing of all major residential development in Ballarat, due to be completed in May 2023, and noted that Central Highlands Water's water plan is not based on planning advice approved by the Minister for Planning.<sup>83</sup> We do not have a role in assessing which growth areas should be included or not by water businesses in their standard new customer contributions proposal. But we expect water businesses, including Central Highlands Water, to ensure that their assumptions are consistent with government land release. Water businesses have the flexibility to negotiate different charges for different developments or growth areas as circumstances may require. We review the prudence and efficiency of water businesses' proposed capital expenditure and, in general, we require them to submit the latest data and evidence available to them prior to the pricing submission in September 2022.

In response to the draft decision Central Highlands Water must provide:

- sufficient information about its transition plan towards achieving full cost reflectivity for both new growth zones and existing growth zones/infill including the timeframes of this plan and provide reasons for adopting this transition plan (including timeframes).
- separate new customer contributions modelling for its new growth zones and existing growth zones/infill.

### **5.4.3 Incremental future revenues that will be earned from customers at connection points**

Our guidance requires that new customer contributions must have regard to future revenues that will be earned from customers at the relevant connection.

Our preliminary view is that the average incremental cost methodology can indirectly meet that new customer contribution pricing principle if the new customer contribution includes new customers in the demand forecasts in the business's pricing model. We consider that including new customers in the demand forecasts in the pricing model is a sufficient condition if the numbers reconcile between the pricing model and the new customer contributions model.

We require further information from Central Highlands Water on the allocation of its assets between its pricing model and new customer contributions model as we are not satisfied that capital expenditures are appropriately allocated to the new customer contributions model. We have not been able to confirm that assets have not been double counted.

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<sup>83</sup> Kaufmann Property Consultants Pty Ltd, submission to the Essential Services Commission Water Price Review 2023, 28 November 2022; Beveridge Williams, submission to the Essential Services Commission Water Price Review 2023, 28 November 2022.

Accordingly, Central Highlands Water has not provided us with sufficient information to enable us to be satisfied that it has had regard to incremental future revenues that will be earned from customers at the relevant connections.

In response to our draft decision, we require Central Highlands Water to provide further information on how it has allocated its capital expenditure to new customer contributions.

#### **5.4.4 Avoidable costs of connection and standalone costs of connection**

Our guidance sets out that new customer contributions must be greater than the avoidable cost of that connection and less than the standalone cost of that connection.

Central Highlands Water has not provided any evidence that the cap on its proposed new customer contributions has not caused the new customer contribution to fall below avoidable cost. Accordingly, Central Highlands Water has not provided us with sufficient information to enable us to be satisfied that it has met this pricing principle.

In response to our draft decision, we require further information from Central Highlands Water on how the proposed cap on new customer contributions complies with the above pricing principle.

#### **5.4.5 Transparency of information and basis of proposal**

Central Highlands Water shared with us the presentation materials used in its engagement with developers. There is minimal information provided to stakeholders about the average incremental cost methodology.

Our preliminary view is that Central Highlands Water has not provided sufficient transparency to stakeholders to allow them to provide meaningful comments on the proposed methodology.

Central Highlands Water participated in a review by VicWater of the current approach to new customer contributions and, as part of that review, VicWater commissioned a consultant to prepare a report in relation to the appropriateness of the current approach to new customer contributions. This report has been provided to us by Central Highlands Water on a confidential basis.

To assist stakeholders, we have outlined in Appendix C to our draft decision how we consider the average incremental cost methodology may meet the relevant requirements in the Water Act 1989. We are interested in receiving stakeholder feedback on our preliminary views.

#### **5.4.6 Next Steps**

In response to our draft decision in relation to new customer contributions, Central Highlands Water must:

- explain how it has allocated its capital expenditure to new customer contributions

- explain its transition plan towards achieving full cost reflectivity for each service including the timeframes of this plan and provide reasons for adopting this transition plan and its timing
- set out how it proposes to fund any shortfall in revenue from new customer contributions, compared to the estimated costs of providing the service
- explain how it considered setting new customer contributions that distinguish between infill and greenfield growth areas and its reasons for not proposing charges to reflect this distinction
- ensure that its proposed new customer contribution charges and connection numbers by service reconcile between its new customer contributions model and financial model
- explain how its proposed new customer contribution is greater than the avoidable cost of that connection and less than the standalone cost of that connection.

Alternatively, in response to the draft decision, Central Highlands Water can recalculate its new customer contributions using the current methodology.

We are also interested in feedback from developers and customers regarding the proposed new customer contributions.

#### **5.4.7 Negotiated new customer contributions framework**

Central Highlands Water has provided its negotiating framework for negotiated new customer contribution contracts. As noted above, we are still assessing the proposed average incremental cost approach used by Central Highlands Water to calculate negotiated new customer contributions. For this reason, our draft decision is to not accept Central Highlands Water's proposed framework for negotiated new customer contributions.

### **5.5 Adjusting prices**

Our draft decision is to accept Central Highlands Water's proposed price adjustment mechanisms for uncertain and unforeseen events and cost of debt.

Central Highlands Water's proposed price adjustment mechanisms are set out at page 93 of its price submission. It proposed:

- to continue with its existing uncertain and unforeseen events mechanism
- to continue with its existing cost of debt mechanism

We also sought additional information on an energy pass-through mechanism Central Highlands Water proposed in its price submission. In response, it confirmed that it was not seeking a

pass-through mechanism to adjust prices unless the impact is greater than \$15 million (either in one year or as a cumulative impact over the 5-year period).<sup>84</sup>

Our draft decision proposes to not accept Central Highlands Water's proposed energy pass-through mechanism as:

- we consider it unclear at the time of this draft decision if Central Highlands Water requires a pass-through mechanism for its urban customers for energy costs above its proposed forecasts
- the existing uncertain and unforeseen events mechanism provides for a reopening of Central Highlands Water's determination if a material event arises over the pricing period, as assessed by the commission.

Our draft decision is to accept Central Highlands Water's proposal to continue with its existing uncertain and unforeseen events mechanism and continue with its existing cost of debt mechanism because these are a continuation of its existing approaches, which we have previously approved.

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<sup>84</sup> Response to request for information, 18 January 2023.



## 6. Financial position

We have reviewed key indicators of Central Highlands Water's financial performance and our preliminary view is that Central Highlands Water will generate sufficient cash flow to deliver on its service commitments.

In approving prices, we must have regard to the financial viability of the water industry.<sup>85</sup> We interpret the financial viability requirements under the *Essential Services Commission Act 2001* and the *Water Industry Regulatory Order (2014)* to mean that the prices we approve should provide a high level of certainty that each water business can generate sufficient cash flow to deliver on its service commitments, including financing costs arising from investments to meet service expectations.

Central Highlands Water's price submission and the supporting financial model provided estimates for key indicators of financial performance. These estimates were based on Central Highlands Water's assumptions about its revenue and expenditure. We have reviewed the key indicators of financial performance and our preliminary view is that we consider Central Highlands Water will generate sufficient cash flow to deliver on its service commitments, including financing costs arising from investments to meet service expectations.

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<sup>85</sup> WIRO clause 8(b)(ii) and ESC Act s.8A(1)(b).

## 7. PREMO rating

PREMO is an incentive mechanism that links the return on equity used to calculate a water business's revenue requirement to that business's level of ambition expressed in its price submission. Our guidance required Central Highlands Water to self-assess the level of ambition of its price submission for each element of the PREMO mechanism and arrive at an overall self-rating.<sup>86</sup> We required Central Highlands Water to self-rate its price submission as either 'Leading', 'Advanced', 'Standard' or 'Basic', with 'Leading' being the most ambitious and 'Basic' the least.

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

We also assessed and rated Central Highlands Water's price submission. As outlined in our guidance, the combination of Central Highlands Water's self-rating and our rating has determined the return on equity we have adopted to calculate Central Highlands Water's revenue requirement in our draft decision.

### 7.1 Our PREMO assessment of Central Highlands Water's price submission

Our draft decision is to rate Central Highlands Water's price submission as 'Standard' under PREMO, which is the same as Central Highlands Water's self-rating.

Central Highlands Water's self-rating for each of the PREMO elements and its overall self-rating are shown in Table 7.1. This table also includes our proposed ratings following our assessment of Central Highlands Water's price submission.

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<sup>86</sup> This is the first price review we have done where the rating has been based on all five elements of PREMO. In our 2018 price review, our PREMO assessment was against only four of the elements — Risk, Engagement, Management and Outcomes.

**Table 7.1**      **PREMO rating**

	Overall PREMO rating	Performance	Risk	Engagement	Management	Outcomes
Central Highlands Water's self-rating	Standard	Standard	Standard	Advanced	Standard	Advanced
Commission's rating	Standard	Standard	Standard	Advanced	Basic	Advanced

Our preliminary view is that we agree with Central Highlands Water's proposed overall PREMO self-rating of its price submission as 'Standard'. This is reflected in the return on equity we propose to approve for Central Highlands Water (see Section 4.4.2). We have formed this view after reviewing Central Highlands Water's proposed self-rating for each of the five PREMO elements, with a summary of our assessment provided below.

### 7.1.1 Performance

For the 2023 price review, a business's rating for the Performance element of PREMO is based on a combination of its overall PREMO rating at its most recent price review, and its level of performance based on achievement of outcomes (related to service targets and performance against expenditure benchmarks set at the previous price review) and customer sentiment.<sup>87</sup>

As noted in Section 3.2, we agree with Central Highlands Water's self-assessment that it has, overall, met its outcome commitments for the period to date.

As noted in Section 3.2, Central Highlands Water revised its measures and targets in consultation with its customer advisory panel and us in 2019-20 (see Section 3.2). Some of its revised targets were more ambitious compared to its previous targets and we consider this demonstrates a commitment to improving customer value.

Central Highlands Water generally remains among the lower performing businesses in the commission's survey of customer sentiment – covering measures of overall satisfaction, value for money, trust, and reputation in the community.<sup>88</sup> In our most recent survey (January 2023), it ranked in the bottom four among businesses across all four measures.

<sup>87</sup> As set out in Essential Services Commission, *2023 water price review: Guidance paper*, 26 October 2021, pp. 74-75. Guiding questions are set out on page 45.

<sup>88</sup> The commission's customer perception survey results are available on our website. See <https://www.esc.vic.gov.au/water/sector-performance-and-reporting/how-customers-rate-their-water-business#tabs-container2>.

In its price submission, Central Highlands Water noted its scores on the commission survey had been improving and presented other survey results that it concluded tended to support this finding, particularly over the past 3 years. This is summarised from page 115 of its price submission.

In 2021-22 (the last available year of audited results), Central Highlands Water's controllable operating expenditure was around 9 per cent higher than the benchmark adopted at the 2018 price review (the same as the average across all businesses in the current price review).

For the current regulatory period, Central Highlands Water's capital expenditure (in net terms) is forecast to be higher than the benchmarks established at the 2018 price review (summarised in Section 4.2.1). However, it has delivered 7 of its 10 major projects in the current 2023–28 regulatory period, which compares favourably to other water businesses.

Our draft decision is to accept Central Highlands Water's self-rating of its price submission as 'Standard' for the Performance element of PREMO. As it received a PREMO rating of 'Advanced' at the 2018 review, if Central Highlands Water had generally achieved expectations in the current period, it could claim a rating of at least 'Advanced' for Performance in the current price review. Taking this into account, and the factors noted above, we accept its self-rating of 'Standard' for the Performance element of PREMO.

### 7.1.2 Risk

The Risk element of PREMO is assessed against guiding questions focused on the appropriate allocation of risk (so that customers don't pay more than they need to), and the business's proposed guaranteed service level scheme (including that it provides incentives for the business to deliver valued services efficiently).<sup>89</sup>

In support of its self-rating of 'Standard' for the Risk element of PREMO, Central Highlands Water's price submission provided an overview of key risks and how the risk is addressed in its price submission.

In support of its self-rating, it proposes to double the payable amounts if it fails to meet two of its guaranteed service levels (a failure to restore clean drinking water and a failure to repair a leaking water service), and also proposes some changes to the scheme to reflect customer priorities. Further, it proposes to maintain its tariff basket form of price control, which means prices are capped subject to constraints identified in its price determination.

In reaching our preliminary assessment we considered these matters alongside Central Highlands Water's proposed approach to treating energy costs and its tax obligations. As set out in

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<sup>89</sup> Essential Services Commission, *2023 water price review: Guidance paper*, p. 45.

Section 5.5, our draft decision is to not accept Central Highlands Water’s proposed adjustment mechanism for energy costs.

For the purpose of its PREMO assessment, we consider the risks of higher energy prices are usually managed by water businesses on behalf of customers (we received no similar requests for such a variation mechanism from other businesses in the current price review).

Contrasting this approach, Central Highlands Water excluded tax from its forecasts based on an assumed Australian Taxation Office ruling on the treatment of tax for gifted assets. If the ruling does not eventuate, Central Highlands Water has committed to bear the financial risk.

Taking into account the above, our draft decision is to accept Central Highlands Water’s self-rating of its price submission as ‘Standard’ for Risk.

### **7.1.3 Engagement**

The Engagement element of PREMO is assessed against guiding questions such as the form, timing, and nature of matters engaged on by the water business, and the influence of engagement on proposals. We also consider the extent to which a business has undertaken inclusive engagement, including with First Nations peoples and those experiencing vulnerability.<sup>90</sup>

Our draft decision is to accept Central Highlands Water’s self-rating of ‘Advanced’ for the Engagement element of PREMO on the basis of the overall suitability of the engagement methods which supported inclusive and effective participation in its engagement process, including by customers experiencing vulnerability and its First Nations customers. We particularly note Central Highlands Water’s efforts to tailor methods and materials to the circumstances of its customers, which had the result of ensuring customers experiencing vulnerability had a reasonable and fair opportunity to influence the issues that affected them.

Central Highlands Water showed strong commitment to the findings of its engagement process and to the influence of customers, including by incorporating all of the preferences of its deliberative assembly. It also provided evidence that participants in its engagement had a positive view of its approach.

### **7.1.4 Management**

The Management element of PREMO is assessed against guiding questions that cover matters such as the efficiency of proposed expenditure and prices, the quality of the business’s submission

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<sup>90</sup> Essential Services Commission, *2023 water price review: Guidance paper*, p. 45.

and supporting information to justify proposals, and evidence that there is senior-level ownership and commitment to the proposals contained in the submission.<sup>91</sup>

Central Highlands Water proposed a self-rating of its price submission as 'Standard' for the Management element of PREMO. For the reasons outlined below, our draft decision is to not accept its self-rating of 'Standard' and to instead propose a rating of 'Basic'.

Central Highlands Water has proposed an operating efficiency improvement rate of around 1 per cent per annum, which is below the average among businesses in the current price review (around 1.3 per cent). The efficiency of proposed prices is also a key matter for the assessment of the Management element of PREMO. Our draft decision proposes adjustments to Central Highlands Water's operating expenditure forecasts, mainly reflecting changes to operating costs relating to its regulatory accounts.

We found that Central Highlands Water's financial model (lodged with its price submission) contained a number of errors and included changes to some formulas that we embedded in the model. Substantive corrections were needed to its financial model, with the corrections both greater in number and more complex to resolve than other businesses. The formula changes Central Highlands Water made to the financial model also impeded our review process.

Based on the above, our draft decision is to not accept Central Highlands Water's self-rating of its price submission as 'Standard' for the Management element of PREMO. Instead, we propose a rating of 'Basic'.

### 7.1.5 Outcomes

The Outcomes element of PREMO is assessed against guiding questions focused on:

- the alignment of proposed outcomes with customer priorities and expenditure forecasts
- whether the proposed outcomes are measurable
- the processes established to measure performance and report to customers.<sup>92</sup>

As noted in Section 3.2, our preliminary view is that Central Highlands Water has provided evidence that demonstrates its outcome measures and targets were developed in consultation with its customers, and that they are supported by customers. Central Highlands Water used a deliberative assembly to provide validation of its proposed outcomes and targets.

Like other water businesses, we found some of its measures and targets will require reworking following our draft decision, to meet the expectations of our guidance. We also noted its proposed

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<sup>91</sup> Essential Services Commission, *2023 water price review: Guidance paper*, p. 45.

<sup>92</sup> Essential Services Commission, *2023 water price review: Guidance paper*, p. 45.

set of measures seemed narrower in scope than its outcomes might suggest, and was missing many key performance measures included its current 2018–23 set.

In terms of customers service levels however, our preliminary view is that some of the targets adopted by Central Highlands Water reflect an overall improvement for its customers, but we could not form an overall view on value until its measures were reworked to meet the requirements of our guidance.

Our draft decision is to accept Central Highlands Water’s self-rating of ‘Advanced’ for the Outcomes element of PREMO. However, its response to this draft decision must provide greater clarity on the customer value represented in its outcomes measures and targets, before we can confirm this rating for our final decision.

## Appendix A – Submissions received

Name or organisation	Date received
Anonymous	7 October 2022
Anonymous	7 October 2022
Michael Heinz	16 November 2022
Anonymous	16 November 2022
Noel Coxall	25 November 2022
Kaufmann Property Consultants	28 November 2022
Beveridge Williams	28 November 2022
Anonymous	29 November 2022
Loreto Ballarat Limited	30 November 2022
Consumer Action Law Centre	30 November 2022
Integra	1 December 2022
Concerned Waterways Alliance	1 December 2022
Concerned Waterways Alliance	21 December 2022



# Appendix B – Commission’s consideration of legal requirements

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

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

In addition to the mandatory factors set out below, clause 11 of the WIRO requires the commission to have regard to the matters specified in the commission’s guidance.<sup>93</sup> We have had regard to the matters specified in our guidance in reaching our preliminary view. Our draft decision provides further information on where we have considered our guidance, and Central Highlands Water’s compliance with our guidance, in reaching our preliminary view.

Note: all chapter and section numbers referenced below refer to our draft decision for Central Highlands Water.

## **Economic efficiency and viability matters**

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

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

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

- Our consideration of customer engagement (Section 3.1).
- Our assessment of the revenue requirement (Chapter 4).
- Our assessment of efficient operating expenditure (Section 4.1) and capital expenditure (Section 4.2).
- Our assessment of tariffs (Section 5.3).

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<sup>93</sup> Essential Services Commission, *2023 water price review: Guidance paper*, 26 October 2021.

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

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

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

- Our consideration of customer engagement (Section 3.1).
- Our assessment of the revenue requirement (Chapter 4).
- Our assessment of efficient operating expenditure (Section 4.1) and capital expenditure (Section 4.2).
- Our assessment of tariffs (Section 5.3).
- Our assessment of financial viability (Chapter 6).

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

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

- Our consideration of customer engagement (Section 3.1).
- Our consideration of outcomes (Section 3.2).
- Our assessment of the revenue requirement (Chapter 4).
- Our assessment of efficient operating expenditure (Section 4.1) and capital expenditure (Section 4.2).
- Our assessment of tariffs (Section 5.3).

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

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

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

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

- Our consideration of customer engagement (Section 3.1).
- Our consideration of outcomes (Section 3.2).
- Our assessment of the revenue requirement (Chapter 4).
- Our assessment of efficient operating expenditure (Section 4.1) and capital expenditure (Section 4.2).
- Our assessment of tariffs (Section 5.3).

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

- A 10-year trailing average approach to estimating the benchmark cost of debt (see Section 4.4.1).
- A regulatory rate of return that we consider will enable Central Highlands Water to recover borrowing costs associated with its investment in services, and generate a return on assets.<sup>94</sup>

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

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

We have had regard to this matter in Chapter 6.

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

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

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

- Our consideration of customer engagement (Section 3.1).
- Our assessment of the revenue requirement (Chapter 4).
- Our assessment of efficient operating expenditure (Section 4.1) and capital expenditure (Section 4.2).

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<sup>94</sup> The regulatory rate of return is comprised of the cost of debt and the return on equity.

- Our assessment of tariffs (Section 5.3).

## **Industry specific matters**

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

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

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

- Our consideration of customer engagement (Section 3.1).
- Our consideration of outcomes (Section 3.2).
- Our assessment of the revenue requirement (Chapter 4).
- Our assessment of efficient operating expenditure (Section 4.1) and capital expenditure (Section 4.2).
- Our assessment of tariffs (Section 5.3).

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

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

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

- Our consideration of the regulatory asset base (Section 4.3).
- Our consideration of the cost of debt (Section 4.4.1).
- Our consideration of the return on equity (Section 4.4.2).

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

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

- indicative bills paid by customers in other jurisdictions in Australia<sup>95</sup>
- operating and capital expenditure costs per connection throughout Australia<sup>96</sup>
- tariff structures applied by water businesses throughout Australia<sup>97</sup>
- the regulatory rate of return set by other regulators.<sup>98</sup>

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

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

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

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

- Our consideration of customer engagement (Section 3.1).
- Our consideration of outcomes (Section 3.2).
- Our assessment of the revenue requirement (Chapter 4).
- Our assessment of efficient operating expenditure (Section 4.1) and capital expenditure (Section 4.2).
- Our assessment of tariffs (Section 5.3).

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

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<sup>95</sup> Bureau of Meteorology, *National performance report 2020-21; urban water utilities, part A*, February 2022.

<sup>96</sup> Bureau of Meteorology, *National performance report 2020-21; urban water utilities, part A*.

<sup>97</sup> Includes Icon Water, Sydney Water, Hunter Water, Central Coast Council, Power and Water Corp, Urban Utilities, Unity Water, SA Water and TasWater.

<sup>98</sup> Independent Pricing and Regulatory Tribunal NSW, *Final Report - Review of WaterNSW's rural bulk water prices*, 9 September 2021; Independent Pricing and Regulatory Tribunal NSW, *Final Report - Review of prices for Sydney Water*, June 2020; Essential Services Commission of South Australia, *SA Water's water and sewerage retail services: 1 July 2020 - 30 June 2024*, Price Determination, 1 July 2020; Queensland Competition Authority, *Final report - Seqwater bulk water price review 2022–26*, March 2022; Queensland Competition Authority (QCA), *Final report - Rural irrigation price review 2020–24, Part A: Overview*, January 2020; Office of the Tasmanian Economic Regulator, *Final report - Investigation into TasWater's prices and services for the period 1 July 2022 to 30 June 2026*, May 2022.

## Customer matters

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

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

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

- Our consideration of customer engagement (Section 3.1).
- Our consideration of outcomes (Section 3.2).
- Our assessment of the revenue requirement (Chapter 4).
- Our assessment of efficient operating expenditure (Section 4.1) and capital expenditure (Section 4.2).
- Our assessment of tariffs (Section 5.3).

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

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

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

- Our consideration of the revenue requirement (Chapter 4).
- Our assessment of efficient operating expenditure (Section 4.1) and capital expenditure (Section 4.2).
- Our consideration of demand (Section 5.1).
- Our consideration of tariffs (Section 5.3).

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

- Our consideration of customer engagement (Section 3.1).
- Our consideration of outcomes (Section 3.2).

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

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

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

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

- Our consideration of tariffs and the form of price control (Section 5.2 and Section 5.3).

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

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

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

- Our consideration of customer engagement (Section 3.1).
- Our assessment of the revenue requirement (Chapter 4).
- Our assessment of efficient operating expenditure (Section 4.1) and capital expenditure (Section 4.2).
- Our assessment of tariffs (Section 5.3).

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

We consider that customer value established through prices and customer outcomes, as well as tariff structures, and assistance available to customers having difficulty paying bills is relevant to this objective.

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

- Our consideration of customer engagement (Section 3.1)

- Our consideration of outcomes (Section 3.2)
- Our consideration of guaranteed service levels (Section 3.4)
- Our consideration of tariff structures and prices (Chapter 5)

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

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

Our draft decision proposes to approve a revenue requirement that will enable Central Highlands Water to deliver the outcomes valued by customers, and on its legal and regulatory obligations.

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

- Our assessment of the revenue requirement (Chapter 4).
- Our assessment of efficient operating expenditure (Section 4.1) and capital expenditure (Section 4.2).
- Our assessment of the form of price control (Section 5.2).

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

Our draft decision proposes to approve a revenue requirement that will enable Central Highlands Water to deliver the outcomes valued by customers, and on its health, safety, environmental sustainability and social obligations.

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

- Our assessment of the revenue requirement (Chapter 4).
- Our assessment of efficient operating expenditure (Section 4.1) and capital expenditure (Section 4.2).
- Our assessment of tariffs (Section 5.3).

## **Other matters**

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

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



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

- Our assessment of engagement (Section 3.1)
- Our assessment of outcomes (Section 3.2)
- Our assessment of efficient operating expenditure (Section 4.1) and capital expenditure (Section 4.2).

We consider that our pricing approach helps to address market power and information asymmetries relating to the water businesses. Our PREMO water pricing approach provides incentives for a water business to provide its “best offer” to customers in its price submission. This is described in further detail in a report we released in 2016.<sup>99</sup>

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

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

- Implementing a price review process so that water businesses may receive streamlined price reviews if they submit a high quality price submission. This reduces the costs of regulation for water businesses and the commission.
- Focusing our assessments of price submissions on the materiality of proposals to customer interests (including low income and vulnerable services), including in terms of price, bill and service impacts.
- Designing our guidance so we minimise the compliance costs for water businesses. Our guidance noted that much of the information required in price submissions should be readily available to water businesses as it would be relevant for other purposes such as corporate planning and project prioritisation and justification.<sup>100</sup>

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

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

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

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<sup>99</sup> Essential Services Commission 2016, Water Pricing Framework and Approach, Implementing PREMO from 2018, October, pp. 11–13.

<sup>100</sup> Essential Services Commission, 2023 water price review: Guidance paper, p. 2.

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

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

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

- Implementing a price review process so that water businesses may receive streamlined price reviews if they submit a high quality price submission. This reduces the costs of regulation for water businesses and the commission.
- Focusing our assessments of price submissions on the materiality of proposals to customer interests (including low income and vulnerable services), including in terms of price, bill and service impacts.
- Designing our guidance so we minimise the compliance costs for water businesses. Our guidance noted that much of the information required in price submissions should be readily available to water businesses as it would be relevant for other purposes such as corporate planning and project prioritisation and justification.<sup>101</sup>

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<sup>101</sup> Essential Services Commission, 2023 water price review: *Guidance paper*, p. 2.

## Appendix C – Average incremental cost methodology and the Water Act

The average incremental cost methodology is capable of complying with section 268(3) of the Water Act 1989.

Section 268(3) of the Water Act 1989 states:

(3) The amount of payment required from an owner must be assessed by the Authority to be fair and reasonable, taking into account the benefit to that property relative to the benefit to other properties.

To take into account the benefit to a connective property relative to the benefit to other properties, a new customer contribution charging regime must determine how much a connecting party should pay upfront versus what will be paid through ongoing charges.<sup>102</sup> Ongoing charges are paid by both the connecting party and all other customers via inclusion in the regulatory asset base.

The water business undertakes this task by deciding:

1. The value of any upfront contribution, and
2. The amount of growth capital expenditure that can be added to the regulatory asset base.

This is the way in which the water business can satisfy the requirement in the Water Act of ‘taking into account the benefit to that property relative to the benefit to other properties’.

This regulatory price setting and cost recovery task can be done through the incremental costs minus incremental revenues calculation required in the current new customer contribution guidance,<sup>103</sup> applied in conjunction with a building block approach that only adds net capital expenditure (that is, gross capital expenditure less contributions) into the regulatory asset base.

It is also possible to do this task by applying the benefits assessment at a planning stage. When setting standard new customer contributions, a water business can determine what costs relate to new connections and what relate to existing customers, and then direct the costs accordingly to new customer contributions and the regulatory asset base (or regulated operating expenditure

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<sup>102</sup> Ongoing charges are paid by both the connecting party and all other customers via inclusion in the regulatory asset base.

<sup>103</sup> Essential Services Commission, Estimator Guidance – New Customer Contributions (September 2012); see also Essential Services Commission, Explanatory Notes – New Customer Contributions for The Victorian Water Industry (9 December 2013) and Essential Services Commission, 2023 water price review: Guidance paper, 26 October 2021, p. 59.

allowance). By ensuring that the calculation of the building block revenues accounts for this view of relative benefits and does not double count the cost recovery, the equivalent regulatory outcome can be achieved.

Accordingly, the average incremental cost approach may be capable of complying with the section 268(3) requirements, provided that:

1. Growth related costs have been appropriately attributed between new customer contribution and ongoing charges. This requires that the basis of attributing expenditure to new customer contribution versus the ongoing charges from all customers is clear and can be reconciled between gross costs and the net costs included in Central Highlands Water's financial model.
2. New customer contribution revenues have been accounted for when setting the regulatory asset base for ongoing charges. This requires that the new customer contribution revenues in the financial model can be reconciled back to the new customer contribution models.