WATER PRICING FRAMEWORK AND APPROACH

Implementing PREMO from 2018

October 2016

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CHAIRPERSON'S OVERVIEW

What value do you deliver to your customers?

Since it commenced economic regulation of the Victorian water industry in 2004, the Commission has used a traditional model and approach to setting water prices. This approach, used by all utility regulators in Australia and many economic regulators around the world, promoted good outcomes among the 19 water businesses over the past 12 years.

The evidence shows that independent economic regulation has brought a much clearer focus on performance and prices to the Victorian water industry; but we felt more could be done to promote greater efficiency and to ensure the delivery of outcomes that customers value. So in 2015, following amendments to the Water Industry Regulatory Order (WIRO) which allowed us to consider new approaches, we initiated a major project to examine the way we go about setting prices.

Our position paper setting out our proposed new approach was released in May 2016, and was generally well received by the water industry and other interested parties including customer representatives. The changes we proposed were designed to deliver better quality price submissions, proposing better customer value, developed through better customer engagement. Those businesses doing this best would be publicly recognised, and rewarded through higher financial returns.

Now, following 18 months of extensive consultation and engagement with the water sector and other stakeholders, we present the new framework and approach that will apply for setting Victorian water prices from the next price review in 2018.

Three mechanisms thread their way throughout our new approach to make it into a comprehensive framework. These mechanisms are: Engagement, Incentives and Accountability.

Engagement. Under the new framework, it will not be possible for water businesses to prepare price submissions for us to consider without having meaningfully engaged their customers. Businesses will need to identify their customers' concerns, interests and priorities so that their submissions can be expressed in terms of the outcomes valued by their customers. To be clear, this requirement is not just about chatting with customers. There will be no satisfactory outcomes for a water business which fails to work closely with its customers and show it engaged with its customers' concerns and interests.

Incentives. While the traditional incentive mechanisms of economic regulation have proven beneficial in the Victorian water industry, more can be done. Under our new framework, we will be linking the rate of return a water business can earn with the level of ambition of its pricing proposal. In other words, the framework will reward businesses that: focus on delivering outcomes sought by their customers; accept risks on behalf of their communities; and deliver services as efficiently as possible.

Accountability. Being customer-facing entities, water businesses will be held accountable for fulfilling their part of the economic bargain. They will be responsible for discovering their customers' preferences. They will be responsible for determining how ambitious they wish to be when responding to those preferences. And uniquely, these service providers will be responsible for self-assessing their proposal before they submit them to us. Under the new framework, our role will be to assess the accuracy and honesty of the businesses' self-assessments.

The customer, not the regulator, is now central to a water business's price submission. Previously, customer consultation was too often treated as the final tick-box to be checked prior to making a submission. But our new framework will change this. We are not looking to bring customers into our regulatory processes; rather the framework will turn the businesses' attention squarely towards their customers. Service providers will not be able to make a submission to the regulator without having consulted with customers before, during and after the development of their plans.

Our framework seeks to move away from the regulatory obsession with defining processes. Instead, water businesses will be required to express their entire proposals in terms that reflect the <u>outcomes</u> they will be delivering to their customers. The future will be about customer outcomes rather than regulatory gratification. There will be no successful regulatory outcomes for service providers if they do not couch their proposals in terms that reflect the concerns, priorities and preferences of their customers.

Only customers know their preferences. Just as occurs in other markets, service providers in the water industry must also endeavour to discover those preferences; and then they must seek to align their outputs with those preferences in order to achieve the most socially efficient outcome possible. For too long, economic regulation has been focused on the pursuit of technical efficiency. Allocative efficiency is rarely mentioned, and we believe a greater focus here is warranted. Under our framework, service providers will need to justify *what* they propose to provide as well as how much they intend to charge for those services.

Our framework makes sure the Board of each water business, and their management teams, are held fully accountable for the actions and decisions they make, and for their final 'best offer' price submission proposals. The accountability mechanisms built into our framework ensure that the Boards of the water businesses cannot and do not confuse their roles with those of the regulator. They alone will be responsible for the delivery of services and for the durability of those services when adverse circumstances unfold.

Our entire framework centres on customers and the value they receive from their water business. In future, water businesses will need to engage with their customers on an early and ongoing basis. To inform their planning processes, they will need to identify their customers' interests, concerns and priorities; and as they develop their plans, they will need to test their ideas and to check whether they are addressing the matters that customers value. And then, when they have decided on their plan of action for the next regulatory period, their price submissions will need to tell this story and show how they are (or why they are not) responding to their customers' interests, concerns and priorities. In doing so, water businesses will finally be able to answer the question I posed to the industry in 2010:

> *What value do you deliver to your customers?*

Dr Ron Ben-David
Chairperson

THIS PAPER

On 1 January 2004, the Essential Services Commission (the Commission) commenced its role as the economic regulator of the Victorian water sector. The Commission's role involves regulating the prices and service standards of the 19 businesses supplying water, sewerage and related services to residential, industrial and commercial, and irrigation customers throughout the state.

The Commission's pricing powers and functions in Victoria's water sector are informed by the Water Industry Regulatory Order (WIRO), which sits within the broader context of the *Water Industry Act 1994 (Vic)* and the *Essential Services Commission Act 2001 (Vic)*.[1] Within the framework established by these instruments, the Commission undertakes price reviews every five or so years to establish the maximum prices water businesses may charge their customers.

The methods and processes the Commission has followed to undertake price reviews have remained largely unchanged since it commenced its pricing functions in 2004. However, in 2014, the Victorian Government reviewed and revised the WIRO, providing the Commission greater flexibility in the manner, approach and method used to deliver efficient pricing and service outcomes for Victorian water and sewerage customers.

Following extensive consultation, the Commission has made a number of changes to the water pricing framework and approach. These changes include a greater focus on customer engagement in price setting. The Commission is also introducing a new incentive mechanism called PREMO, which links reputation and financial outcomes for businesses to the value water businesses deliver to their customers.

[1] The prices for rural infrastructure operators in the Murray Darling Basin are regulated under the Commonwealth Water Infrastructure Charge Rules. This affects the approach to setting prices for rural infrastructure operated by Goulburn-Murray Water and Lower Murray Water.

The purpose of this paper is to set out the pricing framework and approach for water price reviews conducted by the Commission from 2018. This is to provide interested parties with an overview of the processes the Commission intends to follow, and the matters that will be considered in future water price reviews.

The pricing framework and approach set out in this paper will inform the guidance the Commission is required to provide water businesses prior to price reviews.[2] The guidance for each price review will specify the information requirements for the price submissions prepared by water businesses, and the Commission's approach to assessing these.

This paper is structured as follows:

- Chapter 1 outlines the Commission's pricing approach review to deliver the new framework.
- Chapter 2 describes the new PREMO incentive framework.
- Chapter 3 provides an overview of the pricing framework and approach.
- Chapter 4 describes the new flexible assessment process for price reviews.
- Chapter 5 describes the legal framework which establishes the Commission's role in water pricing.
- Appendix A summarises the new framework and the changes from the previous framework.

[2] The guidance is required under clause 13 of the WIRO.

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1 PRICING APPROACH REVIEW

1.1 THE REVIEW

In 2014, the Victorian Government reviewed and revised the Water Industry Regulatory Order (WIRO). The changes allow the Commission greater discretion to decide on the manner, approach and method (the pricing approach) used to deliver efficient pricing and service outcomes for Victorian water and sewerage customers.[3]

Given the increased discretion available under the 2014 WIRO, in April 2015 the Commission publicly released a consultation paper[4] to start reviewing its pricing approach for the Victorian water sector. The review has been preparation for the 2018 water price review of 16 urban water businesses and Southern Rural Water[5] and will inform the guidance the Commission will issue to water businesses to explain its expectations for the development and content of price submissions.

In its consultation paper, the Commission stated the objective for its pricing approach review was to:

> *… identify the pricing approach that will produce the best outcomes for Victorian customers, namely, services delivered at the lowest price while meeting all quality and reliability standards. Our approach to pricing will involve establishing strong incentives for the water businesses to operate efficiently and innovatively, while providing for their long term viability. Alternatively stated, our approach to pricing seeks to uphold the*

[3] The Commission undertakes its economic regulatory functions within the parameters established in the legislation and regulation that guides our role. This includes provisions in the *Essential Services Commission Act (Vic)* 2001, *Water Industry Act* (Vic) 1994, and the WIRO. These instruments guide and place limits on the discretion available to the Commission.

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

[5] Prices for Goulburn-Murray Water and Melbourne Water will be established for a four and five year period respectively, from 1 July 2016. The Commission regulates the prices of Goulburn-Murray Water's infrastructure services under the Australian Competition and Consumer Commission's Water Charge (Infrastructure) Rules.

> *long term viability of Victorian water businesses that operate efficiently and invest prudently. Victorian customers should expect no less.*[6]

This remained the primary objective of the pricing approach review, which involved extensive consultation and engagement with the water businesses and other key stakeholders.

In May 2016, the Commission released a position paper[7] setting out its proposed new pricing approach, and invited submissions on its proposal. Commission staff met with key representatives from each water business to discuss the Commission's proposal in more detail and to help inform their submissions. The Commission received submissions from all Victorian water businesses and from other stakeholders.[8]

Submissions were generally supportive of the overall proposal, in particular the focus on customer value and the incentives to prepare high quality price submissions. Most of the matters raised in submissions are addressed in this framework paper, or will be addressed in greater detail in the price review guidance.

Accordingly, the water pricing framework set out in this paper is consistent with implementing the approach proposed in the May position paper.

1.2 THE NEED FOR CHANGE

The pricing approach for Victoria's water sector has remained largely unchanged since it was established in 2004. Expert and transparent scrutiny of the water sector has produced tangible benefits for customers. There has been a much clearer focus on the performance of the Victorian water businesses and the prices they charge.

Despite these gains, more can be done to promote efficiency and delivery of the outcomes most valued by customers.

[6] Essential Services Commission 2015, *op.cit.,* p. 2.

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

[8] Submissions are available on the Commission's website at www.esc.vic.gov.au

The Commission has previously outlined a number of limitations of the original pricing framework and approach.[9] In summary, these are:

- Customer engagement has generally been undertaken by water businesses and the regulator as an afterthought, with little opportunity for customers to influence a water business's service or price proposals before they are submitted to the Commission. Customer consultation has too often been treated as the final tick-box to be checked prior to making a price submission. This raises questions as to whether the proposals of water businesses sufficiently take into account the priorities and concerns of customers.
- Water businesses have generally not responded strongly to incentives to deliver services as efficiently as possible. For example, the Commission has observed that many businesses do not endeavour to outperform the expenditure benchmarks established in price reviews in the pursuit of profits or discretionary funds. Many businesses also have adopted overly risk-averse assumptions about forecast costs, reflected in the relatively large contingencies that businesses propose for capital works, for example. As a result, customers are more likely to inappropriately bear risk on behalf of their water business, and to pay higher prices than they otherwise might.
- Water businesses have tended to cluster on most measures of service performance, indicating there is little incentive for one or more businesses to 'break from the pack' and outdo their peers. In other words, there is little ambition within the sector to drive a step change in service performance.
- Businesses have had limited incentives to be accountable to customers for delivering on their service commitments. While service standards and performance reporting have been central features of the pricing approach, there have been no material consequences for water businesses that don't achieve the standards to which they commit.

[9] See for example: Essential Services Commission 2016, A new model for pricing services in Victoria's water sector, Position Paper, May, and Ron Ben-David, Marcus Crudden and Dean Wickenton 2016, *A new approach to regulatory pricing*, September (appearing in the Australian Competition and Consumer Commission's September 2016 Network publication).

1.3 OBJECTIVES OF THE NEW PRICING APPROACH

In developing the new water pricing approach, four high level objectives were set. These are:

- Customers — the pricing approach will pivot the businesses' attention squarely towards their customers. The water businesses will be required to express their price submissions in terms that reflect the outcomes they will be delivering to their customers. The future will be about customer outcomes rather than compliance with regulatory tick-boxes. Businesses are expected to couch their price submissions in terms that reflect the concerns, priorities and preferences of their customers, in order to achieve a successful regulatory outcome.
- Autonomy — in consultation with customers, water businesses will decide on the services to be delivered and the prices to be paid. Boards will determine the risk their businesses assume on behalf of their customers. Having committed to those decisions, each Board will be responsible for self-assessing the level of ambition of its pricing proposals. The level of ambition will determine the return on equity reflected in the business's proposed prices.
- Performance — the pricing approach provides new incentives for ambition in the delivery of services and outcomes that matter most to customers, and to deliver these as efficiently as possible.
- Simplicity — the pricing approach attempts to avoid focusing on matters that make little difference to the outcomes experienced by customers. The Commission seeks to achieve this by choosing simplicity whenever it can.

1.4 OVERVIEW OF THE NEW PRICING APPROACH

The new pricing approach introduces new financial, reputational and procedural incentives to create a better alignment between the interests of water businesses and the customers they serve. These build on aspects of the previous pricing approach.

A water business's revenue requirement will continue to be established using the building blocks methodology. The Commission will continue to assess proposed prices by taking into account the need for water businesses to recover a rate of return on prudent and efficient capital expenditure on assets, a return of the cost of investing in those assets, prudent and efficient operating costs, and tax.

The business may use the allowed return on its investment to pay a dividend to the shareholder, fund projects, reduce debt, reduce prices, or any combination of these strategies as decided by the board and shareholder. These are decisions for the boards, not the regulator.

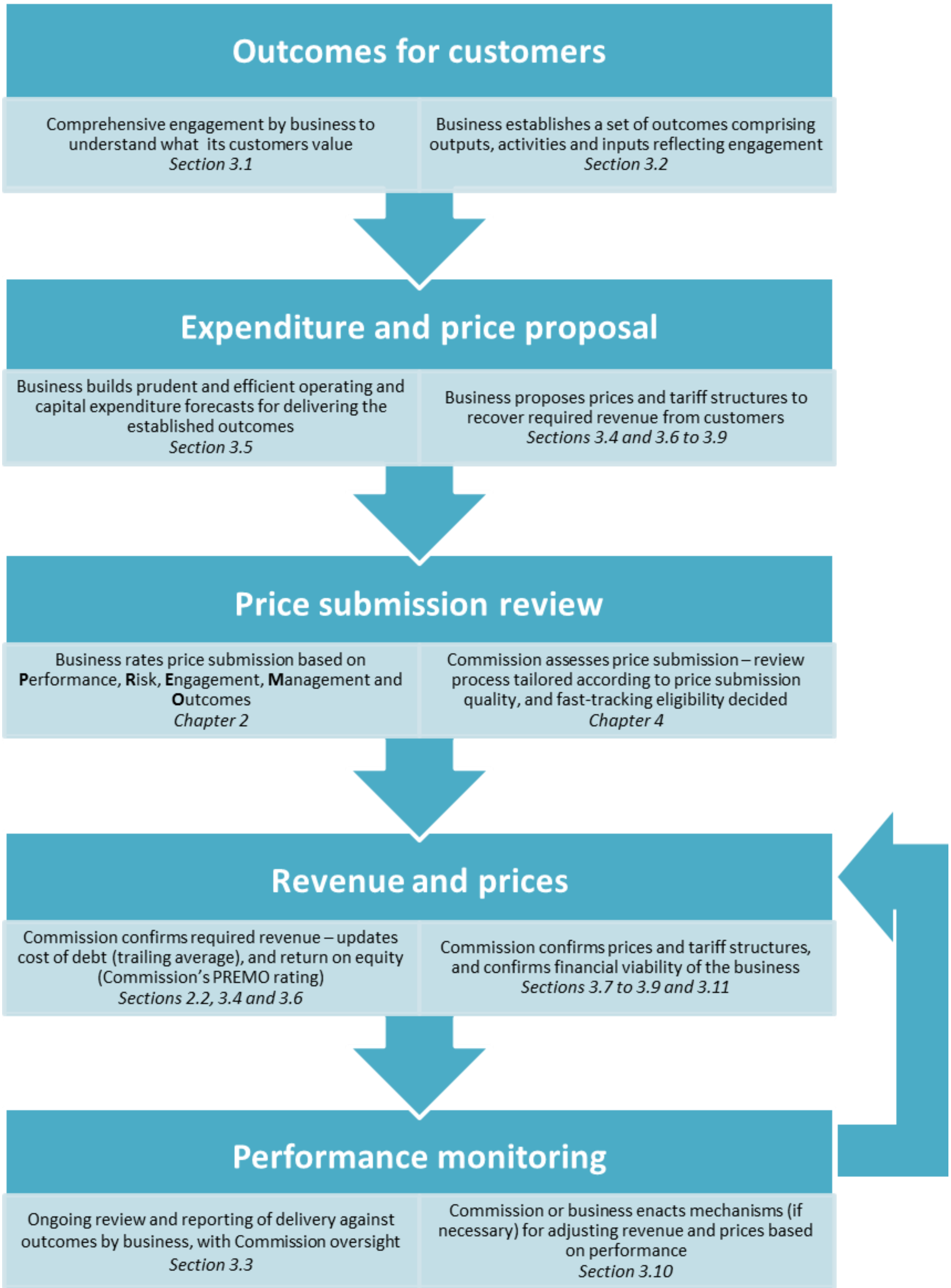
The main changes to the pricing approach are:

- a greater emphasis on the role of customer engagement to inform and influence the price submissions of water businesses
- a new incentive mechanism called PREMO, which links the rate of return earned by a water business to the level of ambition in its price submission and to how well a business delivers on the commitments it makes to customers, and
- new flexibility mechanisms to help ensure the pricing approach accounts for the diversity of the water businesses and their customers, and to allow for streamlined price review processes.

Appendix A summarises the new pricing framework and approach, identifying which elements have changed from the previous framework and approach, and which elements remain unchanged.

Figure 1.1 summarises the price review process that will apply from 2018.

FIGURE 1.1 THE NEW PRICING APPROACH



In the first step, a water business engages with its customers and community to inform the outcomes to be delivered in a pricing period (sections 3.1 and 3.2).

In the second step, a water business develops its estimate of prudent and efficient expenditure (section 3.5) to deliver the outcomes identified at the first step, and obligations imposed by government and technical regulators.[10] A price submission should demonstrate alignment of expenditure with the outcomes to be delivered. Priorities and options are tested with customers throughout the price submission development process. The business also develops its proposed prices and tariff structures (sections 3.6 to 3.9).

The third step involves a new approach to the assessment of price submissions, which will influence the returns allowed in prices for each water business. The return on equity established at the start of a pricing period could vary for each business, depending on the ambition of its price submission. Ambition will be assessed against five elements: Performance, Risk, Engagement, Management and Outcomes (PREMO). Chapter 2 describes the new PREMO incentive mechanism.[11]

In its price submission to the Commission, a water business will self-rate the ambition of its submission based on the PREMO elements. After receiving the price submission, the Commission will also rate it against the PREMO elements.

This PREMO assessment process will inform the return on equity to be reflected in revenue and prices (the fourth step). Water businesses would continue to recover a benchmark cost of debt, but estimated using a ‘trailing average’ approach rather than the previous ‘on-the-day’ approach (section 3.6.2).

The new pricing approach allows for a more flexible price review process that is influenced by the quality of price submissions. In particular, businesses putting forward high quality price submissions may benefit from a streamlined price review (chapter 4).

[10] Government obligations are typically outlined in a Statement of Obligations issued to water businesses. Technical regulators include the Department of Environment, Land, Water and Planning, EPA Victoria, and the Department of Health and Human Services.

[11] The ‘P’ element of PREMO is a backward looking consideration of performance against specified outcomes during the period, and will not be assessed at the 2018 water price review, but will come into effect for a business’s second price review under the new PREMO incentive framework.

The final step is the ongoing review of outcomes delivered by water businesses (section 3.3). As well as performance reporting, a business's revenue and prices may be adjusted within a regulatory period to reflect performance against outcome commitments (section 3.10.3).

Many water businesses have called for greater autonomy in the pricing approach. The new pricing approach provides this opportunity. A water business will have greater autonomy over the returns it may generate, and the nature of the Commission's review of its price submission. However, the degree of autonomy will depend on how well a business understands and reflects preferences of customers in price submissions, and demonstrates that it will deliver on these outcomes efficiently.

In short, the Commission is moving away from a 'one-size-fits-all' pricing approach to one that more clearly distinguishes and recognises the performance of each water business in meeting its customers' needs.

2 PREMO — A NEW INCENTIVE FRAMEWORK

The 2018 water price review will be the first to incorporate PREMO, a new incentive mechanism that links reputation and financial outcomes for businesses to the quality of outcomes they deliver to their customers.

Under PREMO, a single weighted average cost of capital (WACC) will no longer apply uniformly to every water business. The new pricing approach departs from the capital asset pricing model which has applied in Victoria's water sector since the commencement of economic regulation. Each business's return on equity will be linked to the tangible outcomes it delivers to customers. This will be achieved by allowing the return on equity to vary according to the level of ambition shown in a price submission.

BOX 2.1 AMBITION IN PRICE SUBMISSIONS

The ambition of a price submission reflects the extent to which a water business has challenged itself to meet all of its statutory and regulatory objectives while delivering the outcomes and prices customers value.

It is a measure of the value customers will receive from their water business. A more ambitious price submission will propose targeted services and outcomes at lower prices, for example. This is achieved through better customer engagement, efficient management practices and rigorous self-examination.

Ambition will be assessed against the five elements of PREMO:

- Performance — have the performance outcomes to which the business committed in its price submission been met or exceeded?[12]
- Risk — has the business sought to allocate risk to the party best positioned to manage that risk?
- Engagement — how effective was the business's customer engagement?
- Management — is there a strong focus on efficiency? Are controllable costs increasing, staying the same, or decreasing?
- Outcomes — do proposed service outcomes represent an improvement, the status quo, or a withdrawal of service standards?

2.1 ESTABLISHING THE RETURN ON EQUITY UNDER PREMO

Prior to each round of price reviews under the new framework, the Commission's guidance to water businesses will set out an assessment methodology to inform the rating of a price submission by a water business and the Commission as 'Leading', 'Advanced', 'Standard' or 'Basic'.[13]

A 'Basic' submission reflects stagnating or declining performance for customers in terms of service outcomes, operating efficiencies or both. In light of these poor outcomes, the return on equity for 'Basic' price submissions will be set at a level commensurate with the benchmark real cost of debt. This ensures that relevant water businesses can, at the least, recover interest costs associated with funding capital investment. This rate should remain fairly constant over time and close to the long-run average cost of debt.

[12] The 'P' element of PREMO is a backward looking consideration of performance against specified outcomes during the period, and will not be assessed at the 2018 water price review, but will come into effect for a business's second price review under the new PREMO incentive framework.

[13] In the Commission's Position Paper, the term 'Ambitious' was used for the rating between 'Standard' and 'Leading'. As the PREMO rating scale measures the *ambition* of a price submission, calling one rating 'Ambitious' could create confusion, as any rating could be considered ambitious according to a business's circumstances. The Commission has subsequently adopted the term 'Advanced', and considers this better represents the intention of this price submission rating, in that its value proposition to customers is greater, or more *advanced*, than a Standard rated price submission.

The return on equity allowed for a ‘Standard’ price submission would be slightly higher. A ‘Standard’ price submission will reflect a good value proposition for customers, albeit it would generally reflect proposals representing a continuation of current outcomes and targets for cost efficiency, for example. Therefore, the allowed return on equity would be largely unchanged from the one expected under the current framework.

More ambitious submissions — that is, either ‘Advanced’ or ‘Leading’ price submissions — would receive a higher allowance for the return on equity. ‘Advanced’ and ‘Leading’ price submissions will demonstrate better value for customers than the commitments given in a ‘Standard’ price submission. Generally, they will commit to improved outcomes for customers in terms of services, prices, or both. ‘Leading’ price submissions will demonstrate that a water business’s proposals place it as a sector leader on key aspects of performance.

The increasing rate of return provides an incentive for businesses to be as ambitious as possible. In addition, these ratings are likely to provide reputational incentives for water businesses to propose and efficiently deliver outcomes that are valued most by their customers.

Principles for how the Commission will set the return on equity range over time are set out in section 3.6.

2.2 BEST OFFERS ONLY

The new pricing approach encourages water businesses to submit price submissions that reflect their ‘best offers’. This is achieved by requiring the businesses to self-assess the level of ambition of their price submissions. These self-assessments will be provided in the businesses’ price submissions. The Commission will then conduct its own, independent assessment. The Commission will apply the same criteria (which it will have previously published) to assess the level of ambition of each price submission. Section 4.2 sets out how a water businesses or any other party, may provide feedback to the Commission on the PREMO rating before the Commission reaches a final decision.

To demonstrate the incentive properties in PREMO the Commission has provided an indicative set of return on equity values for each price submission rating category at figure 2.1.

The best outcomes for a water business in terms of the return on equity will be achieved when the Commission and the business align in their respective assessments. Situations of aligned assessments are represented by the upper diagonal of the matrix shown in figure 2.1. The more ambitious the submission according to both the business and the Commission, the greater will be the allowed return on equity.

The grey shaded area above this diagonal indicates the Commission will not assess a price submission more favourably than the water business's self-assessment. This provides an incentive for the business to put forward its best offer, and to provide an honest assessment of the appropriate price submission rating.

But water businesses have an even more powerful incentive not to overstate their level of ambition. If the Commission finds a water business has overstated its ambition, then the return on equity will be lower than had the water business accurately assessed itself. This can be seen in the diminishing values moving left along each row in figure 2.1. This design feature penalises water businesses that seek to 'bluff' the regulator. Consistent with the Water Industry Regulatory Order (WIRO), the Commission considers that this is in the best interests of Victorian water customers, as it reduces the likelihood of water businesses being allowed rates of return that are not commensurate with the outcomes it proposes to achieve. It also supports an incentive-based framework that will deliver better consumer outcomes.

The (red) shaded zone at the bottom of the matrix represents an area within which the Commission will reserve its discretion. For example, it may require the water business to resubmit its proposal, or approve a shortened pricing period if it rates a business's submission to be in this part of the matrix.

Together, the design features of the matrix provide the businesses with a strong incentive to assess their price submissions accurately and honestly. The framework requires water businesses to submit their 'best offers' and not to be lured into making ambit or inflated claims.

FIGURE 2.1 INDICATIVE REGULATED RETURN ON EQUITY (REAL)

ESC assessment of submission	Water business self-assessment: Leading	Advanced	Standard	Basic
Leading	5.3			
Advanced	4.7	4.9		
Standard	4.1	4.3	4.5	
Basic			3.9	4.1

3 PRICING FRAMEWORK

This chapter provides an overview of the water pricing framework and approach, incorporating PREMO and other changes arising from the Commission's pricing approach review. Appendix A includes a summary table of the new framework and approach, identifying which elements have changed from the previous framework and approach, and which elements remain unchanged.

3.1 CUSTOMER ENGAGEMENT

Water businesses will need to engage extensively with their customers to inform their price submissions.

In a competitive market, to retain and gain market share, a successful business would put the customer at the centre of its planning, striving to clearly understand what products and services its customers (and potential customers) want and expect. Having gained that understanding, it would seek to deliver those outcomes that matter most to customers, as efficiently as possible.

Victoria's water businesses should seek to do the same, taking into account the capabilities of their own business operations, and an accurate understanding of any constraints on their ability to deliver outcomes valued by customers.

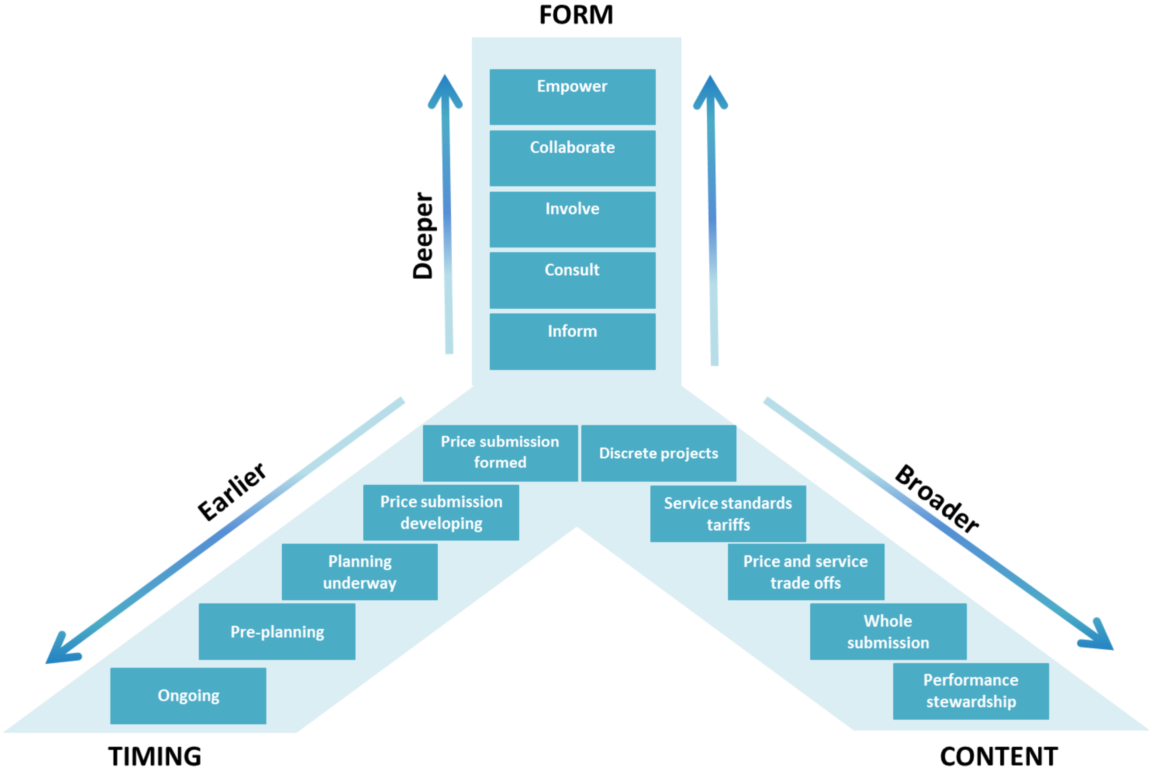
The Commission will not prescribe the manner in which water businesses engage with their customers. Each water business is best positioned to explore different approaches to find the engagement strategy that works best for its customers and develop this strategy over time. An abundance of information on customer engagement is publicly available, and water businesses are free to use the most appropriate resources.

The Commission has developed five key principles for good customer engagement, which will form the basis of its assessment of water businesses' price submissions:

1. The form of customer engagement undertaken by a water business should be tailored to suit the content on which it is seeking to engage, and to the circumstances facing the water business and its customers.
2. A water business must provide customers with appropriate instruction and information, given the purpose, form and the content of the customer engagement.
3. A water business's customer engagement should give priority to matters that have a significant influence on the services provided and prices charged by the business.
4. A water business should start customer engagement early in its planning. The engagement should be ongoing, to keep testing proposals with customers.
5. A water business should demonstrate in its price submission how it has taken into account the views of its customers.

Good engagement is therefore broad, deep, and starts early. The Commission has developed a tool to help businesses describe the extent of their customer engagement programs across three axes of form, timing and content (figure 3.1).

FIGURE 3.1 CUSTOMER ENGAGEMENT DIAGRAM



An expansive engagement program leads to a large triangle overlayed across the three axes. Not all engagement activities need to be expansive, however broad rather than narrow engagement provides a business the opportunity to test its understanding with customers and to ensure it has properly captured expectations. It also provides stronger justification and legitimacy to the outcomes businesses propose to deliver.

A key factor in assessing the effectiveness of customer engagement is how the business describes its customer engagement activity and translates the findings into its submission. The business will need to explain why it chose the various engagement activities, what it learnt and how it used the information gained from its engagement program to develop its submission. A price submission must clearly describe how the business has taken into account the customer views and values revealed through the engagement processes, and how these have informed the customer outcomes proposed.

This does not mean water businesses must simply adopt whatever their customers want. The businesses alone are still responsible for the decisions they make in compiling their price submissions, for what they do and do not include from their engagement findings, and the justifications for these decisions. The engagement process is to inform good decision making within the capabilities and constraints of the business's operation, not to justify poor business decisions. The water businesses will always be held accountable for their proposals.

Accordingly, where a business proposes not to deliver outcomes consistent with the engagement findings, it should communicate the reasoning behind this to its customers.

3.2 OUTCOMES

The new framework makes a key shift in how water businesses should prepare their price submissions to focus on customer outcomes that it proposes to deliver. Rather than exhaustive discussion around the inputs into a price submission, a business should describe what its customers will receive for the prices charged, and how this relates to the customers' expectations as revealed through the engagement process. And rather than relying on a series of specific engineering metrics with little meaning to customers to describe performance, a business should also report its performance against the proposed customer outcomes, to clearly demonstrate whether it has delivered the customer value it promised for the prices charged.

A set of outcomes focused on what the water business will deliver to its customers will effectively replace the previous core 'service standards' encapsulated in the Commission's Customer Service Code. These service standards are a mostly generic set of KPI metrics, for which each business sets its own performance targets for each year of the pricing period, with little stewardship or accountability for meeting these performance targets. The suite of service standards does not directly reflect the customer experience, nor provide an aggregate indication of good or poor service. However, the existing service standards do serve as a comparative measure of performance for specific metrics for each business from year to year, and also across businesses each year, and to this end will remain as part of the Commission's comparative performance reporting program (section 3.3.1).

The Commission considers that outcomes should:

- Be derived through engagement with customers, and reflect what customers have said they expect from their water business.
- Be tested with customers, to ensure they do capture and reflect customer expectations — where they don't, the water business should explain any deviations and inform customers why the proposed outcome does not directly reflect what customers have said.
- Be measurable — this may comprise one or a suite of deliverable or measurable outputs to demonstrate whether the proposed outcome has been achieved or not. (The outputs might be drawn from the existing set of service standards and performance monitoring KPIs, or businesses may propose their own new output measures if more appropriate — most likely a mix of both will be used.)

These outputs and deliverables should also be derived through customer engagement, with agreed performance targets for measurable metrics, and completion dates for specific projects or programs. The business can then be held to account on its achievement of these output targets throughout the regulatory pricing period, to demonstrate to its customers whether or not it has delivered the proposed outcomes.

A price submission should therefore clearly present to the regulator:

- A set of customer outcomes that reflect the value customers will receive during the pricing period, demonstrating how each has been derived and how it relates to the business's customer engagement processes.
- The measurable outputs and deliverables and associated targets that will demonstrate achievement of each outcome.
- The actions or programs that the business will undertake to meet the agreed targets.
- The costs and cost savings associated with each of these.
- How these costs are reflected in tariff structures and prices charged to customers.

Table 3.1 below demonstrates how these various components come together to define an outcome.

The narrative describing each customer outcome will form the backbone of a pricing submission — the 'golden threads' that bind a price submission into a coherent story about the outcomes customers will enjoy.

Key operating expenditure movements and capital investment plans should be clearly linked back to the proposed outcomes in order to demonstrate how they deliver improved customer value.

TABLE 3.1 OUTCOME EXAMPLE
Safe clean drinking water

Outcome • What the customer will receive	**Safe clean drinking water**
Outputs and deliverables • Measures and targets • Key projects • Derived with customers	• Compliance with E. coli and turbidity standards • No boil water notices required • Water quality complaints per 100 customers • Percentage of customers that trust the safety of water supply • Completion of specific water quality related capital projects • Publish annual water quality report
Activities and processes • Business programs • Specific actions to be developed/implemented	• Catchment to tap water quality management • Upgrade treatment plant to implement dual barrier protection in accordance with *Safe Drinking Water Act 2003* • Water mains cleaning program • Protections to avoid down time at water treatment plants • Hazard Analysis and Critical Control Points (HACCP) certification • Pass water quality regulator's audit (*Department of Health and Human Services*) • Undertake water quality testing in accordance with regulations • Investigate water quality complaints
Inputs • Costs and/or cost movements • Resources required • Price impact	• $ - opex and capex costs, or cost changes, to deliver or improve the specific programs • Resources • Business unit responsibility

3.2.1 GUARANTEED SERVICE LEVELS

The Commission requires all water businesses to implement a guaranteed service level (GSL) scheme.

A GSL scheme provides incentives for water businesses to make efficient investment decisions, or internalise the costs of making investment decisions that leave some customers with poor service outcomes. It also provides a form of recognition that an individual customer has received relatively poor levels of service.

Where businesses do not meet certain defined service standards, they pay (or rebate) a pre-determined amount to affected customers.

GSLs should reflect the most important service outcomes identified by customers. The customer engagement process should identify the specific services to be guaranteed, the appropriate service level, and the payment or rebate amount. A business may set itself higher GSL payments as a stronger incentive to deliver its proposed customer outcomes.

The Commission may also mandate specific GSLs to be included in a business's GSL scheme.[14]

3.3 PERFORMANCE STEWARDSHIP AND REPORTING

Businesses' performance will be monitored and reported against both:

- a common set of comparative key performance indicators
- each business's own set of outcomes and measurable outputs.

[14] At the time of publishing this framework, the only mandatory GSL required by the Commission for all urban water businesses is the Hardship-related GSL, which strives to prevent water supply restrictions being applied to customers in financial hardship.

3.3.1 COMPARATIVE REPORTING

The Commission will continue to monitor and report publicly on the performance of the Victorian water industry, through the annual regulatory audit and comparative performance report. This will reveal where each business sits relative to other businesses and its own previous performance for a range of key performance indicators. This process will also continue to feed into any national water performance reporting.

The Commission will continue to refine its existing performance reporting process, and to rationalise the current indicator set. It will look to more qualitative reporting aspects that provide a greater focus on customer satisfaction.

3.3.2 REPORTING TO CUSTOMERS

Under the new framework, water businesses will be accountable to their customers for delivering the outcomes set out in their price submissions. This will require a business to report at least annually to its customers on its performance against the specified outputs for each outcome, with an overall assessment of whether it has delivered on expectations for each outcome. This should also include appropriate explanation for any performance shortfalls and how the business intends addressing this in the coming year(s). A business may propose to set its annual prices lower than the maximum approved to recognise its customers are not receiving the full benefits promised in its price submission, for example. Price submissions could discuss how prices might be adjusted in the event of performance shortfalls.

The business's reporting should be readily available to its customers and the Commission, including on its website. This direct accountability to customers will strengthen the business-customer relationship.

Section 3.10.3 describes how the Commission may intervene where it considers a business's performance is falling well short of its commitments.

3.4 REVENUE REQUIREMENT

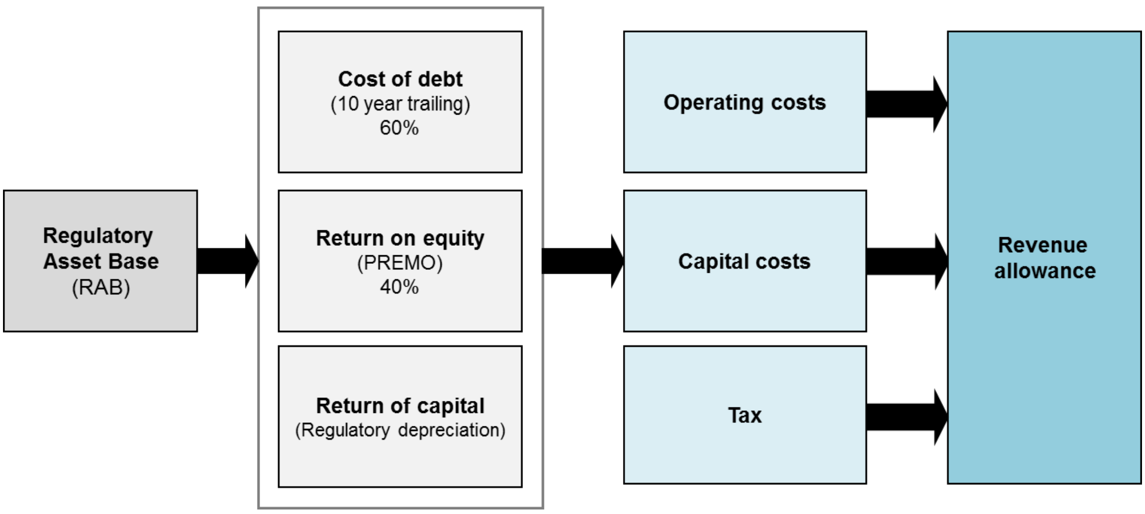
The revenue requirement will continue to be derived using a building blocks approach, based on a rolling regulatory asset base (RAB), and will comprise:

- Operating expenditure (section 3.5.1)
- Return on capital expenditure (section 3.5.2) through the RAB (section 3.6), comprising:
  - Cost of Debt
  - Return on Equity
- Return of capital invested (regulatory depreciation) (section 3.6.2)
- Tax (section 3.6.2)

The key change under the new pricing framework is in the calculation of the return on capital expenditure, which includes significant changes in the approach to the cost of debt and return on equity used to calculate the return. This is discussed further in section 3.6.2.

Figure 3.2 shows the revenue build-up under the new framework.

FIGURE 3.2 REVENUE BUILD-UP UNDER PREMO FRAMEWORK



3.5 EXPENDITURE

Forecasts of each water businesses' expenditure over the regulatory pricing period are a key input into the forward looking revenue requirements that form the basis of proposed prices. The Water Industry Regulatory Order (WIRO) places a particular emphasis on matters of efficiency. The Commission will approve prices that reflect only prudent and efficient expenditure forecasts, including reasonable efficiency improvements.

The Commission also requires businesses to take into account a planning horizon that extends beyond the pricing period, typically a 10-year outlook as a minimum.

Accordingly, a key issue is how the businesses satisfy the Commission that the expenditure forecasts proposed in their price submissions are prudent and efficient and reflect a long term planning horizon relevant to the water businesses' assets. Expenditure forecasts should represent the best available information at the time of preparing a price submission.

Significant changes in costs should be clearly linked to new or changed obligations, or to the proposed customer outcomes and demonstrate how the changes will provide improved customer value.

Expenditure forecasts are used to establish benchmark efficient cost assumptions for the purposes of establishing maximum prices. These benchmark costs are not intended to match the actual amounts that businesses need to spend each year to meet all regulatory and legal obligations and deliver the service outcomes expected by customers. Instead, they form the basis for establishing a reasonable annual revenue requirement sufficient to meet the expenditure that would be incurred by a prudent service provider acting efficiently to achieve the lowest cost of delivering on validated service outcomes, taking into account a long-term planning horizon.

In addition to the regulatory returns allowed under the new PREMO framework, businesses may still strive to outperform these cost benchmarks to increase profits or discretionary funds. These may be returned to the shareholder in the form of a dividend, used to pay down debt, or reduce prices, for example.

Businesses' forecast expenditure and efficiency assumptions will be a key factor in the assessment of the 'Management' PREMO element.

3.5.1 OPERATING EXPENDITURE

Prudent and efficient forecast operating expenditure will be reflected dollar for dollar in the revenue requirement. Businesses should provide operating expenditure details for each year of the pricing period, and by major service category. These categories will be defined in the Commission's guidance.

Changes in forecast annual operating expenditure will need to be explained relative to a reference or baseline year, which will normally be the last full financial year of actual costs. Businesses will need to demonstrate reasonable efficiency improvements have been reflected in proposed prices.

3.5.2 CAPITAL EXPENDITURE

Net capital expenditure (that is, gross capital expenditure less any capital contributions from government and customers) will continue to be recovered by being added to the regulatory asset base (RAB).

Businesses should set out prudent and efficient capital expenditure forecasts for each year of the pricing period and beyond, and by major service category. Pricing for the period will be determined using the forecast expenditure, but the RAB will be updated at the end of the period to reflect the actual prudent and efficient net capital expenditure incurred during the period.

This true-up of actual prudent and efficient expenditure effectively protects the businesses and customers from significant changes in capital expenditure. As such businesses do not need to include high contingency allowances in capital project cost estimates, nor allow capital for speculative or un-scoped projects.

3.6 RETURN ON THE REGULATORY ASSET BASE

Prudent and efficient capital expenditure will be reflected in the revenue requirement as a return on the RAB (return on equity) and a return of capital invested through regulatory depreciation.

3.6.1 REGULATORY ASSET BASE (RAB)

Each water business's RAB represents the value, as assessed by the Commission, of past capital investments. This is the value on which a business can expect to earn a return (return on capital), and the value that is returned to the business over the economic life of the assets (as regulatory depreciation).

The starting RABs were established by the Minister for Water in 2004. These have been updated annually to allow for actual prudent and efficient capital expenditure, less regulatory depreciation, capital contributions and asset disposals, and adjusted for inflation to retain the time value of money.

The RAB will continue to be updated each year following this same approach.

Prices during a regulatory period will be calculated using the capital expenditure forecasts for each year of the period. However, the RAB will be updated at the end of the period to reflect the actual expenditure incurred during the period.

The opening RAB for a period will be calculated as follows:

$$
\begin{aligned}
\text{Opening RAB}_{\text{New period}} = \; & \text{RAB}_{\text{Beginning current period (adjusted for actual in final year of previous period)}} \\
+ \; & \text{Capital expenditure (gross)}_{\text{Actual, with forecast for final year}^{*}} \\
- \; & \text{Contributions}_{\text{Actual, with forecast for final year}^{*}} \\
- \; & \text{Regulatory depreciation}_{\text{Forecast for all years of current period}} \\
- \; & \text{Proceeds from disposal of assets}_{\text{Actual, with forecast for final year}^{*}}
\end{aligned}
$$

* At the time of preparing and submitting a price submission, the actual costs for the final year of the current period will be unknown, and a forecast estimate will need to be used to calculate prices.

3.6.2 RETURN ON THE RAB

A single weighted average cost of capital (WACC) will no longer apply uniformly to every water business. While a benchmark cost of debt will be calculated and applied uniformly to all water businesses, each business's return on equity will be linked to the tangible outcomes it delivers to customers according to the PREMO assessment framework. This will be achieved by allowing the return on equity to vary according to the level of ambition shown in a price submission.

For the purposes of estimating the revenue allowance and the regulatory discount rate, the debt to equity ratio will remain the same as that used previously — that is a benchmark assumption that capital invested is 60 per cent debt funded and 40 per cent equity funded, reflecting an efficiently financed business, and not the business's actual debt position. The new calculation methodologies are described below.

COST OF DEBT

Previously, the cost of debt has been established using an on-the-day approach, which assumes a business's entire debt portfolio is refinanced within a 20 to 40 day period close to the time the Commission makes its final decision. In practice, businesses do not manage their debt portfolio in the manner implied by the rate on-the-day approach.

The Commission reviewed its approach to estimating the benchmark cost of debt in 2016 as part of the Melbourne Water price review and approved a 10-year trailing average approach for Melbourne Water.[15]

The Commission will apply a 10-year trailing average approach to estimate the benchmark cost of debt for all water businesses, as it considers this approach better aligns the actual cost of debt for an efficient business to the regulated benchmark. The trailing average cost of debt will be updated annually to roll-in the latest year's data, and the new figure will be used in setting the annual tariff adjustments. The methodology for calculating and applying the cost of debt will be set out in the Commission's guidance for each price review.

[15] In approving this change during the Melbourne Water price review, the Commission took into consideration that most other Australian regulators had moved to a trailing average approach to estimating the cost of debt.

For the first regulatory period under this new approach, an adjustment will be made to the historical data series for the years affected by the Global Financial Crisis (2008-09 to 2012-13). During these years, the financial accommodation levy — the credit risk spread set by the Victorian Department of Treasury and Finance on a government business's borrowings — was maintained at the pre-GFC level. Victorian water businesses did not actually incur the higher market (GFC) rates at that time.

The Commission will also include a benchmark allowance for debt raising costs, usually around 0.15 per cent, to reflect the cost incurred by a water business for raising its finances with Treasury Corporation Victoria.

RETURN ON EQUITY

The return on equity used to calculate each business's prices will vary according to the outcomes of the PREMO price submission rating process (chapter 2). The Commission's guidance issued prior to price reviews will include real return on equity values in a PREMO matrix that will be used for the upcoming price review.

The return on equity values in the PREMO matrix will be determined via the following steps:

- Determining the spread of return on equity values in the matrix.

  The lowest value in the matrix would be set no lower than the prevailing benchmark cost of debt estimated by the Commission. The upper value would be set having regard to the extent of financial incentives the Commission wants to provide a water business for demonstrating a higher level of ambition, and the forecast impacts on business profits (or discretionary funds) and customer prices.

- Determining the steps between each category within the spread.

  The steps would be set having regard to the number of PREMO rating categories in each price review, and the extent of financial incentives the Commission wants to provide water businesses for demonstrating a higher level of ambition.

  The steps could be evenly separated or get bigger or smaller as the level of ambition increases. Bigger steps would provide greater incentives for businesses to increase the level of ambition in their price submissions.

- Determining an adjustment rule for what happens when the Commission rates a water business's price submission to be of lower ambition than the business proposed.

  The values would be determined having regard to the extent of financial incentives the Commission wants to provide water businesses to rate their price submissions accurately. For example, the values could get larger as familiarity with PREMO increases.

The return on equity allowed for a price submission rated as 'Standard' by a water business and the Commission would be close to long run estimates of the rate of return on investment (in assets with equivalent risk) expected by a private investor. The Commission would, however, take into account current market conditions before finalising the return on equity values in the PREMO matrix. This has been the Commission's practice in past price reviews when setting a benchmark WACC.

REGULATORY DEPRECIATION

Regulatory depreciation allows for the return of prudent capital expenditure over the asset life. Allowing for the cost of assets to be returned to the business is consistent with supporting financial viability. A water business's estimate for regulatory depreciation should reflect reasonable assumptions about asset life and utilisation.

Generally, businesses will adopt a straight line depreciation profile over the life of the asset. This approach has been allowed by the Commission in the past. Most economic regulators have used this approach when approving prices. However, businesses may propose alternative approaches where appropriate.

Regulatory depreciation must not be claimed for any asset until the asset is in service.

TAX ALLOWANCE

The Commission's approach estimates a cost of debt and return on equity on a post-tax basis, so revenue benchmarks (which are defined in pre-tax terms) must include an allowance for expected taxation liabilities. In principle, the taxation allowance should be an unbiased estimate of the cost of taxation for an efficient company calculated on a reasonable basis.

The Commission uses benchmark assumptions in the calculation of tax liabilities, which reflect the major features and implications of the taxation law, to give businesses incentives to employ efficient financing arrangements. This means that the taxation allowance can be reconciled with changes to factors influencing the taxation liability and can be replicated over time.

Australia has an integrated taxation system, so Australian resident shareholders can receive a credit for corporate taxation. This is paid at the company level when they determine their personal income taxation liabilities for dividend imputation. For competitive neutrality reasons, the Commission accounts for this benefit when making assumptions about the revenue required by the water businesses.

Only a small number of water businesses are in a tax paying position — for most regional and rural water businesses, the tax allowance will be zero.

3.7 DEMAND FORECAST

In order to calculate the proposed prices that recover the revenue needed to deliver regulated services, businesses need to forecast demand for the regulatory period and provide indicative forecasts for future demand.

Demand forecasts are also a key determinant of capital and operating expenditure — as they drive the level of new connections and the need to augment existing systems. The demand forecasts influence the extent to which a water business's proposed prices are sufficient to recover the revenue required over the regulatory period.

The demand forecasts are particularly important for water businesses that tend to experience high annual and/or seasonal variation in water use. They are also important for those that have relatively rapid growth in customer numbers or that have a relatively large proportion of revenue that is generated from volumetric charges.

Different factors can influence demand. These factors are likely to include:

- the number of new dwellings constructed
- rainfall, which primarily influences outdoor use
- temperature (and hence evaporation)

- the nature of new dwellings, including garden size
- the number of persons per household
- the price of water and wastewater services, along with customer response to changes in prices and price structures (the price elasticity of demand)
- the existence of water-efficient appliances and water-saving devices (including water tanks)
- demand from large industrial and commercial customers, which is usually related to the economic conditions prevailing in the specific industries in which those customers operate
- economic growth more generally, which tends to drive small-business demand
- restrictions or other controls on water use
- system losses and leakage, and stormwater infiltration into the sewage system
- government policy objectives for demand management
- public education and attitudes towards water conservation.

In assessing price submissions, the Commission expects that the demand forecasts are reasonable and based on sound information. In preparing demand forecasts, the Commission expects water businesses to:

- analyse historical levels of demand and identify relevant trends and the principal factors that determine the trend and have well developed demand models based on past consumption and behaviours
- consult with major service users about their anticipated requirements over the regulatory period — large industrial, commercial or irrigation customers, for example
- consult with councils, regional planning bodies and land developers about anticipated housing and other growth and adopt population and household forecasts in line with the Victoria in the Future projection **(**official state government projection of population and households) published by the Department of Environment, Land, Water and Planning (DELWP)
- consider the likely impact of any proposed changes in tariffs, tariff structures and other demand management initiatives

- have regard to any regional and industry-specific economic conditions
- reflect water conservation initiatives such as per capita use targets, existing or likely restrictions, water conservation and education campaigns, the use of water efficient appliances and potable substitution from water recycling.

Water businesses will also need to consider how their demand estimates are integrated with their choice of pricing control — different forms of price control increase or decrease the risk associated with forecasting errors.

The Commission's position paper proposed a new autonomous demand model that could apply to water business.[16] The Commission will not mandate use of this model. Businesses may propose to implement this model if they choose, and take this into account for their PREMO 'Risk' element rating.

3.8 FORM OF PRICE CONTROL

The form of price control specifies the approach that water businesses take to translate their revenue requirement into customer prices which the Commission approves through its pricing determinations. The form of price control can include processes for approving individual prices, pricing principles and explicit price controls, such as a price cap, revenue cap or hybrid approach.

The form of price control is an important tool for ensuring water businesses achieve sustainable revenue streams over the regulatory period. The Commission requires water businesses to clearly indicate their proposed form of price control for each service, accompanied by an explanation of how the proposed form of price control meets the WIRO requirements.

Where a business proposes any change to the form of price control, it must demonstrate that this has been undertaken in consultation with customers, and takes into account issues associated with:

- risk management

[16] Essential Services Commission 2016, op. cit., Appendix B.

- price stability
- transition arrangements
- customer choice.

When making a price determination, the WIRO requires the Commission to have regard to the following pricing principles:

- customers can easily understand the prices charged or the manner in which the prices are calculated, determined or otherwise regulated
- prices provide customers with appropriate signals about efficient costs while avoiding price shocks where possible
- prices take into account customers' interests, including low income and vulnerable customers.

The following are the different forms of price control that may be adopted by Victorian water businesses:

- *Individual price caps* — Prices are approved by the regulator at the start of the regulatory period and escalated annually by applying the CPI-X formula to each price component. Prices are not rebalanced within the regulatory period. This is the most commonly used form of price control for Victorian water businesses.
- *Revenue cap* — The maximum revenue businesses can earn is set at the start of a regulatory period. Prices are adjusted during the regulatory period to reflect fluctuations in demand, such that demand risk is borne by customers instead of the business.
- *Weighted average price cap (or price basket)* — A weighted average price cap is applied to a basket of services. The prices businesses submit each year must conform to a predetermined price path escalated by the consumer price index less a productivity factor (CPI-X). The weights are usually derived from the actual quantities of the service sold.
- *Weighted average revenue (or revenue yield)* — The average revenue per unit of service earned by the business is capped in any period. The average is calculated by dividing total revenue by total output. This requires a standard unit of output, such as megalitres.
- *Any combination of the above* — Businesses can use a hybrid approach.

In applying the WIRO principles above, under PREMO, the Commission will take into account how a business's proposed form of price control:

- allocates demand and supply risks to the party best able to control or manage the risk, and
- incentivises the party to reduce the risk or manage it effectively.

3.9 PRICES AND TARIFF STRUCTURES

The Commission has typically given businesses a large degree of discretion to decide on tariff structures. This recognises that businesses are often best placed to consider the interests of their customers in designing tariffs and that existing tariff structures have been developed over time to deal with a variety of local circumstances. The Commission intends to continue this approach.

In its guidance, the Commission will require businesses to specify the prices and tariffs they propose to apply over the regulatory period at a level that reflect the businesses' revenue requirements and customers' preferences. The price submission should focus on justifying any proposed changes to prices and tariffs, with reference to appropriate customer engagement and support. The price submission must also explain how the business has considered the allocation of risks between itself and customers through the form of price control, and its consideration of which party is best placed to manage the different types of risk.

The WIRO specifies the following services as being prescribed services for which the Commission has the power to regulate prices:

- retail water services — the supply of water by a water business to a retail customer
- retail sewerage services — the removal, treatment and disposal of sewage and trade waste by a metropolitan retailer or a regional water authority
- retail recycled water services — the supply of recycled water by a water business to a retail customer
- storage operator and bulk water services — the supply of bulk water from one water business to another

- bulk sewerage services — the conveyance, treatment and disposal of wastewater by Melbourne Water for another water business
- bulk recycled services — the supply of recycled water by Melbourne Water
- metropolitan waterways and drainage services — the supply of waterways and drainage services by Melbourne Water
- irrigation drainage services — the removal and disposal of run-off of irrigation by a rural water authority
- connection services — the connection of a serviced property to a water supply or sewerage system
- services to which developer charges apply — contributions to the cost of works for connections services
- diversion services — the management, extraction or use of groundwater or surface water by a water business.

The Commission's role of regulating prices does not extend to other services that water businesses may provide, such as plumbing services, waste management services and the sale of gardening products and water tanks.

Table 3.2 outlines the tariff principles water businesses should have regard to when developing their tariff structures. These principles also reflect PREMO elements, particularly the assessment of risk allocation and the extent of customer engagement on, and their understanding of, tariffs. The Commission's assessment of proposed tariff structures against the tariff principles will provide input into the overall PREMO rating assessment.

TABLE 3.2 TARIFF PRINCIPLES

Sustainable revenue	Tariff structures, levels and the form of price control should ensure an economically sustainable revenue stream over the regulatory period.
Subsidy free pricing and inefficient bypass	For each tariff class, the revenue expected to be recovered should lie on or between an upper bound representing the stand alone cost of serving the customers in that class and a lower bound representing the avoidable cost of not serving those customers.
Tariff structures	Tariff structures should be simple, understandable and cost reflective. *Bulk Water Charges Structure* — A two part charge comprising a fixed charge and a volumetric component to recover a bulk supplier's revenue requirement from its customers for each bulk water service. *Retail Water Tariffs Structure* — A two part tariff comprising a fixed charge and a volumetric component to recover a water business's revenue requirement from each tariff class. *Sewerage Charges* — The tariff structure should reflect the cost structure - and may comprise a one or two part tariff (all fixed, all volumetric or a fixed charge and a volumetric component). *Trade Waste* — Trade waste charges should be load-based where measurement is feasible and where the benefits outweigh the costs.
Determining fixed charges	Fixed charges should be calculated to recover the difference between the total revenue requirement for a tariff class and the revenue recovered through volumetric charges.
Determining volumetric charges	The volumetric charge should have regard to the long run or short run marginal costs, where appropriate.
Customer focus and equity	Retail tariff and service offerings, and the form of price control, should have regard to the ability of customers to understand the tariff and service offering and respond to price signals, customer preferences and needs in relation to service standards or new services, the costs of implementing the tariff offering, including administration and marketing costs and price path stability.
Locational and postage stamp pricing	Postage stamp pricing comprises retail tariffs that do not reflect any differences in costs of distribution systems by time or location. Postage stamp pricing should be applied when water supply is predominantly interconnected and/or is more equitable and administratively simple. Locational pricing comprises tariffs that vary by location – reflecting the cost structure of water supply, transport and treatment across the business. Locational pricing should be applied when water supply is less integrated and where there are material differences in costs between water networks. The WIRO does not specify whether a business should use locational or postage stamp pricing. It is up to the business to make the case for which is most appropriate.

3.9.1 DEVELOPER CHARGES

Developer charges, also known as New Customer Contributions (NCCs), are a one-off, upfront charge that a water business may apply when a new connection is made to its water, sewerage or recycled water network. Generally, they are paid by developers who are subdividing land on the urban fringe or redeveloping sites within built up areas. They may also be charged by a water business when an existing property owner decides to connect to a service for the first time.

Water businesses must establish their NCCs in accordance with the approach and principles established by the Commission. The Commission introduced a principles-based NCC charging framework on 1 July 2013. The NCC framework aims to:

- send signals to developers about the costs of developing in different locations
- share the costs and benefits of growth between new and existing customers
- administer NCCs in a transparent way.

The current NCC approach and principles are available on the Commission's website,[17] and may be amended from time to time through appropriate consultation processes.

A tool for estimating NCCs is also provided, with guidance on how to use it.

The NCC framework remains unchanged.

3.9.2 PRICING PRINCIPLES FOR NON-SCHEDULED CHARGES

There are some regulated services provided by water businesses that by their nature are not amenable to having a scheduled uniform charge. In these circumstances the Commission has established pricing principles that apply when establishing or negotiating a price for these services. These services and principles are set out below.

[17] At the time of publishing this Framework, the appropriate NCC guidance is:

Essential Services Commission 2013, *New Customer Contributions: Explanatory Note*, December.

RECYCLED WATER PRICING PRINCIPLES

Recycled water prices should be set so as to:

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

Where a water business does not propose to fully recover the costs associated with recycled water, it must demonstrate to the Commission that:

- it has assessed the costs and benefits of pursuing the recycled water project
- it has clearly identified the basis on which any revenue shortfall is to be recovered, and
- if the revenue shortfall is to be recovered from non-recycled water customers, either the project is required under the Statement of Obligations which applies to the water business or pursuant to other Government policies that apply to the water business, or there has been consultation with the affected customers about their willingness to pay for the benefits of increased recycling.

PRICING PRINCIPLES FOR UNIQUE SERVICES (INCLUDING TRADE WASTE)

Where the nature of the service provided to a particular customer or customer group (including, in the case of trade waste customers, the volume or load of waste treated) is unique, prices must be set as follows:

- variable prices (including, in the case of trade waste customers, load based charges) should reflect the long run marginal cost (LRMC) of providing services (including, in the case of trade waste customers, trade waste transfer, treatment and disposal)
- the total revenue received from each customer should be greater than the cost that would be avoided from ceasing to serve that customer, and (subject to meeting avoidable cost) less than the stand alone cost of providing the service to the customer in the most efficient manner

- the methodology used to allocate common and fixed costs to that customer should be clearly articulated and be consistent with any guidance provided by the Commission
- prices should reflect reasonable assumptions regarding the customer's demand for services (including, in the case of trade waste customers, the volume and strength of trade waste anticipated to be produced by that customer)
- depreciation rates and rates of return used to determine prices should be consistent with those adopted by the Commission for the purposes of making a price determination
- customers should be provided with full details of the manner in which prices have been calculated and any new, renewed or renegotiated contractual agreements with customers should indicate that the prices to apply are subject to any determination made by the Commission
- where applying these principles results in significant changes to prices or tariff structures, arrangements for phasing in the changes may be considered and any transitional arrangements should be clearly articulated.

PRICING PRINCIPLES FOR MISCELLANEOUS SERVICES

Prices for miscellaneous services must be set according to actual cost calculated on the basis of the aggregate of:

- direct third party or contractor invoice cost
- direct marginal internal costs, including labour, materials and transport costs, and
- a fair contribution to overheads.

For bank dishonour, debt collection and legal fees, the third party costs must be charged directly to the customer with no contribution for internal costs or a contribution to overheads.

3.10 DEALING WITH UNCERTAINTY

An important issue associated with setting prices is how businesses propose to deal with uncertain or unforeseen events that may have significant implications for the revenue required over the regulatory pricing period.

Typically, once a price determination is made by the Commission, the price path for the pricing period does not diverge from the determination. The business effectively manages any differences between actual and forecast costs and demand during the regulatory period. This provides incentives for the business to ensure forecasts are accurate and well founded.

However, during the regulatory period, a business may face a significant increase or decrease in costs or demand over which it has little or no control, particularly with regard to changes in regulatory obligations. This may have implications for the financial viability of the business.

The framework provides a number of options to deal with uncertainty in a regulatory period, including:

- annual updating of financial parameters, such as inflation and the cost of debt
- reflecting approved cost pass-through events (such as tax changes)
- accommodating significant changes in circumstances
- reflecting substantial deviations in performance relative to the approved outcomes and targets.

Each mechanism will affect prices, customers and businesses differently and it is important to recognise these effects when deciding the most appropriate option. It is also important to consider how prices, customers and businesses will be affected if there are no adjustments made to reflect uncertainty.

How a business proposes to address uncertainty will be a consideration in the PREMO assessment, in particular the 'Risk' element.

3.10.1 ANNUAL PRICE ADJUSTMENTS

The Commission releases annual pricing decisions setting out water businesses' prices for the next year, which reflect its final determinations for the regulatory period. While no adjustments are typically made to prices for general differences between forecast and actual regulatory parameters, prices are adjusted annually to account for:

- inflation
- updates to the cost of debt as part of the 'trailing average' approach to estimating the benchmark cost of debt
- any relevant cost pass-throughs, which reflect material differences between forecast and actual costs (including desalination security payments and the cost of any water ordered, and taxes, for example).

Annual adjustment mechanisms are established in the Commission's price determination for each water business.

3.10.2 UNCERTAIN AND UNFORESEEN EVENTS MECHANISM

The uncertain or unforeseen events mechanism allows businesses to apply for a price adjustment to account for events that were significant and uncertain or unforeseen at the time of the original determinations. Application of this mechanism involves:

- A water business promptly notifying the Commission upon becoming aware of an event which could form part or the entire basis of an application.
- A water business applying to the Commission for amendment of its determination and/or adjustment of the scheduled prices to reflect increased or decreased costs incurred, or increased or decreased revenue received, as a result of events which were uncertain or unforeseen at the time the determination was made.
- The Commission potentially taking action to adjust forecast revenues and prices in respect of an uncertain events application where the Commission is satisfied that such action:
  - is necessary or desirable to take account of events that were uncertain or unforeseen at the time of making the determination, and
  - takes into account the interests of customers.

Price adjustments can occur during or at the end of the regulatory period, and be initiated by a business or by the Commission. The Commission will approve price adjustments when it is satisfied that:

- the event is clearly outside of the control of the business and not predictable with any confidence
- customers are not unduly exposed to risk or price fluctuations
- the impact of the event is material, clearly observable and verifiable
- the net impact on costs or revenue of all changes that have occurred during the period under consideration is significant
- the business has done everything within their control to mitigate against the circumstances in which they find themselves.

Water businesses should consider this mechanism for major capital projects that are not fully scoped, costed or internally approved (an approved business case, for example) at the time of submitting a price submission. For these projects, the Commission considers it reasonable to include revenue to cover the costs associated with project development and design works, but not the full construction costs for an undefined or unapproved project. In some circumstances, it may be appropriate for a water business to seek to recover a notional amount to partially cover anticipated construction costs that will be incurred during the period, with the balance to be rolled into the RAB at the end of the period.

3.10.3 PERFORMANCE-RELATED CORRECTIONS

A water business's rate of return on equity is set according to the PREMO rating assigned to the business's price submission, with more ambitious proposals able to earn a higher equity return. The rate of return therefore reflects the value to be received by customers.

Ordinarily, outperformance or underperformance against the business's specified outcomes will be taken into account at the end of the period and feed into the 'Performance' PREMO element rating for the next period.

However, the Commission envisages two scenarios where the PREMO rating and the corresponding return on equity might be adjusted during a regulatory period, leading to a price adjustment.

Where a business's performance is not delivering the outcomes proposed, and customers are receiving lower value than their prices intended, the Commission expects the business would address this with customers, by lowering prices so they are consistent with the actual performance delivery, for example. However, in situations where the Commission considers the business has not adequately addressed this itself, the Commission may decide to correct this anomaly by assigning a lower PREMO rating more fitting of the business's actual performance, with a corresponding reduction in the return on equity for the remainder of the pricing period. This would in turn flow through to a reduction in prices, protecting customers from further over-collection of revenue.

If during its price submission assessment the Commission downgrades a business's PREMO rating, the Commission may elect to include specific conditions or performance criteria in the pricing determination that, if met, would allow the business to apply to have its original PREMO rating restored. This would likely involve the business demonstrating efficiency improvements or better service. A successful application to the Commission may result in an increase in revenue requirement corresponding to the higher equity return rate, which would in turn be reflected in prices.

3.11 FINANCIAL VIABILITY

The WIRO requires the Commission to have regard to the financial viability of the water industry. The revenue requirement should enable an efficient water business to pay its bills as they fall due, and undertake its forecast capital program in order to deliver services.

It is possible that the revenue requirement estimated via a building block methodology may not provide a business with sufficient cash flow to remain viable in the short-term.

This may reflect a number of factors, such as the use of benchmark finance costs to establish prices, or significant increases in capital expenditure.[18]

A financial viability test allows the Commission to make a 'safety net' adjustment to prices if the regulatory pricing model results in prices that would leave a water business financially unviable. In other words, the financial viability test acts as a filter to identify any potential financial viability issues before the Commission approves maximum prices.

To this end, the Commission's financial model, which water businesses populate to estimate their revenue requirement and proposed prices, includes calculations and indicators to allow the Commission to assess a water business's financial position.[19] The indicators and ranges are informed by those used by private sector credit ratings agencies. The indicators and ranges used by the rating agencies provide a useful reference point due to their wide currency, and reflect accumulated experience on measures of financial viability.

The four indicators and the associated benchmark ranges used in the Commission's financial viability test (and replicated in the financial model) are set out at table 3.3 below. The financial viability test gives priority to forecast outcomes for interest cover, as the Commission considers this provides the best indicator of a business's ability to pay its bills as they fall due, and undertake its forecast capital program in order to deliver services.

Note that the benchmark range for each indicator in table 3.3 is only intended to inform the Commission's financial viability test for the purpose of establishing maximum prices — these do not represent ranges that it expects each water business to achieve. Financial performance and measurement are matters for the management and Board of each water business.

Water businesses must also provide the Commission with findings of any credit ratings provided to them by independent credit ratings agencies.

[18] For further details see: NERA Economic Consulting 2013, *Assessing the Financeability of Regulated Water Service Providers – A report for the Essential Services Commission*, October, p. 4–5.

[19] The indicators used by the Commission are discussed in: Essential Services Commission 2014, *Assessing the financial viability of Victorian water businesses: Summary of views and proposed new indicator*, June.

TABLE 3.3 FINANCIAL INDICATORS

Indicator	Calculation	Benchmark Range	Description
Primary indicator – used to determine size of adjustments			
FFO interest cover	(FFO + net interest) / net interest	> 1.5 times < 1.8 times used as a caution	Measures the extent of the cash flow buffer a business has to meet its debt obligations.
Secondary indicators – used only as contextual information to determine whether an adjustment is necessary			
Net Debt / Regulatory Asset Value (%) (Gearing)	(Interest bearing liabilities – cash) / RAV	< 70 per cent	Measures the debt component of the regulatory capital structure.
FFO / Net debt (%)	FFO / (Interest bearing liabilities – cash)	> 10 per cent	Measures the extent to which the serviceability of debt is improving, remaining stable, or declining.
Internal financing ratio (%)	(FFO – dividends) / net capital expenditure	> 35 per cent	Measures the extent to which an entity has cash remaining to finance a prudent portion of capital expenditure after making dividends.

Notes:

FFO refers to ‘funds from operations’ and RAV refers to the ‘regulatory asset value’.

Regarding FFO interest cover, the Commission believes the 1.8 times benchmark signals a need for caution from businesses and closer observation by the Commission in its price reviews and performance reporting. But until a business breaches or is forecast to breach the benchmark of 1.5 times, it is unlikely the Commission would make a viability adjustment.

3.12 LENGTH OF REGULATORY PERIOD

The WIRO requires the Commission to set the term of the regulatory period that a pricing determination will apply. A standard regulatory period of five years will be applied, unless:

- the water business applies for and provides sufficient justification for a longer or shorter term
- the Commission considers a different term is more appropriate; for example, if the Commission is not satisfied that the water business’s submission delivers sufficiently strong outcomes.

4 FLEXIBLE ASSESSMENTS

Price submissions received by the Commission will be assessed in accordance with the Water Industry Regulatory Order (WIRO) and the guidance issued by the Commission (section 5.1). This will include evaluating the outcomes set out in the submission, along with the supporting discussion, measurable outputs proposed and the various inputs, including costs. The Commission will form its view on the appropriate PREMO rating to apply to the whole submission, and compare this with the business's self-rating in order to establish the final return on equity to be applied (as described in chapter 2).

The assessment process will effectively recognise water businesses that have robust management processes, with prices and service levels reflecting customer expectations. High quality price submissions are those that include significant, transparent and credible evidence to demonstrate prudent and efficient expenditure to deliver service outcomes for customers — these submissions may benefit from a streamlined assessment process. This allows the Commission to then focus on investigating price submissions it considers to be lower quality and lacking in significant, transparent and credible evidentiary support. The more rigorous scrutiny this affords for a smaller number of businesses should help to ensure efficient pricing and service outcomes for all Victorian water customers, regardless of the quality of their water business's price submission.

Accordingly, the Commission will deliver a flexible price review process by:

- tailoring the scope of its assessment to the quality of each price submission, which may include resubmission when businesses provide insufficient information
- fast tracking high quality price submissions through the assessment process to an early draft and final decision
- providing financial and reputational incentives linked to the ambition of a price submission through its overall PREMO rating.

The opportunity for a price submission to be fast tracked through the assessment process is not directly linked to its PREMO rating, rather to the quality and clarity of the submission and its proposals, and the supporting information. The Commission does not intend to provide a check-list set of criteria for a business to *qualify* for fast tracking. Instead, it considers that a price submission can be fast tracked to an early draft decision if it is satisfied with the proposals in the price submission, and considers that no further enquiry is required because of the significant, transparent and credible evidence put forward in the submission. In this regard, it is up to each water business to prepare a clear, accurate, consistent and easily understood price submission.

4.1 THE PRICE REVIEW PROCESS

The Commission will assess price submissions using a three-stage review process:

- Stage 1 — Price submission evaluation to verify the quality and strength of the submission and the proposed outcomes, and to establish what further verification work, if any, is needed to inform the Commission's draft decision. If further review is not necessary, the Commission can make its draft decision to accept the submission's proposed prices, or with relatively minor changes, effectively bypassing stage 2.
- Stage 2 — Further verification work, which may range from simple requests for further information through to a full review of cost forecasts by an expert consultant. The Commission will make its draft decision for these businesses when it has completed the additional review. In extreme cases, the Commission may reject the price submission if it considers it is unable to reach a draft decision based on the information submitted.
- Stage 3 — Public consultation on the Commission's draft decision, leading to its final decision and a price determination for each business. Final price decisions for fast-tracked businesses could be made earlier than for the businesses requiring further verification work.

To facilitate a quick and simple stage 1 assessment and the possibility of fast tracking, a price submission must clearly convey its key messages and data to the Commission.

The guidance issued by the Commission will inform businesses on what to include in their price submissions, consistent with this rapid assessment.

The Commission's financial modelling template will also be structured consistent with this assessment approach, and businesses must complete the template as required to be eligible for fast tracking.

4.2 RESPONDING TO A DRAFT DECISION

The WIRO requires the Commission to release a draft decision prior to issuing a price determination that specifies the maximum prices to apply in a pricing period. The WIRO also requires the Commission to set out the reasons for making its draft decision, and to consider feedback prior to issuing a price determination. In this way, the draft decision provides a means for water businesses and other interested parties to contest the Commission's reasoning or draft decisions, prior to a final decision and price determination.

The draft decision will include the Commission's reasoning for any adjustments it may recommend to the water business's original price submission, including the business's self-assessment of its PREMO rating. If the Commission proposes a lower PREMO rating than that proposed by the business, the business:

- **may** seek to clarify and justify its original rating by putting on additional evidence in support of that rating or by seeking to demonstrate that the Commission's draft decision was in error, and
- **may not** seek to improve its rating with an alternate proposal, or seek to revise its submission with a lower rating to match the Commission's rating assessment.

The Commission has adopted these limited grounds because the PREMO framework requires a business to put its best offer forward in its price submission, which provides an appropriate incentive for it to maximise the value of outcomes that it proposes to deliver to Victorian water consumers. However, as described in section 3.10.3, the draft decision will provide an opportunity for the business to propose specific criteria such that it might apply to have its original PREMO rating restored during the period.

5 LEGAL FRAMEWORK

5.1 GUIDANCE PAPER

For previous water price reviews, the Commission issued guidance on its own accord to the water businesses well in advance of price reviews, to provide certainty about how the review would be conducted, and what the Commission expected to see in the pricing submissions. The 2014 Water Industry Regulatory Order (WIRO) formalises the requirement for the Commission to provide guidance, following consultation, including with the regulated water businesses, and specifies the matters the guidance must set out. The Commission may develop common guidance across all or some regulated entities, as well as specific guidance tailored to a particular regulated entity's circumstances.

Clause 13 of the WIRO sets out the specific matters to be covered in the guidance, including, among other things:

- the manner in which the Commission proposes to regulate prices
- the approach and methodology the Commission proposes to adopt to assess a price submission and make a price determination
- the nature and scope of matters to be addressed in a price submission
- the Commission's expectations regarding customer consultation and information to be provided by the water business, and
- the timing and processes the Commission proposes to follow during the price review and key dates.

Clause 11(c) of the WIRO also states that when making a price determination, the Commission must have regard to the matters specified in its guidance. Further, clause 14(b) states that the Commission may specify prices if it considers a water business's price submission does not comply with the guidance.

5.2 OBJECTIVES OF PRICE REGULATION

The 2014 WIRO removed the previous requirement for the Commission to be satisfied that proposed prices complied with a long list of often competing 'regulatory principles'. This significantly simplifies the objectives for the Commission's regulation of the Victorian water industry, and provides a clearer link to the objectives in the *Essential Services Commission Act 2001 (Vic.)* (ESC Act) and the *Water Industry Act 1994 (Vic.)* (WI Act), which together create the regulatory pricing framework.

Clause 8 of the WIRO simply states that the objectives of regulation of the water industry are those set out in:

- section 8 of the ESC Act, and
- section 4C of the WI Act.

In addition, clause 8 of the WIRO requires the Commission to:

- have regard to the matters in section 8A of the ESC Act, and
- have regard to and place particular emphasis on:
  - the promotion of efficient use of prescribed services by customers
  - the promotion of efficiency in regulated entities as well as efficiency in, and the financial viability of, the regulated water industry, and
  - the provision to regulated entities of incentives to pursue efficiency improvements.

When making a price determination, the Commission is required by clause 11 of the WIRO to have regard to a list of matters including:

- the objectives specified in clause 8 of the WIRO
- the matters specified in the Commission's guidance
- the principle that prices should be easily understood by customers and provide signals about the efficient costs of providing services, and
- the principle that prices should take into account the interests of customers of the regulated entity, including low income and vulnerable customers.

Table 5.1 lists the specific objectives and the various matters the Commission must have regard to when making a price determination.

TABLE 5.1 MATTERS THAT WATER BUSINESSES AND THE COMMISSION MUST HAVE REGARD TO

Economic efficiency and viability matters	Industry/business specific matters	Customer matters
• promotion of efficient use of prescribed services by customers [cl 8(b)(i), WIRO] • 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] • provision to regulated entities of incentives to pursue efficiency improvements [cl 8(b)(iii), WIRO] • efficiency in the industry and incentives for long term investment [s 8A(1)(a), ESC Act] • 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] • financial viability of the industry [s 8A(b), ESC Act]	• 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] • return on assets in the regulated industry [s 33(3)(c), ESC Act] • 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]	• 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] • 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] • 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] • take into account the interests of customers of the regulated entity, including low income and vulnerable customers [cl 11(d)(iii), WIRO]

TABLE 5.1 MATTERS THAT WATER BUSINESSES AND THE COMMISSION MUST HAVE REGARD TO (CONT)

Benchmarking	Health, safety and social obligations	Other
• any relevant interstate and international benchmarks for prices, costs and return on assets in comparable industries [s 33(3)(d), ESC Act]	• the relevant health, safety, environmental and social legislation applying to the industry [s 8A(1)(d), ESC Act] • 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]	• the degree of, and scope for, competition within the industry, including countervailing market power and information asymmetries [s 8A(1)(c), ESC Act] • consistency in regulation between States and on a national basis [s 8A(1)(f), ESC Act] • 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) and (ii) regulated entities [s 8A(1)(e), ESC Act] • wherever possible, to ensure that the costs of regulation do not exceed the benefits [s 4C(a), WI Act]

5.3 PRICE REVIEW PROCESS

The WIRO requires that the Commission's guidance set out the timing and processes the Commission proposes to follow in making a price determination. The key steps in the process required under the WIRO are set out in figure 5.1 below.

FIGURE 5.1 KEY STEPS IN THE REGULATORY PROCESS

When making a price determination, clause 14 of the WIRO allows the Commission to approve the maximum prices (or the manner in which maximum prices are to be determined) as proposed by the water business, or to specify the maximum prices. The Commission may only specify prices if:

- the price submission does not, in the Commission's opinion, comply with the Commission's guidance or have adequate regard for the matters specified in clause 11 of the WIRO (as set out in table 5.1), or
- a water business fails to submit its price submission to the Commission within the specified time period.

5.4 APPEALS MECHANISM

RIGHTS OF APPEAL

A person who is affected by a decision of the Commission has a right of appeal under the ESC Act.[20] An appeal against a determination can only be made on the grounds that:

- there has been bias, or
- the determination is based wholly or partly on an error of fact in a material respect.

In making an appeal, a person must lodge an application with the registrar within 21 working days after the Commission's decision has been published.

The appeal rights under the ESC Act do not apply when the Commission is exercising its functions under the Commonwealth Water Charge (Infrastructure) Rules (WCIR).[21]

APPEAL PANEL

An appeal panel must be formed within 7 working days after notice of the appeal is lodged. The appeal is then heard and decided within 30 working days of the appeal panel being constituted, or within a further period of not more than 15 working days if the appeal panel requires more time.

The Department of Treasury and Finance is responsible for convening an Appeal Panel.

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[20] ESC Act, s55(1)(c).

[21] ESC Act, s10A.

APPENDIX A — FRAMEWORK CHANGE SUMMARY

Table A.1 identifies the main elements of the water pricing framework and approach, and shows where elements have stayed the same or changed. The following colour scheme applies:

Changed from the past approach

Unchanged from the past approach

TABLE A.1 SUMMARY OF CHANGES TO THE PRICING FRAMEWORK

Element	**Approach**
Customer engagement	The pricing framework and approach places a stronger emphasis on the role of customer engagement to inform and influence the price submissions of water businesses. Five principles will form the basis of the Commission's assessment of a water business's customer engagement: 1. The form of customer engagement undertaken by a water business should be tailored to suit the content on which it is seeking to engage, and to the circumstances facing the water business and its customers. 2. A water business must provide customers with appropriate instruction and information, given the purpose, form and the content of the customer engagement. 3. A water business's customer engagement should give priority to matters that have a significant influence on the services provided and prices charged by the business. 4. A water business should start customer engagement early in its planning. The engagement should be ongoing, to keep testing proposals with customers. 5. A water business should demonstrate in its price submission how it has taken into account the views of its customers.

TABLE A.1 SUMMARY OF CHANGES TO THE PRICING FRAMEWORK (CONT.)

Element	Approach
Outcomes	A set of outcomes focused on what the water business will deliver to its customers will effectively replace the previous core 'service standards' encapsulated in the Commission's Customer Service Code. A price submission should clearly present: • A set of customer outcomes that reflect the value customers will receive during the pricing period, demonstrating how each has been derived and how it relates to the business's customer engagement processes. • The measurable outputs and deliverables and associated targets that will demonstrate achievement of each outcome. • The actions or programs that the business will undertake to meet the agreed targets. • The costs and cost savings associated with each of these. • How these costs are reflected in tariff structures and prices charged to customers.
Guaranteed service level schemes	A GSL scheme provides incentives for water businesses to make efficient investment decisions, or internalise the costs of making investment decisions that leave some customers with poor service outcomes. It also provides a form of recognition that an individual customer has received relatively poor levels of service. GSL payments or rebates reduce revenue for businesses, so can drive business activities that minimise the number of GSL payment events. The revenue at risk under GSLs will be an input to the assessment of the 'Risk' element of PREMO.
Recovering costs for policy and regulatory obligations	The pricing framework and approach will continue to allow water businesses to recover efficient costs for the delivery of policy or regulatory obligations. Policy and regulatory obligations will generally be specified in a Statement of Obligations, or in separate instruments administered by the Environment Protection Authority (Victoria) and the Department of Health and Human Services.
Calculating the revenue requirement	A water business's revenue requirement will continue to be derived using the building block methodology. The revenue requirement will reflect the forecast revenue required to recover efficient cost of delivering on its policy and regulator obligations, and validated service outcomes. The main change relates to the calculation of the return reflected in maximum prices. The return on regulated equity will vary according to the level of ambition shown in a price submission. Ambition will be assessed against five elements: Performance, Risk, Engagement, Management and Outcomes (PREMO). Under the new pricing framework and approach, a benchmark cost of debt will be calculated based on a 10-year trailing average.
Operating expenditure	A forecast of prudent and efficient operating expenditure will be reflected dollar for dollar in the revenue requirement.
Capital expenditure and regulatory asset base (RAB)	Each water business's RAB represents the value of past capital expenditure. The starting RABs were established by the Minister for Water in 2004. The RAB for each water business will continue to be updated to allow for actual prudent and efficient capital expenditure, less regulatory depreciation, capital contributions and asset disposals, and adjusted for inflation (measured by the Consumer Price Index, All-Groups – Australia and published by the Australian Bureau of Statistics) to retain the time value of money. The revenue requirement for each water business reflects a return on investment (via the return on equity) and a return of investment (via regulatory depreciation) that is calculated from the RAB. For the purposes of estimating a water business's revenue allowance and the regulatory discount rate, the debt to equity ratio will remain the same as that used previously, that is a benchmark assumption that capital invested is 60 per cent debt funded and 40 per cent equity funded. The cost of debt and return on equity will be calculated on a real, post-tax basis.

TABLE A.1 SUMMARY OF CHANGES TO THE PRICING FRAMEWORK (CONT.)

Element	Approach
Cost of debt	Previously, the cost of debt has been established using an on-the-day approach, which assumes a business's entire debt portfolio is refinanced within a 20 to 40 day period close to the time the Commission makes a price determination. Under the new pricing framework and approach, a benchmark cost of debt will be calculated based on a 10-year trailing average. This approach generally better reflects the debt management practices of the water businesses. Prices will be adjusted annually as part of the annual tariff approval process to reflect changes in the 10-year trailing average cost of debt.
Return on equity	The new pricing framework and approach departs from the capital asset pricing model which has applied in Victoria's water sector since the commencement of economic regulation. In future, a water business's return on regulated equity will be linked to the tangible outcomes it delivers to customers. This will be achieved by allowing the return on equity to vary according to the level of ambition shown in a price submission. Ambition will be assessed against five elements: Performance, Risk, Engagement, Management and Outcomes (PREMO).
Regulatory depreciation	Regulatory depreciation allows for the return of prudent capital expenditure over the asset life. Allowing for the cost of assets to be returned to the business is consistent with supporting financial viability. A water business's estimate for regulatory depreciation should reflect reasonable assumptions about asset life and utilisation.
Tax	The Commission's approach will estimate a cost of debt and return on equity on a post-tax basis, so revenue benchmarks (which are defined in pre-tax terms) must include an allowance for expected taxation liabilities. The Commission uses benchmark assumptions in the calculation of tax liabilities.
Efficiency incentives	Expenditure forecasts are used to establish benchmark efficient cost assumptions for the purposes of establishing maximum prices. Businesses may strive to outperform these cost benchmarks to increase profits or discretionary funds. These may be returned to the shareholder in the form of a dividend, used to pay down debt, or reduce prices, for example. The new pricing approach includes new efficiency incentives. Via PREMO, the rate of return a water business can earn is linked to the level of ambition of its pricing proposal. The framework will reward businesses that: focus on delivering outcomes sought by their customers; appropriately allocate risk to the party best able to manage it; and deliver services as efficiently as possible.
Demand	Demand is a key determinant of prices. In order to calculate the proposed prices that recover the revenue requirement, businesses need to forecast demand for the pricing period.
Form of price control	The pricing framework and approach will continue to allow water business to consider a range of different forms of price control. This includes price caps, revenue caps, and tariff basket forms of control.
Tariffs	The Commission has typically given businesses a large degree of discretion to decide on tariff structures. This recognises that businesses are often best placed to consider the interests of their customers in designing tariffs and that existing tariff structures have been developed over time to deal with a variety of local circumstances. We will continue this approach. Pricing principles will continue to apply for some regulated services provided by water businesses that by their nature are not amenable to having a scheduled uniform charge. This includes recycled water and miscellaneous charges.

TABLE A.1 SUMMARY OF CHANGES TO THE PRICING FRAMEWORK (CONT.)

Element	Approach
Developer charges	Developer charges or New Customer Contributions (NCCs) are a one-off, upfront charge that a water business may apply when a new connection is made to its water, sewerage or recycled water network. Generally, they are paid by developers who are subdividing land on the urban fringe or redeveloping sites within built up areas. They may also be charged by a water business when an existing property owner decides to connect to a service for the first time. Water businesses must establish their NCCs in accordance with the approach and principles established by the Commission.
Dealing with uncertainty	The uncertain and unforeseen events mechanism will continue to provide a process for a water business or the Commission to reopen price determinations to account for events that were uncertain or unforeseen at the time of the price review. The annual tariff approval process will continue to provide for the pass through of inflation (measured by the Consumer Price Index, All-Groups – Australia and published by the Australian Bureau of Statistics) and to account for changes in costs such as those related to the desalination plant.
Financial viability test	A financial viability test allows the Commission to make a 'safety net' adjustment to prices if the regulatory pricing model results in prices that would leave a water business financially unviable. In other words, the financial viability test acts as a filter to identify any potential financial viability issues before the Commission approves maximum prices.
Length of regulatory period	A standard regulatory period of five years will be applied, unless the water business applies for and provides sufficient justification for a longer or shorter term, or the Commission considers a different term is more appropriate (for example, if the Commission is not satisfied that the water business's submission delivers sufficiently strong outcomes).
Reporting	The WIRO provides an explicit function for the Commission to monitor, audit and report publicly on the performance of the regulated water industry. The Commission will continue to monitor and report publicly on the performance of the Victorian water industry, through the annual regulatory audit and comparative performance report. The key change under the new framework is that water businesses will be accountable to their customers for delivering the outcomes set out in their price submissions. This will require a business to report annually to its customers on its performance against the specified outputs for each outcome, with an overall assessment of whether it has delivered on expectations for each outcome. This should also include appropriate explanation for any performance shortfalls and how the business intends addressing this in the coming year(s). The business's reporting should be readily available to its customers and the Commission, including on its website. This direct accountability to customers will strengthen the business-customer relationship.