

# 2026 Melbourne Water price review

Guidance paper

19 November 2024



## Acknowledgement

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

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

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

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# Summary

The 2026 water price review will set the maximum prices that Melbourne Water can charge for its water and sewerage services and for its waterways and drainage services from 1 July 2026. It is the second price review under our PREMO incentive framework for Melbourne Water.<sup>1</sup> Our guidance for Melbourne Water's review is similar to the guidance we used in our 2023 water price review of 14 Victorian government owned water businesses (which did not include Melbourne Water).<sup>2</sup> We have made modifications to the guidance to reflect Melbourne Water's role as a bulk water and sewerage service provider, and its waterways and drainage functions.

There are two notable differences for this second price review of Melbourne Water under the PREMO framework:

- We are introducing the backward-looking Performance element of PREMO, which holds Melbourne Water accountable for its proposals from the previous price review.
- Its price submission needs to demonstrate how Melbourne Water is building on its previous proposal to deliver great value to its customers.

PREMO incentives provide up-front rewards for ambitious proposals delivering better customer value. However, Melbourne Water is ultimately accountable for delivering on its commitments.

The Performance element of PREMO effectively closes the loop on the current regulatory period by addressing two key questions:

- Did Melbourne Water deliver on its promises?
- Did customers get what they paid for?

This also establishes a continuum from one regulatory period to the next as Melbourne Water seeks to maintain or improve customer value, and to address any shortfalls in performance going forward. Customers should expect no less.

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<sup>1</sup> We first introduced our new PREMO (Performance, Risk, Engagement, Management and Outcome) framework at our 2018 price review of 17 Victorian water businesses. Melbourne Water's 2021 price review was its first under PREMO.

<sup>2</sup> An independent review by farrierswier following the 2018 price review found that PREMO was successful in providing incentives for water businesses to deliver better outcomes for their customers. This reflected extensive engagement by water businesses, so price submissions were better informed by customer priorities. A subsequent review following the 2023 and 2024 price reviews, also by farrierswier, confirmed the PREMO framework was still delivering against its original objectives. The commission is still considering its response to the most recent farrierswier review, and we have not made adjustments to this guidance based on the outcomes of the review. Both reports are published on our website.

We expect Melbourne Water will engage with its customers across its range of services to understand their preferences for prices and service levels. Melbourne Water is required to use these engagement insights to inform the outcomes it proposes to deliver in its price submission.

Melbourne Water's price submission also needs to consider major challenges confronting the community. This includes the impact of climate change, heightened economic uncertainty, and customer vulnerability.

While we anticipate these events, and related matters, will be prominent in the price submission considerations, they do not materially affect the nature of our guidance. We still expect Melbourne Water to justify its forecasts, and show how it has sought to manage the risks of this uncertainty on behalf of its customers.

The price submission must also incorporate the efficient cost of meeting legislative and government policy obligations.

This guidance sets out how we will assess Melbourne Water's price submission. We will do so in line with the requirements of the Water Industry Regulatory Order 2014.<sup>3</sup>

If we can assess Melbourne Water's price submission in a shorter timeframe – subject to the clarity, quality and strength of its justifications and proposals – we may be able to release an earlier draft decision for Melbourne Water. Indicative assessment timelines are shown at Figure 2.2.

The PREMO framework affords greater autonomy for Melbourne Water if it demonstrates clear ownership of its proposals. Key to this is the requirement in our guidance that Melbourne Water's board attests to:

- the quality and accuracy of its price submission
- its commitment to the customer outcomes proposed.

**Ultimately, we expect Melbourne Water's price submission to reflect its 'best offer' to its customers (irrespective of the PREMO price submission rating).**

The price submission must be lodged with us by **Wednesday 1 October 2025**.

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<sup>3</sup> The WIRO 2014 is available at <http://www.gazette.vic.gov.au/gazette/Gazettes2014/GG2014G043.pdf#page=45>, pp. 2485–2491.

# 1. About this guidance

## 1.1. Our role

We will undertake a review of the maximum prices Melbourne Water can charge for its water and sewerage services and its waterways and drainage services for the regulatory period from 1 July 2026 (the **2026 price review**).

Our pricing powers and functions in Victoria's water industry are governed by the Water Industry Regulatory Order 2014 (**WIRO**),<sup>4</sup> which sits within the broader context of the *Water Industry Act 1994* (Vic) (**WI Act**) and the *Essential Services Commission Act 2001* (Vic) (**ESC Act**).

We must make a price determination which determines the maximum prices that Melbourne Water may charge for prescribed services, or the manner in which prices are to be calculated, determined or otherwise regulated, from 1 July 2026.<sup>5</sup>

Clause 14 of the WIRO (provided at **Appendix A**) requires us to assess a price submission prepared by Melbourne Water, and form an opinion on whether the price submission:

- complies with the guidance issued by the commission under clause 13 of the WIRO
- has adequate regard for the matters specified in clause 11 of the WIRO.

If we form a view that Melbourne Water's price submission complies with our guidance and has adequate regard for the relevant matters specified in the WIRO requirements, then we must approve the maximum prices Melbourne Water may charge for prescribed services as proposed in its price submission. If the price submission does not, in our opinion, comply with this guidance or have adequate regard for the relevant matters specified in the WIRO, we may specify maximum prices, or the manner in which prices are to be calculated, determined or otherwise regulated.<sup>6</sup>

## 1.2. About this paper

This paper is the guidance we are required to issue to Melbourne Water under clause 13 of the WIRO (provided at **Appendix B**). In compliance with clause 13 of the WIRO, the guidance sets out

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<sup>4</sup> The WIRO 2014 is available at <http://www.gazette.vic.gov.au/gazette/Gazettes2014/GG2014G043.pdf#page=45>, pp. 2485–2491.

<sup>5</sup> WIRO, clause 10(a). The prescribed services are listed at clause 7(b) of the WIRO. The primary types of prescribed services Melbourne Water provides are storage operator and bulk water services, bulk sewerage services, bulk recycled water services, metropolitan waterways and drainage services and diversion services.

<sup>6</sup> WIRO, clause 14.



our approach to Melbourne Water’s price review and information requirements for its price submission.<sup>7</sup>

Much of this guidance remains unchanged from the guidance we issued Melbourne Water for its 2021 price review. It is consistent with the guidance we issued to 14 Victorian water businesses for their 2023 water price review, which was published following extensive consultation with these water businesses and other key water sector stakeholders, including with Melbourne Water. We have consulted with Melbourne Water in developing specific modifications for this guidance, including considering its review of our proposed final draft and incorporating its feedback as appropriate. We also sought input from customers of Melbourne Water, including the regional urban water businesses and metropolitan retail water businesses connected to Melbourne Water’s network, as well as the consumer representative group Consumer Action Law Centre.

Where possible we have sought to minimise compliance costs for Melbourne Water.<sup>8</sup> In considering the information required to support its price submission, much of the information should be readily available and relevant for other purposes such as corporate planning or project justification and prioritisation.

This guidance recognises the nature of the different services provided by Melbourne Water. For example, our guidance requires Melbourne Water to present expenditure information for its bulk services separately to its waterways and drainage services. Expenditure in these service areas is subject to very different drivers. Major customers for bulk services are the metropolitan retail water businesses and regional urban water businesses. For waterways and drainage services, the main customers are residential and non-residential customers. Melbourne Water’s engagement will need to consider these differences.

Much of the supporting information detailed in this guidance can be provided by completing the financial model template (issued by us) that forms part of Melbourne Water’s price submission. We encourage Melbourne Water to keep its price submission as clear and succinct as possible. To this end, Melbourne Water need not include all the supporting information for the claims made in its submission. However, it must be able to provide any supporting information requested by us.

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<sup>7</sup> Clause 13 of the WIRO also requires us to provide guidance following consultation, including with the regulated entities. Over the course of 2024, we consulted with Melbourne Water and other key water sector stakeholders on the various elements of this guidance.

<sup>8</sup> Under section 4C (a) of the *Water Industry Act (Vic) 1994* we have an objective to ensure the costs of regulation do not exceed the benefits, wherever possible.

### 1.3. Water pricing framework and approach

We implemented our PREMO water pricing approach for the first time at the 2018 water price review, and for Melbourne Water at its 2021 price review. The PREMO incentive framework includes financial, reputational and procedural incentives to align the interests of Melbourne Water and the customers it serves.

PREMO stands for Performance, Risk, Engagement, Management, and Outcomes. Melbourne Water must demonstrate its level of ambition in delivering value-for-money for customers in its price submission across the five elements:

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

Key elements of the pricing approach are:

- an emphasis on the role of customer engagement to inform and influence the price submission
- linking the return on equity earned by Melbourne Water to the level of ambition in its price submission for Performance, Risk, Engagement, Management and Outcomes
- flexibility mechanisms to help ensure the pricing approach accounts for the diversity of Melbourne Water and its customers, and to allow for a streamlined price review process.

An independent review found PREMO was successful in contributing to better outcomes for Victorian water customers at the 2018 water price review, including through lower prices and better targeted services.<sup>9</sup> A subsequent review following the 2023 and 2024 price reviews, also by Farrierswier, confirmed the PREMO framework was still delivering against its original objectives.

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<sup>9</sup> Farrierswier 2019, Victoria’s water sector: The PREMO model for economic regulation, 28 March.

A key change for Melbourne Water's 2026 price submission is the introduction of the Performance element of PREMO, which involves a backward look at how well the business has performed relative to the commitments it made at its previous review. We will assess whether the commitments made by Melbourne Water have been delivered.

For our 2023 price review guidance and for this 2026 guidance, we have updated our price submission requirements to reflect current industry practices compared to the 2018 and 2021 water price reviews. We have revised the PREMO assessment tool accordingly, in some instances 'raising the bar' on our requirements for a 'Standard' rating and corresponding higher PREMO ratings. We have also introduced new requirements for Melbourne Water to demonstrate inclusive and effective engagement with First Nations people and with customers experiencing vulnerability, in its price submission.<sup>10</sup> For Melbourne Water we expect these engagement practices to be particularly effective in supporting the participation of relevant Traditional Owner groups.<sup>11</sup>

As we did for its 2021 price review, we have modified some elements of PREMO from the 2023 price review to reflect the specific nature of Melbourne Water and its services. The main changes relate to the PREMO matrix and the return on equity that may be reflected in prices, and some modification to the PREMO assessment tool to reflect the nature of services delivered by Melbourne Water.

We have also updated the return on equity values in the PREMO matrix (see Section 3.14), consistent with our 2023 guidance, informed by latest market observations and recent decisions by other regulators.

Other than these changes, our application of the PREMO incentive framework remains largely unchanged.

The high-level PREMO incentive framework is set out in a paper published by the commission in 2016.<sup>12</sup> Although informed by our framework and approach paper, where there are any inconsistencies, this guidance paper takes precedence for the purpose of informing the content of Melbourne Water's price submission.

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<sup>10</sup> This guidance progresses some actions of the commission's 'Getting to fair' strategy relating to the water industry. See Essential Services Commission 2021, Getting to fair: Breaking down barriers to essential services, 12 August.

<sup>11</sup> Traditional Owner groups hold rights and interests in relation to land and waterways and are therefore important stakeholders, especially in relation to land and water management issues.

<sup>12</sup> Essential Services Commission 2016, Water Pricing Framework and Approach: Implementing PREMO from 2018, October.

## 1.4. Amendments to this guidance

This guidance was prepared in consultation with Melbourne Water.<sup>13</sup> Our consultation focused on the key changes to the guidance issued for Melbourne Water's 2021 price review, and to the guidance issued for the 14 water businesses under the 2023 water price review. We have also discussed our approach for Melbourne Water with the Department of Energy, Environment and Climate Action, the Department of Health, the Environment Protection Authority Victoria, and the consumer representative group Consumer Action Law Centre.

We may issue additional guidance or amend this guidance during the price review. The need to issue additional guidance or amend guidance may arise from any changes to law or regulations, or in the economic environment. We will consult with the regulated entity and relevant stakeholders where any additional guidance or amendment to the guidance is required.

## 1.5. Structure of this guidance

The guidance is structured as follows:

- Chapter 2 sets out:
  - the manner in which we propose to regulate prices
  - our approach and methodology to assessing a price submission and making a price determination
  - the impact of PREMO on price submission information requirements
  - our approach to consultation during the review process
  - the assessment process and the 2021 price review timeline.
- Chapter 3 sets out:
  - the 'governing criteria' for each of the components of the building block methodology which will inform the nature and scope of the matters to be included in the price submission, and form the basis of our assessment of the price submission
  - the supporting information required to be included in the price submission.

## 1.6. Interpretation of this guidance

If Melbourne Water requires clarification or interpretation on any matters relating to our pricing framework or this guidance, it should contact commission staff.

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<sup>13</sup> Clause 13 of the WIRO requires us to provide guidance following consultation with the regulated entity.

If Melbourne Water is considering proposing significant or material changes to its current pricing proposals and approach, it should raise this with commission staff as early as possible. This will allow us to consider the proposed changes and the need for any additional guidance to inform Melbourne Water's price submission, and our subsequent assessment.

## 2. Our approach to the price review

This chapter sets out:

- the manner in which we will regulate prices<sup>14</sup>
- our approach and methodology to assessing Melbourne Water's price submission and making a price determination<sup>15</sup>
- the impact of PREMO on price submission information requirements<sup>16</sup>
- our approach to consultation during the review process<sup>17</sup>
- the assessment process and the 2026 price review timeline.<sup>18</sup>

### 2.1. How we will regulate Melbourne Water's prices

Clause 12(b) of the WIRO provides that a price determination may specify maximum prices, or the manner in which prices are to be calculated, determined or otherwise regulated, for regulated services in a manner consistent with section 33(5) of the ESC Act — that is, in any manner that we consider appropriate.

We will use a building block methodology to determine the forecast revenues that will provide Melbourne Water with a reasonable opportunity to recover a rate of return on prudent and efficient capital expenditure on assets, a return of the cost of investing in those assets (through depreciation), prudent and efficient operating costs, a benchmark tax allowance and recovery of costs required to deliver on its service outcomes and comply with relevant health, safety, environmental, social and other regulatory obligations over the next regulatory period commencing 1 July 2026. (A list of obligations is shown in Section 3.6.)

For a defined regulatory period, our assessment methodology involves the following steps:

- first, outcomes that Melbourne Water proposes to deliver to its customers will be assessed to validate that they reflect government (and technical regulator) obligations or demonstrated customer needs

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<sup>14</sup> WIRO, clause 13(a)(i).

<sup>15</sup> WIRO, clause 13(a)(ii).

<sup>16</sup> WIRO, clause 13(a)(v).

<sup>17</sup> WIRO, clause 13(a)(iv) and 13(a)(viii).

<sup>18</sup> WIRO, clause 13(a)(vi) and 13(a)(vii).

- second, the following ‘building blocks’ will be determined in accordance with governing criteria for each element (specified in Chapter 3), to:
  - establish an efficient benchmark level of forecast operating expenditure for the next regulatory period
  - establish an efficient benchmark level of forecast capital expenditure for the next regulatory period
  - roll-forward the regulatory asset base
  - apply a rate of return to the regulatory asset base, calculated using:
    - a benchmark cost of debt estimated using a 10-year trailing average approach
    - a benchmark return on equity value determined by Melbourne Water’s PREMO rating
  - establish a return of capital through a regulatory depreciation allowance
  - establish a benchmark tax allowance.

These ‘building blocks’ will determine the forecast revenue that is required for Melbourne Water to deliver on its service outcomes and obligations.

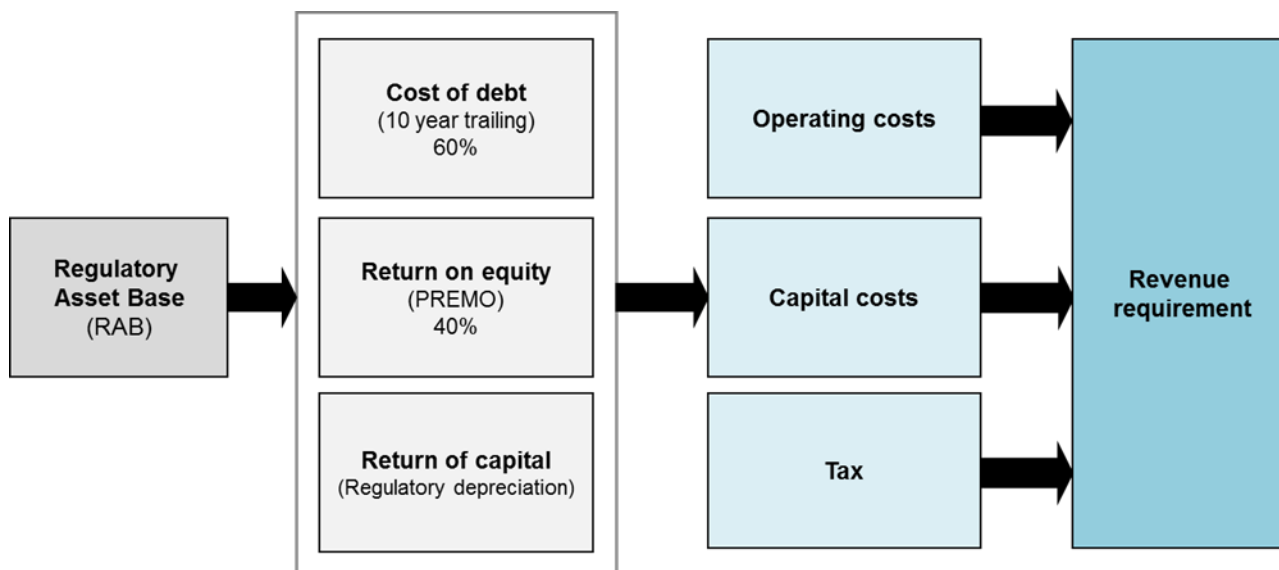
A summary of the building block methodology is shown in Figure 2.1.

Once the revenue requirement for the regulatory period has been determined using building blocks, the form of price control that will be applicable to Melbourne Water specifies how this revenue is to be translated into customer prices.

The prices charged by Victorian water businesses have previously been regulated under various forms of price control, including price caps (that is, fixed maximum prices), revenue caps (which allow prices to vary with changes in demand during the period to recover the maximum revenue), tariff baskets (which allow prices within the basket to be adjusted within an approved constraint) and hybrid forms of control. The prices charged by Melbourne Water have mostly been regulated under a price cap form of price control. Subject to meeting the requirements of our guidance, we continue to provide Melbourne Water with discretion to propose the form of price control to be applied for its regulatory period.

Our price determination will set out the prices that are to apply for the year commencing 1 July 2026, and the prices or the manner in which prices will be calculated for the remaining years of the regulatory period.

**Figure 2.1 Revenue under Building Blocks**



## **2.2. Approach and methodology for assessing the price submission**

Our regulatory task is to assess Melbourne Water’s price submission and form a view about whether or not the price submission:<sup>19</sup>

- has adequate regard for the matters specified in clause 11 of the WIRO
- complies with our guidance issued under clause 13 of the WIRO.

### **2.2.1. Assessing the extent to which the price submission has regard for matters specified in clause 11**

Clause 11 of the WIRO refers to matters specified in the ESC Act, the WI Act, our guidance issued under clause 13 of the WIRO, and a number of pricing principles (at clause 11(d)) that we must have regard to in making a price determination.<sup>20</sup>

To facilitate our assessment, Melbourne Water is required to support the proposals in its price submission by reference to the matters in clause 11 of the WIRO.

<sup>19</sup> WIRO, clause 14(b)(i).

<sup>20</sup> The matters referred to in clause 11 of the WIRO have been grouped into themes in Appendix C.



In doing so, Melbourne Water is required to place particular emphasis on the matters in clause 8(b) of the WIRO which primarily relate to the promotion of various types of efficiency.<sup>21</sup> Chapter 3 of this guidance sets out a number of discrete considerations the price submission must address in order to demonstrate that Melbourne Water has fully and meaningfully addressed clause 11 of the WIRO.

### 2.2.2. Assessing compliance with this guidance

Melbourne Water must lodge its price submission with us by **Wednesday 1 October 2025**. We expect the price submission (including the financial model template provided by the commission) to comply with Chapter 3 of this guidance. We will assess whether Melbourne Water has sufficiently justified its proposals in accordance with the governing criteria in Chapter 3, and satisfied all of the information requirements.

### 2.2.3. Consequences if we assess non-compliance with this guidance

Consistent with clause 14 of the WIRO, if we form a view that Melbourne Water's price submission complies with our guidance, and has adequate regard for the matters specified in clause 11 of the WIRO, then we must approve the proposals in the price submission. If the price submission does not, in our opinion, comply with this guidance or have adequate regard for the relevant matters specified in the WIRO, we may specify maximum prices, or the manner in which prices are to be calculated, determined or otherwise regulated.<sup>22</sup> This may include us specifying prices for a shorter regulatory period than proposed by Melbourne Water.

While we expect that Melbourne Water's price submission will comply with the requirements of this guidance, our review will generally focus on matters that have a material impact on the prices customers pay or the services customers receive. In practice, if Melbourne Water's price submission has not fully complied with the guidance, our intention is to provide the business with an opportunity to provide the information required to demonstrate compliance before we make a draft decision.

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<sup>21</sup> In summary, clause 8(b) of the WIRO provides that in having regard to the overarching objectives in the ESC Act, particular emphasis is to be placed on:

- (i) 'the promotion of efficient use of prescribed services by customers;
- (ii) the promotion of efficiency in regulated entities as well as efficiency in, and the financial viability of, the regulated water industry; and
- (iii) the provision to regulated entities of incentives to pursue efficiency improvements.'

<sup>22</sup> WIRO, clause 14(b)(i).

## 2.3. Approach to assessing PREMO price submission ratings

The PREMO incentive mechanism links the return on equity reflected in approved prices to the level of ambition expressed in a price submission.<sup>23</sup> The return on equity will depend on whether the price submission is rated as 'Leading', 'Advanced', 'Standard' or 'Basic'.

Section 3.14 discusses the manner in which Melbourne Water should assess its price submission to decide on the submission's PREMO rating, and therefore the return on equity to be reflected in its proposed prices. Appendix E includes a PREMO assessment tool that Melbourne Water must use to inform its PREMO ratings.

The tool includes a set of guiding questions that set out the matters to be considered in assessing a price submission PREMO rating, and examples of what might constitute a 'Leading', 'Advanced', 'Standard' or 'Basic' rating for each element of PREMO. For the 2026 price review, the ambition expressed in Melbourne Water's price submission will be rated according to all five elements of PREMO — Performance, Risk, Engagement, Management and Outcomes.

Informed by its assessment for the five elements of PREMO, Melbourne Water must propose an overall PREMO rating for its price submission. The assessment tool guides Melbourne Water to consider its level of ambition in relation to matters covered in its price submission, such as proposals related to operating and capital expenditure, form of price control, tariffs, and demand.

A price submission must meet all of the requirements set out in Chapter 3 of this guidance, which represents the minimum requirements for a 'Standard' overall PREMO rating.

We will also rate Melbourne Water's price submission, with our decision on the PREMO rating determining the benchmark return on equity to be reflected in approved prices.

Melbourne Water should have confidence that well justified PREMO self-ratings – those that provide credible information supporting the self-ratings – will be assessed reasonably by us. We want to reward ambition that provides improved value to customers.

Our PREMO rating is an assessment of Melbourne Water's price submission. It is not an assessment of Melbourne Water itself.

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<sup>23</sup> See our pricing approach paper for further context: Essential Services Commission 2016, Water pricing framework and approach: Implementing PREMO from 2018, October.

## 2.4. Our consultation process during the 2026 price review

A focus on customer engagement by Melbourne Water under PREMO should result in less need for direct engagement by us with its customers. This is consistent with our objectives to emphasise the business and customer relationship, and to provide greater autonomy to Melbourne Water.

We expect price submissions to be heavily informed by customer engagement. As in past price reviews, we will invite submissions from interested parties on the proposals contained in Melbourne Water's price submission prior to making a draft decision.

Following the release of our draft decision, we will invite submissions and intend to engage with customers and other stakeholders, either by holding public meetings and/or through online platforms, before we make our final decision and issue a price determination.<sup>24</sup>

We will consult with agencies such as the Department of Energy, Environment and Climate Action, the Department of Health, and the Environment Protection Authority Victoria.

We will make our papers (including the reports of consultants assisting with our review), Melbourne Water's price submission, and submissions from other interested parties, available on our website ([www.esc.vic.gov.au](http://www.esc.vic.gov.au)) in accordance with our submissions policy.<sup>25</sup>

If there is information that Melbourne Water or a stakeholder does not want disclosed publicly, because it is confidential or commercially sensitive, the matter should be discussed with commission staff before lodging the submission.

## 2.5. 2026 price review process and timeline

Melbourne Water must lodge its price submission with us by **1 October 2025**.<sup>26</sup> If Melbourne Water fails to lodge its submission by this date, we may use our discretion to specify maximum prices.<sup>27</sup>

We will assess Melbourne Water's price submission using a three-stage review process:

- **Stage 1** — Initial evaluation to verify the quality and strength of the submission and the proposed outcomes for customers, and to establish what further verification work might be required to inform our draft decision. If very little is required, we may be able to fast track the

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<sup>24</sup> WIRO, clause 16(b).

<sup>25</sup> View our submissions policy at <https://www.esc.vic.gov.au/about-us/our-policies/our-submissions-policy>.

<sup>26</sup> Clause 13(a)(vi) of the WIRO requires us to provide guidance on the timing and processes we propose to follow in making a price determination. Clause 13(a)(vii) also requires us to specify the date by which Melbourne Water is required to deliver its price submissions to us.

<sup>27</sup> WIRO, clause 14(b)(ii).

price submission through the additional verification process in stage 2 and make an earlier draft decision to accept prices, or propose relatively minor changes, effectively expediting stage 2.

- **Stage 2** — Conduct further verification work as required, tailored to the quality of the price submission, which may range from simple requests for further information through to a full review of cost forecasts by an expert consultant. We may make our draft decision once we have completed the additional review (or reject the price submission if unable to reach a draft decision based on the information submitted).
- **Stage 3** — Public consultation on our draft decision, leading to a final decision and a price determination for Melbourne Water. An earlier final decision may be made if consultation does not result in further review being required after the draft decision.

Figure 2.2 sets out our assessment process and timeline for the 2026 price review. All dates other than the price submission due date (1 October 2025) are indicative and will be confirmed later in the price review.

### **2.5.1. Our flexible assessment process – fast tracking our price submission assessment**

Any fast tracking of a high quality price submission to an earlier draft decision will provide Melbourne Water with early certainty over its price proposal and allow it to focus its resources on delivering its services to customers with a reduced regulatory burden.

As highlighted above, to facilitate a quick and simple stage 1 assessment (and the possibility of fast tracking), Melbourne Water's price submission must clearly convey its key messages and data to us. This guidance informs Melbourne Water on what to include in its price submission, consistent with this stage 1 assessment. The financial model template (Section 3.23.3) must also be accurately completed for Melbourne Water to be eligible for an early draft decision.

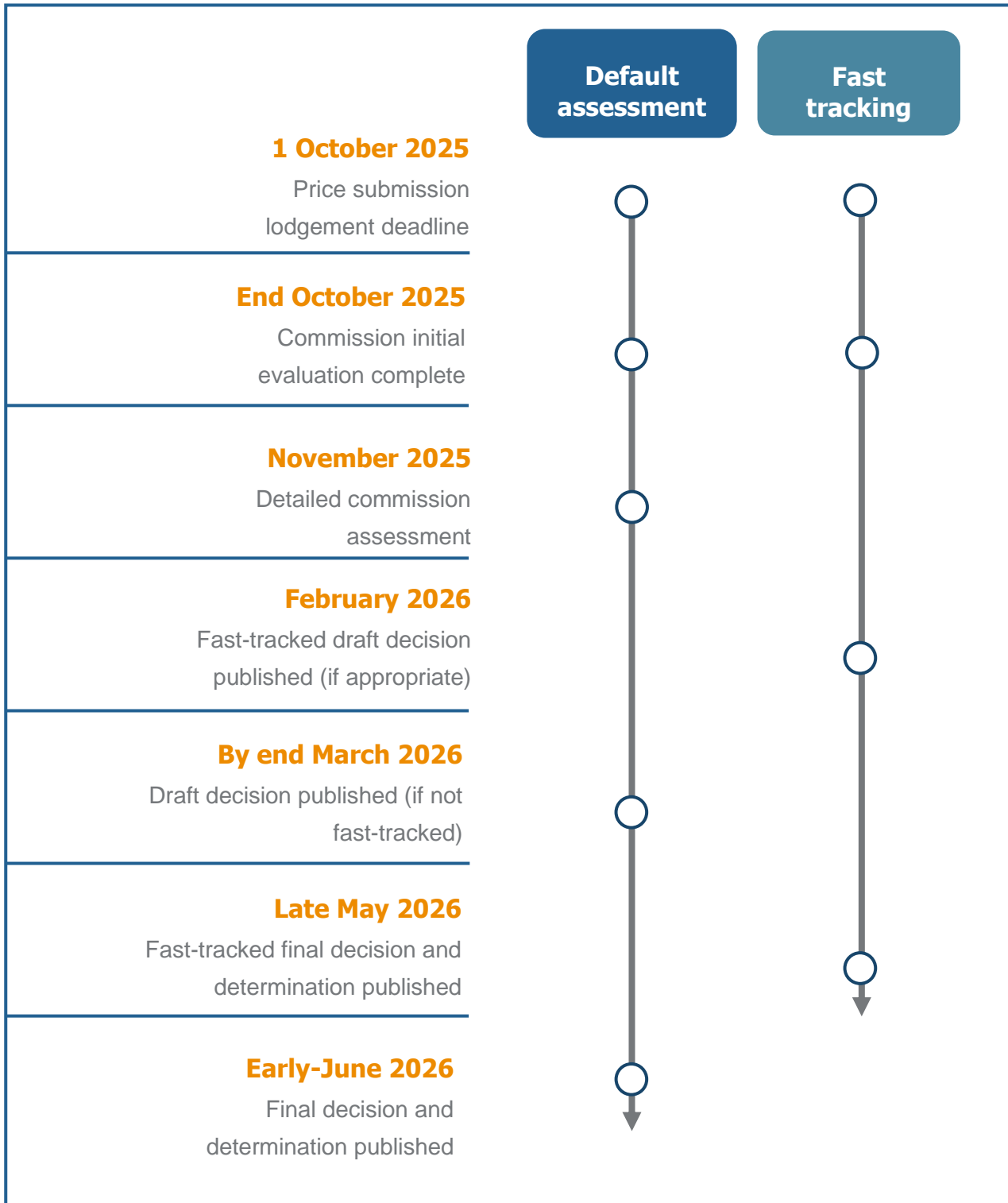
The opportunity to fast track a price submission and make an early draft decision will be done at our discretion, taking into account:

- the quality and accuracy of the submission, and any other matter we consider is relevant
- how well Melbourne Water demonstrates it has captured the views of its customers and explains how it has considered feedback
- how promptly Melbourne Water provides clear and robust supporting evidence, where requested, to justify its proposals.

We are unlikely to be able to fast track Melbourne Water's assessment if there are major areas of contention with any of its metropolitan retail water business customers or regional urban water business customers.

Following the release of an early draft decision, if our review process finds there are issues that need to be further explored, we may revert a price submission back to the default assessment timeline described in Figure 2.2.

**Figure 2.2 Price review timeline and assessment process**



### 3. Required contents of Melbourne Water’s price submission

Pursuant to clause 13(a)(iii) and 13(a)(v) of the WIRO, this chapter sets out the governing criteria and supporting information requirements for the major components of Melbourne Water’s price submission, covering the regulatory period commencing 1 July 2026 (the next regulatory period).

Melbourne Water should prepare its price submission with the commission as its target audience. Although the price submission will be released publicly, the content and language should be tailored to facilitate our review. Melbourne Water may consider other ways – such as fact sheets – to communicate its proposals to other stakeholders, including its customers.

Melbourne Water’s price submission must clearly and succinctly identify and explain how its proposal demonstrates value for money for customers – that is, what outcomes will be delivered to customers in return for the prices they pay, and how this reflects what customers value most.

The information requirements specified in this chapter reflect the information we need to undertake the 2026 price review consistent with the WIRO. Much of the information requested would already exist within normal business practice – for internal planning and corporate reporting, for example. Also, much of the detail can be provided by completing the financial model template (issued by us) that forms part of Melbourne Water’s price submission (see Section 3.23.3).

To support clear and succinct price submissions, Melbourne Water need not include all the supporting information for the claims made in its submission. However, Melbourne Water must be able to provide any supporting information requested by us. For example, a consultant’s report may be referenced in a submission without providing the full report as an attachment. We may request copies of material supporting a price submission, including (where need be) through the issue of compulsory information notices under the ESC Act.

We expect Melbourne Water’s price submission will focus on those matters having a material impact on the prices customers pay or the services customers receive.

Under our PREMO incentive framework, a price submission must address all of the requirements set out in this guidance to achieve a ‘Standard’ rating or higher.

### 3.1. Managing risk

The WIRO requires the commission to place particular emphasis on matters relating to various efficiencies in undertaking our regulatory functions in Victoria's water sector.<sup>28</sup>

Efficiency is promoted when risk is adequately identified, quantified, and allocated. Prices should reflect the costs incurred in delivering services incorporating reasonable assumptions about risk.

Melbourne Water's price submission must be informed by a robust risk identification process, taking into account a long term planning horizon. We anticipate such analysis is undertaken by the business as part of its normal business planning. Significant risks must be identified in a price submission. A price submission must also demonstrate that risk has been allocated appropriately, and where Melbourne Water has decided it is best placed to carry a risk, identify the approaches it proposes to manage the risk.

Appendix D summarises some of the major risks facing Melbourne Water, and potential approaches that Melbourne Water may propose to deal with risk. Some of these relate to climate change, including operational risks related to asset security. Climate change is likely to present a range of risks and challenges to regulated businesses and their customers, particularly in an environment where risk has to be managed and resilience built across the supply chain amid increasing uncertainty and change. Key risks may reflect:

- damage to infrastructure – due to changes in weather patterns resulting from climate change (such as flooding, bushfires, or rising sea levels) or increased heat stress
- changing market conditions – due to changes in customer demand for water
- evolving government policy – around emissions reduction obligations and targets
- financing, insurance issues and other related corporate pressures – including where access to financing or insurance is tied to emission levels or to achieving emission reduction targets, or where other businesses in the supply chain place pressure on regulated businesses to reduce emissions
- reputational issues – where reducing or offsetting emissions is viewed as being consistent with a business's social licence to operate.

We anticipate Melbourne Water will propose initiatives aimed at addressing climate change in response to its own planning and government policy.<sup>29</sup>

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<sup>28</sup> WIRO, clause 8(b).

<sup>29</sup> The Queensland Competition Authority (QCA) prepared a position paper on its approach to climate change related expenditure and published a guideline for the water businesses it regulates. This guideline may assist Victorian water businesses in planning for and proposing climate change related spending in their price submissions. See: <https://www.qca.org.au/wp-content/uploads/2023/09/qca-climate-change-guideline-september-2023.pdf>

There are mechanisms in the framework that enable Melbourne Water to deal with uncertainty in relation to demand forecasts (see Appendix D). There are also provisions in determinations (which we propose to continue) to enable reconsideration of pricing within a regulatory period due to uncertain or unforeseen events, including where revenues or costs vary significantly from forecasts.

In past reviews, we observed many water businesses adopting overly risk-averse assumptions in price submissions, which implies that customers are expected to bear more than an efficient allocation of risk (one result of this is that proposed prices are higher than they need to be).

For example, in past price submissions some water businesses have:

- proposed to include the costs for highly uncertain projects and large contingencies in capital expenditure forecasts (and therefore, prices)
- sought to justify price increases on the basis of financial viability concerns, without providing evidence they have fully explored other avenues to manage financial performance.

We expect Melbourne Water to manage the risks associated with uncertain capital expenditure forecasting. Rather than including upfront allowances for uncertain projects and contingencies, Melbourne Water should seek alternative ways to mitigate construction and capital forecasting risk, such as through better project or contract management.

Alternatively, Melbourne Water could exclude planned but not fully scoped projects, or projects with uncertain delivery schedules, from upfront cost recovery, noting that actual prudent and efficient capital expenditure will be rolled into its asset base at the end of the regulatory period.

The water sector already adopts techniques such as real options analysis to inform decision making as circumstances unfold, including in relation to infrastructure works. We note evidence of use of options analysis (or similar methods), along with Melbourne Water's approach to dealing with uncertainty and allocating risk in relation to demand, can be used to support its PREMO price submission rating.

Businesses concerned about financial viability should demonstrate their financial risks through credit rating assessments undertaken by an independent credit rating agency. Melbourne Water should also demonstrate that it has sought to manage its financial risks before transferring them to customers.

In later sections of Chapter 3, we have specified where we require information on Melbourne Water's consideration of risk to support its proposals in specific areas including length of the regulatory period, expenditure, demand, form of price control, and tariffs. Expenditure proposals related to climate change adaptation and mitigation need to consider our expenditure guidance in Chapter 3. Climate change expenditure by regulated businesses can be broadly divided into two categories:



- Adaptation expenditure focuses on enhancing operational readiness and response, and/or the resilience of infrastructure to better cope with extreme weather events.
- Mitigation expenditure focuses on reducing carbon dioxide equivalent emissions. Such expenditure relates to responding to changes in government policies, meeting existing obligations and targets, community sentiment or external corporate factors, and maintaining a social licence to operate.

Our view is that prudent and efficient expenditure, whether it is climate related or not, can continue to be supported and assessed under our existing frameworks. Consistent with this view, we are open to considering climate change expenditure proposals by regulated businesses.

We are also seeking evidence that Melbourne Water has given strategic consideration to risk and identified those risks that may have a material impact on the prices customers pay, or the services they receive (taking into account a long-term planning horizon). This is the focus of the information requirements in Section 3.1.1.

### **3.1.1. Supporting information**

In its price submission Melbourne Water must:

- identify any significant risks that may impact on customer prices or services, and if requested, make available to us scenario analysis for each risk including an assessment of the nature and scale of the risk and its probability of occurring
- identify how it has addressed significant risks through its proposals, explain how it has considered the allocation of risk, and demonstrate how its proposals support efficiency
- provide evidence that it has given strategic consideration to the allocation and management of risk in developing its price submission – this may involve providing references and making available to us material on its risk identification and management framework or processes, rather than including detail in its price submission.

Upon request, Melbourne Water must also make available to us the following information about significant risks it proposes to manage that require cost allowances:

- the categorisation of the risk (as operational or financial risk, for example)
- measurement of the risk including:
  - the nature and scale of the risk
  - the probability of the risk event occurring
  - factors influencing the probability of the risk event occurring
  - the financial or service impact of the risk if it occurs
- options considered for allocating the risk
- rationale for the allocation of the risk, given alternative options

- an explanation of why the regulatory risk mitigation tools listed in Appendix D do not adequately mitigate the risk
- the role customers will be expected to play in dealing with these risks and how customers will be engaged in this process.

## **3.2. Regulatory period**

### **3.2.1. Criteria**

We are required to set the term of the regulatory period over which Melbourne Water's price determination will apply.<sup>30</sup> We propose to set a five-year regulatory period starting 1 July 2026, but remain open to alternatives proposed by Melbourne Water.

A default five-year regulatory period provides the following benefits:

- a relatively long period of certainty for customers about the outcomes to be delivered and prices to be charged
- sufficient time for Melbourne Water to focus on service delivery and achieving the customer outcomes it has set for the period.

A risk associated with a regulatory period longer than five years is that revenue or expenditure outcomes could diverge significantly from the benchmarks used to establish prices, possibly resulting in customers paying prices which are significantly above, or below, those required to recover efficient costs. Accordingly, if Melbourne Water proposes a regulatory period longer than five years, it is required to demonstrate that the benefits of a longer period outweigh the potential risks. If a submission proposes a longer regulatory period, the submission should propose checks and balances that will apply during the longer period to ensure customers are receiving value for money.

Relatively short regulatory periods can increase the cost of reviews for stakeholders and weaken the autonomy Melbourne Water has to focus on service delivery for its customers.

If Melbourne Water is considering a regulatory period other than five years, it should engage with us as soon as possible.

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<sup>30</sup> WIRO, clause 9.

### 3.2.2. Supporting information

If Melbourne Water proposes a five-year regulatory period, it needs only to state this in its price submission, summarising how it has considered any views from customers on a different term. If Melbourne Water proposes a different term, then its submission must:

- provide reasons for the proposed regulatory period length, having regard to the benefits and risks identified in Section 3.2.1, including demonstrating that the benefits of a longer or shorter period outweigh the risks and costs from a customer's perspective
- outline the results of customer engagement on the length of regulatory period, and how feedback has been taken into account.

In addition, if Melbourne Water proposes longer than five years, its price submission must:

- Demonstrate that the expenditure forecasts and asset management plans underpinning the price submission are sufficiently robust, particularly having regard to the capacity of the assets and demand forecasts towards the end of the proposed regulatory period.
- Include details of mechanisms that will provide both the commission and customers with confidence that prices reflect value for money and efficient service delivery after year five of the proposed regulatory period.
- Describe how the business will keep customers engaged throughout the longer regulatory period, including how it will update customers on performance.
- Describe how it will adapt to changing customer needs during the regulatory period, within the constraints of the determination. For example, the approach to re-aligning capital programs in response to customer preferences.
- Outline its approach to dealing with uncertainty and risk during the regulatory period, particularly financial viability risk, having regard to the mechanisms for mitigating risk outlined in Appendix D.

### 3.3. Customer engagement

The WIRO requires us to set out our expectations regarding a water business's customer engagement in developing its price submission.<sup>31</sup> Melbourne Water must engage with its customers and other key stakeholders to inform its price submission.<sup>32</sup> The purpose of this engagement is for Melbourne Water to clearly understand the priorities of its customers, including

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<sup>31</sup> WIRO, clause 13(a)(iv).

<sup>32</sup> We recognise Melbourne Water delivers services that impact the community or parts of the community, and encourage engagement with these groups in the development of its price submission.

the nature of products and services expected. This is to enable Melbourne Water to deliver outcomes that matter most to its customers.

We expect Melbourne Water to design its engagement taking into account the unique context within which it operates. Melbourne Water has a number of distinct stakeholder groups. Two of its main stakeholders are its two key customer groups:

- Melbourne Water provides bulk water and sewage services to three metropolitan retail water businesses and bulk water services to some regional urban water businesses – other than a small number of exceptions, Melbourne Water does not provide water and sewerage services directly to end-use customers.
- Melbourne Water provides waterways and drainage services to residential and non-residential end use customers.

Melbourne Water is best placed to design and undertake engagement to suit its circumstances and those of its customers and other key stakeholders. Accordingly, we have not prescribed how Melbourne Water should engage with its customers. However, we expect Melbourne Water to demonstrate a good understanding of the nature and circumstances of its customers and to tailor its engagement to suit their needs. We expect Melbourne Water's engagement with the metropolitan retail water businesses and regional urban water businesses will have regard to the outcomes sought by these businesses for their end-use water and sewerage customers, and consider how its proposals might support the achievement of these outcomes. We expect Melbourne Water to engage with end-use customers on issues not already covered by water businesses in their own engagement processes, including on its waterways and drainage proposals.

Generally, we have retained the same principles and assessment criteria that we specified for Melbourne Water's 2021 price review. We have included an additional focus on inclusive and effective engagement practices that support the participation of First Nations people and people experiencing vulnerability which is similar to the approach we took with water retailers at the 2023 and 2024 price reviews.<sup>33 34</sup> For Melbourne Water we expect these engagement practices to be particularly effective in supporting the participation of relevant Traditional Owner groups.<sup>35</sup>

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<sup>33</sup> First Nations people for the purposes of these guidelines includes Traditional Owner groups, First Nations customers and, where appropriate, Aboriginal Community Controlled Organisations providing customer support or advocacy.

<sup>34</sup> This guidance progresses some actions of the commission's 'Getting to fair' strategy relating to the water industry. See Essential Services Commission 2021, Getting to fair: Breaking down barriers to essential services, 12 August.

<sup>35</sup> Traditional Owner groups hold rights and interests in relation to land and waterways and are therefore important stakeholders, especially in relation to land and water management issues.

The following key principles should guide Melbourne Water's customer engagement:

- The form of engagement should be tailored to suit the content on which Melbourne Water is seeking to engage, and to the circumstances facing its customers and community, including First Nations people and people experiencing vulnerability.
- Melbourne Water must provide participants in its engagement process with appropriate information, given the purpose, form and the content of the engagement, and a reasonable and fair opportunity to participate in the process.
- Melbourne Water's engagement process should give priority to matters that have a significant influence on the services provided and prices charged by the business.
- Melbourne Water should start engagement early in its planning. The engagement should be ongoing, to keep testing proposals with customers.
- Melbourne Water should demonstrate in its price submission how it has taken into account the views of its customers and other key stakeholders.

We note that insights from Melbourne Water's engagement may complement its justification for forecast operating or capital expenditure. However, customer support should not be used on its own to justify the prudence and efficiency of expenditure proposals. Refer to Sections 3.7 and 3.8 for our expenditure criteria.

### 3.3.1. Criteria

The assessment criteria set out below relate to the principles set out above.

Our assessment of Melbourne Water's engagement will consider:

- Melbourne Water's justification for its decisions on how and when to engage, and the matters that it decided to engage on, including for First Nations people and people experiencing vulnerability. This includes how Melbourne Water has justified its engagement was appropriate and sensitive to the people it was seeking to engage.
- Whether customers, and others who are affected by the outcomes of the price submission, were given a reasonable and fair opportunity to participate, particularly in relation to matters that have a significant influence on the services provided and prices charged by Melbourne Water. This includes consideration of the time available, and information provided to support input by participants.
- How feedback received through engagement was taken into account by Melbourne Water in reaching its proposals (and what feedback was provided to customers and other key stakeholders).
- Melbourne Water's justification for how it will address customer and community expectations that will not or cannot be met.

### 3.3.2. Supporting information

Melbourne Water's price submission must:

- Describe and justify how and when Melbourne Water engaged with its various customer groups and community. Melbourne Water must explain how it ensured engagement was universal and inclusive of customers and the community affected by the outcomes proposed in the price submission, including First Nations people and people experiencing vulnerability. The submission must also explain how engagement was appropriate and sensitive to the people it was seeking to engage with.
- Describe and justify the matters covered by its engagement processes.
- Explain what it learned from customer engagement, and how it satisfied itself that customers were given a reasonable and fair opportunity to participate, and that any views expressed were sufficiently representative of its customers.
- Explain how feedback was taken into account by the business in reaching its proposals.
- Explain how it will address customer expectations that will not or cannot be met.

Melbourne Water must make available, or provide on request, resources and materials provided to customers during its engagement, and any customer feedback about the engagement program.

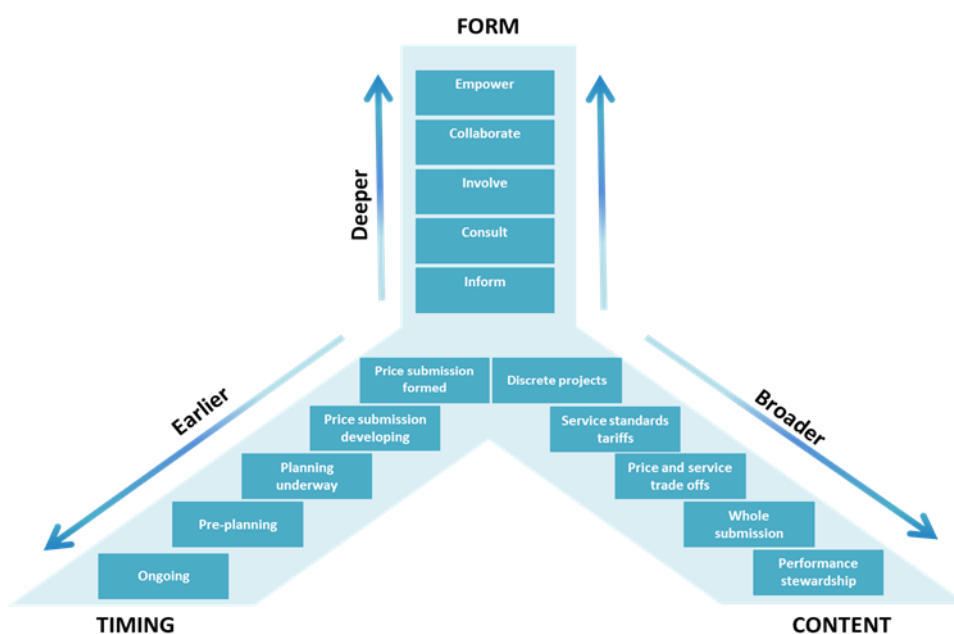
### 3.3.3. Customer engagement and PREMO

As noted above, we have not prescribed how Melbourne Water engages with its customers and community. However, we note that adopting forms of engagement that provide for deeper participation and influence for customers will support the achievement of a higher PREMO Engagement rating.

Melbourne Water may wish to use the customer engagement diagram (Figure 3.1) as a descriptive tool of its overall program, or of individual activities. For example, it can show how it has evolved its engagement since the 2021 price review, to support its PREMO price submission ratings.

More detail on our PREMO assessment for Engagement can be found in the assessment tool in Appendix E.

Figure 3.1 Customer engagement diagram



### 3.4. Outcomes

Melbourne Water must propose a set of outcomes that represent the value its customers will receive during the next regulatory period. Melbourne Water must define measurable outputs and deliverables, with associated annual targets, that will be monitored during the next regulatory period to demonstrate the achievement of each outcome.

This set of outcomes and performance targets is essentially Melbourne Water’s commitment to its customers for the regulatory period. Actual performance against these output measures and targets will allow Melbourne Water to clearly demonstrate whether its customers received the value they paid for. It will also inform the rating for the Performance element of PREMO at the next price review.

Melbourne Water must report at least annually to its customers on its performance against the specified output measures for each outcome. We expect Melbourne Water will already have established self-reporting practices in place for reporting directly to customers as soon as practical after the completion of each reporting year. We will also report Melbourne Water’s annual performance against its outcome commitments through our annual Outcomes Report published on our website.

We consider the outcomes commitment and reporting process to be dynamic – it is not a ‘set-and-forget’ activity tied exclusively to price reviews. To this end, we encourage regular interaction with customers throughout the regulatory period to:

- report on performance and gain an insight into customer views of the business’s performance – this can include customer involvement and endorsement of the annual self-rating process
- test if customer values have shifted
- consider and, where appropriate, improve or add new measures and targets to reflect changing circumstances or customer needs.

### **Outcomes in subsequent PREMO reviews**

Melbourne Water will already have in place a set of outcomes, output measures and targets that were established at its 2021 price review. For the regulatory period beginning in 2026, we don’t expect Melbourne Water will need to establish a new set of outcomes from scratch. Rather, this is an opportunity for Melbourne Water to re-test customer expectations, with a mind to refresh, update and evolve its outcome commitments in line with its customers’ evolving preferences.

Accordingly, this price submission should account for Melbourne Water’s actual performance against its outcome commitments for the current regulatory period, which also informs its Performance PREMO rating. The price submission should explore the changes in outcome commitments from the current regulatory period to the next.

#### **3.4.1. Criteria**

Proposed outcomes must demonstrate linkages to customer preferences, as revealed through Melbourne Water’s customer engagement program. Outcomes and associated performance targets must be prepared for each of Melbourne Water’s main services, including bulk water and sewerage, and waterways and drainage.

Proposed output measures for each outcome must:

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



The set of outcome measures proposed by the business should reflect both:

- specific commitments made by the business to address customer preferences revealed through the engagement processes
- core 'business-as-usual' performance measures that provide a broad representation of the underlying value received by all customers, and general customer expectations.

Melbourne Water must outline how it will address shortfalls in meeting an outcome, and it must also commit to reporting at least annually to its customers on its performance against its proposed output measures for each outcome.

An example of how an outcome links to outputs and deliverables, programs and activities, and inputs is provided in Table 3.1.

### **Mandatory output measures**

Customers and community expect that their water business comply with key regulatory requirements, especially those with potential widespread consequences for non-compliance. We consider the revenue requirement we approve for a business is sufficient to meet all its legislative, regulatory and government policy obligations (see Section 3.6). Accordingly, the following performance measures are considered fundamental for an urban water business and are required to be included in its proposed set of measures against its most relevant outcome commitment, with suitable annual targets.

- Number of non-compliances with the Safe Drinking Water Regulations
- Number of non-compliances with EPA licence(s)

### 3.1 Table 3.1 Example – outcome measurement and delivery

Safe clean drinking water for all customers

Outcome	Safe clean drinking water for all customers
<b>Outputs and deliverables</b> <ul style="list-style-type: none"> <li>Measures and targets</li> <li>Key projects</li> </ul>	<ul style="list-style-type: none"> <li>Number of non-compliances with the Safe Drinking Water regulations</li> <li>Number of boil water notices issued</li> <li>Water quality complaints per 100 customers</li> <li>Percentage of customers that trust the safety of water supply (through customer survey responses such as an annual survey, with the rating methodology stated in the measure)</li> <li>Completion of specific water quality related capital projects</li> <li>Publish annual water quality report</li> </ul>
<b>Activities and processes</b> <ul style="list-style-type: none"> <li>Business programs</li> <li>Specific actions to be developed/implemented</li> </ul>	<ul style="list-style-type: none"> <li>Catchment to tap water quality management</li> <li>Upgrade treatment plant to implement dual barrier protection in accordance with Safe Drinking Water Act 2003</li> <li>Water mains cleaning program</li> <li>Protections to avoid down time at water treatment plants</li> <li>Hazard Analysis and Critical Control Points (HACCP) certification</li> <li>Pass water quality regulator’s audit (Department of Health)</li> <li>Undertake water quality testing in accordance with regulations</li> <li>Investigate water quality complaints</li> </ul>
<b>Inputs</b> <ul style="list-style-type: none"> <li>Costs and/or cost movements</li> <li>Resources required</li> </ul>	<ul style="list-style-type: none"> <li>\$ - opex and capex costs, or cost changes, to deliver or improve the specific programs</li> <li>Price impact</li> <li>Resources</li> <li>Business unit responsibility</li> </ul>

Source: Updated from original table in Essential Services Commission 2016, Water Pricing Framework and Approach, October, p. 20.

#### 3.4.2. Supporting information

Melbourne Water’s price submission must:

- present a set of customer outcomes, linked to customer preferences, each with clear and unambiguous output measures and associated targets
- for each output measure, state the performance target for each year of the regulatory period and provide past performance (for at least the last two years before the regulatory period)
- explain how the outcomes, output measures and targets were informed by Melbourne Water’s customer engagement program

Required contents of Melbourne Water’s price submission

- clearly explain its chosen output measure targets and how they represent continued or improved customer value if they are set below current business performance
- specify the key actions, activities, and programs that Melbourne Water will undertake to meet its targets (and consequently deliver its outcome commitments)
- demonstrate the connection between the output measures, key actions, activities and programs proposed and achievement of a specified outcome
- present and explain any cost increases or savings for operating or capital expenditure that correspond to each outcome (Sections 3.7 and 3.8)
- explain how the cost increases or cost savings are reflected in prices charged to customers
- explain how Melbourne Water will respond to underperformance in delivery of its outcomes
- outline a process by which it will report at least annually to its customers on its performance against the specific output measures for each outcome.

Melbourne Water may also choose to describe in its price submission how the business might adapt its outcomes, output measures and targets to respond to changing customer preferences, including an ongoing customer engagement program to inform business priorities throughout the next regulatory period.

### **3.5. Guaranteed service levels**

Guaranteed service levels define a water business's commitment to deliver a specified service level to individual customers. For each guaranteed service level, the water business commits to a payment or a rebate on bills to those who have received a level of service below the guaranteed level.<sup>36</sup>

Our 2021 guidance to Melbourne Water did not specifically require it to establish a guaranteed service level scheme. However, during the review Melbourne Water did develop and propose a scheme that involved a separate set of guaranteed service levels for each of its three metropolitan retail water business customers – Yarra Valley Water, South East Water and Greater Western Water. We confirmed that these retail water businesses were consulted and supported their respective set of guaranteed service level targets and payments. We accepted Melbourne Water's proposal as submitted.

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<sup>36</sup> Our requirements for a guaranteed service level scheme for an urban water business are set out at: Essential Services Commission 2022, Water Industry Standard – Urban Customer Service, September, clause 20. While not directly applying to bulk water, sewerage or recycled water services provided to a water business, it can serve as a guide for a guaranteed service scheme proposal by Melbourne Water.

Melbourne Water's unique scheme has two components:

- A reimbursement to the retail water business for guaranteed service level payments the retailer paid to its own customers, where Melbourne Water has triggered the payment.
- Direct payments to a retail water business for Melbourne Water's failure to meet agreed service levels.

A price review provides Melbourne Water with an opportunity to review the nature of its guaranteed service levels, and the payment or rebate amount that will apply in the event of a breach of a guaranteed service level. The rebate amounts should be reviewed in consultation with Melbourne Water's customers.

Melbourne Water may use its proposed guaranteed service level scheme to support its rating for the 'Risk' element of PREMO. The customer payment or rebate amounts established under the guaranteed service level scheme can indicate the extent to which Melbourne Water is taking on revenue risk to provide incentives for it to deliver efficient levels of service to its customers.

### **3.5.1. Criteria**

A guaranteed service level scheme must:

- reflect the main service priorities and concerns of customers, informed by Melbourne Water's customer engagement
- provide incentives for Melbourne Water to provide efficient service levels to all customers
- define each guaranteed service level objectively, in a way that is easy to understand, and is able to be reported.

### **3.5.2. Supporting information**

Melbourne Water's price submission must specify each guaranteed service level and the corresponding payment or rebate amount that will apply where a customer has received a level of service below the guaranteed level. The price submission must identify and justify any changes to the guaranteed service level scheme compared with those approved for the current regulatory period.

For any new or amended guaranteed service level, the price submission must:

- explain the basis for the guaranteed service level, including how it has been informed by customer engagement
- specify whether benefits to customers will take the form of payments or rebates
- explain the reasons for the proposed size of the customer payment or rebate that applies to each guaranteed service level.

Melbourne Water must also justify any proposal to remove a guaranteed service level that was in place during the current regulatory period, including how the proposal has been informed by customer engagement.

### **3.6. Revenue requirement**

Our decision on Melbourne Water’s revenue requirement for the next regulatory period must meet the WIRO objectives of promoting and providing incentives for efficiency in the regulated entities, as well as efficiency in, and the financial viability of, the regulated water industry.<sup>37</sup>

The revenue requirement proposed in its price submission must provide Melbourne Water with sufficient revenue to efficiently meet all of its legislative, regulatory and government policy obligations. This includes, but is not limited to, the items listed in Box 3.1 below.

#### **Box 3.1 Legislative, regulatory and policy obligations**

- Legislation and matters administered by the Essential Services Commission
- Legislation and matters administered by the Environment Protection Authority Victoria
- Legislation and matters administered by the Department of Health
- Legislation and matters administered by the Department of Energy, Environment and Climate Action
- Health and safety legislation
- Gender Equality Act 2020 (Vic)
- The Victorian Government Climate Change Strategy
- The Victorian Government’s Central and Gippsland Region Sustainable Water Strategy
- The Victorian Government’s Housing Statement

#### **3.6.1. Criteria**

The required revenue for Melbourne Water for the next regulatory period will be estimated by the building block approach, under which the building blocks are:

- prudent and efficient forecast operating expenditure — determined in accordance with Section 3.7

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<sup>37</sup> WIRO, clause 8(b).

- prudent and efficient forecast capital expenditure — determined in accordance with Section 3.8
- return on the regulatory asset base (RAB) — determined in accordance with the sections below:
  - the ‘roll forward’ of the RAB — determined in accordance with Section 3.11
  - the cost of debt — determined in accordance with Section 3.13
  - return on equity — determined in accordance with Sections 3.14 and 3.15
- return of capital through a regulatory depreciation allowance — determined in accordance with Section 3.12
- a benchmark tax allowance — determined in accordance with Section 3.16.

The revenue requirement is net of any additional revenue earned from regulated assets, outside of scheduled tariffs — revenue from the sale of water entitlement allocations, for example, or the sale of electricity generated from customer-funded regulated assets. The revenue requirement is also net of any revenue earned from non-prescribed services (discussed at Section 3.23.9).

### **3.6.2. Supporting information**

The price submission, including the financial model, must specify Melbourne Water’s forecast total revenue requirement for each year of the next regulatory period.

The price submission must also provide an estimate of the required revenue for each year after the next regulatory period to at least 2035-36. It must provide a brief explanation of the trend in the forecast over the next two regulatory periods from 1 July 2026.

## **3.7. Forecast Operating Expenditure**

Our assessment of Melbourne Water’s operating expenditure will consider the Waterways and Drainage part of the business separately to the Bulk Water and Sewerage services. Our financial model includes separate tabs to allow the two major business service areas to be presented independently of each other.

### **3.7.1. Criteria**

The forecast operating expenditure to be included for the purposes of calculating Melbourne Water’s revenue requirement is operating expenditure which would be incurred by a prudent service provider acting efficiently to achieve the lowest cost of delivering on service outcomes over the regulatory period, taking into account a long-term planning horizon (prudent and efficient forecast operating expenditure).

We consider that a prudent and efficient operating expenditure forecast has the following characteristics:

- baseline year expenditure is reflective of efficient recurring operating costs and is used as a basis to forecast expenditure
- forecast operating expenditure incorporates reasonable expectations for expenditure growth and cost efficiency improvement
- expenditure requirements above the baseline year (adjusted for growth and efficiency improvements) are fully explained and justified.

### **Operating expenditure with uncertain outcomes**

If Melbourne Water seeks additional operating expenditure for investments where the outcomes are uncertain (pilot or demonstration projects, for example) we expect it to consider how risk is being shared if customers are being asked to cover all additional expenditure. Melbourne Water should also clarify how it will demonstrate the value of these investments to customers.

At the next price review, Melbourne Water would need to demonstrate the prudence and efficiency of this expenditure if seeking to have it included in the baseline, or to support new or ongoing expenditure in its price submission.

### **3.7.2. Supporting Information**

Melbourne Water's price submission must include a forecast of total prudent and efficient operating expenditure for each year of the next regulatory period. Forecast operating expenditure is to be presented separately for the two major business service areas, and for each major service category as applicable.<sup>38</sup>

For total and annual forecast operating expenditure and for each major service category, forecast operating expenditure for each year of the next regulatory period, and beyond to at least 2035-36, must be further broken down where relevant, in the financial model template for:

- operations and maintenance
- bulk charges (further broken down into bulk charges by type and system, for example, transfer charges, Greater Yarra System – Thompson River fixed charges, Victorian Desalination Plant – Water Order variable charges)
- treatment
- customer service and billing
- GSL payments

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<sup>38</sup> For Melbourne Water, the major service categories include water, sewerage, recycled water, bulk water, waterways & drainage, and diversions.

- licence fees (Essential Services Commission, Department of Health, and EPA Victoria)
- corporate costs
- other operating expenditure.

Forecasts for the environmental contribution must also be provided in the financial model. Where future amounts are not yet available, Melbourne Water must use the last approved annual amount as its annual forecast in subsequent years.

Melbourne Water must also provide actual operating expenditure for the current regulatory period (using latest forecasts for 2025-26), categorised in the same way as above, in the financial model template.

Forecast operating expenditure must be presented relative to a reference or baseline operating year (Box 3.2), with allowance for expenditure growth (e.g. based on customers or demand growth) and cost efficiency improvements over the next regulatory period. Any significant changes in the forecast years' costs relative to this baseline year must be clearly presented and explained, including how they are reflected in the proposed customer outcomes and how they represent improved customer value (Section 3.4).

Our financial model sets out the forecast operating costs consistent with this approach.

### **Box 3.2 Baseline Controllable Operating Expenditure**

In preparing forecast operating expenditure, Melbourne Water must establish a baseline controllable operating expenditure which comprises efficient recurring controllable costs from the last full year of actual data (2024-25) for those activities and services that are expected to be incurred throughout the next regulatory period.

The baseline is established from the actual prescribed operating expenditure for 2024-25, adjusted as follows:

- remove any non-controllable expenditure<sup>39</sup>
- remove any one-off or non-recurring expenditure items incurred in that year, or add any normally occurring items that did not occur in that year
- remove any further ongoing cost savings or efficiency commitments that will be realised in the final year of the current regulatory period (2025-26).

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<sup>39</sup> Controllable costs are those that can be directly or indirectly influenced by a water business's operational decisions. Examples of non-controllable costs include: bulk water costs (where prices are set by the Commission), regulatory licence fees, and the environmental contribution.



Melbourne Water's price submission must justify the adjustments proposed to the baseline year in order to establish the baseline controllable operating expenditure, and demonstrate that this represents efficient ongoing operating costs (consistent with any efficiency targets for the current regulatory period).

Melbourne Water's price submission must reconcile its proposed baseline controllable operating expenditure against the benchmark controllable operating expenditure allowance for 2024-25 established at the previous price review. This reconciliation should include consideration of:

- actual growth rate compared with the forecast assumptions
- efficiency gains achieved compared with the business's forecast assumptions
- any other new costs, cost escalations or variations from the forecast assumptions.

We expect Melbourne Water will be able to provide appropriate quantitative evidence to support its baseline cost reconciliation. The price submission should also highlight how customers have been impacted by any change from forecasts.

Melbourne Water's baseline year controllable operating expenditure must reconcile with its audited regulatory account data.

Our 2021 final decision for Melbourne Water reinstated \$21.2 million (\$2020-21) of operating expenditure for various waterways and drainage service related activities. However, these costs were effectively ring-fenced from future operating expenditure, subject to review at the next price review. Our decision stipulated Melbourne Water would need to report annually on how this money was being expended, the expected benefits and the outcomes being achieved. It would also need to demonstrate how much, if any, of the approved expenditure uplift should be included in baseline operating expenditure at the 2026 price review.<sup>40</sup> Accordingly, Melbourne Water's price submission must reconcile its actual expenditure on these matters in 2024-25 against its benchmark allowance (\$4.2 million in \$2020-21) and justify the ongoing inclusion of any of these costs in its baseline forecast.

Using the 2024-25 baseline controllable operating expenditure, Melbourne Water must propose and justify:

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<sup>40</sup> Essential Services Commission 2021, Melbourne Water Final Decision: 2021 water price review, 16 June, pp. 25–27.

- its forecast expenditure growth rate assumptions (for each year)<sup>41</sup>
- its annual cost efficiency improvement rate on its business-as-usual operations (for each year)
- how proposed cost changes deliver improved customer value.

### **Relationship between growth allowance and efficiency improvement rate**

In previous price reviews, water businesses have mostly based their controllable operating expenditure growth rate on forecast customer growth over the relevant regulatory period. However, we recognise that the customer connections growth rate may not directly correlate with the forecast expenditure growth rate.

As such, we expect that Melbourne Water will use its price submission to clearly justify why the proposed controllable operating expenditure growth rate is most appropriate, particularly whether a growth factor other than customer connections growth is more accurate. This should be supported by recent evidence (e.g. based on the latest expenditure, customer number and usage data).

By taking a more targeted approach to forecasting operating expenditure we believe there will be a flow on benefit of producing efficiency improvement rates that will better reflect the value that customers will ultimately receive. Where operating expenditure forecasts have been higher or lower than actual expenditure, Melbourne Water should consider confirming the actual efficiency gains achieved with its customers.

Melbourne Water's price submission must also:

- demonstrate why any proposed cost increases are not covered within the growth allowance, or by inflation, or absorbed within the stated net efficiency improvement rate
- demonstrate how proposed cost changes relate to the proposed customer outcomes and the associated outputs and deliverables (Section 3.4), and in particular:
  - identify and explain operating expenditure savings or new operating expenditure arising from capital expenditure and projects (including desalination capitalisation), and how they relate to the cost efficiency improvement rate<sup>42</sup>

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<sup>41</sup> Melbourne Water should draw on Victoria in Future forecasts, Australian Bureau of Statistics data, and other information as required. For Waterways and Drainage service, the growth rate may be indexed off a different base to customer numbers – square kilometres drained, for example.

<sup>42</sup> We expect material operating cost savings resulting from a major capital investment be presented as a step reduction to the baseline, rather than embedded in the efficiency rate. Such savings are not true efficiency gains if they only result from significant additional expenditure. Likewise, new operating costs arising from capital investments should also be presented as a forecast step change above the baseline. We expect business cases for capital investments would clearly identify any expected operational savings or cost increase as part of the business's internal review and approval processes.

- explain any trend or major annual variations in forecast operating expenditure (including identifying cost items that are having an upward or downward influence on operating expenditure) compared with historic operating expenditure<sup>43</sup>
- demonstrate that proposed costs associated with new or revised regulatory obligations and policy requirements are prudent and efficient
- set out and where relevant, justify the non-controllable cost forecasts including:
  - bulk water purchases from other water businesses
  - regulatory licence fees
  - environmental contribution
  - any other proposed non-controllable costs.

The price submission should explain Melbourne Water’s approach to allocating shared costs, especially where related to non-prescribed business activities, or reference documentation that may be requested by the commission to verify the business’s approach.

### Capitalising expense items

For regulatory pricing purposes, businesses may propose to capitalise certain statutory operating expense items where it is appropriate to spread the cost recovery over a longer timeframe where it meets the guidance and WIRO requirements. This might include expenditure that delivers benefits to customers over a long timeframe.

In the case of a major IT-related project, for example, the development and implementation costs of a new system might be justified as capital expenditure and recovered over the expected life of the new system, while any licencing and ongoing operating costs would remain as operating expenditure.

Other examples where this might apply include large irregular operating costs that are not incurred every regulatory pricing period but provide a customer benefit over two or more regulatory periods, such as infrequent lagoon desludging.

Melbourne Water’s price submission will need to clearly show where expense costs have been capitalised and provide justification against our guidance and WIRO to explain:

- why it is appropriate to do so

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<sup>43</sup> Including, but not limited to, assumptions and trends relating to:

- wage and salary escalations, total labour costs and employee number assumptions
- electricity and energy costs, and underlying volume and load assumptions
- information technology costs
- other risks that have been identified.

- what the depreciation (cost recovery) period will be
- a comparison showing the revenue or price impact for both treatments (operating expenditure compared with capital expenditure).

We do not envisage this will result in a large transfer of overall expenditure from operating to capital (or vice-versa).

Melbourne Water's annual regulatory accounting statements should be consistent with any variation to statutory accounting principles that has been approved by the commission for pricing purposes, or that is being proposed by the business for commission approval.

### **3.8. Forecast Capital Expenditure**

Capital expenditure forecasting essentially involves anticipating the scope, timing and costs for a large number of various sized projects, ranging from the replacement of existing assets at the end of their lives to the construction of major new assets and facilities.

In preparing capital forecasts, Melbourne Water should avoid including speculative capital expenditure in its price submission forecasts. Where capital projects are not fully scoped, costed or internally approved (via an approved business case, for example) at the time of preparing the price submission, Melbourne Water should consider the following options so that customers are not asked to bear the full cost should the project scope or timing change:

1. Include sufficient expenditure to cover only the development costs of the project, with efficient actual construction costs incurred during the period to be rolled into Melbourne Water's regulatory asset base (RAB) at the end of the period, along with any accumulated interest. This provides sufficient revenue allowance for the project to proceed during the next regulatory period, with cost recovery to commence in the following regulatory period at no net loss to the business.
2. Include development costs and a notional allowance for construction, with the balance of efficient construction costs (plus associated interest) to be rolled into the RAB at the end of the period. This allows a reasonable portion of the project, based on the various options and cost estimates at the time of preparing the price submission, to be included in prices.
3. Identify the project as a possible 'uncertain and unforeseen event' to be addressed via the mechanisms outlined in Section 3.20 during the regulatory period.

Melbourne Water should also consider the above options for projects where the benefits are unclear or have not been fully defined, or where the linkages to customer value have not been established.

### 3.8.1. Criteria

The forecast capital expenditure to be included for the purposes of determining the required revenue is capital expenditure that would be incurred by a prudent service provider acting efficiently to achieve the lowest cost of delivering service outcomes, taking into account a long-term planning horizon (prudent and efficient forecast capital expenditure).

We consider that prudent and efficient capital expenditure has the following characteristics which reduce the risk borne by customers:

- required expenditure is based on a P50 estimate, in which there is an equal likelihood of project costs being higher or lower than forecast (noting a P50 estimate may not be appropriate where a business's proposed capital program is dominated by one or two major projects)
- contingency allowances are optimised
- forecast capital expenditure for renewals incorporates expectations for a reasonable rate of improvement in cost efficiency
- risks of project delays and cost overruns are managed through contractual agreements with service providers.

Where actual construction costs are found to exceed their efficient level, we will not roll these inefficient expenditures into the regulatory asset base. Inefficient costs will be borne by Melbourne Water and will not be recovered from customers.

### 3.8.2. Supporting Information

Melbourne Water's price submission must include a forecast of total prudent and efficient capital expenditure for the next regulatory period, including forecast capital expenditure for each year of the next regulatory period, and beyond to 2035-36.

Forecast capital expenditure is to be presented separately for the two major business service areas, by major service category and by the following cost drivers:<sup>44</sup>

- forecast capital expenditure to maintain service standards — that is, renewals
- forecast capital expenditure to expand services — that is, growth
- forecast capital expenditure to make improvements or upgrades to existing services or to comply with existing or changed government or regulator obligations — that is, improvements/compliance.

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<sup>44</sup> The major service categories are water, sewerage, recycled water, bulk water, waterways & drainage, and diversions.

Melbourne Water's financial model template must also specify actual capital expenditure for the current regulatory period (with an updated forecast for 2025-26) and also for the final year of the previous period (2020-21), categorised in the same way as above. Melbourne Water's price submission must identify and explain any material cost or timing discrepancies between actual capital expenditure in the current regulatory period and the level of capital expenditure approved in its current price determination. This must include a reconciliation showing how Melbourne Water has met its commitments to delivering its major capital projects in the current regulatory period, consistent with the annual major project reporting that has occurred over the period. Impacts on customer service levels and value due to non-delivery must also be identified. This information will form part of our assessment of Melbourne Water's Performance element under the PREMO framework.

Further to this, our 2021 final decision for Melbourne Water reduced its proposed capital expenditure forecast by \$250 million (\$2020-21) (a non-specified \$50 million per year). This was to address uncertainty that Melbourne Water would deliver its entire capital program during the regulatory period given the ongoing uncertainty caused by the coronavirus pandemic. We stated that Melbourne Water would have the opportunity to true-up its asset base to reflect actual prudent and efficient expenditure incurred over the period. Our assessment of Melbourne Water's actual expenditure against the approved benchmarks, as well as its PREMO rating for the Performance element, will necessarily consider this previous adjustment made by the commission.<sup>45</sup>

We also expect that Melbourne Water will report to both customers and the commission on the outcomes that have been achieved from capital expenditure in trials or pilots in the current regulatory period, and in particular, an assessment of customer value for money. As well as providing an assessment of customer value for money arising from trials or pilots, where relevant, price submissions must identify how the outcomes of these trials or pilots have informed proposed future projects and expenditure. This is necessary to inform whether it is efficient to support any expansion of pilot programs into future capital expenditure.

Capital expenditure will fall into one of three key types:

- Major capital projects — large, discrete capital investment projects (may be completed within a regulatory period, or may span more than one period)
- Capital programs — ongoing programs of capital expenditure allocation, containing multiple works or projects (for example; water main renewals, sewer odour management, ICT equipment upgrades, etc.)
- Other capital expenditure — typically smaller discrete projects and programs.

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<sup>45</sup> Essential Services Commission 2021, Melbourne Water Final Decision: 2021 water price review, 16 June, pp. 32–38.

Melbourne Water's price submission must present the capital expenditure forecasts for both business service areas set out according to these three key types, as follows:

**Major capital projects** — comprising the 'top 15' discrete capital projects, by total capital cost, to be started or completed during the next regulatory period.<sup>46</sup> Melbourne Water may also include significant discrete projects that fall outside the top 15 by cost but are scheduled for the next regulatory period. For each of these major projects, provide:

- the project name and scope, and relevant major service and asset category
- justification for the project, including the cost driver
- start and completion dates
- total capital cost (itemising any government or customer contributions), and expenditure by year
- objectives of the project, including how the project aligns with the various customer outcomes proposed (Section 3.4) or addresses any major risks (Section 3.1)
- and have available:
  - a business case outlining the options considered for achieving the identified objectives and the approach to identifying the optimal solution<sup>47</sup>
  - risk analysis of the selected option and plans to mitigate the identified risks to ensure the project can be delivered on budget and on time
  - the incentive and penalty payment arrangements with contractors<sup>48</sup>
  - information to identify whether the project has (or will be) the subject of competitive tendering.

**Capital programs** — all key capital expenditure programs or allocations that will be ongoing throughout the regulatory period (excluding any discrete projects separately specified in the 'top 15' above). For each program, provide:

- the program (or cost allocation) name, and relevant major service category
- the cost driver
- total capital cost (itemising any contributions), and expenditure by year
- objectives of the program, including how the program aligns with the various customer outcomes proposed (Section 3.4) or addresses any major risks (Section 3.1)

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<sup>46</sup> Expanding the usual requirement for the 'top 10' projects to a 'top 15' allows Melbourne Water to include its top 5 or so projects representing investment in each major service: water, sewerage, and waterways and drainage.

<sup>47</sup> This should also include an assessment of a 'do nothing' option. Cost comparisons of various options should consider P5, P50 and P95 estimates. Forecasts for capital expenditure must be based on the P50 estimate.

<sup>48</sup> Melbourne Water's proposed prices must reflect incentive and penalty payment arrangements that are based on a symmetrical sharing of risk for delivery or non-delivery of projects.



- historical annual costs, and an explanation for significant increases or decreases in the forecast average annual expenditure
- and have available:
  - the list of projects (where known) included within the program or cost allocation for the next regulatory period, and business cases and options analyses
  - a description of the methodology for assessing risk and prioritising projects within the program
  - the cost estimation basis.

**Other capital expenditure** — all other capital expenditure not associated with a defined major project or major capital program should be grouped into one or more programs as appropriate, to be included under the capital programs list, as above.

Consistent with the above capital expenditure breakdowns (by type and major service category) in the price submission or financial model template where appropriate, Melbourne Water must also:

- for each year of the next regulatory period, and beyond to at least 2035-36, provide annual forecasts for capital expenditure separately identifying (where appropriate) and reconciling:
  - total capital expenditure
  - contributions (government and customer)
  - gifted assets
  - proceeds from asset sales
  - written down value of assets disposed
  - net capital expenditure.
- explain the methodology used to estimate forecast capital expenditure
- identify and explain the key assumptions which underpin the capital expenditure forecasts by each major service category, and how any risks or uncertainties have been addressed
- justify the timeframe for delivering the proposed new capital expenditure given Melbourne Water’s delivery of major projects in the past
- explain the reasons for the trend or any major annual variations in forecast capital expenditure (including identifying cost items that are having an upward or downward influence on capital expenditure), compared with historic capital expenditure
- justify the total forecast capital expenditure against the criteria in Section 3.8.1, taking into account:
  - forecast demand
  - any relevant industry or economy-wide benchmarks of expenditure
  - the substitution possibilities between forecast operating expenditure and forecast capital expenditure.



Our financial model template sets out the forecast capital expenditure consistent with the breakdowns and methodology described above. It includes separate tabs to allow the two major business service areas to be presented independently of each other.

### **3.9. Treatment of desalination security payments**

Melbourne Water's expenditure related to desalination includes annual security payments, and payments for any water ordered from the desalination plant. This section covers the annual desalination security payments. Our guidance on expenditure related to water orders is covered at Section 3.7.2.

Melbourne Water is obliged to pay for the security service provided by the Victorian desalination plant's current operator over a lease period of 27 years to 2039, after which Melbourne Water will assume ownership of the plant. The desalination plant's asset life is much greater than 27 years and Melbourne Water has the choice to reflect some of these security payments as capital expenditure, spreading the recovery of capital costs from customers over a period longer than the lease. Melbourne Water's previous proposals and our determinations have reflected the capitalisation of a portion of the desalination security payments since 2013. This approach supports the principle that customers contribute to the cost of assets as they receive the benefits of those investments.

Melbourne Water is not disadvantaged under this approach because it is allowed to generate a return on its investment (which includes a component to cover estimated costs of finance) and a return of its investment (through a depreciation allowance) over the estimated asset life of the desalination plant.

Most recently in 2021, Melbourne Water proposed, and we approved, the capitalisation of amounts that were the same as its capital (principal) payments for tax purposes.<sup>49</sup> We expect Melbourne Water to continue this approach, because it satisfies the criteria set out below. Consistent with our final decision in 2021, we do not intend to allow capitalisation amounts above those implied for tax purposes for the purpose of offsetting any capitalisation shortfall in prior years.

#### **3.9.1. Criteria**

For the purposes of determining the required revenue, Melbourne Water must propose an approach to the recovery of forecast annual desalination security charges that:

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<sup>49</sup> See ruling made by the Australian Tax Office on 29 October 2015 to address the appropriate tax treatment of Melbourne Water's finance lease payments associated with the Victorian Desalination Plant.

- reflects reasonably based assumptions about the operating and capital-related components of the desalination security charge
- adopts a time profile for recovery of the capital-related component of the desalination security charge which best meets the following:
  - that prices provide signals about the efficient costs of providing services to current and future customers
  - the alignment of the recovery of costs by Melbourne Water with the time period over which the security service will be provided
  - the views of customers (the water retail businesses and their customers)
  - the alignment of the benefits that customers receive from the desalination security service with the payments that customers make
  - the financial viability of Melbourne Water (taking into account the financial indicators specified in Section 3.22).

### 3.9.2. Supporting information

Melbourne Water's price submission must, in relation to the annual security payments associated with the Victorian desalination plant, specify the amount attributed to forecast operating and capital expenditure. Melbourne Water's price submission must also:

- describe and quantify capitalisation scenarios considered, including in terms of:
  - estimated impact on residential and non-residential water and sewerage customers, and
  - Melbourne Water's financial position (in accordance with our financial indicators specified in Section 3.22)
- identify its preferred approach to recovering the desalination security payments and justify how this approach best meets the matters raised in Section 3.9.1
- provide a description of how Melbourne Water consulted with customers, and a summary of the views received from customers
- describe how the views received from customers were taken into account in determining the time profile for recovering the desalination security payments.

The price submission must also include, and justify, all assumptions used in modelling various scenarios. This includes assumptions about:

- forecasts for desalination security payments (including assumptions about estimates of the breakdown of the desalination security payments between operating costs and the capital-related costs)
- depreciation (asset life) assumptions for the desalination plant.

Melbourne Water's approach to capitalisation of desalination security payments will be a key input to our assessment of its PREMO rating. Due to the size of Melbourne Water's desalination security payments, its treatment for pricing purposes can have a relatively large impact on the ability to address customer affordability.

### 3.10. Return on regulatory asset base

A regulatory rate of return is applied to the regulatory asset base (RAB) to calculate the annual return on the RAB to be included in the revenue requirement. The regulatory rate of return comprises two components: a return on equity and a cost of debt.

The benchmark cost of debt will be determined based on a trailing average approach. A benchmark gearing level of 60:40 debt to equity will apply.

The formula for the regulatory rate of return (post-tax, real) is therefore:

$$\text{Regulatory rate of return (RRR)} = \text{Re } 0.4 + \text{Rd } 0.6$$

Where: Re = PREMO rate of return on equity

Rd = benchmark 10 year trailing average rate for the cost of debt.

The benchmark regulatory rate of return must be calculated in nominal terms, and then converted to real terms.<sup>50</sup>

### 3.11. Forecast regulatory asset base

#### 3.11.1. Criteria

The regulatory asset base (RAB) calculated for the purposes of determining the revenue requirement must reflect capital expenditure (less regulatory depreciation, contributions and/or asset disposals) which would be incurred by a prudent service provider acting efficiently to achieve the lowest cost of delivering on service outcomes, taking into account a long-term planning horizon (prudency criteria).

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<sup>50</sup> The Fisher equation will be used to convert cost of debt from nominal to real estimates; that is:

$$(1 + \text{nominal rate}) = (1 + \text{real rate}) * (1 + \text{inflation rate})$$

Refer to Section 3.13.1 for our approach to estimating the forecast inflation in the financial model template.

The opening RAB must be calculated as follows:

Opening RAB 1 July 2026 = RAB at 1 July 2021 (2020-21 actual and inflation adjusted to \$2026)

+ Actual capital expenditure (gross) 2021-22 to 2024-25 and inflation adjusted to \$2026

+ Forecast capital expenditure (gross) 2025-26\* and inflation adjusted to \$2026

– Actual contributions 2021-22 to 2024-25 and inflation adjusted to \$2026

– Forecast contributions 2025-26\*\* and inflation adjusted to \$2026

– Forecast regulatory depreciation 2021-22 to 2025-26\* and inflation adjusted to \$2026

– Proceeds from disposal of assets 2021-22 to 2024-25 and inflation adjusted to \$2026

– Forecast proceeds from disposal of assets 2025-26\*\* and inflation adjusted to \$2026

(\*denotes the forecast used in the 2021 price determination)

(\*\* denotes the latest available forecast for 2025-26)

Our financial model template has been amended to enable Melbourne Water to show its updated gross capital expenditure forecast for 2025-26 alongside the forecast benchmark for that year in the 2021 price determination, and to select which of the two values it proposes to roll into the opening RAB from 1 July 2026. We expect Melbourne Water to select the lower of the two values. However, if Melbourne Water seeks to roll-in a higher value than the benchmark, it must advise us in advance that it intends to do so and demonstrate how this is in the best interest of its customers, and ensure it can meet the prudence and efficiency requirements set out in Section 3.9.

If the updated developer contribution forecast for 2025-26 is higher than the forecast benchmark for that year in the 2021 price determination, then Melbourne Water must use the higher amount.

The same approach must be used to determine the opening value on 1 July for each subsequent year in the next regulatory period, using the forecasts for capital expenditure, customer and government contributions, regulatory depreciation and asset disposals.

### 3.11.2. Supporting information

Melbourne Water's price submission must propose:

- the closing value for the RAB at 30 June 2025 (using actual data)
- the opening value of the RAB at 1 July 2026 (calculated according to the criteria above)
- the forecast value of the RAB for each year of the next regulatory period, in accordance with the prudence criteria set out above
- the forecast value of the RAB for each year after the next regulatory period until at least 2035-36.

Required contents of Melbourne Water's price submission

The price submission must also:

- provide estimates for regulatory depreciation (Section 3.12)
- provide separate data and justify estimates for:
  - government contributions — federal, state and local government contributions towards the capital cost of a project
  - customer contributions — upfront cash payments made by new customers
  - the value of gifted assets — assets constructed and then handed over to the water business to operate and maintain
- include estimates of revenue expected from disposal of assets for each year from 1 July 2026, to be deducted from the roll forward of the RAB.

To assist with our review, we may seek further information on Melbourne Water’s justification for capital expenditure in 2020-21 and in the period 2021-22 to 2024-25. We may also request a reconciliation of actual net capital expenditure against the benchmarks allowed in the water business’s 2021 price determination (Section 3.8.2), including for any expenditure related to trials or pilot programs.

### **3.12. Regulatory depreciation**

We recognise a return of capital expenditure (regulatory depreciation) for an asset when the asset enters service. We prefer a straight-line depreciation profile.

The estimates and profiles for regulatory depreciation should reflect reasonable assumptions about asset life and utilisation.

Melbourne Water can propose an alternative approach to straight-line depreciation having regard to the following assessment principles:

- the depreciation rate should account for technological change, projected future demand and any other factors that may affect the value of the assets in the future
- the technical lives of assets
- impact on prices over the long-term.

### **3.13. Cost of debt**

We will use a 10-year trailing average approach to estimate the benchmark cost of debt. The trailing average approach will determine the whole cost of debt (covering the risk free rate and debt risk premium). We use a Reserve Bank of Australia (RBA) data set to estimate the cost of debt, and add an amount to reflect debt raising costs. The averaging period will be the 10 years preceding the year in which the rate applies.

Each year, the 10-year trailing average cost of debt will be updated by rolling forward the data series by one year, such that:

- the cost of debt for the roll-forward (previous) year reflects the yields of the RBA 10-year BBB rated corporate bond – Reserve Bank of Australia Table F3 series FNFYBBB10M
- the annual update is a simple average of 12 months of the RBA 10-year BBB rated corporate bond over 1 April in the previous calendar year to 31 March in the current calendar year and the assumption of 0.15 per cent for debt raising costs
- the trailing average is a simple average of 10 years of cost of debt
- the cost of debt is calculated in nominal terms which would then be converted to real terms based on our long term inflation estimate.<sup>51</sup>

The historical data series for the cost of debt calculated using the method described above is set out in Table 3.2.

**Table 3.2 Annual cost of debt (values for calculating trailing average)**  
Nominal values

	2016-17	2017-18	2018-19	2019-20	2020-21	2021-22	2022-23	2023-24	2024-25	2025-26
Cost of debt	4.91%	4.53%	4.61%	3.31%	3.05%	3.75%	6.76%	6.53%	6.53% <sup>a</sup>	6.53% <sup>a</sup>

<sup>a</sup> The cost of debt values for 2024-25 and 2025-26 will be updated to reflect annual averages based on actual data, prior to the final decision, consistent with the methodology outlined in Section 3.13

Data source: Reserve Bank Australia, Treasury Corporation Victoria and the Essential Services Commission

Melbourne Water is not required to submit information on the cost of debt in its price submission, because the cost of debt will be determined on the basis of the data outlined above. However, Melbourne Water must use the values above to estimate its revenue requirement and prices, subject to any updated values we provide before we make a price determination (the values in Table 3.2 will be reflected in the financial model template we provide to Melbourne Water).

<sup>51</sup> The Fisher equation will be used to convert cost of debt from nominal to real estimates; that is:

$$(1 + \text{nominal rate}) = (1 + \text{real rate}) * (1 + \text{inflation rate})$$

Refer to Section 3.13.1. for our approach to estimating the forecast inflation in the financial model template.

### 3.13.1. Forecast for expected inflation

The forecast for expected inflation is an input to calculating the trailing average cost of debt. We need to convert the nominal cost of debt to real terms consistent with our real post-tax pricing model. Our approach to estimating expected inflation is:

- We estimate expected inflation based on the simple average of the 'RBA geometric' and 'bond breakeven' inflation rates. We will use a five-year average to estimate inflation under each method.
- Under both methods, the value for 2026-27 reflects actual inflation – that is, calculated based on the annual percentage change in the Australian Bureau of Statistics March 2026 consumer price index (all groups, Australia).
- After 2026-27, the 'RBA geometric' inflation rate will use the RBA forecast consumer price index inflation rate for year two and three of the regulatory period, and the midpoint of the RBA target inflation band of two to three per cent for years four and five.
- After 2026-27, the 'bond breakeven' inflation rate will use values implied by the difference between the yields on 10-year nominal and indexed (inflation-linked) Commonwealth Government Securities.

This approach is consistent with the approach we have adopted at recent price reviews. The forecast for expected inflation will be released in early May 2026 together with the actual cost of debt for 2025-26.

### 3.13.2. Approach to forecasting the cost of debt for the revenue requirement

To establish a revenue requirement, we need to adopt an assumption for the future nominal cost of debt, noting estimates are 'trued up' for actuals annually during the regulatory period.

In past reviews, to calculate the revenue requirement at the time of our price determination, we have used the 10-year trailing average figure used for the first year of the next regulatory period, for all years of the regulatory period.

To estimate the revenue requirement for the next regulatory period, we will adopt the most recent annual cost of debt (at the time of our determination) as the new figure that is rolled in to the 10-year trailing average. This is in response to previous (2021) feedback from water businesses noting that adopting the most recent annual figure will result in reduced variation from the revenue requirement (and prices) established during our price reviews, as actual figures replace the forecasts. It is also consistent with the principle that the current cost of debt is a better predictor of the future cost of debt than the average rate over the prior 10-year period.

For Melbourne Water's price submission, we will provide the actual cost of debt for 2024-25 (and the March quarter 2025 consumer price index) around early May 2025, and then we will update for the actual cost of debt for 2025-26 for our final decision.

### 3.14. PREMO Rating

We have reviewed the PREMO framework and assessment process to consider the nature of services delivered by Melbourne Water, including its role as Melbourne's supplier of bulk water and sewerage services. As noted earlier, we consider that the PREMO framework and incentive mechanisms should apply to Melbourne Water, but with minor amendments. These amendments mostly impact the return on equity values in our PREMO matrix and are discussed further below.

The return on equity to be reflected in prices will be established via the PREMO incentive mechanism, under which Melbourne Water's return on equity will be linked to the level of ambition expressed in its price submission.<sup>52</sup>

Under PREMO, Melbourne Water must self-assess the level of ambition of its price submission as either 'Leading', 'Advanced', 'Standard' or 'Basic'. We will independently assess the price submission and also rate it as 'Leading', 'Advanced', 'Standard' or 'Basic'. This two-stage PREMO assessment and rating process will determine the return on equity to be reflected in approved prices.

The range of possible outcomes (in real terms) for the return on equity resulting from the two-stage assessment and rating process is provided in Figure 3.2.

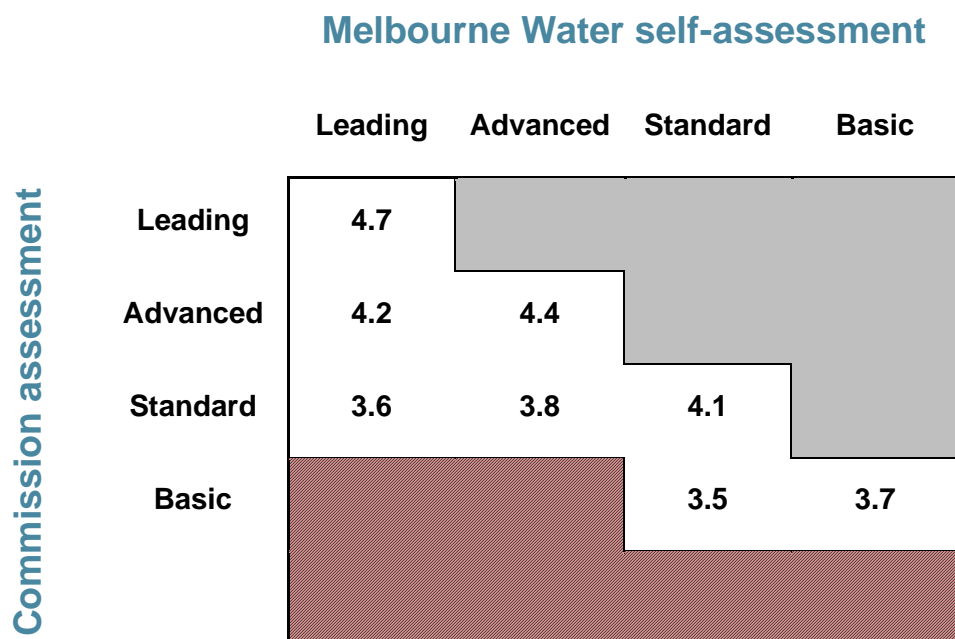
For Melbourne Water's 2021 price review, we changed the incentive return on equity values for Melbourne Water from the values applied to other water businesses in our 2018 price review. Most notably, we lowered the step increases above the 'Standard' value from 40 basis points to 30 basis points, to reflect an incentive return on equity value equal to approximately a 1 per cent change in Melbourne Water's revenue requirement, which on average, was equivalent to the impact of the step increases in the PREMO matrix applied to other businesses. The same approach has been applied to the 'Leading' and 'Advanced' values in Figure 3.2 below, with the remaining values consistent with those established for our recent 2023 and 2024 price reviews.

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<sup>52</sup> For more detail, see Essential Services Commission 2016, Water Pricing Framework and Approach: Implementing PREMO from 2018, October, pp. 9–13.



**Figure 3.2 Regulated return on equity**  
Real per year rate (per cent)



Note: Melbourne Water must self-assess its price submission before lodging with us. We then complete our assessment of the price submission.

Melbourne Water will achieve the highest return on equity for its nominated PREMO rating when the commission and the water business align in their respective assessments. Situations of aligned assessments are represented by the upper diagonal of the matrix shown in Figure 3.2. The more ambitious the submission according to both Melbourne Water and the commission, the greater will be the allowed return on equity.

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

If we find Melbourne Water has overstated its ambition, then the return on equity will be lower than had it accurately assessed itself. This can be seen in the diminishing values moving left along each row in Figure 3.2.

We consider that the incentives embedded in the return on equity matrix at Figure 3.2 are in the best interests of Victorian water customers, as it reduces the likelihood of a water business being allowed a rate of return that is 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 we will reserve our discretion. For example, we may require Melbourne Water to resubmit its proposal, or approve a shortened regulatory period, if we rate its submission to be in this part of the matrix.

Together, the design features of the matrix provide Melbourne Water with a strong incentive to assess its price submission accurately and honestly.

If during its price submission assessment the commission downgrades Melbourne Water's PREMO rating, the commission (at its discretion) may elect to include specific conditions or performance criteria in the price determination that, if met, would allow Melbourne Water to apply to have its original PREMO rating restored. This would likely involve Melbourne Water demonstrating efficiency improvements or better service during the regulatory period, over a timeframe we specify. 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.

For Melbourne Water's 2026 price review, the ambition expressed in the price submission will be rated according to all five elements of PREMO — Performance, Risk, Engagement, Management and Outcomes.

Melbourne Water must self-rate its price submission for each of these five elements and use these ratings to arrive at its overall PREMO rating and corresponding return on equity.

### **3.14.1. Criteria**

Melbourne Water must include a price submission self-rating of 'Leading', 'Advanced', 'Standard' or 'Basic'. The price submission must also identify the rating for the Performance, Risk, Engagement, Management and Outcomes elements of PREMO.

We will agree with Melbourne Water's self-ratings where transparent and credible evidence has been provided that justifies the ratings. The guiding questions in Table 3.3 set out the matters we will consider in assessing Melbourne Water's proposed rating for each PREMO element.

Appendix E includes a PREMO assessment tool that Melbourne Water must use to inform its PREMO ratings. The tool includes examples of what might constitute a 'Leading', 'Advanced', 'Standard' or 'Basic' rating for each element of PREMO. Informed by the assessment for each element of PREMO, Melbourne Water must propose an overall PREMO rating for its price submission. Appendix E also includes a scoring methodology to assist Melbourne Water with this rating process, noting use of the scoring methodology is not mandatory.

Melbourne Water's price submission must address all of the requirements set out in this guidance to achieve a 'Standard' rating or higher.

**Table 3.3 Guiding questions for PREMO assessment**

PREMO element	Guiding question
<b>Performance</b>	<ul style="list-style-type: none"> <li>• To what extent has Melbourne Water demonstrated delivery of its customer outcomes commitment over the current regulatory period? Did its customers get what they paid for?</li> <li>• How does Melbourne Water’s actual operating expenditure across the current period compare with its established benchmark allowance, and to what extent has the water business rationalised any discrepancies?</li> <li>• How does actual capital expenditure across the current period compare with the established benchmark allowance, and to what extent has Melbourne Water rationalised any discrepancies?</li> <li>• To what extent does customer sentiment demonstrate satisfaction in Melbourne Water’s performance over the current regulatory period? Are customers happy with the value they receive from Melbourne Water?</li> </ul>
<b>Risk</b>	<ul style="list-style-type: none"> <li>• To what extent has Melbourne Water demonstrated a robust process for identifying risk, and how it has decided who should bear these risks? i.e such that customers are not paying more than they need to.</li> <li>• To what extent does the proposed guaranteed service level (GSL) scheme provide incentives for Melbourne Water to be accountable for the quality of services delivered, and provide incentives to deliver valued services efficiently?</li> </ul>
<b>Engagement</b>	<ul style="list-style-type: none"> <li>• To what extent has Melbourne Water justified how the form of engagement suits the content of consultation, the circumstances facing the water business and its various customer groups?</li> <li>• To what extent has Melbourne Water demonstrated that it provided appropriate instruction and information to its various customer groups about the purpose, form and content of the customer engagement?</li> <li>• To what extent has Melbourne Water demonstrated that the matters it has engaged on are those that have the most influence on the services provided to its various customer groups and prices charged?</li> <li>• To what extent has Melbourne Water explained how it decided when to carry out its engagement?</li> </ul>

- To what extent has Melbourne Water demonstrated how its engagement with its various customer groups has influenced its submission?
- To what extent has Melbourne Water demonstrated that its engagement was inclusive of consumers experiencing vulnerability?
- To what extent has Melbourne Water demonstrated that its engagement was inclusive of First Nations people and relevant Traditional Owner groups?

#### **Management**

- To what extent has Melbourne Water demonstrated how its proposed prices reflect only prudent and efficient expenditure?
- To what extent has Melbourne Water justified its commitment to cost efficiency or productivity improvements?
- To what extent has Melbourne Water justified or provided assurance about the quality of the submission, including the quality of supporting information on forecast costs or projects?
- To what extent has Melbourne Water provided evidence that there is senior level, including Board level, ownership and commitment to its submission and its outcomes?
- To what extent has Melbourne Water demonstrated its price submission is an 'open book'?

#### **Outcomes**

- Has Melbourne Water provided evidence that the outcomes proposed have taken into account the views, concerns and priorities of its end-use customers and water retailers?
- Has Melbourne Water provided sufficient explanation of how the outcomes it has proposed align to the forecast expenditure requested?
- Has Melbourne Water proposed outputs to support each of its outcomes, which are measurable, robust and deliverable?
- Has Melbourne Water provided evidence that the outputs it has proposed are reasonable measures of performance against stated outcomes?
- Has Melbourne Water demonstrated a process to measure performance against each outcome and to inform its end-use customers and water retailers?

### **3.14.2. Supporting information**

Melbourne Water's price submission must provide information that satisfies the procedural requirements set out in the criteria above. The price submission must also:

Required contents of Melbourne Water's price submission

- identify the reasons for the self-ratings for the Performance, Risk, Engagement, Management and Outcomes elements of PREMO, with reference to the guiding questions above
- identify the reasons for the price submission’s overall PREMO rating.

### 3.15. Return on equity

The price submission PREMO rating proposed by Melbourne Water will correspond with a value for a return on equity to be reflected in its price submission (Table 3.4).

**Table 3.4** Maximum return on equity for each PREMO rating  
Real per year rate (per cent)

	Leading	Advanced	Standard	Basic
Maximum return on equity to be reflected in Melbourne Water’s proposed revenue requirement	4.7	4.4	4.1	3.7

#### 3.15.1. Criteria

Melbourne Water’s proposed revenue requirement must incorporate a value for the return on equity that is no higher than the value specified in Table 3.4 for its proposed price submission rating. For example, an ‘Advanced’ rating will correspond with a maximum return on equity of 4.4 per cent. No further supporting information regarding Melbourne Water’s return on equity is required.

### 3.16. Tax allowance

#### 3.16.1. Criteria

The tax allowance included for the purposes of determining the required revenue must reflect an estimate of the corporate income tax to be paid, less the imputation credits that would be received by a hypothetical private investor in Melbourne Water. In estimating the value of imputation credits Melbourne Water must multiply the annual estimated corporate income tax bill by an imputation factor.<sup>53</sup>

This is consistent with the income tax calculation in the financial model.

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<sup>53</sup> While franked dividends are not generally paid by government businesses, in order to maintain competitive neutrality, it is necessary to make an assumption of the value of imputation credits for a hypothetical private investor in the regulated entity. Therefore, it will be necessary to assume a value of imputation credits in the tax calculation.

### 3.16.2. Calculating the tax allowance

Once populated by Melbourne Water, the financial model will include an estimate of Melbourne Water's future nominal tax allowance based on the following formula:

$ETC_t = (ETI_t \times r_t) (1 - \gamma)$ , where:

- $ETC_t$  is an estimate of the future nominal tax allowance
- $ETI_t$  is an estimate of the taxable income for each regulatory year
- $r_t$  is the expected statutory income tax rate for each regulatory year
- $\gamma$  is the value of imputation credits (which will be at the rate of \$0.50 for every \$1 of company tax paid, as in past price reviews).

In relation to the estimate of  $ETI_t$  for each year of the next regulatory period:

- the revenue and expenditure estimates used in the calculation are the same revenue and expenditure estimates used to establish maximum prices (except that customer contributions and gifted assets are treated as revenue)
- the interest expenses (deductions) reflect the nominal cost of debt and the assumed stock of debt (that is, gearing multiplied by the regulatory asset base)<sup>54</sup>
- the calculation allows for an adjustment to reflect tax depreciation.

The financial model template adjusts the nominal tax allowance for inflation in order to derive the real tax allowance for each regulatory year. This estimate must be used by Melbourne Water as the basis for its tax allowance forecasts. The forecast tax allowance may also be informed by Melbourne Water's latest estimate of tax to be paid over the next regulatory period.

The financial model template allows the tax rate to be entered for each year of the next regulatory period, to allow Melbourne Water to reflect any expected changes in the applicable tax rate. Melbourne Water should estimate the applicable tax rate and include it in the relevant input fields in the financial model template.

### 3.16.3. Supporting information

The price submission must propose a total tax allowance for the next regulatory period. An estimate must also be provided for each year of the next regulatory period.

The price submission must also:

- state the basis on which the tax allowance for the next regulatory period has been calculated

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<sup>54</sup> The tax allowance benchmarks in the price determination will be kept constant for the regulatory period, and will not vary with the cost of debt.

- in the financial model template, provide an estimate of the income tax for each year after the next regulatory period up until at least 2035-36
- make available to us Melbourne Water's latest corporate forecasts for annual tax payments for the next regulatory period, and the basis for the forecasts.

### **3.17. Demand**

#### **3.17.1. Criteria**

Demand forecasts proposed by Melbourne Water must represent the best available estimates derived from an appropriate forecasting methodology. Assumptions on the key drivers of demand over the next regulatory period must be well explained and reasonable. These assumptions must be based on the latest data and evidence available.

#### **3.17.2. Supporting information**

Melbourne Water's price submission must summarise its demand forecasts, including expected trends for the next two regulatory periods, as well as outline the key assumptions adopted to develop those forecasts. Melbourne Water should use at least a 10-year horizon for demand forecasting and scenario work, and reflect this in its price submission.

The price submission must also include:

- a description of the key demand forecasting issues that lists and justifies the most important assumptions adopted in generating the forecasts — demand forecasts should be based on the latest available Victoria in Future estimates provided by the Victorian Government, with variations and underlying assumptions clearly explained
- a description of the forecasting methodology used, and the justification for using the methodology
- reference to any external reports or information relied upon
- a description of how forecasts have accounted for the impact of any proposed changes to tariff structures or form of price control expected in the next regulatory period
- details on the levels of restrictions or nature of any permanent water conservation measures reflected in the forecast
- written information on where price elasticity was applied, the input assumptions used, and how the assumptions were translated into Melbourne Water's demand forecasts
- an explanation of how demand forecasts are consistent with proposed expenditure (in terms of the level and nature of expenditure).

Melbourne Water must also make available evidence that a range of supply and demand scenarios were modelled. This should include low, normal and high water inflow scenarios, and consideration

of a range of 'low' to 'high' population growth assumptions. Written justification must be provided for the selection of the forecasts proposed.

The financial model template will require Melbourne Water to provide detailed demand forecasts for every tariff and tariff category. If detailed forecasts at this level are unavailable, Melbourne Water must explain why and provide estimated demand for these services. The detail in the model does not need to be reproduced in the price submission.

### **3.18. Form of price control**

Melbourne Water currently uses a tariff basket form of price control for most of its water and sewerage services, which allows it to adjust its prices within the tariff basket in a regulatory year subject to ensuring the weighted average price movements under each tariff basket for each year of the regulatory period do not exceed the weighted average price movements approved by the commission for that year. For waterways and drainage services, Melbourne Water currently uses a price cap form of price control under which it can charge customers up to the maximum price approved in a determination issued by the commission. In considering whether to approve a proposed price control, we will have particular regard to whether the proposal involves a continuation of an existing structure or whether changes are proposed. We note that different forms of price control may apply to different services.

Where an existing price control structure is being continued, the justification requirements below may be satisfied more easily. Where a change is proposed, however, Melbourne Water will need to provide evidence to demonstrate that the new price control better satisfies the requirements in clause 11 of the WIRO than the existing structure.

#### **3.18.1. Criteria**

We will assess proposals against the following factors:

- Melbourne Water's justification for the proposed form of control, including its consideration of efficiency and risk allocation and management
- Melbourne Water's approach to consultation on the form of control and how the views of water retailers and end-use customers were taken into account
- where a change to the form of price control is proposed, whether Melbourne Water has considered and demonstrated that appropriate transition strategies will be implemented for affected customers
- the administrative complexity of the proposed form of control
- the ability of customers to understand the resulting tariffs and tariff movements throughout the regulatory period.



In assessing Melbourne Water’s proposed form of price control, in particular where a change is proposed, we will place a strong weighting on the feedback received from its customers and water retailers.

### **3.18.2. Supporting information**

The price submission must:

- clearly state the proposed form of price control to apply to each service over the next regulatory period
- include the formula to give effect to the form of price control, including any proposed side constraints if Melbourne Water is proposing a revenue cap form of price control
- if applicable, specify and justify which tariffs are subject to a tariff basket form of control and how those tariffs are grouped (e.g. according to similar cost structures, customer class or service category).

If changes to the form of price control are proposed by Melbourne Water, then its price submission must:

- explain how the proposed form of control would operate and services affected
- demonstrate that Melbourne Water has consulted with potentially affected customers, and explain how the feedback from water retailers and end-use customers informed its proposals, and how the change benefits customers
- provide data and supporting information that describes how the proposed form of price control is consistent with providing signals about the efficient cost of delivering services and how it is likely to impact on price stability
- explain how Melbourne Water has considered risk allocation and management (including demand and financial risk)
- explain how a transition to a new form of price control may impact customers, and Melbourne Water’s approach to minimising any adverse impacts.

### **3.19. Prices and tariff structures**

We typically provide businesses with a large degree of discretion to decide on tariff structures. This recognises that Melbourne Water is best placed to consider the interests of its customers in designing tariffs and that existing tariff structures have been developed over time to deal with a variety of local circumstances. We intend to continue this approach.

Any reforms to bulk water tariffs must be justified by Melbourne Water as meeting the requirements in clause 11 of the WIRO. Melbourne Water’s price submission must also provide a summary of stakeholder views on bulk water tariffs, and how these views have been considered in reaching its final proposals.

Required contents of Melbourne Water’s price submission

We also require Melbourne Water to continue to move to a more cost-reflective non-residential waterways and drainage tariff, and consider the customer impacts, including impacts to water retailers, and any transition strategies for non-residential customers most affected by the reforms.

Melbourne Water's price submission must list each of its proposed tariffs to apply in the next regulatory period and include:

- each element of a multi-part tariff structure
- a price for each tariff
- where relevant, the pricing principles that it proposes to apply in setting prices.

We anticipate prices for recycled water, unique services such as trade waste, and miscellaneous services will be set with reference to pricing principles. The pricing principles for the regulatory period commencing 1 July 2021 are outlined in Appendix F. Guidance on developer charges is provided in Section 3.21.

There may be instances where tariffs are proposed that relate to a very small proportion of revenue or are applicable to very few customers. In these cases, Melbourne Water may propose specific pricing principles.

In developing its pricing proposals, we encourage Melbourne Water to consider the tariff assessment principles listed in Table 3.5.

**Table 3.5 Tariff principles**

Principle	Description
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	<p>Tariff structures should be simple, understandable and cost reflective.</p> <p><b>Bulk Water Charges Structure</b> — 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.</p> <p><b>Bulk Sewerage Charges</b> — 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).</p> <p><b>Trade Waste</b> — Trade waste charges should be load-based where measurement is feasible and where the benefits outweigh the costs.</p>
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	<p>Tariffs and charges and service offerings, and the form of price control, should have regard to:</p> <ul style="list-style-type: none"> <li>• the ability of customers to understand the tariff and service offering and respond to price signals</li> <li>• customer preferences and needs in relation to service standards or new services</li> <li>• the costs of implementing the tariff offering, including administration and marketing costs</li> <li>• price path stability.</li> </ul>
Locational and postage stamp pricing	<p>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.</p> <p>Locational pricing comprises tariffs that vary by location – reflecting differences in cost structure of water supply, delivery and treatment across Melbourne Water’s service region. Locational pricing should be applied when water supply is less integrated and where there are material differences in costs between water networks.</p> <p>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.</p>

The principles in Table 3.5 provide guidance for Melbourne Water to check its proposed tariffs are consistent with the WIRO, including that tariffs provide signals to customers about the efficient costs of providing services. Compliance with the tariff assessment principles may also support Melbourne Water's proposed PREMO rating.

### 3.19.1. Criteria

We will assess Melbourne Water's proposals against the following factors:

- Melbourne Water's consideration of risk and efficiency – particularly how proposed tariffs are consistent with providing signals about the efficient cost of delivering services
- the extent to which proposed new tariffs or tariff structures are consistent with the tariff assessment principles in Table 3.5
- Melbourne Water's approach to consultation on the tariff structures and how the views of customers were taken into account
- whether Melbourne Water has considered and demonstrated that appropriate transition strategies will be implemented for any materially affected customers
- where applicable, whether Melbourne Water has justified changes to its tariff strategy
- the ability for customers to understand the resulting tariffs and tariff movements throughout the regulatory period.

For price levels, we will assess proposals against the following factors:

- Melbourne Water's justification for the proposed prices, particularly how proposed prices are consistent with providing signals about the efficient cost of delivering services, and providing incentives for Melbourne Water to pursue efficiency improvements
- how Melbourne Water has taken into account the interests of its end-use customers and water retailers, in particular low-income customers and customers experiencing vulnerability
- whether Melbourne Water has adequate transition strategies in place to manage the impacts of significant price shocks for affected customers.

The matters the commission must have regard to in making a decision are set out under clause 11 of the WIRO. We will have particular regard to whether tariffs are continuing in the same form as applied during the last period, or whether changes are proposed.

We recognise that an important objective under the WIRO includes avoiding price shocks for end-use customers and water retailers where possible. Where an existing tariff structure is being continued, this objective may be satisfied more easily. Where changes from existing tariff structures are proposed, however, Melbourne Water will need to provide evidence to demonstrate that the amended tariff structure better satisfies clause 11 of the WIRO than the existing structure.

### 3.19.2. Supporting information

Melbourne Water's price submission must:

- include a tariff schedule listing each tariff and the price (or principles) proposed, including each element of a multi-part tariff structure and miscellaneous tariffs
- outline Melbourne Water's tariff strategy and highlight any major proposed changes during the regulatory period commencing 1 July 2026
- provide indicative bill impacts for waterways and drainage customers and customers of retail water businesses (households and businesses) that receive services from Melbourne Water – estimates must be provided for each year of the regulatory period using customer connections and demand forecast data sourced from water retailers and specified in real terms
- include a summary of Melbourne Water's approach to consultation on its proposed tariffs and how the views of customers and other key stakeholders informed the price submission
- for any changes in Melbourne Water's tariff structures and principles, or new tariffs:
  - state how each tariff is to be applied – for example, frequency of charging, customer class, applying prices through connection or meter size
  - describe the relationship between the proposed price for a service and the associated short run or long run marginal cost
  - provide data and supporting information that describes how proposed new tariffs are consistent with providing signals about the efficient cost of delivering services<sup>55</sup>
  - describe how Melbourne Water has considered risk and its allocation and management
  - provide a summary of Melbourne Water's approach to consultation and how the views of end-use customers and water retailers informed the price submission
- for real price changes of more than 10 per cent for any tariff in any year for the regulatory period commencing 1 July 2026:<sup>56</sup>
  - describe the relationship between the cost of service provision and the proposed price
  - provide a summary of Melbourne Water's approach to consultation (including the approach to identifying affected end-use customers and water retailers)
  - summarise the customer feedback received on the proposed price increase

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<sup>55</sup> We require the price submission to propose prices that seek to reduce and minimise cross-subsidies. The extent to which this may be achieved will depend on a range of factors, including how well any adverse customer impacts may be managed. These issues will need to be explored in price submissions.

<sup>56</sup> Clause 11(d)(ii) of the WIRO requires the commission to have regard to the principle that prices should provide signals about the efficient costs of providing services, while avoiding 'price shocks' where possible. A price shock is an increase of greater than 10 per cent in any year for any individual tariff. For any proposed price increases of greater than 10 per cent in any year, Melbourne Water will need to consider the merits of the increase while having regard to the cost of delivering the particular service (that is, cost reflectivity) and the impacts on its customers.

- describe the transition arrangements considered, and ultimately proposed, for affected customers
- provide estimated tariffs for each service for each year beyond the next regulatory period up until at least 2035-36, in the financial model template
- provide the Top 10 miscellaneous charges by forecast revenue for the next regulatory period and the following period up until 2035-36 in the financial model template
- provide supporting information that describes how proposed miscellaneous tariffs are calculated in accordance with requirements in the WIRO and the pricing principles provided below.

### **3.19.3. Pricing principles for miscellaneous services**

Prices for miscellaneous services must be set according to actual costs 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
- 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.

## **3.20. Adjusting prices**

Melbourne Water's price submission must specify any proposed price adjustment mechanisms to apply in the regulatory period commencing 1 July 2026. The 2021 price determination includes mechanisms that allow for prices to adjust in order to take into account:

- uncertain and unforeseen events
- differences between forecast and actual desalination costs (covering Victorian Desalination Plant security payments and the cost of any water ordered)
- a 'pass through' of changes in some costs (such as taxes, desalination water order) during the regulatory period
- annual changes to the benchmark cost of debt.

Our view is that these price adjustment mechanisms have worked well, and we propose these arrangements will continue. In the past, water businesses have also provided specific price adjustment mechanisms, which we have approved and included in their respective determinations.

The proposed price control formulas must continue to include a mechanism to allow for price adjustments to occur on an annual basis, including desalination water orders.

If Melbourne Water proposes to continue with the existing price adjustment mechanisms, the supporting information requirements will be easily satisfied. Where a change is proposed, Melbourne Water will need to provide evidence to demonstrate how the new or amended adjustment mechanism satisfies the requirements in clause 11 of the WIRO.

We will consider proposals addressing other events that may require a pass-through to adjust prices during the regulatory period, provided a clearly articulated justification is included in the price submission. Where there is a potential policy or regulatory change that is known but uncertain in its impact on Melbourne Water's costs, the change may be nominated in Melbourne Water's price submission as a potential pass-through, or an uncertain or unforeseen event. Capital projects which are anticipated, but have not been fully scoped or costed (as described in Section 3.8) may be nominated as an uncertain event.

### **3.20.1. Criteria**

In approving proposed pass-through or uncertain or unforeseen events, we will consider:

- the extent to which the event is outside Melbourne Water's control and poses significant risk of cost changes during the period
- the extent to which the nominated event is uncertain in its impacts and/or timing
- whether it is reasonable that Melbourne Water's customers should bear risk associated with the nominated event
- the impact of the nominated event on efficiency incentives for Melbourne Water
- the ability for Melbourne Water to otherwise manage the risk and cost impact posed by the event – for example, in its form of price control, tariff structures or approach to contracting.

### **3.20.2. Supporting Information**

Melbourne Water's price submission must:

- specify any proposed price adjustment mechanisms to apply in the regulatory period commencing 1 July 2026, and specify the proposed process and/or formula for adjusting prices
- if proposing new or changed price adjustment mechanisms:
  - clearly specify and explain how the adjustments would work
  - demonstrate that Melbourne Water has sought to appropriately balance revenue and cost risk between the business and its customers, without materially impacting on price stability
  - justify any proposal against relevant matters in clause 11 of the WIRO and consistency with proposed outcomes.

For any identified pass-through or uncertain and unforeseen events, the price submission must also:

- describe each proposed event, and explain why it is uncertain in its timing or impacts on Melbourne Water or its end-use customers and/or water retailers
- explain why it is appropriate that either end-use customers and/or water retailers should bear risk associated with the event
- explain how Melbourne Water considered the impacts on its incentives to pursue efficiencies
- propose a price adjustment mechanism to implement the pass-through.

### 3.20.3. Schedule of prices to be included in the Determination (Schedule 2)

A template of the schedule of prices from the Determination (Schedule 2) has been included in the financial model template. Melbourne Water must complete the tariff and price components of the schedule of prices, including the price path movement, in the template when it submits its financial model template.

## 3.21. Developer charges

Services to which developer charges apply are a prescribed service for Melbourne Water (also known as new customer contributions). Developers pay Melbourne Water for the capital investment required to provide drainage and waterway services on undeveloped land.

In our 2021 price review for Melbourne Water, we approved a set of pricing principles that determine how developer charges are calculated by Melbourne Water. The pricing principles for developer charges for drainage schemes are outlined in Box 3.3.

### 3.21.1. Criteria

If Melbourne Water does not propose any changes to the pricing principles outlined in Box 3.3 to calculate developer charges, we are likely to approve them for the 2026 price review, as these principles have worked well in the past.

However, if Melbourne Water proposes changes to these pricing principles, then we would assess the changes against the matters in clause 11 of the WIRO.

#### Box 3.3 Developer charges pricing principles

Developer charges will be calculated by:

- identifying future capital expenditure for each year of the expected life of the scheme
- identifying forecast developable hectares for each year using an estimate of development density
- applying a pre-tax real discount rate (consistent with that determined by the commission) to convert future cash flows into present value terms



- setting the developer charge such that the present value of future income equals the present value of future costs, where future income is equal to the developable hectares in each year multiplied by the developer charge
- reviewing the financial assumptions relating to each scheme on an annual basis and reviewing engineering specifications every five years.

### 3.21.2. Supporting Information

Melbourne Water's price submission must specify the pricing principles that will apply for developer charges, and if changes to the pricing principles are proposed:

- provide the rationale for the changes, having regard to the relevant matters in clause 11 of the WIRO and feedback received from customers
- describe the consultation that has occurred with interested parties, including how their feedback was incorporated into Melbourne Water's proposal.

Melbourne Water must outline how it proposes to adequately resource the administration requirements of developer charges, including the assessment of applications it receives from developers. We would also encourage Melbourne Water to establish and commit to a maximum response time for its review of applications received from developers.

## 3.22. Financial position

The financial model template will calculate estimates for the financial indicators specified in Tables 3.6 and 3.7 for each year to 2035-36. A new financial indicator (RCF/Net debt) has been introduced to assess if the size of a business's dividend or capital repatriation payments will result in a financeability concern. We have also reclassified an existing indicator from a secondary to a primary indicator of financeability – the FFO/Net debt indicator measures the capacity of a business to repay debt. It provides a medium-term view of a business's financeability. The indicators are explained in more detail in Table 3.6.

We are introducing financial indicators to undertake notional tests, in addition to the typical actual tests. The notional test assesses whether the building blocks methodology to setting prices is sound, while the actual test assesses whether the business can remain financeable based on changes to prices in any given price submission.

Melbourne Water must populate the financial model template to enable our assessment of its financial position in the context of the prices proposed in its price submission. Melbourne Water should also provide us with the findings of any independent ratings assessments conducted by an independent credit ratings agency since 1 July 2021.

**Table 3.6 Financial indicators – actual test**

Indicator	Calculation	Benchmark range	Description
<b>Primary indicator — used to determine size of any viability adjustments</b>			
FFO interest cover	$(\text{FFO} + \text{net interest}) / \text{net interest}$	> 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.
FFO / Net debt (%)	$\text{FFO} / (\text{Interest bearing liabilities} - \text{cash})$	> 6 per cent	Measures the extent to which the serviceability of debt is improving, remaining stable, or declining.
<b>Secondary indicators — used only as contextual information to determine whether an adjustment is necessary</b>			
Net Debt / Regulatory Asset Value (%) (Gearing)	$(\text{Interest bearing liabilities} - \text{cash}) / \text{RAV}$	< 80 per cent	Measures the debt component of the regulatory capital structure.
RCF / Net debt (%)	$\text{RCF} / (\text{Interest bearing liabilities} - \text{cash})$	> 4 per cent	Measures the extent to which the serviceability of debt is improving, remaining stable, or declining once cash extracted from the business is considered.
Internal financing ratio (%)	$(\text{FFO} - \text{dividends}) / \text{net capital expenditure}$	> 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’. RCF refers to ‘retained cash flow’, which is calculated by subtracting dividends from FFO.

**Table 3.7 Financial indicators – Notional Test**

Indicator	Calculation	Benchmark range	Description
<b>Primary indicators — used to determine size of any viability adjustments</b>			
FFO interest cover	$(\text{FFO} + \text{net interest}) / \text{net interest}$	> 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.
FFO / Net debt (%)	$\text{FFO} / (\text{Interest bearing liabilities} - \text{cash})$	> 6 per cent	Measures the extent to which the serviceability of debt is improving, remaining stable, or declining.
<b>Secondary indicators — used only as contextual information to determine whether an adjustment is necessary</b>			
Internal financing ratio (%)	$(\text{FFO} - \text{dividends}) / \text{net capital expenditure}$	> 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: The notional test uses benchmark inputs like the notional level of gearing and cost of debt. 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 the business 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.

### 3.23. Additional requirements

#### 3.23.1. Executive summary

A price submission must contain a summary which outlines and brings together the key elements of its proposals. The summary should include:

- an overview of Melbourne Water’s proposed prices
- indicative bill impacts of the proposed prices for end-use customers, including customers of retail water businesses
- an overview of the outcomes proposed for Melbourne Water’s end-use and water retail customers, including how services will change from previous levels
- Melbourne Water’s nominated PREMO rating
- an attestation from the Melbourne Water board on the quality and accuracy of information provided in the price submission.

### 3.23.2. Board attestation

Our guidance requires the Melbourne Water board to attest to the quality of its price submission and its compliance with our guidance (in all material respects). Our reason for including the attestation is to promote board involvement and ownership of its business's proposals. This attestation, endorsed by a resolution of the board of directors, must be included in the price submission.

The form of the required attestation is below:

The directors of Melbourne Water having made such reasonable inquiries of management as we considered necessary (or having satisfied ourselves that we have no query), attest that, to the best of our knowledge, for the purpose of proposing prices for the Essential Services Commission's 2026 Melbourne Water price review:

- information and documentation provided in the price submission and relied upon to support Melbourne Water's price submission is reasonably based, complete and accurate in all material respects;
- financial and demand forecasts are Melbourne Water's best estimates, and supporting information is available to justify the assumptions and methodologies used; and
- the price submission satisfies the requirements of the 2026 Melbourne Water price review guidance paper issued by the Essential Services Commission in all material respects.

To support its PREMO rating, Melbourne Water may wish to make available to us information on the procedures implemented to ensure its price submission reflects the requirements of our guidance.

The justification for Melbourne Water's final PREMO self-rating is always the sole responsibility of Melbourne Water, even if it engages a third party to review and advise on its proposed PREMO self-rating.

### 3.23.3. Financial model

Melbourne Water must complete the financial model template prepared by the commission to accompany its price submission. Melbourne Water's price submission must be consistent with the data provided in the financial model template.<sup>57</sup> Where there is any discrepancy between the price

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<sup>57</sup> The financial model template requires Melbourne Water to provide detailed information on key assumptions underpinning its prices (such as expenditure estimates) so we can assess its proposal. The model also provides a mechanism for Melbourne Water to estimate its revenue allowance and prices. The model will require both historic and forecast data. Historic data must be consistent with Melbourne Water's regulatory accounts.

submission and the financial model template, we will rely on the data in the financial model template. The financial model template will clearly identify the cells for which Melbourne Water must provide data. Melbourne Water must not amend any other cells in the financial model template – this includes adding rows, columns, or information not requested by the commission.

The model will include a forecast inflation rate (refer to Section 3.13.1 for information on our approach to estimating forecast inflation). The inflation rate will be used to estimate components of the regulatory rate of return (see Section 3.10) and estimates for financial indicators (see Section 3.22).

We will provide the following values to Melbourne Water to enter into the financial model template at around early May 2025:

1. actual March quarter annual CPI value for 2025-26
2. actual cost of debt value for 2024-25 and an updated estimate cost of debt value for 2025-26.

We will update for the actual cost of debt for 2025-26 for our final decision.

We intend to release for public comment and consultation the populated financial model that is used to inform the prices Melbourne Water proposes in its price submission.

#### **3.23.4. Requirement for reasonably-based information**

All information contained in Melbourne Water's price submission (and financial model template – see Section 3.23.3) must be reasonably-based. All financial and demand related information must represent Melbourne Water's best available estimates at the time of finalising the submission.

#### **3.23.5. Basis upon which information is provided**

All financial information (including prices, operating and capital expenditure) in Melbourne Water's price submission (and financial model template) must be in 2025-26 dollars (with the March quarter 2025 CPI as the base).

All reports, studies or any other materials (for example, research reports, policy documents, and cost benefit analyses or studies) which are relied upon in the price submission must be made available to the commission at lodgement or on request.

#### **3.23.6. Confidentiality**

We will publish Melbourne Water's price submission, financial model template and any supplementary information on our website. If there is information that Melbourne Water does not want disclosed publicly, because it is confidential or commercially sensitive, this should be discussed with commission staff before lodging the price submission. As per our submissions

policy, we may require Melbourne Water to provide a redacted version for public disclosure on our website.<sup>58</sup>

### 3.23.7. Accessibility

The commission intends to use the Engage Victoria platform for its consultation during Melbourne Water's 2026 water price review. If not addressed by Melbourne Water's price submission lodged with the commission, the water business must provide an accessible version of its price submission and supplements (public versions) **by 8 October 2025**.

### 3.23.8. Notification of changes to assumptions

During the price review, Melbourne Water must promptly advise us if it becomes aware of any event that may require substantial changes to the assumptions underpinning the proposals in its price submission. Melbourne Water must also explain the basis for any changes to assumptions, explain the impact on its proposals, and demonstrate compliance with relevant sections of the guidance.

In the event of any changes, Melbourne Water must promptly provide us with an updated financial model template, reconciling changes to the financial model template provided to the commission with its price submission as lodged on or before 1 October 2025.

### 3.23.9. Non-prescribed services

While we have no role in regulating prices for non-prescribed services, we need to be satisfied that these services have been correctly classified as not related to regulated services, and that the costs of these services are accurately identified and excluded from the regulated cost base. Melbourne Water's price submission and financial model template must identify whether it provides any non-prescribed services, and where relevant, provide or reference information that demonstrates that the costs of any non-prescribed services have been excluded from its expenditure and price calculations related to its prescribed services.

Where Melbourne Water identifies costs to deliver both prescribed and non-prescribed services, its price submission must justify the extent that costs are relevant to prescribed services (and should be recovered from customers through regulated prices).<sup>59</sup> Melbourne Water must also be able to justify the approach or methodology it has applied to allocate any shared costs between its prescribed and non-prescribed services.

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<sup>58</sup> View our submissions policy at <https://www.esc.vic.gov.au/about-us/our-policies/our-submissions-policy>.

<sup>59</sup> Prescribed services are set out in WIRO, clause 7(b).

Further, where a business is providing non-prescribed services, its price submission and financial model template should clearly identify where any profit generated via the provision of non-prescribed services has been used to offset its revenue requirement to deliver prescribed services.

## Appendix A – Approach for making a price determination

### **WIRO Clause 14**

- a) In making a price determination the Commission may either:
  - i. approve the maximum prices the regulated entity may charge for prescribed services, or the manner in which the regulated entity's prices are to be calculated, determined or otherwise regulated, as proposed by the regulated entity in its price submission; or
  - ii. specify the maximum prices the regulated entity may charge for prescribed services, or the manner in which the regulated entity's prices are to be calculated, determined or otherwise regulated.
- b) The Commission may only specify the maximum prices, or the manner in which prices are to be calculated, determined or otherwise regulated, if:
  - i. the price submission of the regulated entity does not, in the Commission's opinion, comply with the guidance provided by the Commission under clause 13 or have adequate regard for the matters specified in clause 11; or
  - ii. the regulated entity failed to submit a price submission to the Commission within the time period specified for this by the Commission.

Excerpt from Water Industry Regulatory Order 2014.



## Appendix B – Matters to include in guidance

### WIRO Clause 13(a)

Before making a price determination and following consultation, including with the relevant regulated entity, the Commission must provide guidance to the regulated entity setting out:

- i. the manner in which the Commission proposes to regulate the prices which the regulated entity may charge for prescribed services for the regulatory period consistent with section 33(5) of the ESC Act and this Order;
- ii. the approach and methodology which the Commission proposes to adopt to assess a price submission and make a price determination for the regulatory period consistent with section 33(2) of the ESC Act and this Order;
- iii. the Commission's expectations of the nature and scope of matters to be addressed by the regulated entity in its price submission;
- iv. the Commission's expectations regarding customer consultation by the regulated entity in developing its price submission;
- v. the Commission's expectations of the information required to be provided by the regulated entity to enable the Commission to make a price determination;
- vi. the timing and processes the Commission proposes to follow in making a price determination consistent with section 35 of the ESC Act and the Commission's Charter of Consultation and Regulatory Practice;
- vii. the date by which the regulated entity is to deliver its price submission to the Commission; and
- viii. any other matter that the Commission considers should be included in the guidance provided to the regulated entity or in the regulated entity's price submission.

Excerpt from Water Industry Regulatory Order 2014 with references to the *Essential Services Commission Act 2001* (Vic).

## Appendix C – Matters businesses and commission must have regard to

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

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

Excerpts from Water Industry Regulatory Order 2014, the *Essential Services Commission Act 2001* (Vic), and the *Water Industry Act 1994* (Vic).

## Appendix D – Risk management

### Types of risk

Melbourne Water faces a range of risks, both within and outside of its control, for example:

- Inflow risk, which presents as an inability for Melbourne Water to meet customer demand due to extended low rainfall and inflows.
- Demand forecasting risk results where actual customer demand during a regulatory period differs materially from the forecasts. It can be mitigated through effective demand forecasting and scenario modelling, variable tariff structures, or the form of price control.
- Operational risks, such as Melbourne Water experiencing a breach of health, environmental or customer performance standards, can result from inadequate processes within Melbourne Water, asset failures or external factors. Melbourne Water can manage these risks through managing operating policies, capital investment, maintenance policies, contracts and insurance.
- Construction risks arise from underestimating costs or project delays. Melbourne Water can manage these risks through effective forecasting and contract management, as well as including reasonable contingency allowances in cost forecasts. Including cost contingencies in revenue allowances transfers risk of project cost overruns to customers. Melbourne Water should also factor in reasonable timelines for approval processes.
- Regulatory and policy risks result from changes in laws and regulations that materially affect the costs or revenue potential of Melbourne Water, and are typically mitigated via a pass-through mechanism.
- Financial risks are those arising from factors which affect the whole economy, such as rising interest rates or economic downturn. These risks are reflected in the cost of debt which forms part of the regulatory rate of return.
- Business risks result from a loss of revenue due to new technology or a change in the competitive landscape. Melbourne Water can mitigate some of these risks through innovative business practices and continually seeking cost efficiencies.
- Climate change is likely to present a range of risks and challenges to water businesses and their customers, particularly in an environment where risk has to be managed and resilience built across the supply chain amid increasing uncertainty and change. Impacts from climate change may appear as any of the above risk types. In considering climate change related risks and any associated expenditure proposals, we suggest water businesses refer to the guidance

provided by the Queensland Competition Authority, and in particular, table 1 on page 7 which sets out the four key elements of a robust business case for climate-related spending.<sup>60</sup>

## Regulatory risk mitigation tools

The regulatory regime established through the WIRO and developed in detail through previous reviews generally identifies, categorises and allocates risk in accordance with standard principles and seeks to provide efficiency incentives to Melbourne Water. The regulatory framework provides the following tools to mitigate or manage risk:

- Recovery of forecast operating and capital expenditure — the forecast expenditure contained within price submissions must be consistent with the risk allocation and incentives provided within the regulatory framework. Therefore, it is important that forecasts are prepared on this basis. Where Melbourne Water seeks recovery of costs for managing risks, we expect it to demonstrate the need for this and provide supporting information in its price submission (Sections 3.7 and 3.8).
- Indexation of prices — This ensures that Melbourne Water remains fully responsible for management of its controllable costs, and that it does not need to bear the full risk associated with general price inflation.
- Rate of return — This provides compensation for non-diversifiable risk (Section 3.10).
- Form of the price control — This provides a mitigating tool for Melbourne Water. Section 3.18 contains our views on the form of the price control for the next regulatory period. The commission also notes that the form of price control can assist in managing the risk that actual demand varies from forecast demand.
- Tariff structures — Section 3.19 sets out the guiding pricing principles for new tariff structures. The impacts of any shift in the mix of service and variable charges in tariffs on risk sharing between Melbourne Water and its customers will need to be addressed in its price submission.
- Length of the regulatory period — A shorter regulatory period can reduce the risk of forecasting uncertainty (see Section 3.2).
- Pass-through mechanisms — Significant uncertainties that materially affect Melbourne Water and that occur within the regulatory period are generally treated as pass-through events. These events must be clearly identified in the price determination. The uncertain and unforeseen events mechanism established by the commission for the 2008 and 2009 water price reviews provides another option for managing and mitigating risks, subject to certain criteria (see Section 3.20)

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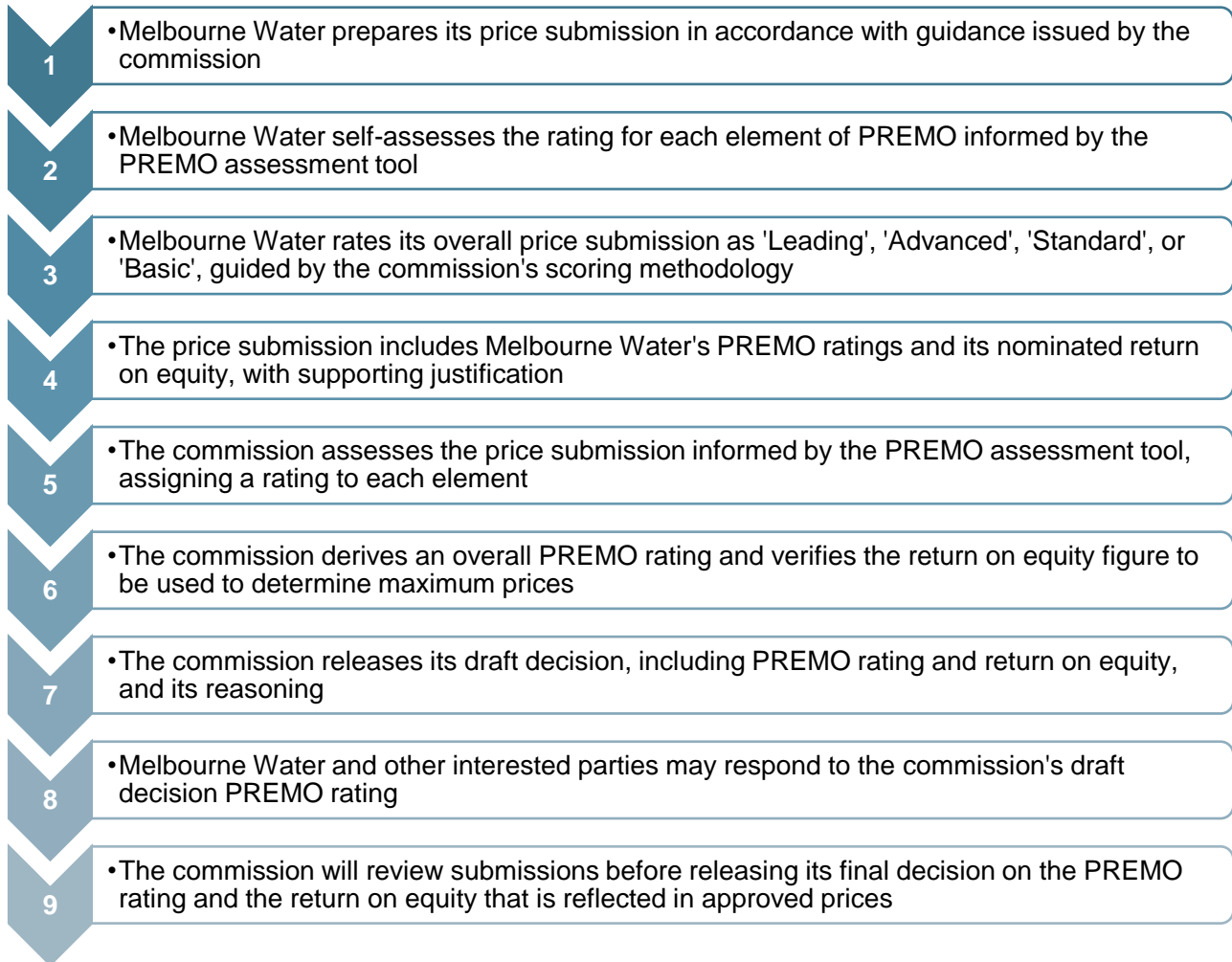
<sup>60</sup> Queensland Competition Authority 2023, Guideline: Climate change related spending, September. The guideline is available at: <https://www.qca.org.au/wp-content/uploads/2023/09/qca-climate-change-guideline-september-2023.pdf>

# Appendix E – Establishing a PREMO rating

## PREMO rating process

The steps for Melbourne Water and the commission to establish the PREMO rating for the business's price submission is outlined in Figure A below.<sup>61</sup>

**Figure A** Process for rating a price submission



<sup>61</sup> For further information, see Essential Services Commission 2016, Assessing and rating PREMO price submissions: A consultation paper prepared by commission staff, October, pp. 5–7.

## PREMO assessment tool

The PREMO assessment tool provides:

- A set of guiding questions for rating price submissions. These will help businesses understand what evidence and justification we expect.
- Examples to demonstrate what might constitute 'Leading', 'Advanced', 'Standard' or 'Basic' ambition for the PREMO elements.

The assessment tool **does not** provide an exhaustive list of what may be taken into account by Melbourne Water or by us in arriving at a price submission rating. Melbourne Water may provide further arguments to support its ratings. Further, if Melbourne Water considers that it does not meet one of the examples in the tool for a given rating, this does not mean it cannot achieve that overall rating, as Melbourne Water should consider on-balance how it meets the guiding questions.

The PREMO assessment tool is provided in the following pages for the Performance, Risk, Engagement, Management and Outcomes elements of PREMO.

### Performance

The Performance element is a backward look at how Melbourne Water has performed relative to its commitments at the last price review. The Performance rating should therefore reflect the final PREMO rating awarded for the current regulatory period. Accordingly, our assessment tool provides examples in terms of a business's current PREMO rating, rather than in absolute terms of Standard, Advanced and Leading ratings as for the other four forward-looking PREMO elements.

The Performance element rating can be considered as follows:

- **Current overall PREMO rating** = Achieved expectations – demonstrated delivery of promised outcomes, account for any material cost variations, and demonstrate customer satisfaction.
- **A higher PREMO rating than current** = Exceeded expectations – demonstrated out-performance whereby customers received significantly higher value than they paid for.
- **A lower PREMO rating than current** = Did not meet expectations – a material shortfall in performance where customers did not receive the value they paid for (or where higher incurred costs will lead to a price rise, and therefore lower value, in the next period).

The Performance element rating may rise or fall by more than one rating level for very large changes in performance and value relative to Melbourne Water's proposals made at its previous price review, as set out in Table A.

**Table A Example rating of the Performance element**

Overall PREMO rating from previous price review	Performance rating in price submission for 2026 water price review		
	Exceeded expectations	Achieved expectations	Did not meet expectations
Leading	Leading	Leading	Advanced/Standard/Basic
Advanced	Leading	Advanced	Standard/Basic
Standard	Leading/Advanced	Standard	Basic
Basic	Advanced/Standard	Standard	Basic

Note: Where a business was rated Basic at the previous price review, achieving expectations would produce a Standard rating for the Performance element.

In support of its rating for the Performance element, Melbourne Water’s price submission must show how its performance in the current regulatory period has compared with its forecasts and expectations, and account for significant variation.



## Performance

Guiding questions	Examples reflecting a lower rating than current	Examples reflecting achievement of the current rating	Examples reflecting a higher rating than current
<p>To what extent has Melbourne Water demonstrated delivery of its customer outcomes commitment over the current regulatory period? Did its customers get what they paid for?</p> <p>How does actual operating expenditure across the current period compare with Melbourne Water's established benchmark allowance, and to what extent has Melbourne Water rationalised any discrepancies?</p> <p>How does actual capital expenditure across the current period compare with Melbourne Water's established benchmark allowance, and to what extent has Melbourne Water rationalised any discrepancies?</p> <p>To what extent does customer sentiment demonstrate satisfaction in Melbourne Water's performance over the current regulatory period? Are end-use customers and water retailers happy with the value they receive from Melbourne Water?</p>	<p>Melbourne Water has underperformed on its outcomes commitments, falling short of delivering the value its customers expected.</p> <p>Melbourne Water did not adequately own its underperformance or address shortfalls with its customers.</p>	<p>Melbourne Water has generally delivered on its outcome commitments, by meeting its performance targets for most output measures across the regulatory period.</p> <p>Melbourne Water clearly took ownership for shortfalls in performance throughout the period and explained to customers what it would do to address each shortfall.</p> <p>Melbourne Water's major capital project program was largely delivered as forecast, with material variations clearly explained to customers through its annual reporting processes.</p>	<p>Melbourne Water consistently met all its outcome commitments, OR Where it fell a little short on some targets, it clearly outperformed on others to deliver great customer value.</p> <p>Melbourne Water adjusted its revenue recovery to reflect a shortfall in performance or major project delivery, to ensure customers did not pay for infrastructure, services or value they did not receive.</p> <p>Melbourne Water reviewed and re-tested its proposed outcome measures and performance targets with customers throughout the period, to ensure they were still relevant, and it was still delivering what customers valued. Measures and targets amended through consultation with customers where appropriate.</p>
	<p>Melbourne Water's controllable operating expenditure exceeded the benchmark allowances, and the additional expenditure did not provide material customer value improvements.</p>	<p>Actual controllable operating expenditure was largely consistent with the benchmark allowances set in the price review</p> <p>Variations to controllable operating expenditure relative to the benchmark are clearly identified and explained in terms of its impact on customer value.</p>	<p>The business outperformed the controllable operating expenditure benchmarks while meeting its outcome expectations, representing better value for customers going forward.</p>

Continued on the following page

## Performance

Guiding questions	Examples reflecting a lower rating than current	Examples reflecting achievement of the current rating	Examples reflecting a higher rating than current
	<p>Melbourne Water fell well short of delivering the major capital project programs it committed to at the previous price review.</p> <p>The program was delivered, but well over budget, resulting in a material increase in the RAB roll-in and upward impact on future prices.</p>	<p>Actual capital expenditure was largely consistent with the benchmark allowances set in its last price review.</p> <p>Significant variations to the capital expenditure forecast are clearly identified and explained. This includes uncertain capital expenditure that was excluded from the price benchmarks.</p>	<p>Melbourne Water delivered its major capital project program (or met its objectives) below the forecast expenditure benchmarks, representing better value for customers going forward through a reduced RAB roll-in.</p>
	<p>Melbourne Water reports an ongoing downward trend in customer sentiment across the regulatory period.</p>	<p>Melbourne Water demonstrates a noticeable lift in positive customer sentiment across the period.</p> <p>Melbourne Water's own customer survey work demonstrates it meets expectations, or shows a positive trend across the period.</p>	<p>Melbourne Water demonstrates a <b>significant</b> lift in positive customer sentiment across the period.</p> <p>Melbourne Water's own customer survey work demonstrates it exceeded expectations, or shows a significant positive trend across the period.</p>

## Risk

Guiding questions	Examples for a Basic submission	Examples for a Standard submission	Examples for an Advanced submission	Examples for a Leading submission
<p>To what extent has Melbourne Water demonstrated a robust process for identifying risk, and how it has decided who should bear these risks? i.e such that customers are not paying more than they need to.</p> <p>To what extent does the proposed guaranteed service level (GSL) scheme provide incentives for Melbourne Water to be accountable for the quality of services delivered, and provide incentives to deliver valued services efficiently?</p>	<p>Melbourne Water has not met the requirements of the commission's Guidance Paper in relation to risk.</p> <p>Melbourne Water has sought to transfer risk to customers which is not supported by customer views.</p> <p>Melbourne Water has not sought to minimise cost and/or price impacts from risk management.</p>	<p>Melbourne Water meets the requirements of the commission's Guidance Paper in relation to risk.</p>	<p>Melbourne Water has implemented a new approach that reduces prices through better risk management, or through accepting risk on behalf of customers.</p>	<p>Melbourne Water has implemented an approach that reduces costs through better risk management, to a level that sets it apart from industry peers.</p> <p>In its price submission, Melbourne Water proposes correction mechanisms to adjust the return on equity where its performance does not meet the outcomes established at the price review.</p>
	<p>Melbourne Water cannot demonstrate compliance with risk standards specified in the Statement of Obligations.</p>	<p>Melbourne Water demonstrates compliance with risk standards specified in the Statement of Obligations (e.g. ISO 55000).</p>	<p>Melbourne Water has been accredited for compliance with risk standards specified in the Statement of Obligations.</p>	
	<p>Projects are proposed that have incomplete scope, no business cases, or are not feasible in terms of timelines for delivery.</p>	<p>Melbourne Water can demonstrate that it has thoroughly evaluated the feasibility of commencement and completion dates for major projects. Business cases are available for all major projects.</p>	<p>Melbourne Water can demonstrate a robust optimisation process that has informed what projects need to be completed, and the timing of those projects. For example, real options analysis has informed planning and ability to adapt to changing circumstances (e.g. variations in demand from forecast) and is evident in proposals.</p>	
	<p>Melbourne Water cannot demonstrate that its aggregate capital expenditure forecasts are consistent with a P50 estimate (noting this is likely not to be appropriate where a business's capital program is dominated by one or two projects).</p>	<p>Melbourne Water has undertaken a Monte Carlo analysis for all major projects.</p> <p>Melbourne Water can demonstrate that its aggregate capital expenditure forecasts are consistent with a P50 estimate (noting this is likely to be inappropriate where a program is dominated by one or two projects). The estimate must be based on the latest credible information on costs.</p>		

Continued on the following page

## Risk

Guiding questions	Examples for a Basic submission	Examples for a Standard submission	Examples for an Advanced submission	Examples for a Leading submission
		<p>Melbourne Water uses regulatory tools such as the pass through and uncertain or unforeseen events mechanisms where appropriate for projects with uncertain timing or costs.</p> <p>Melbourne Water has evaluated whether major projects should be funded via capital or operating expenditure for pricing purposes.</p>		
	<p>Melbourne Water has not proposed a GSL scheme that reflects the main service concerns and priorities of customers.</p>	<p>Melbourne Water has proposed a GSL scheme that reflects the main service concerns and priorities of customers.</p>	<p>Melbourne Water has refined its GSL scheme to provide greater service accountability to customers, or to provide increased incentives to deliver services efficiently.</p> <p>Melbourne Water has proposed a GSL scheme that compares favourably to industry peers in terms of incentives to deliver services efficiently.</p>	
	<p>Melbourne Water adopts assumptions that seek to maximise unit rates proposed.</p>	<p>The unit rates used to evaluate projects and options reflect recent historical trends, and/or independently verified market forecasts.</p>		
	<p>Melbourne Water cannot support its assessment of financial viability by reference to cash flow projections and independent benchmarks (e.g. credit rating metrics).</p>	<p>Melbourne Water can support its assessment of financial viability by reference to cash flow projections and independent benchmarks (e.g. credit rating metrics).</p>	<p>Melbourne Water has had its financial position reviewed by an independent credit ratings agency.</p>	
	<p>The form of price control and/or tariffs over allocates risk to customers (e.g. higher fixed tariffs versus variable may reflect a business putting more volume risk on its customers).</p>	<p>Through the form of price control and tariffs proposed, the submission appropriately balances revenue and cost risk between Melbourne Water and its end-use and retail customers, without materially impacting on price stability (e.g. higher variable tariffs versus fixed may reflect a business taking on greater volume risk on behalf of customers).</p>		

## Engagement

Guiding questions	Examples for a Basic submission	Examples for a Standard submission	Examples for an Advanced submission	Examples for a Leading submission
<p>To what extent has Melbourne Water justified how the form of engagement suits the content of consultation, as well as the circumstances of its customers and other key stakeholders?</p> <p>To what extent has Melbourne Water demonstrated that it provided appropriate instruction and information to participants about the purpose, form and content of the customer engagement?</p> <p>To what extent has Melbourne Water demonstrated that the matters it has engaged on are those that have the most influence on the services provided to its customers and prices charged?</p> <p>To what extent has Melbourne Water explained how it decided when to carry out its engagement?</p> <p>To what extent has Melbourne Water demonstrated how its engagement has influenced its submission?</p>	<p>The form of customer engagement is not justified as being fit for purpose given the content and circumstances facing Melbourne Water and its customers.</p> <p>Information provided to Melbourne Water's customers and other key stakeholders was written in technical jargon, and/or was not appropriate for customer use.</p> <p>Melbourne Water provided selective or incomplete information to customers that biased the responses or did not provide sufficient context for customer input.</p> <p>Engagement has not occurred on matters that are important to customers or significant to the outcomes they receive and prices they are charged.</p>	<p>The form of customer engagement is justified as being fit for purpose given the content and circumstances facing Melbourne Water and its customers and other key stakeholders. For example, information was appropriate given the capability of participants, participants had time to learn about the issues, form opinions, and influence Melbourne Water's proposals. Methods supported inclusion and effective participation.</p> <p>Melbourne Water demonstrates that the information provided to its engagement participants was appropriate given the purpose, form and content of customer engagement.</p> <p>Melbourne Water demonstrates that engagement has occurred on matters that its customers and other key stakeholders reveal are the most important to them.</p>	<p>The onus is on Melbourne Water to make the case as to why it might rate its customer engagement as Advanced or Leading. This justification could be based on:</p> <ul style="list-style-type: none"> <li>• Clear, unambiguous and unbiased feedback about the appropriateness of the engagement given the context and quality of the engagement program it delivered. For example, independent participant reviews, or demonstrated use of independent chairpersons.</li> <li>• Participants in the engagement program provide feedback that Melbourne Water has delivered on the engagement commitments given by the business (e.g. on what matters would participants provide feedback, and the influence they would have on business decisions).</li> <li>• Engagement methods that are effective in overcoming power imbalances.</li> <li>• The level of its customer influence on proposals. This includes a strong alignment between Melbourne Water's proposals and the preferences and interests elicited in its engagement program.</li> <li>• The quality of participation of people who are experiencing vulnerability, or whose vulnerability on issues that affect them.</li> <li>• The quality of involvement of First Nations people in matters that affect them.</li> </ul>	

Continued on the following page

## Engagement

Guiding questions	Examples for a Basic submission	Examples for a Standard submission	Examples for an Advanced submission	Examples for a Leading submission
<p>To what extent has Melbourne Water demonstrated that its engagement was inclusive of consumers experiencing vulnerability?</p>	<p>Engagement was undertaken late, after Melbourne Water had developed its key strategies and priorities.</p>	<p>Melbourne Water demonstrates that engagement was undertaken early, prior to locking in key strategies and priorities.</p>		
<p>To what extent has Melbourne Water demonstrated that its engagement was inclusive of First Nations people and relevant Traditional Owner groups?</p>	<p>Melbourne Water has failed to demonstrate that its engagement program elicited information that it could use to shape the strategic direction and priorities in its price submission.</p>	<p>Melbourne Water demonstrates it used engagement methodologies that elicit views that are representative of its customer base and other key stakeholders.</p>		
	<p>Melbourne Water has not retested its position and proposals with its customers as it developed its price submission.</p>	<p>Melbourne Water demonstrates that it re-tested its position and proposals with its customers as it developed its price submission.</p>		
	<p>The price submission does not clearly link the outcomes of engagement to the outcomes proposed, and the alignment of outcomes to expenditure and prices.</p>	<p>The price submission describes what was learned from its customer engagement, and how this influenced its proposed outcomes, expenditure (composition and level) and prices.</p>		
	<p>Melbourne Water has not provided reasonable justification for instances where its proposed outcomes are not consistent with its customer views.</p>	<p>In any instances where outcomes proposed are not consistent with customer views, Melbourne Water provides reasonable justification.</p>		

## Management

Guiding questions	Examples for a Basic submission	Examples for a Standard submission	Examples for an Advanced submission	Examples for a Leading submission
<p>To what extent has Melbourne Water demonstrated how its proposed prices reflect only prudent and efficient expenditure?</p> <p>To what extent has Melbourne Water justified its commitment to cost efficiency or productivity improvements?</p> <p>To what extent has Melbourne Water justified or provided assurance about the quality of the submission, including the quality of supporting information on forecast costs or projects?</p> <p>To what extent has Melbourne Water provided evidence that there is senior level, including Board level, ownership and commitment to its submission and its outcomes?</p> <p>To what extent has Melbourne Water demonstrated its price submission is an “open book”?</p>	<p>Melbourne Water has not proposed productivity improvements.</p> <p>Forecast operating expenditure incorporates a rate of efficiency improvement that is below the average rate for a Standard rated business at the 2023 water price review.</p> <p>Proposals relating to major expenditure changes, projects or reforms are not adequately supported by multiple and independent measures to support justification.</p>	<p>Forecast operating expenditure incorporates a rate of efficiency improvement equivalent to the average rate of a Standard rated business at the 2023 water price review (approx. 1.2% pa).</p> <p>Multiple and independent measures are used to support justification for the prudence and efficiency of major expenditure changes, projects or reforms.</p> <p>The price submission/expenditure forecasts include delivery of government policy commitments (reflected at efficient cost).</p>	<p>Melbourne Water has proposed a significant improvement in the cost efficiency of the services delivered.</p> <p>Forecast operating expenditure incorporates a rate of efficiency improvement equivalent to the average rate of an Advanced rated business at the 2023 water price review (approx. 1.8% pa). Alternatively, evidence is provided that demonstrates Melbourne Water is at or near to the efficiency frontier for the sector.</p> <p>The operating expenditure forecast places Melbourne Water well ahead of the industry average in terms of cost efficiency.</p>	<p>Melbourne Water has proposed a very significant improvement in the cost efficiency of the services delivered.</p> <p>Forecast operating expenditure incorporates a rate of efficiency improvement that is significantly above the average rate of an Advanced rated business at the 2023 water price review. Alternatively, evidence is provided that demonstrates Melbourne Water is a leader in relation to operating at the efficiency frontier for the sector.</p> <p>Forecast operating expenditure incorporates a rate of efficiency improvement that places Melbourne Water as a leader in the industry.</p> <p>The operating expenditure forecast places Melbourne Water as a leader in the industry in terms of cost efficiency.</p>
	<p>Melbourne Water has not provided timely access to robust business cases that validate the basis for all major projects and capital programs.</p> <p>Melbourne Water has not proposed efficiency improvements in relation to its capital renewals program.</p>	<p>Melbourne Water can provide business cases and justification for all major projects and capital programs, including evidence that a range of options have been considered.</p> <p>Forecast depreciation adopts a straight-line calculation approach. Alternative approaches are clearly justified.</p>	<p>Melbourne Water has proposed a significant improvement in the efficiency of its capital program.</p>	<p>Melbourne Water has proposed a very significant improvement in the efficiency of its capital program.</p> <p>The rate of improvement in capital expenditure efficiency places Melbourne Water as a leader in the industry.</p>

Continued on the following page

## Management

Guiding questions	Examples for a Basic submission	Examples for a Standard submission	Examples for an Advanced submission	Examples for a Leading submission
	The Board of Directors has not attested that it has undertaken appropriate internal procedures to assure themselves of the quality and accuracy of their price submission. The attestation included in the commission's guidance is not included with the price submission.	The Board of Directors has attested that it has undertaken appropriate internal procedures to assure themselves of the quality and accuracy of their price submission. The attestation included in the commission's guidance is provided with the price submission.		
	The price submission does not address all requirements set out in the commission's Guidance Paper	The price submission addresses all requirements specified in the commission's Guidance Paper.		
	The price submission and its supporting documents contain errors and/or omissions of sufficient concern to the commission.	The price submission and its supporting documents contain no material or obvious errors or omissions.		
	The financial model template is incomplete and/or inconsistent with the price submission or with regulatory accounting statements prepared during the current regulatory period.	The financial model template provided to the commission is completed with no material error and requires minimal adjustment by the commission. The financial model template is consistent with the written price submission and with regulatory accounting statements prepared during the current regulatory period.		
	The price submission and supporting information are provided to the commission after the time requested.	The price submission and supporting information are provided to the commission by the time requested.		
	The price submission is contradictory across main elements of the submission (e.g. there is inconsistency between Melbourne Water's demand forecasts and capital works program for example).	The price submission is internally consistent, demonstrating alignment between different elements of the price submission (e.g. there is consistency between the outcomes proposed, and demand and expenditure forecasts).		

Continued on the following page



## Management

Guiding questions	Examples for a Basic submission	Examples for a Standard submission	Examples for an Advanced submission	Examples for a Leading submission
	<p>Forecasts for expenditure (including benchmarks for labour, energy and construction costs) and demand are not based on sound methodologies and assumptions.</p>	<p>Forecasts for expenditure (including benchmarks for labour, energy and construction costs) and demand are based on sound methodologies and assumptions.</p>		
	<p>Melbourne Water has not provided evidence that it has actively sought to reprioritise its expenditure plans to mitigate the cost and price impacts of any new obligations (whether imposed by government or technical regulator, or to address a new service priority revealed through engagement).</p>	<p>Melbourne Water can demonstrate that it has actively sought to reprioritise its expenditure plans to mitigate the cost and price impacts of any new obligations (whether imposed by government or technical regulator, or to address a new service priority revealed through engagement).</p>		
	<p>Melbourne Water has not proposed adequate mitigation strategies to avoid any price shocks.</p>	<p>Melbourne Water has proposed adequate mitigation strategies to avoid any price shocks.</p>		
	<p>Melbourne Water has not provided timely access to meaningful and robust supporting documentation, on request from the commission.</p>	<p>Melbourne Water retains meaningful and robust supporting documentation to justify its proposals, with ongoing access available to the commission.</p>		
	<p>Melbourne Water is not transparent in providing information to the commission on stakeholder views, or any other information or assessments that may be relevant to the assessment of key initiatives or proposals.</p>	<p>Melbourne Water is transparent in providing information to the commission on stakeholder views or other information or assessments that may be relevant to the assessment of key initiatives or proposals.</p>		

## Outcomes

Guiding questions	Examples for a Basic submission	Examples for a Standard submission	Examples for an Advanced submission	Examples for a Leading submission
<p>Has Melbourne Water provided evidence that the outcomes proposed have taken into account the views, concerns and priorities of its end-use and retail customers?</p> <p>Has Melbourne Water provided sufficient explanation of how the outcomes it has proposed align to the forecast expenditure requested?</p> <p>Has Melbourne Water proposed outputs to support each of its outcomes, which are measurable, robust and deliverable?</p>	<p>Melbourne Water has proposed degradation in customer outcomes, not justified or supported by customer feedback. This represents a reduction in customer value.</p>	<p>The outcomes proposed (for both water &amp; sewerage and waterways &amp; drainage services) are broadly consistent with existing levels of service provided to Melbourne Water's end-use and retail customers.</p>	<p>The outcomes proposed reflect a significant improvement in Melbourne Water's end-use and retail customer value delivered. This might be demonstrated by significant improvements in output targets (or performance measures) for outcomes that matter most to most of its end-use and retail customers, or similar targets at significantly lower prices.</p> <p>Melbourne Water proposes outcomes that are well ahead of the industry average or Melbourne Water's own past performance (measured by reference to output targets).</p>	<p>The outcomes proposed reflect a very significant improvement in Melbourne Water's end-use and retail customer value delivered.</p> <p>Melbourne Water proposes outcomes that lead the industry.</p>
<p>Has Melbourne Water provided evidence that the outputs it has proposed are reasonable measures of performance against stated outcomes?</p> <p>Has Melbourne Water demonstrated a process to measure performance against each outcome and to inform its end-use and retail customers?</p>	<p>Outcomes are not defined in ways that reflect the customer service experience.</p> <p>Melbourne Water has proposed outputs that are not appropriate measures of performance for each outcome proposed. Measures and deliverables are not clearly defined.</p>	<p>All outcomes proposed (for both water &amp; sewerage and waterways &amp; drainage services) have been defined in ways that reflect Melbourne Water's end-use customer service experience (e.g. safe, clean water supply) and retail customer expectations.</p> <p>Melbourne Water has proposed outputs that are appropriate measures of performance for each outcome proposed. Measures and deliverables are clearly defined and unambiguous.</p>		

Continued on the following page

## Outcomes

Guiding questions	Examples for a Basic submission	Examples for a Standard submission	Examples for an Advanced submission	Examples for a Leading submission
	<p>The outcomes proposed do not clearly reflect Melbourne Water's end-use and retail customer preferences and priorities revealed through engagement.</p>	<p>The outcomes proposed have been prioritised by Melbourne Water in terms of importance to its end-use and retail customers as revealed through customer engagement. Melbourne Water's expenditure forecasts reflect the prioritisation of outcomes.</p>		
	<p>Where applicable, Melbourne Water has not explained or justified why outcomes proposed are not consistent with its end-use and retail customer preferences and priorities.</p>	<p>Where applicable, Melbourne Water has explained or justified why outcomes proposed are not consistent with its end-use and retail customer preferences and priorities.</p>		
	<p>The level and composition of forecast expenditure is inconsistent with the outcomes proposed.</p> <p>The expenditure profile has not changed to reflect customer priorities.</p>	<p>The level and composition of forecast expenditure is consistent with the outcomes proposed.</p> <p>The expenditure profile has changed where required to reflect Melbourne Water's end-use and retail customer priorities.</p>		
	<p>Melbourne Water has not committed to a process for monitoring and reporting to its end-use and retail customers on its performance against outcomes.</p>	<p>Melbourne Water has an established customer performance reporting approach that is targeted to both its end-use and retail customer needs, including across different regions and customer types.</p>	<p>The performance reporting approach is justified as being well ahead of peers in terms of accessibility, transparency and information provided to customers on performance.</p>	

## **An approach to establishing a PREMO rating**

We have developed a scoring methodology to assist Melbourne Water to rate its price submission against the five elements of PREMO and to rate its overall price submission. We have provided the following scoring methodology as a guide to accompany the PREMO assessment tool – in other words, it is not mandatory that Melbourne Water uses the scoring methodology below to rate its price submission.<sup>63</sup>

### **Weighting**

Melbourne Water should give equal weighting to all five elements – Performance, Risk, Engagement, Management and Outcomes – when establishing an overall PREMO price submission rating.

### **Scoring and assessment tool**

It is not an expectation that Melbourne Water rate or allocate a score against all the matters listed in the PREMO assessment tool, as these are provided as examples of the matters that should be taken into account. Rather, these examples should be used to guide the rating or score for each of the five PREMO elements.

The scoring methodology is predicated on the level of confidence with which Melbourne Water or the commission considers an element of PREMO meets a particular ambition rating.

Table B summarises possible scores for each element of PREMO graded by confidence level. The component scores for each element of PREMO would be aggregated to inform an overall price submission rating.

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<sup>63</sup> We do not allocate a score against all the matters listed in the PREMO assessment tool when we assess a water business's price submission.

**Table B** An approach to scoring for an overall PREMO rating

Rating	Possible scores for each element of PREMO		Aggregated score for overall PREMO ratings
Leading	4	Very confident the element is 'Leading'	19 to 20
	3.75	Confident the element is 'Leading'	
Advanced	3.5	Very confident the element is 'Advanced'	14.5 to 18.75
	3.25	Confident the element is 'Advanced'	
	3	Satisfied the element is 'Advanced'	
	2.75	Reasonably confident the element is 'Advanced'	
Standard	2.5	Very confident the element is 'Standard'	9.5 to 14.25
	2.25	Confident the element is 'Standard'	
	2	Satisfied the element is 'Standard'	
	1.75	Reasonably confident the element is 'Standard'	
Basic	1.5	Very confident the element is 'Basic'	5 to 9.25
	1.25	Confident the element is 'Basic'	
	1	Satisfied the element is 'Basic'	

To reiterate, the scoring methodology outlined here is only a guide. We will assess Melbourne Water’s reasoning for its overall price submission PREMO rating. In other words, the score as shown above on its own is not justification for a particular price submission rating. Similarly, Melbourne Water ultimately has the discretion to select any PREMO price submission rating, even if it may not correspond with an aggregated score.

## Appendix F – Pricing Principles

### **Pricing principles for non-scheduled charges**

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

#### **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 Melbourne Water does not propose to fully recover the costs associated with recycled water, it must demonstrate to us 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 Melbourne Water or pursuant to other Government policies that apply to Melbourne Water, 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 us

- 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 us 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 us
- 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.