

2026 North East 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 North East Water can charge for its water and sewerage services from 1 July 2026. It is the second price review under our PREMO incentive framework for North East Water, which participated in the 2018 water price review.¹ Our guidance for North East 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 North East Water).²

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

1. We are introducing the backward-looking Performance element of PREMO, which holds North East Water accountable for proposals made in its 2018 price review.
2. Its price submission needs to demonstrate how it is building on its previous proposals to deliver great value to its customers.

PREMO incentives provide up-front rewards for ambitious proposals delivering better customer value. However, North East 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 North East 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 North East Water seeks to maintain or improve customer value, and to address any shortfalls in performance going forward. Customers should expect no less.

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

¹ We first introduced our new PREMO (Performance, Risk, Engagement, Management and Outcome) framework at our 2018 price review of 17 Victorian water businesses.

² 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.

North East 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 North East 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 North East Water's price submission. We will do so in line with the requirements of the Water Industry Regulatory Order 2014.³

If we can assess North East 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 North East Water.

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

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

Ultimately, we expect North East 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**.

³ 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 North East Water can charge for its water and sewerage 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**),⁴ 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 North East Water may charge for prescribed services, or the manner in which prices are to be calculated, determined or otherwise regulated, from 1 July 2026.⁵

Clause 14 of the WIRO (provided at **Appendix A**) requires us to assess a price submission prepared by North East 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 North East 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 North East 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.⁶

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

⁵ WIRO, clause 10(a). The prescribed services are listed at clause 7(b) of the WIRO.

⁶ WIRO, clause 14.

1.2. About this paper

This paper is the guidance we are required to issue to North East Water under clause 13 of the WIRO (provided at **Appendix B**). In compliance with clause 13 of the WIRO, the guidance sets out our approach to North East Water's price review and information requirements for its price submission.⁷

Much of this guidance remains unchanged from the guidance we issued for 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 North East Water. We have consulted with North East Water in developing this guidance, including considering its review of our proposed final draft and incorporating its feedback as appropriate. We also sought input from the consumer representative group Consumer Action Law Centre.

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

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 North East Water's price submission. We encourage North East Water to keep its price submission as clear and succinct as possible. To this end, North East 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.

1.3. Water pricing framework and approach

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

⁷ 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 North East Water and other key water sector stakeholders on the various elements of this guidance.

⁸ Under clause 4C(a) of the WI Act, we have an objective to ensure the costs of regulation do not exceed the benefits, wherever possible.

PREMO stands for Performance, Risk, Engagement, Management, and Outcomes. North East 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 North East Water committed in the previous regulatory period been met or exceeded?
- Risk — has North East Water sought to allocate risk to the party best positioned to manage that risk? To what extent has North East Water accepted risk on behalf of its customers?
- Engagement — how effective was North East 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 North East 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 North East 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.⁹ A subsequent review following the 2023 and 2024 price reviews, also by Farrierswier, confirmed the PREMO framework was still delivering against its original objectives.

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

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

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 water price review. 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 North East Water to demonstrate inclusive and effective engagement with First Nations people and with customers experiencing vulnerability, in its price submission.¹⁰

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 2016.¹¹ 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 North East Water’s price submission.

1.4. Amendments to this guidance

This guidance was prepared in consultation with North East Water.¹² Our consultation focused on the key changes to the guidance issued for the 14 water businesses under the 2023 water price review. We have also discussed our approach for North East 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, 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.

¹⁰ 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.

¹¹ Essential Services Commission 2016, Water Pricing Framework and Approach: Implementing PREMO from 2018, October.

¹² Clause 13 of the WIRO requires us to provide guidance following consultation with the regulated entity.

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 2026 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 North East Water requires clarification or interpretation on any matters relating to our pricing framework or this guidance, it should contact commission staff.

If North East 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 North East 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 prices¹³
- our approach and methodology to assessing North East Water's price submission and making a price determination¹⁴
- the impact of PREMO on price submission information requirements¹⁵
- our approach to consultation during the price review process¹⁶
- the assessment process and the 2026 price review timeline.¹⁷

2.1. How we will regulate 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 we consider appropriate.

We will use a building block methodology to determine the forecast revenues that will provide North East 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 3.7.)

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

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

¹³ WIRO, clause 13(a)(i).

¹⁴ WIRO, clause 13(a)(ii).

¹⁵ WIRO, clause 13(a)(v).

¹⁶ WIRO, clause 13(a)(iv) and 13(a)(viii).

¹⁷ 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 North East 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 North East Water to deliver on its service outcomes and obligations.

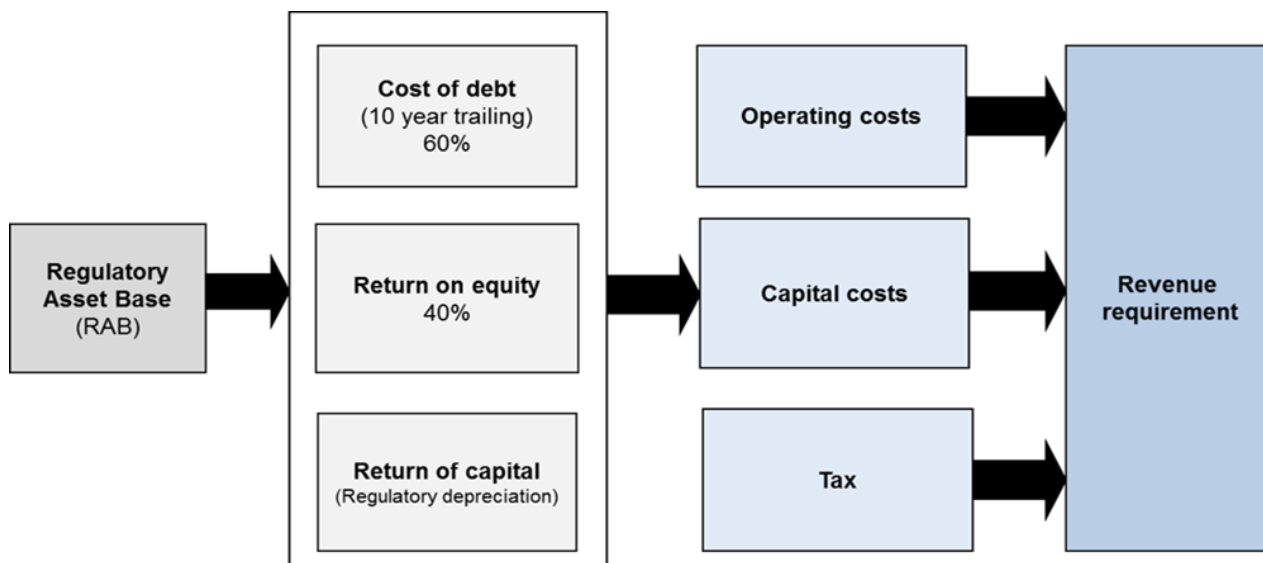
A summary of the building block methodology is shown in Figure 2.1.

Once the revenue requirement for the regulatory period has been determined using building blocks, the form of price control that will be applicable to North East 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 North East 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 North East 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 North East Water’s price submission and form a view about whether or not the price submission:¹⁸

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

2.2.1. Assessing the extent to which the 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, the guidance we issue 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.¹⁹

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

¹⁸ WIRO, clause 14(b)(i).

¹⁹ The matters referred to in clause 11 of the WIRO have been grouped into themes in Appendix C.

In doing so, North East 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.²⁰ Chapter 3 of this guidance sets out a number of discrete considerations the price submission must address in order to demonstrate that North East Water has fully and meaningfully addressed clause 11 of the WIRO.

2.2.2. Assessing compliance with this guidance

North East 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 North East 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 North East 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.²¹ This may include us specifying prices for a shorter regulatory period than proposed by North East Water.

While we expect that North East 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 North East 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.

²⁰ 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.'

²¹ 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.²² 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 North East 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 North East 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 North East 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, North East Water must propose an overall PREMO rating for its price submission. The assessment tool guides North East 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 North East Water's price submission, with our decision on the PREMO rating determining the benchmark return on equity to be reflected in approved prices.

North East 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 North East Water's price submission. It is not an assessment of North East Water itself.

²² 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 North East Water under PREMO should result in less need for direct engagement by us with its customers. This is consistent with our objective to emphasise the business and customer relationship, and to provide greater autonomy to North East 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 North East 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.²³

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), North East Water's price submission, and submissions from other interested parties, available on our website (www.esc.vic.gov.au) in accordance with our submissions policy.²⁴

If there is information that North East 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

North East Water must lodge its price submission with us by **1 October 2025**.²⁵ If North East Water fails to lodge its submission by this date, we may use our discretion to specify maximum prices.²⁶

We will assess North East 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

²³ WIRO, clause 16(b).

²⁴ View our submissions policy at <https://www.esc.vic.gov.au/about-us/our-policies/our-submissions-policy>.

²⁵ 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 North East Water is required to deliver its price submissions to us.

²⁶ 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 our final decision and a price determination for North East 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 North East 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.

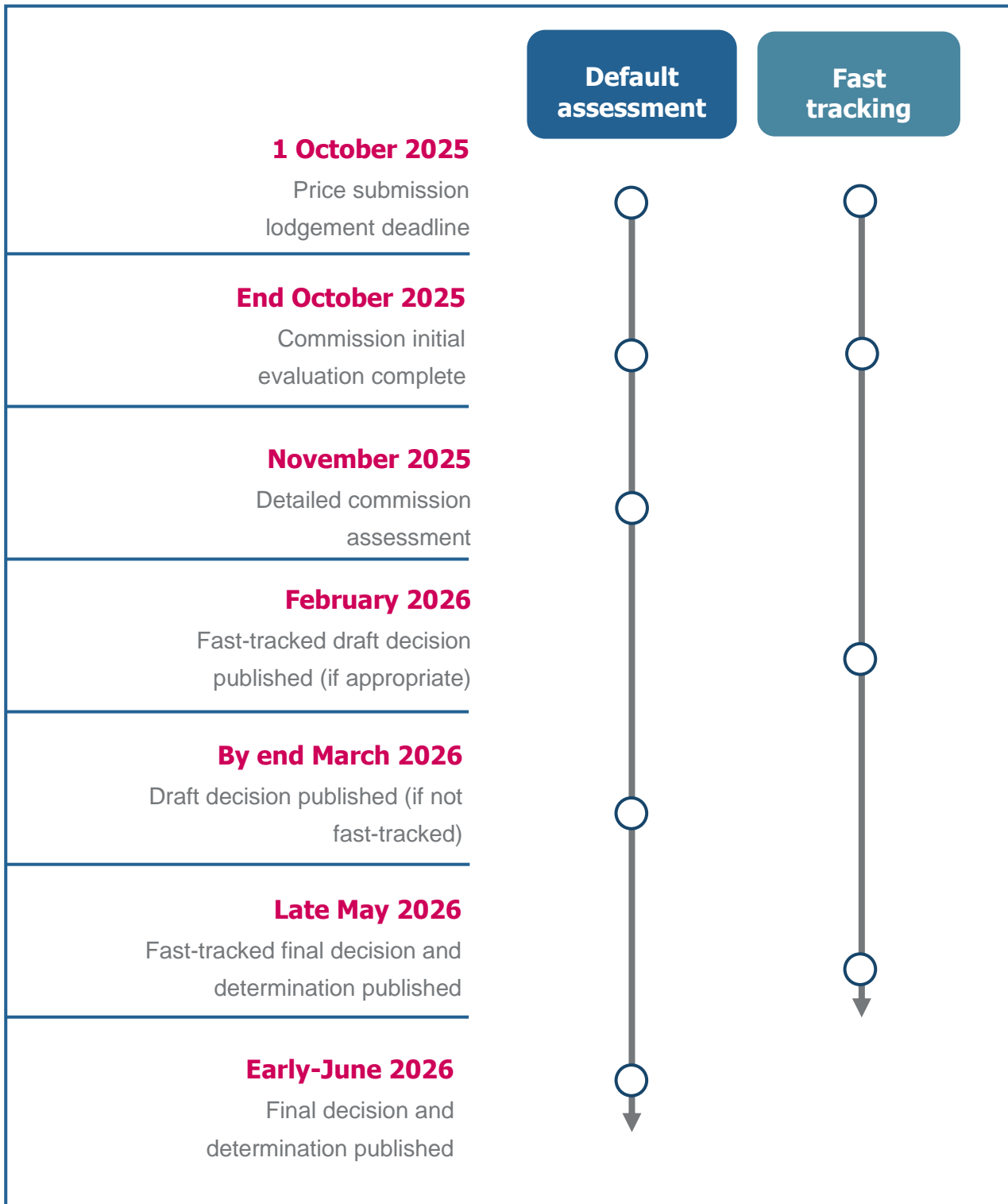
As highlighted above, to facilitate a quick and simple stage 1 assessment (and the possibility of fast tracking), North East Water's price submission must clearly convey its key messages and data to us. This guidance informs North East Water on what to include in its price submission, consistent with this stage 1 assessment. The financial model template (Section 3.23.3) must also be accurately completed for North East 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 North East Water demonstrates it has captured the views of its customers and explains how it has considered feedback
- how promptly North East Water provides clear and robust supporting evidence, where requested, to justify its proposals.

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 process described in Figure 2.2.

Figure 2.2 Price review timeline and assessment process



3. Required contents of a 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 North East Water's price submission, covering the regulatory period commencing 1 July 2026 (the next regulatory period).

North East 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. North East Water may consider other ways – such as fact sheets – to communicate its proposals to other stakeholders, including its customers.

North East 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 North East Water's price submission (see Section 3.23.3).

To support clear and succinct price submissions, North East Water need not include all the supporting information for the claims made in its submission. However, North East 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 North East 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 us to place particular emphasis on matters relating to various efficiencies in undertaking our regulatory functions in Victoria's water sector.²⁷

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.

North East 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 North East 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 a water business may face, and potential approaches that North East 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 North East Water will propose initiatives aimed at addressing climate change in response to its own planning and government policy.²⁸

²⁷ WIRO, section 8(b).

²⁸ 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 North East 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 North East Water to manage the risks associated with uncertain capital expenditure forecasting. Rather than including upfront allowances for uncertain projects and contingencies, North East Water should seek alternative ways to mitigate construction and capital forecasting risk, such as through better project or contract management.

Alternatively, North East 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 North East 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. North East 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 North East Water's consideration of risk to support the business's 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:

Required contents of a price submission

- 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 North East Water has given strategic consideration to risk and identified those 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 North East 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, North East 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

Required contents of a price submission

- 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 North East Water's price determination will apply.²⁹ We note that North East Water is currently concluding an eight-year regulatory period which commenced on 1 July 2018, whereas the other water businesses involved in the 2018 review all adopted a five-year regulatory period.³⁰ In our 2023 guidance paper for those other businesses, we proposed a default five-year regulatory period starting 1 July 2023.

We propose to set a five-year regulatory period starting 1 July 2026, but remain open to alternatives proposed by North East Water.

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

- a relatively long period of certainty for North East Water's customers about the outcomes to be delivered and prices to be charged
- sufficient time for North East 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 our usual 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 North East 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.

²⁹ WIRO, clause 9.

³⁰ In adopting an eight-year regulatory period from 1 July 2018, North East Water committed to conducting a mid-period review to confirm that continuing with the longer period was still appropriate and in the interests of its customers. If not, it would prepare a price submission and seek a new price determination from 1 July 2023 with the other 14 water businesses. Following its mid-period review in 2021, North East Water concluded it would continue on the eight-year price path. The commission was satisfied with North East Water's review process and its conclusion, and supported continuing under the current price determination.

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

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

3.2.2. Supporting information

If North East 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 North East 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 North East 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.³¹ North East Water must engage with its customers and other key stakeholders to inform its price submission.³² The purpose of this engagement is for North East Water to clearly understand the priorities of its customers, including the nature of products and services expected. This is to enable North East Water to deliver outcomes that matter most to its customers.

North East 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 North East Water should engage with its customers. However, we expect North East Water to demonstrate a good understanding of the nature and circumstances of its customers and to tailor its engagement to suit their needs.

Generally, we have retained the same principles and assessment criteria that we specified at the 2018 price review of North East Water. 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.³³ ³⁴ This recognises the importance of inclusive engagement approaches – which we know the Victorian water sector has already prioritised.

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

- The form of customer engagement should be tailored to suit the content on which North East Water is seeking to engage, and to the circumstances facing its customers and community, including First Nations people and people experiencing vulnerability.
- North East 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 as part of the process.

³¹ WIRO, clause 13(a)(iv).

³² We recognise North East 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.

³³ 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. 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.

³⁴ 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.

- North East Water’s engagement process should give priority to matters that have a significant influence on the services provided and prices charged by the business.
- North East Water should start engagement early in its planning. The engagement should be ongoing, to keep testing proposals with customers.
- North East 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 North East 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 3.8 and 3.9 for our expenditure criteria.

3.3.1. Criteria

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

Our assessment of North East Water’s engagement will consider:

- North East 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 North East 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 North East 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 North East Water in reaching its proposals (and what feedback was provided to customers and other key stakeholders).
- North East Water's justification for how it will address customer and community expectations that will not or cannot be met.

3.3.2. Supporting information

North East Water’s price submission must:

- Describe and justify how and when North East Water engaged with its customers and community. It must explain how North East Water 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 North East Water in reaching its proposals.
- Explain how North East Water will address expectations that will not or cannot be met.

North East 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.

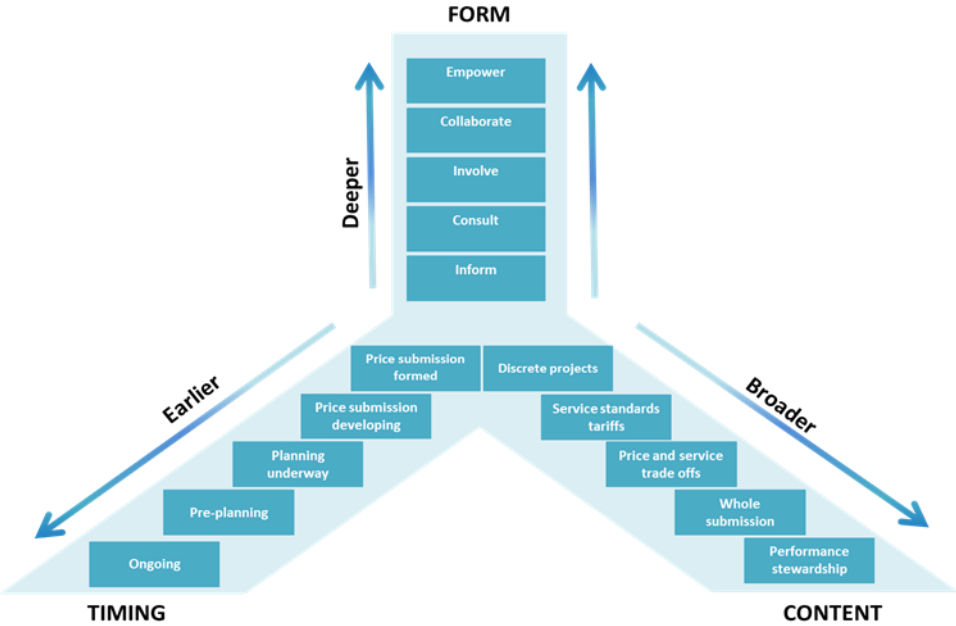
3.3.3. Customer engagement and PREMO

As noted above, we have not prescribed how North East 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.

North East 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 its last 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



Required contents of a price submission

3.4. Outcomes

North East Water must propose a set of outcomes that represent the value its customers will receive during the next regulatory period. North East 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 North East Water's commitment to its customers for the regulatory period. Actual performance against these output measures and targets will allow North East 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.

North East Water must report at least annually to its customers on its performance against the specified output measures for each outcome. We expect North East 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 North East 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

North East Water will already have in place a set of outcomes, output measures and targets that were established at its 2018 price review. For the regulatory period beginning in 2026, we don't expect North East Water will need to establish a new set of outcomes from scratch. Rather, this is an opportunity for North East 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 North East 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 North East Water's customer engagement program.

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.

North East 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 3.7). 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)

Table 3.1 Example – outcome measurement and delivery

Safe clean drinking water for all customers

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

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

3.4.2. Supporting information

North East 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 North East Water’s customer engagement program

Required contents of a 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 North East Water will undertake to meet its targets (and consequently deliver its outcomes 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 3.8 and 3.9)
- explain how the cost increases or cost savings are reflected in prices charged to customers
- explain how North East 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.

North East 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. Service standards relating to reliability and faults

A service standard allows a water business to define a level of service a typical customer can expect to receive. We require North East Water to provide a target level of service for the list of service standards relating to reliability and attending faults that align with provisions in our urban water industry standards.³⁵ A price review provides North East Water with an opportunity to review the target for each of its service standards in consultation with its customers.

North East Water must also explain how any proposed changes in service standard targets relative to equivalent service standard targets in the current regulatory period were informed by customer preferences, and the resulting impacts on expenditure forecasts and customer value.

³⁵ Essential Services Commission 2022, Water Industry Standard – Urban Customer Service, September, clause 18.2

3.6. Guaranteed service levels

North East Water must propose guaranteed service levels (GSLs) for the regulatory period from 1 July 2026 (a GSL scheme). Guaranteed service levels define North East Water's commitment to deliver a specified service level to individual customers. For each guaranteed service level, North East Water commits to a payment or a rebate on bills to those who have received a level of service below the guaranteed level.³⁶

A price review provides North East 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 North East Water's customers.

North East 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 North East Water is taking on revenue risk to provide incentives for it to deliver efficient levels of service to customers.

3.6.1. Criteria

A guaranteed service level scheme must:

- reflect the main service priorities and concerns of customers, informed by North East Water's customer engagement
- provide incentives for North East 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.

The guaranteed service level scheme **must** include the payment difficulty information disclosure guaranteed service level that has been in place since 2010.³⁷ That is, a payment or rebate will be made available to customers if North East Water breaches its service level obligation by:

Restricting the water supply of, or taking legal action against, a residential customer prior to taking reasonable endeavours to contact the customer and provide information about help that is available if the customer is experiencing difficulties paying.

³⁶ Essential Services Commission 2022, Water Industry Standard – Urban Customer Service, September, clause 20

³⁷ Previously known as the hardship related GSL, refer to: Essential Services Commission 2012, Hardship related Guaranteed Service Level review: Final decision, May. The latest (3 February 2015) check-list for minimum 'reasonable endeavours' at the time of this paper can be found at <https://www.esc.vic.gov.au/water/codes-and-guidelines/hardship-related-guaranteed-service-level-measures-review-2011>

3.6.2. Supporting information

North East 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. A 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.

North East 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.

3.7. Revenue requirement

Our decision on North East 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.³⁸

The revenue requirement proposed in its price submission must provide North East 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.

³⁸ WIRO, clause 8(b).

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 Housing Statement

3.7.1. Criteria

The required revenue for North East 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 3.8
- prudent and efficient forecast capital expenditure — determined in accordance with Section 3.9
- 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).

We note that customer aged debt has increased over time. North East Water may seek to justify increases in the allowance for bad debt in its submission. Any changes need to have regard to the

trend in customer arrears, the impacts of business support measures for payment difficulty, and the economic outlook.

3.7.2. Supporting information

The price submission, including the financial model, must specify North East 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.

3.8. Forecast operating expenditure

3.8.1. Criteria

The forecast operating expenditure to be included for the purposes of calculating North East 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 North East 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. North East Water should also clarify how it will demonstrate the value of these investments to customers.

At the next price review, North East 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.

3.8.2. Supporting information

North East 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 each major service category.³⁹

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, examples from previous submissions include, transfer charges, Greater Yarra System – Thompson River fixed charges, Victorian Desalination Plant – Water Order variable charges)
- treatment
- customer service and billing
- GSL payments
- 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 template. Where future amounts are not yet available, North East Water must use the last approved annual amount as its annual forecast in subsequent years.

North East 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 template sets out the forecast operating costs consistent with this approach.

³⁹ For North East Water, the major service categories include water, sewerage, and recycled water.

Box 3.2 Baseline controllable operating expenditure

In preparing forecast operating expenditure, North East 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 expenditure⁴⁰
- 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).

North East 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).

North East 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 North East 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.

North East Water's baseline year actual expenditure must reconcile with its audited regulatory account data.

⁴⁰ Controllable costs are those that can be directly or indirectly influenced by North East Water'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.

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

- its forecast expenditure growth rate assumptions (for each year)⁴¹
- 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 North East 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, North East Water should consider confirming the actual efficiency gains achieved with its customers.

North East 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:

⁴¹ Businesses should draw on Victoria in Future forecasts, Australian Bureau of Statistics data, and other information as required.

- identify and explain operating expenditure savings or new operating expenditure arising from capital expenditure and projects, and how they relate to the forecast cost efficiency improvement rate⁴²
- 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 expenditure⁴³
- 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.

North East Water’s price submission should explain the business’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 chosen 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.

⁴² 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 increases as part of the business’s internal review and approval processes.

⁴³ 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.

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.

North East 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
- 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).

North East 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.

3.9. 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, North East 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, North East 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 North East Water's 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 North East Water.
2. Include development costs and a notional allowance for construction, with the balance of efficient construction costs (plus associated interest if required) 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 or unforeseen event' to be addressed via the mechanisms outlined in Section 3.20 during the regulatory period.

North East 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.

3.9.1. 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 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 North East Water and will not be recovered from customers.

3.9.2. Supporting information

North East 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 by major service category and by the following cost drivers:⁴⁴

- 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.

North East 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 (2017-18), categorised in the same way as above. North East 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 North East 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 North East Water's Performance element under the PREMO framework.

Our 2018 final decision accepted North East Water's proposal to exclude \$47 million (in \$2017-18) of growth-related and small town projects from its expenditure forecasts, due to uncertainty about timing, scope and cost. This approach to uncertainty supported its rating of 'Advanced' for the Risk element of PREMO. Our draft decision set out the requirement for North East Water to demonstrate the prudence and efficiency of these costs if they were incurred during the 2018–26 regulatory period if seeking to include them in the regulatory asset base.⁴⁵

We also expect that North East 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.⁴⁶ 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

⁴⁴ Major service categories are water, sewerage, and recycled water.

⁴⁵ Essential Services Commission 2018, *North East Water draft decision: 2018 Water Price Review*, 28 March, pp. 24–25.

⁴⁶ Our 2018 decision for North East Water included \$1 million of capital expenditure to support further investigations and trials for its proposed digital water metering roll-out, and our expectation North East Water would define the success criteria of any pilot before a broader roll-out could proceed.

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.

North East Water's price submission must present the capital expenditure forecasts set out according to these three key types, as follows:

Major capital projects — comprising the 'top 10' discrete capital projects, by total capital cost, to be started or completed during the next regulatory period. North East Water may also include significant discrete projects that fall outside the top 10 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 solution⁴⁷
 - 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 contractors⁴⁸
 - information to identify whether the project has (or will be) the subject of competitive tendering.

⁴⁷ 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.

⁴⁸ A business'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.

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 10’ 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)
- 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, North East Water must also:

- for each year of the next regulatory period, and beyond to 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 North East 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 3.9.1, 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.

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.⁴⁹

⁴⁹ 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.

3.11. 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).

The opening RAB must be calculated as follows:

Opening RAB 1 July 2026 = RAB at 1 July 2018 (adjusted to reflect 2017-18 actual and inflation adjusted to \$2026)

- + Actual capital expenditure (gross) 2018-19 to 2024-25 and inflation adjusted to \$2026
- + Forecast capital expenditure (gross) 2025-26* and inflation adjusted to \$2026
- Actual contributions 2018-19 to 2024-25 and inflation adjusted to \$2026
- Forecast contributions 2025-26** and inflation adjusted to \$2026
- Forecast regulatory depreciation 2018-19 to 2025-26 and inflation adjusted to \$2026
- Proceeds from disposal of assets 2018-19 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 at the 2018 price determination)

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

Our financial model template has been amended to enable North East Water to show its updated gross capital expenditure forecast for 2025-26 alongside the forecast benchmark for that year in the 2018 price determination, and to select which of the two values it proposes to roll into the opening RAB from 1 July 2026. We expect North East Water to select the lower of the two values. However, if North East Water seeks to roll-in a higher value than the benchmark (for example, to include that part of the excluded \$47 million of uncertain capital expenditure that is expected to be incurred in 2025-26), 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 prudency and efficiency requirements set out in Section 3.9. Any decision to roll in an amount higher than the 2025-26 benchmark will necessarily consider the total aggregate spend across the regulatory period.

If the updated developer contribution forecast for 2025-26 is higher than the forecast benchmark for that year in the 2018 price determination, then North East Water must use the higher amount.

Required contents of a price submission

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

North East 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.

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 North East Water 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 North East Water's justification for capital expenditure in 2017-18 and in the period 2017-18 to 2024-25. We may also request a reconciliation of actual net capital expenditure against the benchmarks allowed in the water business's 2018 price determination (Section 3.9.2), 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.

North East 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 also 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.⁵⁰.

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

⁵⁰ 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.

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% ^a	6.53% ^a

^a The cost of debt 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.

North East 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, North East 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 North East Water).

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.

Required contents of a price submission

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 North East 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

The return on equity to be reflected in prices will be established via the PREMO incentive mechanism, under which North East Water's return on equity will be linked to the level of ambition expressed in its price submission.

Under PREMO, North East 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.

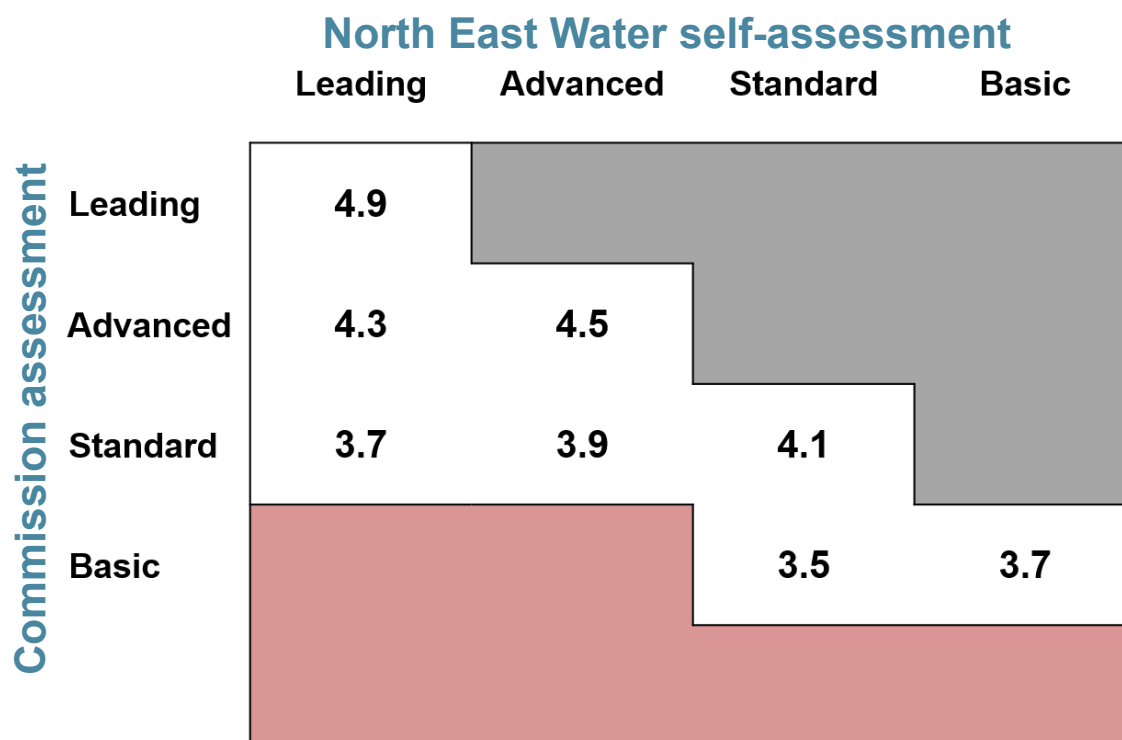
The range of possible values (in real terms) for the return on equity resulting from the two-stage assessment and rating process is provided in Figure 3.2.

The values in the matrix are lower than those established for the 2018 review. Other economic regulators have recently set the return on equity benchmark below the 2018 rates we used. A key reason for the lower benchmarks is reductions in the real risk-free rate. Compared to the 2018 rates, we have lowered the return on equity benchmarks to reflect a lower real risk free rate. However, reflecting our long-term approach, we have not fully reflected these reductions in the return on equity benchmarks. The values in Figure 3.2 are consistent with those established for our recent 2023 and 2024 price reviews.

We note that the lowest value in the matrix is above the estimated cost of debt, and therefore supports revenue sufficiency for North East Water.

Figure 3.2 Regulated return on equity

Real per year rate (per cent)



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

North East 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 North East Water and the commission, the greater will be the allowed return on equity.

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

If we find North East 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 rates of return that are not commensurate with the outcomes it proposes to achieve. It also supports an incentive-based framework that will deliver better consumer outcomes.

The (red) shaded zone at the bottom of the matrix represents an area within which we will reserve our discretion. For example, we may require North East 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 North East Water with a strong incentive to assess its price submission accurately and honestly.

If during its price submission assessment the commission downgrades North East 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 North East Water to apply to have its original PREMO rating restored. This would likely involve North East 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 the 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.

North East 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

North East 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 North East 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 North East Water's proposed rating for each PREMO element.

Appendix E includes a PREMO assessment tool that North East 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, North East Water must propose an overall PREMO rating for its price submission. Appendix E also includes a scoring methodology to assist businesses with this rating process, noting use of the scoring methodology is not mandatory.

North East 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 questions
Performance	<ul style="list-style-type: none"> • To what extent has North East Water demonstrated delivery of its customer outcomes commitment over the current regulatory period? Did its customers get what they paid for? • How does North East 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? • How does actual capital expenditure across the current period compare with the established benchmark allowance, and to what extent has North East Water rationalised any discrepancies? • To what extent does customer sentiment demonstrate satisfaction in North East Water’s performance over the current regulatory period? Are customers happy with the value they receive from North East Water?
Risk	<ul style="list-style-type: none"> • To what extent has North East 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. • To what extent does the proposed guaranteed service level (GSL) scheme provide incentives for North East Water to be accountable for the quality of services delivered, and provide incentives to deliver valued services efficiently?
Engagement	<ul style="list-style-type: none"> • To what extent has North East Water justified how the form of engagement suits the content of consultation, the circumstances facing the water business and its customers? • To what extent has North East Water demonstrated that it provided appropriate instruction and information to customers about the purpose, form and content of the customer engagement? • To what extent has North East Water demonstrated that the matters it has engaged on are those that have the most influence on the services provided to customers and prices charged? • To what extent has North East Water explained how it decided when to carry out its engagement? • To what extent has North East Water demonstrated how its engagement with customers has influenced its submission?

PREMO Element	Guiding questions
	<ul style="list-style-type: none"> • To what extent has North East Water demonstrated that its engagement was inclusive of consumers experiencing vulnerability? • To what extent has North East Water demonstrated that its engagement was inclusive of First Nations people?
Management	<ul style="list-style-type: none"> • To what extent has North East Water demonstrated how its proposed prices reflect only prudent and efficient expenditure? • To what extent has North East Water justified its commitment to cost efficiency or productivity improvements? • To what extent has North East 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 North East Water provided evidence that there is senior level, including Board level, ownership and commitment to its submission and its outcomes? • To what extent has North East Water demonstrated its price submission is an 'open book'?
Outcomes	<ul style="list-style-type: none"> • Has North East Water provided evidence that the outcomes proposed have taken into account the views, concerns and priorities of customers? • Has North East Water provided sufficient explanation of how the outcomes it has proposed align to the forecast expenditure requested? • Has North East Water proposed outputs to support each of its outcomes, which are measurable, robust and deliverable? • Has North East Water provided evidence that the outputs it has proposed are reasonable measures of performance against stated outcomes? • Has North East Water demonstrated a process to measure performance against each outcome and to inform customers?

3.14.2. Supporting information

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

- 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.

Required contents of a price submission

3.15. Return on equity

The price submission PREMO rating proposed by North East 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 North East Water's proposed revenue requirement	4.9	4.5	4.1	3.7

3.15.1. Criteria

North East 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 4.5 per cent. No further supporting information regarding North East 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 North East Water. In estimating the value of imputation credits North East Water must multiply the annual estimated corporate income tax bill by an imputation factor.⁵¹

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

⁵¹ 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 North East Water, the financial model template will produce an estimate of the business'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
- γ 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)⁵²
- 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 North East Water as the basis for its tax allowance forecasts. The forecast tax allowance may also be informed by North East 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 North East Water to reflect any expected changes in the applicable tax rate. North East 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

⁵² 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 North East 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 North East 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

North East 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. North East 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 North East Water's demand forecasts
- an explanation of how demand forecasts are consistent with proposed expenditure (in terms of the level and nature of expenditure).

North East 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 North East Water to provide detailed demand forecasts for every tariff and tariff category, by residential and non-residential customers. If detailed forecasts at this level are unavailable, North East 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

North East 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, North East 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:

- North East Water's justification for the proposed form of control, including its consideration of efficiency and risk allocation and management
- North East Water's approach to consultation on the form of control and how the views of customers were taken into account
- where a change to the form of price control is proposed, whether North East 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 North East 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.

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 North East 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 North East Water, then its price submission must:

- explain how the proposed form of control would operate and services affected
- demonstrate that North East Water has consulted with potentially affected customers, and explain how the feedback from 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 North East 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 North East 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 North East 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. If North East Water proposes tariff reforms, it should engage with its customers and take into consideration their views in its proposal.

The 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, including miscellaneous services
- where relevant, the pricing principles that it proposes to apply in setting prices.

Required contents of a price submission

We anticipate prices for recycled water and unique services such as trade waste and miscellaneous services will be set with reference to pricing principles. The pricing principles for miscellaneous services are outlined in Section 3.19.3.

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, North East Water may propose specific pricing principles.

In developing its pricing proposal, we encourage North East 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>Bulk Water Charges Structure — A two-part charge comprising a fixed charge and a volumetric component to recover a bulk supplier’s revenue requirement from its customers for each bulk water service.</p> <p>Retail Water Tariffs Structure — A two-part tariff comprising a fixed charge and a volumetric component to recover North East Water’s revenue requirement from each tariff class.</p> <p>Sewerage Charges — The tariff structure should reflect the cost structure, and may comprise a one or two-part tariff (all fixed, all volumetric or a fixed charge and a volumetric component).</p> <p>Trade Waste — 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	<p>Retail tariff and service offerings, and the form of price control, should have regard to:</p> <ul style="list-style-type: none"> • the ability of customers to understand the tariff and service offering and respond to price signals • customer preferences and needs in relation to service standards or new services • the costs of implementing the tariff offering, including administration and marketing costs • price path stability.
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 the cost structure of water supply, transport and treatment across North East Water. 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 North East Water to make the case for which is most appropriate.</p>

The principles in Table 3.5 provide guidance for North East 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 North East Water's proposed PREMO rating.

3.19.1. Criteria

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

- North East 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
- North East Water's approach to consultation on the tariff structures and how the views of customers were taken into account
- whether North East Water has considered and demonstrated that appropriate transition strategies will be implemented for any materially affected customers
- where applicable, whether North East 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 North East Water's proposals against the following factors:

- North East 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 the business to pursue efficiency improvements
- how North East Water has taken into account the interests of customers, in particular low-income customers and customers experiencing vulnerability
- whether North East 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 includes avoiding price shocks for customers where possible. Where an existing tariff structure is being continued, this may be satisfied more easily. Where changes from existing tariff structures are proposed, however, North East 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

North East 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 North East Water's tariff strategy and highlight any major proposed changes during the regulatory period commencing 1 July 2026
- provide indicative bill impacts for North East Water's key customer groups – for residential (owner occupiers and tenants) and business customers (small, medium and large), estimates must be provided for each year of the regulatory period using representative consumption amounts and specified in real terms
- include a summary of North East 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 North East 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 services⁵³
 - justify how the proposed change delivers better signals to North East Water's customers about the efficient costs of service provision
 - describe how North East Water has considered risk and its allocation and management
 - provide a summary of North East Water's approach to consultation and how the views of customers informed the price submission
 - update the residential bill calculator in the financial model template, reflecting the proposed tariffs and price levels
- for real price changes of more than 10 per cent for any tariff in any year for the next regulatory period commencing 1 July 2026:⁵⁴
 - describe the relationship between the cost of service provision and the proposed price

⁵³ 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.

⁵⁴ 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. For the purposes of the 2018

- provide a summary of North East Water’s approach to consultation (including the approach to identifying affected customers)
 - summarise the customer feedback received on the proposed price increase
 - 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

A price submission must specify any proposed price adjustment mechanisms to apply in the next regulatory period. The 2018 price determinations include common mechanisms that allow for prices to adjust in order to take into account:

- uncertain or unforeseen events
- a ‘pass through’ of changes in some costs (such as taxes) during the regulatory period
- annual changes to the benchmark cost of debt.

price review, we defined a price shock as 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, North East 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.

Required contents of a price submission

Our view is that these 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.

If North East Water proposes to continue with the existing price adjustment mechanisms, the supporting information requirements will be easily satisfied. Where a change is proposed, North East 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 North East Water's costs, the change may be nominated in the business'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 3.9) 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 North East 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 North East Water's customers should bear risk associated with the nominated event
- the impact of the nominated event on efficiency incentives for North East Water
- the ability for North East 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

North East 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 North East Water has sought to appropriately balance revenue and cost risk between the business and its customers, without materially impacting on price stability

Required contents of a price submission

- 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 North East Water or its customers
- explain why it is appropriate that customers should bear risk associated with the event
- explain how North East 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. North East 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. New customer contributions

New Customer Contributions (NCC) are a prescribed service for urban water businesses (also known as developer contributions). We introduced a principles-based NCC charging framework which came into effect from 1 July 2013. For detailed guidance on NCC, North East Water should continue to refer to our explanatory note, released in December 2013, and reproduced in Appendix F.⁵⁵

3.21.1. Criteria

North East Water must use approved pricing principles (outlined in Box 3.3) to calculate the net incremental cost of connections. NCC will be either standard NCC, which are approved by us in North East Water's determination, or negotiated NCC, which are agreed between a developer and North East Water.

⁵⁵ Essential Services Commission 2013, New customer contributions: Explanatory note, December.

Box 3.3 NCC pricing principles

Standard and negotiated NCC charges will:

- have regard to the incremental infrastructure and associated costs in one or more of the statutory cost categories attributable to a given connection⁵⁶
- have regard to the incremental future revenues that will be earned from customers at that connection
- be greater than the avoidable cost of that connection and less than the standalone cost of that connection.

3.21.2. Supporting information

North East Water's price submission must:

- Specify the proposed NCC charges and how they are to be applied – for example by customer class (water, sewerage, recycled water), location or development type (infill, greenfield).
- Provide the model(s) used to calculate the maximum NCC charges, including accompanying notes describing the data sources and input assumptions used, in order for us to assess that proposed NCC charges have been established in accordance with the NCC pricing principles (Box 3.3). The model(s) must use the same financial parameters as in the financial model template.⁵⁷
- Provide evidence of consultation with developers and how their views have informed the proposed charges, particularly if proposed Standard NCCs are significantly higher than the existing NCCs.
- Provide details about how the forecast developer contributions in the financial model template have been derived and explain how past outcomes for contributions have been considered, and assumptions about future connections growth. This includes how costs have been allocated to new customer contributions.
- Provide a copy of the negotiated new customer contribution framework to be applied for the forthcoming regulatory period, including any proposed changes in track changes.

We expect North East Water will use the commission's current NCC model to calculate its maximum new customer contributions. This should be supported by accompanied notes (as

⁵⁶ Statutory cost categories means costs for works imposed under Division 6 of Part 13 of the Water Act 1989.

⁵⁷ North East Water must update and resubmit its NCC calculation model(s) following our draft decision on parameters such as demand forecasts and expenditure forecasts and the weighted average cost of capital (WACC).

referenced above) to facilitate our assessment of the model and proposed charges. If North East Water is considering using a different model or approach, it must advise us as early as possible.

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.

North East 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. North East Water should also provide us with the findings of any independent ratings assessments conducted by an independent credit ratings agency since 1 July 2018.

Table 3.6 Financial indicators – actual test

Indicator	Calculation	Benchmark Range	Description
Primary indicator — used to determine size of any viability adjustments			
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 water 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.
Secondary indicators — used only as contextual information to determine whether an adjustment is necessary			
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
Primary indicators — used to determine size of any viability adjustments			
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.
Secondary indicators — used only as contextual information to determine whether an adjustment is necessary			
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 North East Water’s proposed prices
- indicative bill impacts of the proposed prices, by key North East Water customer groups
- an overview of the outcomes proposed for North East Water customers, including how services will change from previous levels
- North East Water’s nominated PREMO rating
- an attestation from the North East Water board on the quality and accuracy of information provided in the price submission.

3.23.2. Board attestation

Our guidance requires the North East 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 North East 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 North East Water price review:

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

To support its PREMO rating, North East 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 North East Water's final PREMO self-rating is always the sole responsibility of North East Water, even if it engages a third party to review and advise on its proposed PREMO self-rating.

3.23.3. Financial model

North East Water must complete the financial model template prepared by the commission to accompany its price submission. North East Water's price submission must be consistent with the data provided in the financial model template.⁵⁸ Where there is any discrepancy between the price

⁵⁸ The financial model template requires North East 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 North East Water to estimate its revenue allowance and prices. The model will require both historic and forecast data. Historic data must be consistent with North East 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 North East Water must provide data. North East 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 North East 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.

3.23.4. Requirement for reasonably-based information

All information contained in North East 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 North East 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 North East 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 analysis 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 North East Water's price submission, financial model template and any supplementary information on our website. If there is information that North East 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 North East Water to provide a redacted version for public disclosure on our website.⁵⁹

3.23.7. Accessibility

The commission intends to use the Engage Victoria platform for its consultation during North East Water's 2026 water price review. If not addressed by North East 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, North East 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. North East 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, North East 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. North East 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 North East 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).⁶⁰ North East 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.

⁵⁹ View our submissions policy at <https://www.esc.vic.gov.au/about-us/our-policies/our-submissions-policy>.

⁶⁰ 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 the commission must have regard to

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

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

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

Water businesses face a range of risks, both within and outside of their control, for example:

- Inflow risk, which presents as an inability for North East 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 North East Water experiencing a breach of health, environmental or customer performance standards, can result from inadequate processes within water businesses, asset failures or external factors. North East 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. North East 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 water revenue allowances transfers risk of project cost overruns to customers. North East 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 North East 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. North East 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.⁶¹

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 North East 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 the price submission 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 North East 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 3.8 and 3.9).
- Indexation of prices — This ensures that North East Water remains fully responsible for management of 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 North East 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 North East Water and its customers will need to be addressed in the 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 North East 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 or 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).

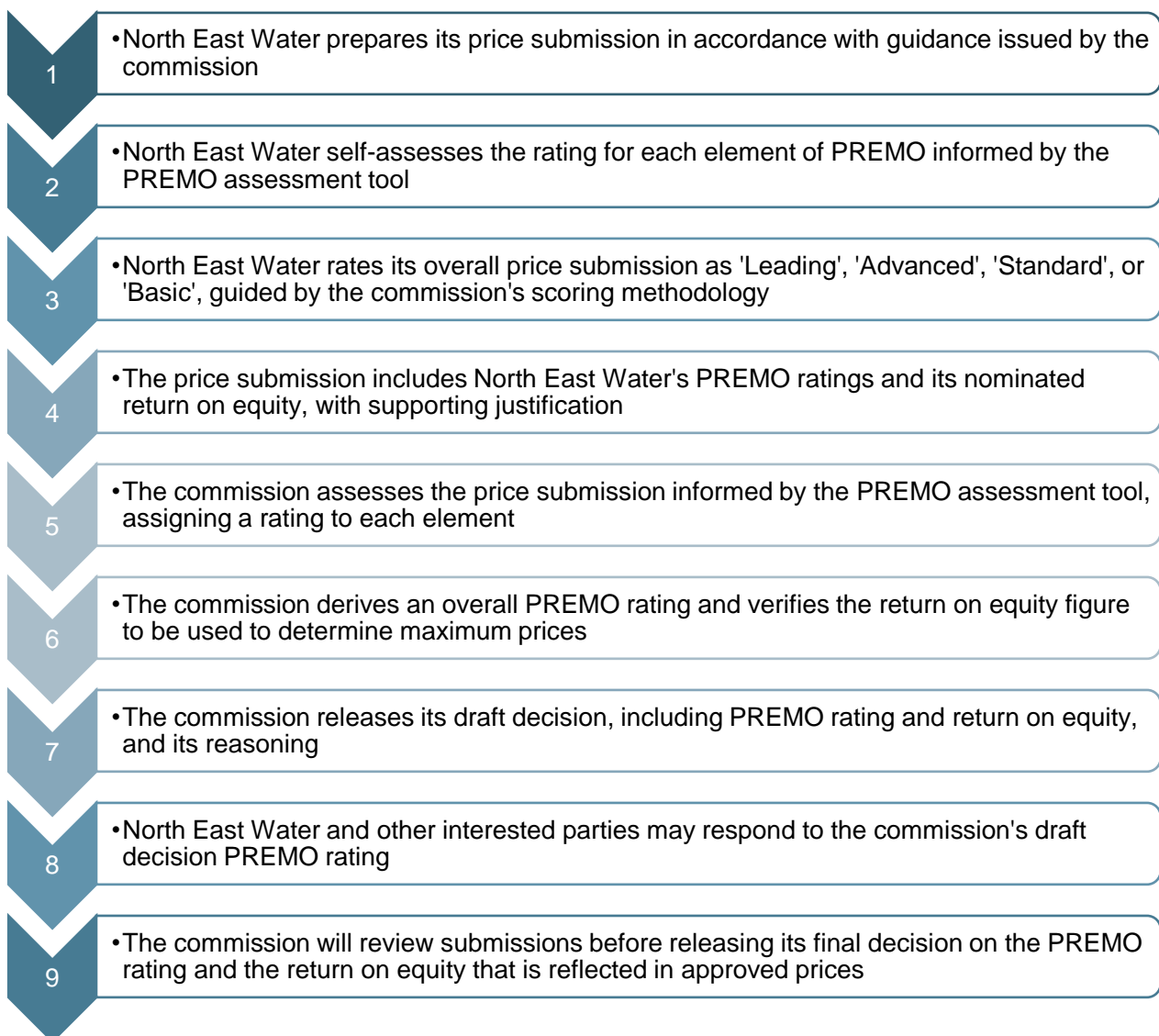
⁶¹ Queensland Competition Authority 2023, Guideline: Climate change related spending, September. The guideline is available at: <https://www.qca.org.au/wp-content/uploads/2023/09/qca-climate-change-guideline-september-2023.pdf>

Appendix E – Establishing a PREMO rating

PREMO rating process

The steps for North East Water and the commission to establish the PREMO rating for the business's price submission is outlined in Figure A below.⁶²

Figure A Process for rating a price submission



⁶² 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 North East Water or by us in arriving at a price submission rating. North East Water may provide further arguments to support its ratings. Further, if North East 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 North East 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 North East 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 North East 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, North East 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 North East 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 North East Water's established benchmark allowance, and to what extent has North East Water rationalised any discrepancies?</p> <p>How does actual capital expenditure across the current period compare with North East Water's established benchmark allowance, and to what extent has North East Water rationalised any discrepancies?</p> <p>To what extent does customer sentiment demonstrate satisfaction in North East Water's performance over the current regulatory period? Are customers happy with the value they receive from North East Water?</p>	<p>North East Water has underperformed on its outcomes commitments, falling short of delivering the value its customers expected.</p> <p>North East Water did not adequately own its underperformance or address shortfalls with its customers.</p>	<p>North East Water has generally delivered on its outcome commitments, by meeting its performance targets for most output measures across the regulatory period.</p> <p>North East 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>North East 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>North East 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>North East 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>North East 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>North East 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>North East 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>North East 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>North East Water consistently scores at the lower end of the ESC's quarterly customer perception survey, and cannot counter this with its own customer survey findings.</p> <p>North East Water reports an ongoing downward trend in customer sentiment across the regulatory period.</p>	<p>North East Water consistently scores on par with the statewide average in the ESC's quarterly customer perception survey.</p> <p>North East Water demonstrates a noticeable lift in positive customer sentiment across the period.</p> <p>North East Water's own customer survey work demonstrates it meets expectations, or shows a positive trend across the period.</p>	<p>North East Water consistently scores above the statewide average in the ESC's quarterly customer perception survey.</p> <p>North East Water demonstrates a significant lift in positive customer sentiment across the period.</p> <p>North East 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 North East 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 North East Water to be accountable for the quality of services delivered, and provide incentives to deliver valued services efficiently?</p>	<p>North East Water has not met the requirements of the commission's Guidance Paper in relation to risk.</p> <p>North East Water has sought to transfer risk to customers which is not supported by customer views.</p>	<p>North East Water meets the requirements of the commission's Guidance Paper in relation to risk.</p>	<p>North East Water has implemented a new approach that reduces prices through better risk management, or through accepting risk on behalf of customers.</p>	<p>North East 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, North East 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>North East Water has not sought to minimise cost and/or price impacts from risk management.</p>	<p>North East Water demonstrates compliance with risk standards specified in the Statement of Obligations (e.g. ISO 55000).</p>	<p>North East 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>North East 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>North East 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>North East 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>North East Water has undertaken a Monte Carlo analysis for all major projects.</p> <p>North East 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>North East 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>North East Water has evaluated whether major projects should be funded via capital or operating expenditure for pricing purposes.</p>		
	<p>North East Water has not proposed a GSL scheme that reflects the main service concerns and priorities of customers.</p>	<p>North East Water has proposed a GSL scheme that reflects the main service concerns and priorities of customers.</p>	<p>North East Water has refined its GSL scheme to provide greater service accountability to customers, or to provide increased incentives to deliver services efficiently.</p> <p>North East Water has proposed a GSL scheme that compares favourably to industry peers in terms of incentives to deliver services efficiently.</p>	
	<p>North East 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>North East Water cannot support its assessment of financial viability by reference to cash flow projections and independent benchmarks (e.g. credit rating metrics).</p>	<p>North East Water can support its assessment of financial viability by reference to cash flow projections and independent benchmarks (e.g. credit rating metrics).</p>	<p>North East 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 North East Water and its 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 North East Water justified how the form of engagement suits the content of consultation, as well as the circumstances facing the water business and its customers and other key stakeholders?</p> <p>To what extent has North East Water demonstrated that it provided appropriate instruction and information to participants about the purpose, form and content of the customer engagement?</p>	<p>The form of customer engagement is not justified as being fit for purpose given the content and circumstances facing North East Water and its customers.</p>	<p>The form of customer engagement is justified as being fit for purpose given the content and circumstances facing North East 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 North East Water's proposals. Methods supported inclusion and effective participation.</p>	<p>The onus is on North East 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"> • 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. • Participants in the engagement program provide feedback that North East 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). 	
<p>To what extent has North East Water demonstrated that the matters it has engaged on are those that have the most influence on the services provided to customers and prices charged?</p> <p>To what extent has North East Water explained how it decided when to carry out its engagement?</p>	<p>Information provided to customers and other key stakeholders was written in technical jargon, and/or was not appropriate for customer use.</p> <p>North East Water provided selective or incomplete information to customers that biased the responses or did not provide sufficient context for customer input.</p>	<p>North East Water demonstrates that the information provided to its engagement participants was appropriate given the purpose, form and content of customer engagement.</p>	<ul style="list-style-type: none"> • Engagement methods that are effective in overcoming power imbalances. • The level of customer influence on proposals. A strong alignment between North East Water's proposals and the preferences and interests elicited in its engagement program would correspond to a higher rating. This includes undertaking engagement in a way that gives customers a strong voice or helps to overcome power imbalances. • The level and quality of participation of people who are experiencing vulnerability, or whose vulnerability might be exacerbated as a result of the outcomes of the price submission. • The level and quality of involvement of First Nations people in matters that affect them. 	
<p>To what extent has North East Water demonstrated how its engagement with customers has influenced its submission?</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>North East Water demonstrates that engagement has occurred on matters that customers and other key stakeholders reveal are the most important to them.</p>		

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 North East Water demonstrated that its engagement was inclusive of consumers experiencing vulnerability?</p> <p>To what extent has North East Water demonstrated that its engagement was inclusive of First Nations people?</p>	<p>Engagement was undertaken late, after North East Water had developed its key strategies and priorities.</p> <p>North East 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>North East Water has not retested its position and proposals with 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>North East Water has not provided reasonable justification for instances where its proposed outcomes are not consistent with customer views.</p>	<p>North East Water demonstrates that engagement was undertaken early, prior to locking in key strategies and priorities.</p> <p>North East Water demonstrates it used engagement methodologies that elicit views that are representative of the customer base and other key stakeholders.</p> <p>North East Water demonstrates that it re-tested its position and proposals with customers as it developed its price submission.</p> <p>The price submission describes what was learned from customer engagement, and how this influenced its proposed outcomes, expenditure (composition and level) and prices.</p> <p>In any instances where outcomes proposed are not consistent with customer views, North East 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 North East Water demonstrated how its proposed prices reflect only prudent and efficient expenditure?</p> <p>To what extent has North East Water justified its commitment to cost efficiency or productivity improvements?</p> <p>To what extent has North East 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 North East 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 North East Water demonstrated its price submission is an "open book"?</p>	<p>North East 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>North East Water has not provided timely access to robust business cases that validate the basis for all major projects and capital programs.</p> <p>North East Water has not proposed efficiency improvements in relation to its capital renewals program.</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>North East 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>North East 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 North East Water is at or near to the efficiency frontier for the sector.</p> <p>The operating expenditure forecast places North East Water well ahead of the industry average in terms of cost efficiency.</p> <p>North East Water has proposed a significant improvement in the efficiency of its capital program.</p>	<p>North East 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 North East 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 North East Water as a leader in the industry.</p> <p>The operating expenditure forecast places North East Water as a leader in the industry in terms of cost efficiency.</p> <p>North East 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 North East 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 North East 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>North East 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>North East 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>North East Water has not proposed adequate mitigation strategies to avoid any price shocks.</p>	<p>North East Water has proposed adequate mitigation strategies to avoid any price shocks.</p>		
	<p>North East Water has not provided timely access to meaningful and robust supporting documentation, on request from the commission.</p>	<p>North East Water retains meaningful and robust supporting documentation to justify its proposals, with ongoing access available to the commission.</p>		
	<p>North East 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>North East 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 North East Water provided evidence that the outcomes proposed have taken into account the views, concerns and priorities of customers?</p> <p>Has North East Water provided sufficient explanation of how the outcomes it has proposed align to the forecast expenditure requested?</p> <p>Has North East Water proposed outputs to support each of its outcomes, which are measurable, robust and deliverable?</p> <p>Has North East Water provided evidence that the outputs it has proposed are reasonable measures of performance against stated outcomes?</p> <p>Has North East Water demonstrated a process to measure performance against each outcome and to inform customers?</p>	<p>North East 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 are broadly consistent with existing levels of service provided to customers.</p>	<p>The outcomes proposed reflect a significant improvement in customer value delivered. This might be demonstrated by significant improvements in output targets (or performance measures) for outcomes that matter most to most customers, or similar targets at significantly lower prices.</p> <p>North East Water proposes outcomes that are well ahead of the industry average or North East Water's own past performance (measured by reference to output targets).</p>	<p>The outcomes proposed reflect a very significant improvement in customer value delivered.</p> <p>North East Water proposes outcomes that lead the industry.</p>
	<p>Outcomes are not defined in ways that reflect the customer service experience.</p>	<p>All outcomes proposed have been defined in ways that reflect the customer service experience.</p>		
	<p>North East Water has proposed outputs that are not appropriate measures of performance for each outcome proposed. Measures and deliverables are not clearly defined.</p>	<p>North East 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 customer preferences and priorities revealed through engagement.</p>	<p>The outcomes proposed have been prioritised by North East Water in terms of importance to customers as revealed through customer engagement. North East Water's expenditure forecasts reflect the prioritisation of outcomes.</p>		
	<p>Where applicable, North East Water has not explained or justified why outcomes proposed are not consistent with customer preferences and priorities.</p>	<p>Where applicable, North East Water has explained or justified why outcomes proposed are not consistent with customer preferences and priorities.</p>		
	<p>The level and composition of forecast expenditure is inconsistent with the outcomes proposed.</p>	<p>The level and composition of forecast expenditure is consistent with the outcomes proposed.</p>		
	<p>The expenditure profile has not changed to reflect customer priorities.</p>	<p>The expenditure profile has changed where required to reflect customer priorities.</p>		
	<p>North East Water has not committed to a process for monitoring and reporting to customers on its performance against outcomes.</p>	<p>North East Water has an established customer performance reporting approach that is targeted to 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 North East 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 North East Water uses the scoring methodology below to rate its price submission.⁶³

Weighting

North East 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 North East 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 North East 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.

⁶³ 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 North East 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, North East Water ultimately has the discretion to select any PREMO price submission rating, even if it may not correspond with an aggregated score.

Appendix F – New customer contributions

Below is our explanatory note on new customer contributions which outlines our principles-based new customer contributions charging framework. We have not made updates to the contents of this document from when it was published in December 2013. It has been included in this guidance to ensure North East Water has all the necessary information it needs in this guidance paper to make its proposals for new customer contribution charges for the next regulatory period.

New customer contributions: explanatory note

Overview

This explanatory note is intended to assist staff in water businesses as well as those in the development industry to apply the new principle-based approach to new customer contributions (NCC). It collates and summarises the commission's 2013 decisions. If there is any inconsistency, the commission's final decisions and determinations will take precedence.

This explanatory note applies during the third regulatory period from 1 July 2013 to 30 June 2018.

What are new customer contributions?

NCC, also known as developer charges, are a one off, upfront charge that a water business may levy when a new connection is made to its water, sewerage or recycled water network. These charges apply in a range of situations. Generally, they are paid by developers who are subdividing land on the urban fringe or redeveloping sites within built up areas. They may also be levied when an existing property owner decides to connect to a service for the first time.

The relevant regulated services are 'services to which developer charges apply', being services provided by water businesses under Division 6 of Part 13 of the Water Act 1989 (Vic) (the Water Act). That Division refers to:⁶⁴

- services that will benefit a property
- works used directly or indirectly for the provision of those services, and any fireplugs associated with those works.

The legal and regulatory framework

The Water Act governs water businesses' rights and obligations in relation to new connections. The Water Industry Regulatory Order (WIRO) provides the commission with the power to regulate charges for NCC.⁶⁵

The commission introduced a principles-based NCC charging framework on 1 July 2013. This NCC framework aims to:

- send signals to developers about the costs of developing in different locations

⁶⁴ See for example section 268, 269 and 270 of the Water Act.

⁶⁵ That is the Water Industry Regulatory Order (WIRO) made by the Governor in Council under section 4D of the Water Industry Act 1994 (Vic). Appendix A is a diagram depicting the regulatory framework for NCC.

- share the costs and benefits of growth between new and existing customers
- administer NCC in a transparent way.

Water businesses must use approved pricing principles (Box 1) to calculate the net incremental cost of connections. NCC will be either standard NCC (approved by the commission in each water business's determination), or negotiated NCC (agreed between a developer and water business).

Box 1 NCC pricing principles

Standard and Negotiated NCC charges will:

- have regard to the incremental infrastructure and associated costs in one or more of the statutory cost categories attributable to a given connection⁶⁶
- have regard to the incremental future revenues that will be earned from customers at that connection
- be greater than the avoidable cost of that connection and less than the standalone cost of that connection.

Guidance on interpreting these principles is set out in the next section of this explanatory note: '[Interpreting the NCC pricing principles](#)'.

Types of NCC – standard or negotiated

Standard NCC

For most water businesses, the commission approved standard NCC that will apply for connections in areas where infrastructure requirements and growth rates are relatively well known. The purpose of standard NCC is to reduce the administrative burden as well as improve the timeliness and predictability of costs faced by developers.

Each water business publishes on its website details of its current approved standard NCC, together with underpinning assumptions (such as timing, infrastructure provision, meter size), and maps showing where they apply.⁶⁷

⁶⁶ Statutory cost categories means costs for works imposed under Division 6 of Part 13 of the Water Act 1989.

⁶⁷ Standard NCC charges approved in 2013 will apply until apply until 30 June 2018.

Negotiated NCC

In situations where standard NCCs are not fair and reasonable or where a new connection is outside the areas designated as eligible for standard NCCs, the NCC framework allows water businesses and developers to negotiate site-specific arrangements that reflect the NCC pricing principles (Box 1).

Dispute resolution

If there is a dispute between a developer and a water business (whether in relation to a standard NCC or negotiated NCC), developers may use the dispute resolution offered by a water business as part of its NCC framework. In addition, developers may follow the Water Act process to object and seek internal review by the water business, and to pursue unresolved matters through the Victorian Civil Administrative Tribunal (VCAT).

Water business communication

Reasonable industry practice will see water businesses prepare and publish:

- development servicing plans (updated from time to time) that show the water business's forecast timing and sequencing of infrastructure that will be required to service new customers
- negotiation protocols (including references to the pricing principles and dispute resolution details)
- explanations of where and when standard NCCs apply, and circumstances in which a developer or water business may introduce a negotiated NCC.

Which water businesses?

This explanatory note applies to:

- all Victorian metropolitan and regional urban water businesses⁶⁸
- any connection applicant seeking services to which developer charges apply.⁶⁹

⁶⁸ This explanatory note does not apply to Melbourne Water, Southern Rural Water and Goulburn-Murray Water. Only rural water businesses which have an urban component are covered by the NCC framework.

⁶⁹ Developer charges are defined in the Water Industry Regulatory Order.

Final decisions and determinations

This explanatory note reflects the following commission determinations and decisions:

- 2013–18 water price review determinations for metropolitan and regional water businesses, dated June 2013, specifically determinations for:
 - Barwon Water, Central Highlands Water, City West Water, Coliban Water, East Gippsland Water, Gippsland Water, Goulburn Valley Water, GWMWater, Lower Murray Water, North East Water, South Gippsland Water, South East Water, Wannon Water, Western Water, Westernport Water and Yarra Valley Water
- Essential Services Commission 2013, *Price Review 2013: Greater Metropolitan Water Businesses — final decision*, June
- Essential Services Commission 2013, *Price Review 2013: Regional Urban Water Businesses — final decision*, June.

Interpreting the NCC pricing principles

The following descriptions provide practical examples and guidance to help interpret the pricing principles set out in (Box 1) on page 97.

Incremental costs

Incremental costs are costs that the business would not have incurred in serving the existing customer base, or at least not to the same scale. They may include capital, operating and financing costs associated with constructing an asset sooner than planned and taxation costs attributable to the connection.

Where the connection arrangement requires assets to be gifted, the value of gifted assets will be excluded for the purposes of calculating net incremental costs.

Incremental costs should be calculated over a period that aligns with the business's growth planning and asset use horizons. For operating costs, this period should be the same as the revenue assessment period.

Incremental cost can include an allocation of costs of assets that the business had prudently built in expectation of future growth. If such costs are included, they should be explicitly revealed.

Incremental benefits

Incremental benefits are those benefits that accrue to the water business as a result of the connection. At a minimum, they include the additional revenue that the water business will earn from the new services being provided (water, sewerage or recycled water) by virtue of that new connection. They may also arise when a given connection facilitates the deferral of previously planned works — for example, a connection to recycled water services may defer the augmentation of potable water infrastructure.

Avoidable and standalone costs

The pricing principle that charges must be greater than the avoidable cost of that connection and less than the standalone cost of the connection will ensure existing customers are not subsidising new connections. It will also ensure connection applicants are not charged more than it would cost to build the assets to service them alone.

Avoidable cost represents the cost that would be avoided if the water business did not provide services to that new customer or group of new customers. Incremental cost, as defined here for

NCC calculation, can be expected to be higher than avoidable cost.⁷⁰ Avoidable cost is forward looking only.

Standalone cost is the least cost, technically efficient servicing solution (the optimised cost). It will be the cheaper option out of:

- working out the share of existing assets and new connection assets required to service just that connection or group of connections
- estimating an entirely new servicing solution that is independent of the existing network.

Calculating incremental financing costs

In cases where a development requires an asset sooner than planned, the water business may recover any incremental financing costs that it incurs.

Water businesses should calculate incremental financing costs (IFC) using this formula:

$$\text{IFC} = (1 - [1 / (1+r)^n]) \times \text{cost of capital being provided sooner than planned}$$

where:

r = estimated pre-tax WACC (see Table 1 Annexure A of each determination)

n = the number of years the asset is required sooner than planned.

Incremental financing costs are negotiated and may apply in addition to a standard NCC. Of course, these additional costs may be offset against revenues earned earlier than expected, consistent with the pricing principles.

Water businesses should demonstrate that their proposed charges are fair and reasonable in the given circumstances, and that the charges satisfy the pricing principles.

Water businesses should be able to recover incremental financing costs whenever an asset is provided sooner than planned, regardless of whether development is in an area covered by a precinct structure plan.⁷¹

⁷⁰ Incremental costs can include an allocation of historical costs that a water business has prudently prebuilt in expectation of future growth.

⁷¹ Essential Services Commission 2013, *Price review 2013: Greater metropolitan water businesses—final decision*, June; Growth Areas Authority 2013, *Precinct Structure Planning Guidelines Part One – Overview of Planning New Communities*.

Charging basis and units

Standard NCC are applied on a per lot basis, and may be levied on any connection of a new customer that is separately titled or is, or can be, individually metered.

For the metropolitan water businesses and Western Water the standard NCC applies for connection with a 20 mm meter. When a larger meter is required the NCC should be negotiated in accordance with the water business's negotiation protocol.

The commission did not determine the NCC charging units to be used by the regional water businesses, but notes that the metropolitan approach would also be appropriate for regional businesses.

Dispute resolution

Under the Water Act, each water business's connection arrangements must be fair and reasonable. The commission's determinations also require water businesses to negotiate in good faith to arrive at NCCs and conditions for a new connection that satisfy the pricing principles.

The arrangements for NCC negotiation must be clear and transparent, and consistent with the statutory rights, obligations and procedures under the Water Act. Information on negotiating arrangements should be presented in a way that is meaningful and helpful for potential connection applicants.

Where negotiations between a water business and developer fail to reach agreement, arrangements should provide for the concerned developer or connection applicant to:

- seek an internal review by the water business
- request independent commercial dispute resolution.

The Water Act also provides for developers to apply to VCAT for resolution.

Importantly, dispute resolution under a negotiating framework is separate and in addition to – not a substitute for – the VCAT process. This alternate dispute resolution would be followed where the parties agreed to the process, to minimise the likelihood of recourse to VCAT. If the parties fail to reach resolution under the informal mechanism, the parties continue to have access to VCAT for resolution.

In its final decisions, the Commission also indicated its willingness to provide non-binding guidance on NCC matters during the Water Plan 3 regulatory period. However, the Commission strongly encourages water businesses and developers to reach agreement through the steps outlined above.

The Commission would, of course, become involved if a water business failed to comply with its determination.

Applying NCCs – suggestions

The NCC framework aligns economic regulation with the policy intent of the Water Act.

Within the framework stakeholders have the opportunity to develop additional detail – or standardised practices – in areas that the industry considers important. This section of the explanatory note outlines matters identified through consultation as potential topics for further industry-led development.

The Commission has provided some initial thoughts on these matters. However, these observations are not part of the existing determinations, and are not binding on the water businesses.

Where hurdles arise, the relevant statutory objectives and pricing principles should guide resolution.⁷² Where matters cannot be progressed or resolved, the Commission will consider providing further regulatory guidance for Water Plan 4 - the next regulatory period.

Negotiation protocols

The Commission encourages all water businesses to publish a negotiation protocol – in a form that is useful and meaningful to developers – that references the core pricing principles (Box 1).

Indicative matters for negotiation may include agreement on:

- which assets are to be constructed and gifted by the developer to the water business
- the charging units that are fit for purpose. Ideally the charging unit should reflect the service capacity in the connection design. Historically charging units (such as equivalent tenements, number of cisterns, or fixtures) may be characterised as proxies for the amount of capacity needed to service the connection.

Calculations

The commission (with input from the water industry) developed a tool to calculate NCC in accordance with the pricing principles. While the commission does not mandate its use, water businesses may find it useful to calculate negotiated NCC during the third regulatory period. The tool and guidance on its use can be found on the commission's website.

⁷² Depending on the area of concern relevant objectives may be the Water Act 'fair and reasonable' requirements, the WIRO requirement for locational signals or other relevant instruments and objectives. See Appendix A for an overview of the regulatory framework and instruments that apply to NCC.

Gifted assets

Water businesses have the discretion to determine which assets are to be gifted (provided their actions are fair and reasonable), and to characterise the gifting as a condition of connection to the water business's works. If disputed, developers may seek internal review by the water business, agree to independent dispute resolution, or seek a review by VCAT as outlined in section 271 of the Water Act.

Standard NCC reflect certain assumptions about assets that will be constructed and gifted by the developer. For negotiated NCC, these assumptions may be different to those used in calculating the standard NCC.

Water businesses should:

- make clear to potential developers which assets a developer will be responsible for providing and gifting, and which will be provided by the water business
- for negotiated NCC, the negotiation should be undertaken in accordance with the water business's published negotiating protocols
- where the connection arrangement requires assets to be gifted, excludes the value of gifted assets for the purposes of calculating net incremental costs.

Development servicing plans

Some water businesses used development servicing plans (also sometimes called infrastructure sequencing plans) as a basis for developing their standard NCCs. The plans are not regulated instruments and are not formally approved by the commission.

Though terminology differs across the businesses, the concept is a publicly available plan prepared by a water business that:

- describes the water business's expected timing and sequencing of developments and infrastructure provision – at a point in time
- can be used as a basis for deriving standard NCC during price reviews
- can be used by a water business to communicate and describe assumptions underpinning its standard NCCs
- if kept up to date, may help inform the calculation of incremental financing costs (see section on 'Calculating incremental financing costs' (on page 101) above).

By showing the timing of a logically-sequenced expansion of a business's water, sewerage and recycled water networks, these plans can help the businesses to explain NCC to developers, and to those involved in resolving disputes.

The accuracy and usefulness of the plans will be enhanced through effective consultation: ideally water businesses will consult on and make these plans publicly available.

Though not expressly required, it would be reasonable practice for any water business to consult with stakeholders and review its plans regularly. Updating development servicing plans annually would not affect approved standard NCC which are set for the regulatory period.

Address pioneer developer issues

Pioneer developer issues arise when a developer pays incremental financing costs to bring forward an asset earlier than planned and then other developers connect to the asset soon after without contributing to the financing costs.

Under the NCC framework, the developer who makes the incremental financing cost payment may negotiate with the water business to be reimbursed (a portion of the financing costs) when other developers connect (to the asset that was brought forward).

The principal requirement is that arrangements are fair and reasonable, as required by the Water Act.

While arrangements that are simple to administer will be preferred, the water business must be able to demonstrate to all developers (not only the pioneer developer) that the arrangement is fair and reasonable.

Publishing these arrangements will assist all developers (current and future) to understand whether a water business is being fair and reasonable.

Increased capacity

The commission's view is that a developer is only required to pay for the minimum servicing solution for its development.

However, there may be situations where a water business requires a developer to provide assets that have excess capacity to service future developments. This is capacity in excess of the minimum servicing solution. If so, the water business needs to arrive at fair and reasonable arrangements for allocating the costs associated with any increased capacity between developments.

The water business has two options to ensure that the developer providing the asset with excess capacity only pays for its share of the asset's capacity.

These are:⁷³

- option 1, where the developer provides the asset, with provision to be reimbursed when subsequent connections start to use the asset
- option 2, where the developer pays their required capacity share, and the remaining share of the assets' costs is paid for by the water business.

If the water business chooses option 2, it may then recover the remaining share of the asset's costs through the overall price process or include the value of the excess capacity in the next reset of standard NCCs or any future negotiated NCC.

⁷³ These options are explained more fully at page 185 of Essential Services Commission 2013, *Price Review 2013: Regional Urban Water Businesses — final decision*, June; and page 202 of Essential Services Commission 2013, *Price Review 2013: Greater Metropolitan Water Businesses — final decision*, June.