

### The Essential Services Commission

The Essential Services Commission (ESC) is the independent economic regulator of the Victorian Water Industry. Under a process set out by the state Government, the ESC periodically assesses prices put forward by water businesses in a three to five year Water Plan. A Draft Decision on water and sewerage prices for Metropolitan Melbourne for the four years commencing 1 July 2009 has just been released.

### Decision on total revenue

The ESC's draft decision sets a total "Revenue Requirement" based on forecast costs for each business. Prices are set to recover this total dollar amount during the period.

### Outputs and Outcomes

Businesses must state in their Water Plans what they are going to achieve during the pricing period. The plans include targets for measurable service standards as well as regulatory obligations that the business must meet. A forecast of demand and supply is an important part of the plan.

### Expenditure

Benchmarks for operating and capital expenditure are generated based on the deliverables identified in the outcomes section of the water plan.

Scrutinising forecasts of input costs and capital programs are a key part of the ESC's work. The Commission's task is to approve a prudent and efficient level of expenditure to deliver the proposed outcomes.

Operating costs go into the revenue requirement in the year they are incurred. Capital expenditure is recovered over the life of the asset through depreciation. Some large infrastructure projects are recovered over 70 to 100 years, while other expenditure may have a shorter depreciation life.

### Weighted Average Cost of Capital (WACC)

A key component of the Commission's decision is to set a "cost of capital". This is a percentage figure applied to capital expenditure and existing assets as a rate of return which goes into the revenue requirement. The rate of return covers the financing costs of capital works.

The WACC is calculated from an assumed set of parameters to replicate a balance between the cost of equity and cost of debt. Changes in market conditions affect the WACC calculation. At the time of the businesses' Water Plans (November 2008), the WACC was estimated at 5.8%.

The WACC in the Draft Decision is 4.8%. This is equivalent to a nominal cost of equity of 8.5% and nominal cost of debt of 7%.

The WACC will be recalculated before the Final Decision in June.

Movements in the WACC can have a significant impact on the total revenue requirement, even when capital expenditure is unchanged.

### Benchmark Tax Liability

The ESC allows a value for tax payable in the total revenue requirement. The amount is calculated based on the assumptions in the Draft Decision.

### Review framework

The Price Review is undertaken according to legislation set out in the "Water Industry Regulatory Order" (or WIRO). The WIRO specifies that businesses should earn a rate of return on assets.

### Final Decision

Following a period of consultation with customers, businesses and stakeholders, the Commission will make a Final Decision in June. This will include a Determination stating explicit price outcomes for the four year period commencing 1 July 2009.

### ESC Draft Decision - Revenue Requirement 1 July 2009 to 30 June 2013

	City West	South East	Yarra Valley	Melbourne Water
\$M Jan 2009				
Operating expenditure	1 101.2	1 655.5	1 669.9	1 406.8
Return on new assets	55.1	60.0	119.2	413.5
Return on existing assets	175.0	341.7	395.8	800.1
Regulatory depreciation	108.6	173.3	193.5	419.2
Benchmark tax liability	24.3	36.7	-	76.2
<b>TOTAL</b>	<b>1 464.3</b>	<b>2 267.2</b>	<b>2 378.3</b>	<b>3 115.9</b>