

# South Gippsland Water draft decision

2020 Water Price Review

25 February 2020



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# Summary

## **In November 2019, South Gippsland Water provided a submission to us proposing prices for a three year period starting 1 July 2020**

This draft decision sets out our views on South Gippsland Water's price submission.<sup>12</sup> This paper should be read in conjunction with South Gippsland Water's price submission.

We invite interested parties to comment on our views in this draft decision before we make a final decision and issue a price determination in June 2020. Details on how to make a submission on our draft decision are provided in Chapter 4.

## **We have completed our review of South Gippsland Water's submission**

South Gippsland Water's price submission provided clear and comprehensive information supporting its proposals. South Gippsland Water also provided evidence that its customer engagement captured the main priorities and concerns of customers and that it has taken this feedback into account. This enabled us to quickly assess its price submission against the legal framework that governs our role, allowing us to bring forward the draft decision release date.

We generally accept South Gippsland Water's proposals set out in its price submission, subject to a final update of proposed prices in response to this draft decision. While we are seeking some further information to inform our final decision, we consider our requests do not involve matters that materially impact on customer prices or outcomes.

## **South Gippsland Water's proposal is informed through customer engagement**

South Gippsland Water engaged extensively with its customers to understand their preferences and test its proposals, building on the engagement undertaken to prepare its 2018 price submission.

South Gippsland Water has reflected customer priorities in its commitments to:

- renew aging infrastructure to maintain service levels
- progress programs that ensure water security for the region
- continue its carbon emission reduction program
- work to minimise unplanned water interruptions
- strengthen support for vulnerable and disadvantaged customers through its hardship program.

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<sup>1</sup> Clause 16 of the Water Industry Regulatory Order 2014 requires us to issue a draft decision.

<sup>2</sup> South Gippsland Water's price submission is available on our website at [www.esc.vic.gov.au](http://www.esc.vic.gov.au).

Overall, our view is that South Gippsland Water has demonstrated its proposals will continue to deliver outcomes that are supported by customers (including low income and vulnerable customers). Our draft decision proposes to approve a revenue allowance that will allow South Gippsland Water to deliver on its customer service commitments, government policy, and obligations monitored by Environment Protection Authority Victoria and Department of Health and Human Services.

### **South Gippsland Water was not required to give itself a PREMO rating**

Our new water pricing framework incorporates the PREMO incentive mechanism, whereby water corporations are required to rate their price submissions in terms of customer value proposed and the quality of the price submission prepared by the corporation. A higher PREMO rating can earn the corporation a higher return on equity.<sup>3</sup>

In its 2018 price submission, South Gippsland Water's PREMO self-rating was 'Standard'. Our decision did not assign a PREMO rating, and lowered the equity return rate to that of a 'Basic' rated corporation.

Given this outcome in 2018, we did not consider it appropriate for South Gippsland Water's 2020 price submission to have access to the higher return rates associated with an 'Advanced' or 'Leading' price submission. Accordingly, our final guidance in December 2018 outlined the minimum information requirements for a 'Standard' rated corporation under the PREMO incentive mechanism. South Gippsland Water was not required to give itself a PREMO rating but had to be satisfied that it met the requirements of our guidance in order to receive an equity return rate of a 'Standard' rated corporation.

We consider that South Gippsland Water has met the requirements of our final guidance, and our draft decision proposes to set its return on equity at 4.5 per cent per annum in line with a 'Standard' rated corporation.

### **Our draft decision accepts South Gippsland Water's proposed revenue and price path**

South Gippsland Water's price submission established a forecast revenue requirement of \$97.1 million across the three-year regulatory period.<sup>4</sup> Our assessment identified a couple of

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<sup>3</sup> Under the PREMO incentive mechanism, return on equity is linked to a water corporation's level of ambition – 'Leading', 'Advanced', 'Standard' or 'Basic'. More information on the PREMO mechanism is available in Essential Services Commission 2016, *2018 Water Price Review, Guidance paper*, November.

<sup>4</sup> The revenue requirement is the forecast amount a water corporation needs to deliver on customer outcomes, government policy, and obligations monitored by technical regulators including Environment Protection Authority Victoria and the Department of Health and Human Services. Along with forecast demand, it is an input to calculating the prices to be charged by a water corporation.

adjustments, but we have confirmed South Gippsland Water's price submission reflects prudent and efficient expenditure forecasts.

However, South Gippsland Water's proposed prices and price path will result in total revenue collected of \$95.3 million, an under-recovery of \$1.7 million. We have assessed South Gippsland Water's financial ratios, which will remain within the commission's benchmark range despite this shortfall against forecast costs.<sup>5</sup> Accordingly, for the purpose of setting maximum prices, our draft decision proposes to accept South Gippsland Water's proposed revenue allowance of \$95.3 million that reflects its commitment to the tariffs and prices proposed in its price submission.

South Gippsland Water proposed price increases of five per cent in 2020-21, two per cent in 2021-22 and two per cent again in 2022-23. Through its customer engagement processes, South Gippsland Water found this was the preferred price pathway and that there was a strong leaning amongst customers towards maintaining current service levels while acknowledging the need for future price increases. Whilst we are open to accepting this proposed price path, we welcome further feedback from customers before making our final decision.

Our final decision on prices will reflect the latest updates to inflation and cost of debt, and any other material changes in laws or government policy that impact costs and revenue required.

### **Tariff structures and the form of price control will remain the same**

We propose to accept South Gippsland Water's proposed price cap form of price control. This means its maximum prices are fixed subject to updates for inflation and the cost of debt, and any other price adjustments we approve in our price determination. South Gippsland Water currently uses a price cap.

We have also accepted South Gippsland Water's proposed tariff structures, which remain unchanged from those currently in place.

For residential water tariffs, South Gippsland Water proposed a fixed service charge and a variable component that depends on water use. For residential sewerage, South Gippsland Water proposed a fixed service charge. Our assessment of the form of price control and tariff structures is set out on pages 25 to 26.

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<sup>5</sup> Financial indicators and benchmark ranges are specified on page 41 of our guidance.



# 1. Our role and approach to water pricing

## **We are Victoria's independent economic regulator**

Our role in the water industry is based on the Water Industry Regulatory Order 2014 (WIRO) which is made under the Water Industry Act 1994 (WI Act) and sits within the broader context of the Essential Services Commission Act 2001 (ESC Act). Our role under the WIRO includes regulating the prices and monitoring service standards of the 19 water corporations operating in Victoria.

## **We are reviewing the prices three water corporations propose to charge customers from 1 July 2020**

We are reviewing prices for two urban water corporations (South Gippsland Water and Western Water) and one rural water corporation (Goulburn-Murray Water).<sup>6</sup>

Our review of the prices proposed by the two urban water corporations covers the prescribed services listed in the WIRO. The prescribed services include retail water and sewerage services, and bulk water and sewerage services delivered by the water corporations.<sup>7</sup>

In November 2019, South Gippsland Water provided a submission to us proposing prices for a three year period starting 1 July 2020. Our task is to assess the price submission against the legal framework that governs our role, and make a price determination that takes effect from 1 July 2020. The price determination will specify the maximum prices South Gippsland Water may charge for prescribed services, or the manner in which prices are to be calculated, determined or otherwise regulated. We also issue a final decision that explains the reasons for our price determination.

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

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

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

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<sup>6</sup> Goulburn-Murray Water's price submission is assessed against the commonwealth government's Water Charge (Infrastructure) Rules (WCIR).

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

section 4C of the WI Act. We are also required to place emphasis on matters relating to efficiency set out in section 8A of the ESC Act.

- the matters specified in our guidance<sup>8</sup>
- the principle that prices should be easily understood by customers and provide signals about the efficient costs of providing services, while avoiding price shocks where possible
- the principle that prices should take into account the interests of customers of the regulated entity, including low income and vulnerable customers.

Appendix A lists the specific objectives and the various matters we must have regard to when making a price determination and provides a guide to where we have done so in this draft decision.

In December 2018, we issued a final guidance paper to South Gippsland Water to inform its price submission. The guidance set out how we will assess South Gippsland Water's submission against the matters we must consider under clause 11 of the WIRO.

If we consider the price submission has adequate regard for the matters in clause 11 of the WIRO and complies with our guidance, we must approve South Gippsland Water's proposed prices.<sup>9</sup>

If we consider the submission does not have adequate regard for the matters specified in clause 11 of the WIRO or comply with our guidance, we may specify maximum prices, or the manner in which prices are to be calculated, determined or otherwise regulated.<sup>10</sup>

### **The 2018 price review was the first undertaken under our new water pricing approach**

In 2014, the Victorian Government reviewed and revised the WIRO. The changes allowed us more flexibility to decide on the pricing approach we use in Victoria's water sector. In April 2015 we released a consultation paper to start reviewing our pricing approach.<sup>11</sup>

Over 2015, we held a series of workshops and hosted a conference to hear from stakeholders and explore alternative ways to approach water pricing.

In May 2016, we released a position paper setting out our proposed new pricing approach, and invited submissions.<sup>12</sup> We met with each water corporation and other interested parties to help inform their submissions. Submissions were supportive of the overall proposal, in particular the greater focus on customer engagement and value.

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<sup>8</sup> Essential Services Commission 2018, *South Gippsland Water's 2020 water price review, final guidance paper*, December.

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

<sup>10</sup> This is provided for under the WIRO, clause 14(b)(i).

<sup>11</sup> Essential Services Commission 2015, *Review of Water Pricing Approach, Consultation paper*, April.

<sup>12</sup> Essential Services Commission 2016, *A new model for pricing services in Victoria's water sector, Position paper*, May.

We finalised our new approach to water pricing in October 2016.<sup>13</sup>

In November 2016, we issued guidance for the 2018 water price review, which set out how price submissions should be prepared in accordance with our new approach, including our new PREMO self-assessment incentive mechanism.<sup>14</sup>

At the 2018 water price review, South Gippsland Water received a decision setting prices for a two-year period, and was required to submit a new price submission for a new three year period from 1 July 2020 to 30 June 2023.<sup>15</sup>

In December 2018 we issued new guidance to South Gippsland Water for its 2020 price review. While still following our new pricing approach, this guidance specified that South Gippsland Water is not required to self-assess and give itself a PREMO rating.<sup>16</sup> Rather we said we would set South Gippsland Water's return on equity at 4.5 per cent, which reflects the rate of return a 'Standard' corporation would receive under the PREMO incentive mechanism, if it met the requirements of our guidance.<sup>17</sup>

Our consultation on the pricing approach informed the guidance we issued South Gippsland Water in December 2018, which informs South Gippsland Water's price submission for the 2020 water price review.

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<sup>13</sup> For more detail on the new water pricing approach see: Essential Services Commission 2016, *Water Pricing Framework and Approach: Implementing PREMO from 2018*, October.

<sup>14</sup> Essential Services Commission 2016, *2018 Water Price Review, Guidance paper*, November.

<sup>15</sup> Our decision to set a two-year period is explained in our final decision paper from the 2018 price review. See Essential Service Commission 2018, South Gippsland Water final decision: 2018 Water Price Review, 19 June, p. 5.

<sup>16</sup> Essential Services Commission 2018, *op. cit.*, p. 2.

<sup>17</sup> Under the PREMO incentive mechanism, return on equity is linked to a water corporation's level of ambition – 'Leading', 'Advanced', 'Standard' or 'Basic'. However, this mechanism does not apply to South Gippsland Water in this instance. More information on the PREMO mechanism is available in Essential Services Commission 2016, *2018 Water Price Review, Guidance paper*, November.



## 2. Our assessment of South Gippsland Water's price submission

We have made our draft decision on South Gippsland Water's price submission after considering: South Gippsland Water's price submission and its responses to our queries.

Any reports or correspondence provided to us which are material to our consideration of South Gippsland Water's price submission are available on our website (to the extent the material is not confidential).

This draft decision should be read in conjunction with South Gippsland Water's price submission.

Our guidance included a number of matters South Gippsland Water must address in its price submission. South Gippsland Water's price submission addressed each of these matters. Our preliminary assessment of these matters is provided in this chapter.

We found South Gippsland Water's price submission presented clear and comprehensive information to support its proposals. South Gippsland Water also provided evidence that its engagement sought to capture the main priorities and concerns of customers, and that it has taken this feedback into account (see the customer engagement section on pages 6 and 7).

We will provide South Gippsland Water with updated values for cost of debt and inflation in April 2020. These changes will likely impact the revenue requirement proposed by South Gippsland Water.

South Gippsland Water must submit a response to our draft decision and provide an updated financial model by 24 April 2020 (via email to [water@esc.vic.gov.au](mailto:water@esc.vic.gov.au)). We will publish this response on our website.

We also invite other interested parties to make a submission in response to our draft decision up until that date (see Chapter 4 for details on how to provide feedback).

We intend to make a price determination for South Gippsland Water in June 2020.

All financial values referred to in this chapter are in \$2019-20.

## **Regulatory period**

Our guidance set a regulatory period of three years, from 2020-21 to 2022-23. South Gippsland Water's price submission is consistent with this requirement. Accordingly, our draft decision sets the term for South Gippsland Water's regulatory period as 1 July 2020 to 30 June 2023.

## **Customer engagement**

Our guidance required South Gippsland Water to engage with customers to inform its price submission.

The engagement by South Gippsland Water:

- took place between February 2019 and October 2019, building on the engagement undertaken between December 2014 and August 2017 for the 2018 price review
- used a range of methods including online and phone surveys, face-to-face interviews and Mini Public deliberative sessions (South Gippsland Water's Mini Public sessions were cross-representative groups comprising 36 customers in total, that met to deliberate on a range of matters put forward by South Gippsland Water)
- sought views from a representative sample of customers, community representatives, traditional owners, vulnerable and disadvantaged customers and their advocates
- covered matters such as water security, prices, customer service and satisfaction, guaranteed service levels and focus areas for future service improvement.

More detail on South Gippsland Water's engagement is available in its price submission.<sup>18</sup>

Evidence that South Gippsland Water's engagement influenced its submission includes its proposed approach for water security, service levels and standards and price movements:

- Water security – South Gippsland Water raised the issue of long term water supply security at its Mini Public sessions, where participants deliberated on the current security outlook and alternative approaches to supplement current supply, before voting to identify a preferred approach. South Gippsland Water adopted this preferred approach to purchase a further two gigitalitres of bulk water entitlements in 2023-24 (see page 31 of its price submission).
- Service levels and standards – South Gippsland Water explored customers' views on the existing guaranteed service level (GSL) scheme at the Mini Public sessions. This resulted in a

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<sup>18</sup> South Gippsland Water's price submission is available on our website at [www.esc.vic.gov.au](http://www.esc.vic.gov.au). See pages 5–11.

proposed change to remove one of the existing GSL payments, while still retaining a focus on achieving the associated level of service (see GSL section below).

- Price movements – Using surveys and the Mini Public deliberative sessions, South Gippsland Water explored the potential price impact of customers’ preferences relating to service standards and water security (see page 11 of its price submission). Participants of the Mini Public sessions deliberated on alternative approaches for increasing the revenue, before agreeing on a preferred price path that would support affordability. South Gippsland Water adopted the preferred approach in its proposal (we discuss this further in the tariff structures section on page 25).

The influence of South Gippsland Water’s engagement on its proposals supports the objectives in our pricing framework relating to efficiency and the interests of consumers.<sup>19</sup>

We are satisfied that South Gippsland Water has met the WIRO requirements through its engagement with vulnerable and disadvantaged customers.<sup>20</sup> Through this engagement it gathered the views of this customer group and their support services to understand the impact of water bills and customer affordability. South Gippsland Water will use these findings to best support this group of vulnerable and disadvantaged customers, as well as its wider community.

## Outcomes

Our guidance required South Gippsland Water to propose a set of outcomes that its customers will receive during the next regulatory period.

South Gippsland Water has reviewed its outcome commitments developed in 2018, in consultation with its customers, to ensure these outcomes were still relevant. South Gippsland Water has revised its proposed outcomes for 2020, deleting one outcome from 2018 and amending others to reflect customer feedback.

The revised outcomes South Gippsland Water proposes to deliver for the next regulatory period starting 1 July 2020 are to:

- plan for the future, be reliable and minimise unplanned interruptions to services
- provide safe, clean drinking water
- provide a safe wastewater service that contributes to the liveability of its communities
- be environmentally sustainable and adapt to a future impacted by climate variability
- act with honesty, respect and strive to balance affordability, value for money and fairness.

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<sup>19</sup> See for example, WIRO clauses 8(b)(i), 8(b)(ii), 8(b)(iii), 11(d)(iii), and ESC Act Sections 8(1), 8A(1)(a).

<sup>20</sup> WIRO, Clause 11(d)(iii).

South Gippsland Water's proposed outcomes, measures and targets are provided on pages 13 to 15 of its price submission.

We note several of the measures established following the 2018 price review to demonstrate South Gippsland Water's performance against its outcome commitments have been removed. We also note that targets for some measures have been changed to become less onerous to achieve, while others have become more ambitious.

Overall, we consider that South Gippsland Water's proposed outcomes are consistent with the guidance. It has set out clearly defined measures and targets that are relevant to its proposed outcomes. It has developed its outcomes in consultation with its customers and has explained how customer preferences have informed its commitments. South Gippsland Water has also specified how its activities, programs and other deliverables are connected to its outcomes and how these are reflected in prices charged to customers.

We will engage with South Gippsland Water to ensure it captures the proposed changes when it prepares its summary outcomes report for the 2019-20 reporting year. South Gippsland Water will need to account for these changes to its outcome commitments through its direct self-reporting to customers.

## **Guaranteed service levels**

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

South Gippsland Water's proposed GSLs are set out on page 18 of its price submission. We note that it reviewed its current GSL scheme with customers at the Mini Public deliberative session, and the proposed GSLs are objectively defined and easily understandable, as required by our guidance.<sup>21</sup>

South Gippsland Water proposes to maintain service levels on sewer spills and unplanned sewer interruptions, and it has made no changes to its existing hardship GSL. In response to customer feedback, it proposes to remove the current GSL on unplanned water interruptions restored within five hours, which has a \$100 rebate paid for each breach of this target. Customers did not agree that payments should be made in every instance where the service level is not met. Customers voted on a range of recommendations where the majority fully supported the removal of the rebate, whilst maintaining the target of restoring interruptions within 5 hours. In response, South Gippsland

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<sup>21</sup> Essential Services Commission 2018, op. cit., p. 19.

Water has proposed to address this customer expectation by including it as a measure in its outcomes reporting.

We propose to accept South Gippsland Water's proposed change to its GSLs because it was developed in consultation with its customers. Final GSLs will be subject to our consideration of any feedback following the release of this draft decision.

## **Revenue requirement**

The revenue requirement is the forecast amount a water corporation needs to deliver on customer outcomes, government policy, and obligations monitored by technical regulators including Environment Protection Authority Victoria and the Department of Health and Human Services. Along with forecast demand, it is an input to calculating prices.<sup>22</sup>

We consider South Gippsland Water's revenue requirement meets WIRO objectives of promoting and providing incentives for efficiency in the regulated entities, as well as efficiency in, and the financial viability of, the regulated water industry.<sup>23</sup>

South Gippsland Water proposed a forecast revenue requirement of \$97.1 million over a three-year period starting 1 July 2020. However, our draft decision proposes to approve a forecast revenue requirement of \$97.0 million, 0.1 per cent lower than proposed by South Gippsland Water. This reflects our assessment of each element that comprises the revenue requirement, as set out in Table 2.1.

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<sup>22</sup> We received input from officers of the Department of Environment, Land, Water and Planning, Department of Health and Human Services, and Environment Protection Authority Victoria, to discuss their expectations of South Gippsland Water in the regulatory period from 1 July 2020. We had regard to their views in our draft decision. It is the water corporation's responsibility to ensure it has priced accordingly to meet all its legislative and regulatory obligations and requirements during the pricing period.

<sup>23</sup> WIRO, Clause 8(b).

**Table 2.1 Draft decision revenue requirement**

(\$ million 2019-20)

|  | 2020-21     | 2021-22     | 2022-23     | Total       |
|--|-------------|-------------|-------------|-------------|
| Operating expenditure                                | 20.6        | 20.7        | 20.6        | 61.9        |
| Return on assets                                     | 6.4         | 6.6         | 6.8         | 19.9        |
| Regulatory depreciation                              | 4.8         | 5.2         | 5.7         | 15.7        |
| Non-prescribed revenue offset of revenue requirement | -0.2        | -0.2        | -0.2        | -0.5        |
| Tax allowance  | 0.0         | 0.0         | 0.0         | 0.0         |
| <b>Draft decision revenue requirement</b>            | <b>31.8</b> | <b>32.4</b> | <b>32.9</b> | <b>97.0</b> |

Note: numbers have been rounded.

The main adjustments we have proposed in our draft decision on the revenue requirement relate to correcting a minor discrepancy in the 2017-18 capital expenditure figure in South Gippsland Water's financial model, and adjusting South Gippsland Water's non-controllable expenditure. These adjustments resulted in a small decrease of \$0.06 million to the overall revenue requirement. Table 2.2 summarises our proposed changes to the revenue requirement.

**Table 2.2 Adjustments to revenue requirement**

(\$ million 2019-20)

|   | 2020-21      | 2021-22      | 2022-23      | Total        |
|---|--------------|--------------|--------------|--------------|
| <b>Proposed revenue requirement</b>       | <b>31.8</b>  | <b>32.4</b>  | <b>32.9</b>  | <b>97.1</b>  |
| – Operating expenditure                   | -0.01        | -0.01        | -0.003       | -0.02        |
| – Return on assets                        | -0.01        | -0.01        | -0.01        | -0.02        |
| – Regulatory depreciation                 | -0.01        | -0.01        | -0.01        | -0.02        |
| <b>Total adjustments</b>                  | <b>-0.02</b> | <b>-0.02</b> | <b>-0.02</b> | <b>-0.06</b> |
| <b>Draft decision revenue requirement</b> | <b>31.8</b>  | <b>32.4</b>  | <b>32.9</b>  | <b>97.0</b>  |

Note: numbers have been rounded.

However, the price path and prices proposed by South Gippsland Water will produce a forecast revenue collection of \$95.3 million, which is lower than the revenue requirement as calculated by the building block methodology set out in our guidance (see Table 2.3). This means South Gippsland Water will forego this revenue difference and has challenged itself to deliver its stated customer outcomes within the lower revenue allowance. As discussed later on pages 28 to 29, we

Our assessment

have verified that despite the potential negative affect on financial viability from a lower revenue allowance, we are satisfied South Gippsland Water will generate sufficient cash flow to deliver on its service commitments, consistent with WIRO requirements.<sup>24</sup> South Gippsland Water’s financial indicators based on this proposed lower revenue allowance fall within our benchmark range.

**Table 2.3 Revenue foregone**

(\$ million 2019-20)

|                                    | 2020-21    | 2021-22    | 2022-23    | Total      |
|------------------------------------|------------|------------|------------|------------|
| Draft decision revenue requirement | 31.8       | 32.4       | 32.9       | 97.0       |
| Forecast revenue collection        | 30.8       | 31.8       | 32.8       | 95.3       |
| <b>Revenue foregone</b>            | <b>1.0</b> | <b>0.6</b> | <b>0.1</b> | <b>1.7</b> |

Our draft decision therefore proposes to adopt South Gippsland Water’s proposed revenue allowance of \$95.3 million.

Our final decision will be based on the latest available information. Accordingly, as well as responding to our draft decision and providing an updated price schedule, South Gippsland Water must update its revenue requirement and prices to reflect our April 2020 updates to estimates for the cost of debt and inflation.

There may be changes in laws or government policy before we make a price determination. If any such changes occur between the draft decision and the price determination, and impact on the revenue requirement, South Gippsland Water should update its price submission and also provide us with an updated financial model. Any updates will be publicly available on our website.

## Operating expenditure

Operating expenditure is an input to the revenue requirement. Operating expenditure is recurrent costs that can be fully allocated to a single year (such as labour or maintenance). This contrasts with capital expenditure which is up-front costs for assets that are used over many years (such as water meters or treatment plants). South Gippsland Water’s price submission provides detail on its forecast operating expenditure on pages 25 to 32.

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<sup>24</sup> WIRO, Clause 8(b)(ii).

We assess both:

- controllable costs – those that can be directly or indirectly influenced by a water corporation’s decisions
- non controllable costs – those that cannot be directly or indirectly influenced by a water corporation’s decisions.

For controllable operating expenditure, our assessment process first confirms an efficient baseline, based on the last year of actual costs prior to our price review (in this case, 2018-19). We then consider the forecast costs relative to this baseline, including the proposed efficiency improvement rate and forecast growth, and any proposed cost changes relative to the baseline. We engaged Deloitte Access Economics to provide expert advice to inform our assessment of controllable operating expenditure. Deloitte’s report on its assessment of South Gippsland Water’s expenditure forecast is available on our website.<sup>25</sup>

For non-controllable expenditure (including bulk water and sewerage services, government charges and licence fees) we confirm the proposed forecasts, with reference to the relevant regulatory body where appropriate.

Table 2.4 sets out our draft decision on South Gippsland Water’s forecast operating expenditure, for the purpose of establishing the revenue requirement (Table 2.1). Details of our assessment and reasons for our proposed adjustments to South Gippsland Water’s proposal follow, with a summary of our adjustments shown in Table 2.5.

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

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

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<sup>25</sup> Deloitte Access Economics 2020, *Expenditure review – South Gippsland Water*, February.

**Table 2.4 Draft decision – operating expenditure**

(\$ million 2019-20)

|   | 2020-21     | 2021-22     | 2022-23     | Total       |
|---|-------------|-------------|-------------|-------------|
| <b>Controllable costs</b>                     | <b>18.6</b> | <b>18.9</b> | <b>18.8</b> | <b>56.3</b> |
| <b>Non-controllable costs</b>                 | <b>2.1</b>  | <b>1.8</b>  | <b>1.8</b>  | <b>5.7</b>  |
| – Bulk services <sup>a</sup>                  | 0.8         | 0.6         | 0.6         | 1.9         |
| – Environmental contribution <sup>b</sup>     | 1.2         | 1.2         | 1.1         | 3.5         |
| – Licence fees – ESC <sup>c</sup>             | 0.013       | 0.013       | 0.020       | 0.047       |
| – Licence fees – DHHS <sup>c</sup>            | 0.010       | 0.010       | 0.010       | 0.030       |
| – Licence fees – EPA <sup>c</sup>             | 0.050       | 0.050       | 0.049       | 0.149       |
| <b>Draft decision – operating expenditure</b> | <b>20.6</b> | <b>20.7</b> | <b>20.6</b> | <b>61.9</b> |

<sup>a</sup> Bulk services covers the supply of bulk water and sewerage services

<sup>b</sup> The Environmental Contribution collects funds from water corporations under the WI Act

<sup>c</sup> Licence fees are paid to cover costs incurred by Department of Health and Human Services, Environment Protection Authority Victoria, and the Essential Services Commission in their regulatory activities related to the water corporation

Note: numbers have been rounded.

### Controllable operating expenditure assessment

South Gippsland Water proposed a total forecast controllable operating expenditure of \$56.3 million over a three-year regulatory period. For the reasons set out below, our draft decision proposes to accept this as the benchmark controllable operating expenditure allowance.

Baseline controllable operating expenditure:

- South Gippsland Water's 2018-19 baseline year controllable operating expenditure was \$21.95 million. After adjusting for non-recurring expenditure, mainly once-off decommissioning costs, this reduced to \$18.73 million, which is 2 per cent above the benchmark of \$18.45 million allowed for 2018-19 in the 2018 price determination. Deloitte assessed the proposed 2018-19 baseline and recommended no adjustment, considering the small increase was due to costs

Our assessment

associated with additional staff added in 2018-19.<sup>26</sup> We accept Deloitte's recommendation as we consider this reflects an efficient baseline cost to forecast annual operating expenditure.

#### Efficiency improvement:

- Baseline operating expenditure forecasts will increase at the growth rate of customer connections, less the efficiency improvement rate proposed by the water corporation. South Gippsland Water's proposed efficiency improvement rate on controllable operating costs is 1.0 per cent per annum, which is lower than the 1.5 per cent it adopted for its 2018 price submission. This rate is lower than South Gippsland Water's forecast connection growth rate of 1.64 per cent per annum, resulting in an increasing annual baseline operating cost. The net growth-efficiency factor of 0.64 per cent is higher than most other Victorian water corporations, however Deloitte considered that South Gippsland Water's baseline was relatively steady and it proposed minimal forecast variations to this baseline, and Deloitte recommended no adjustment to the proposed efficiency improvement rate. We note that 1.0 per cent is the minimum required for a 'Standard' PREMO rating, and given South Gippsland Water's challenge to meet cost pressures and its proposed revenue shortfall (described in the previous section), we accept the proposed efficiency rate. We also note that South Gippsland Water's proposed forecast will result in a decline (in real terms) in controllable operating expenditure per water customer relative to the baseline year (Figure 2.1).

#### Proposed cost changes:

- South Gippsland West Water has proposed an overall reduction in operating expenditure of \$0.9 million to its total baseline cost for electricity, arising from lower forecast contract rates and a reduction in demand for purchased electricity when it commissions four solar electricity projects in 2020-21. This is despite an overall increase in electricity usage associated with increased pumping for the new Lance Creek pipeline. Deloitte considered South Gippsland Water's energy costs and raised no issues with its forecast electricity consumption. However, Deloitte recommended a further decrease of \$0.1 million over the 2020–23 period, to reflect decreases in tariffs included in recent regulatory proposals from Victorian electricity network businesses.
- South Gippsland Water proposed an additional \$0.23 million in 2021-22 for consultants to prepare its Urban Water Strategy – this figure is based on the cost to prepare its previous strategy. Deloitte considered it is likely that past work on the strategy could be leveraged such that preparation of the updated Urban Water Strategy would not be as extensive. Additionally South Gippsland Water could jointly procure the consultancy services with other water businesses. South Gippsland Water indicated that this did not occur last time but acknowledged

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<sup>26</sup> Deloitte Access Economics, op. cit., pp.14–15.

that it could be possible to do so in the future. Accordingly, Deloitte recommended the allowance for this additional work be reduced to \$0.18 million.

Other operating expenditure assessments:

Deloitte's expenditure review included extensive consideration of South Gippsland Water's proposed forecasts for electricity, labour, chemical and IT costs, as well as vehicle costs which has been raised by Deloitte in previous reviews. Details are available in Deloitte's report, but a brief summary of its findings for each follows.

- Electricity – see discussion above.
- Labour – Deloitte considered South Gippsland Water's labour forecasts were consistent with the Victorian Government's Wages policy and proposed no change to full-time employee numbers over the regulatory period. Deloitte recommended no changes to the forecast costs.
- Chemicals – South Gippsland Water's costs for treatment of water and sewerage have fallen over recent years, and are proposed to remain flat across the regulatory period. There is some uncertainty about changes in chemical use due to the new Lance Creek operating system using water from the Melbourne supply system, but South Gippsland Water has proposed to absorb any variations in chemical expenditure that may arise. Deloitte recommended no changes to the forecast costs.
- IT – South Gippsland Water's IT cost has been increasing over the past five years, due to the use of cloud services, capability for cyber security, resourcing associated with delivering larger system upgrades and establishing improved business intelligence capability. This trend is consistent across other utility businesses. South Gippsland Water has proposed no change in IT costs across the forecast period, despite indicating a need for further IT investments to support the organisation. The proposal seeks to minimise impacts on customer affordability while the corporation seeks alternative means to deliver this capability. Deloitte considered it likely IT costs would be higher than forecast, but recommended no adjustment.
- Vehicles – Deloitte has previously found South Gippsland Water's vehicle costs to be high compared with other water corporations, and has again recommended some savings should be possible in this area, proposing to reduce the allowance by \$0.06 million per year. Whilst we agree with Deloitte that the current proposed vehicle costs are not prudent and efficient, we acknowledge the high fleet expenditure in part reflects legacy employment contracts and that it may be difficult for South Gippsland Water to transition away from the current level of vehicle expenditure (or equivalent wages compensation) in the short-to-medium term. We note that South Gippsland Water has recognised the need to change its policies with regards to vehicles.

We acknowledge that Deloitte's rigorous review has identified some opportunities to reduce the operating expenditure forecasts. But it has also identified several areas where South Gippsland Water is assuming considerable expenditure risk rather than passing it on through prices. On balance, we consider the overall controllable operating expenditure forecast presented by South

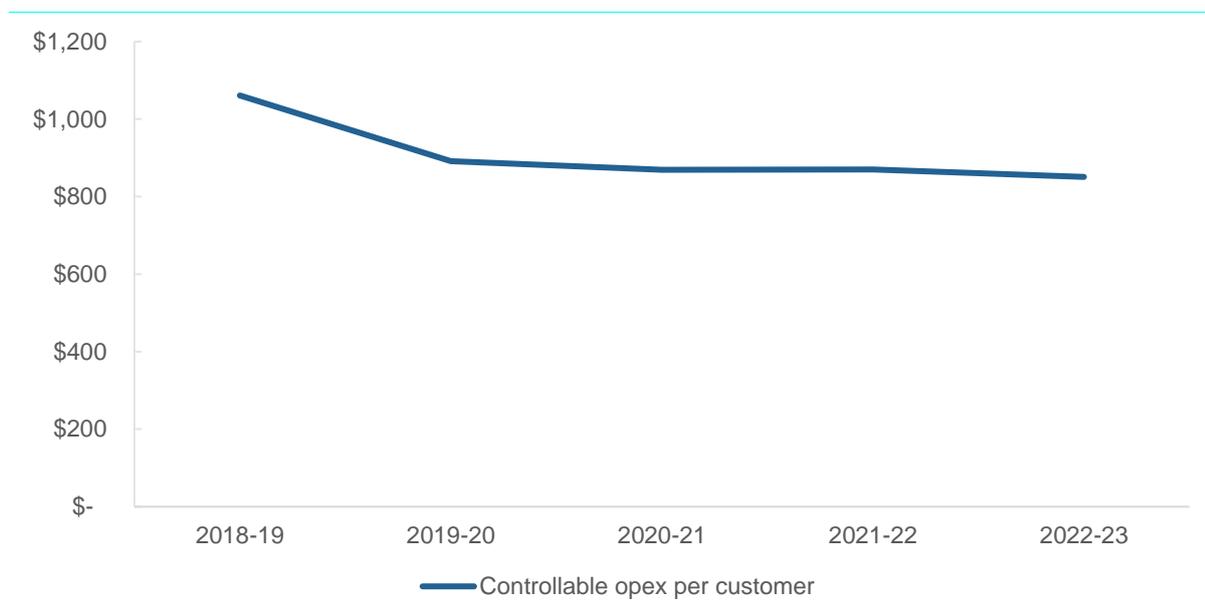
Our assessment

Gippsland Water reflects the requirements of the WIRO and the criteria for prudent and efficient expenditure outlined in our guidance.<sup>27</sup>

Further, the overarching premise in South Gippsland Water's price submission is to recover \$1.7 million lower than the forecast revenue requirement suggests, and we note the adjustments recommended by Deloitte (totalling \$0.34 million) would not lower the proposed revenue to be recovered, and would therefore have no impact on South Gippsland Water's proposed prices.

Accordingly, for the purposes of making this draft decision, we propose to accept the controllable operating expenditure forecast of \$56.3 million proposed in South Gippsland Water's price submission. Whilst we have proposed not to adjust the forecast revenue requirement, we expect South Gippsland Water will consider Deloitte's review recommendations as it seeks to reduce its actual operating expenditure to minimise the revenue shortfall.

**Figure 2.1 Controllable operating expenditure per water connection**  
(\$2019-20)



### Non-controllable operating expenditure assessment

For non-controllable operating expenditure, we have adjusted South Gippsland Water's forecasts where required based on the latest information received from the relevant regulatory authorities on their licence fees and the environmental contribution. The values we have adopted for our draft decision are set out in Table 2.4 above.

<sup>27</sup> Essential Services Commission 2018, op. cit., p. 21.

For the environmental contribution, we have used the values provided by the Department of Environment, Land, Water and Planning and for this draft decision assumed it will remain flat in nominal terms (decline in real terms) across the 2020–23 regulatory period. However, the department is currently reviewing the environmental contribution to be recovered over the four years from 1 July 2020, and we will adjust for any changes to the forecast in our final decision.

We have assumed the licence fees for the Department of Health and Human Services, the Environment Protection Authority Victoria and the Essential Services Commission remain flat in real terms across the period, but with a 50 per cent increase for our commission fee in 2022-23 to align with our major regulatory review cycle.<sup>28</sup>

We have verified South Gippsland Water’s forecast external bulk water charges against Melbourne Water’s current price determination.

We have decreased South Gippsland Water’s forecast non-controllable operating expenditure by \$0.02 million across the 2020–23 period, resulting from our adjustments to:

- increase the Environment Protection Authority Victoria licence fee by \$0.001 million per year (a total increase of \$0.003 million)
- increase the Department of Health and Human Services license fee by \$0.001 million per year (a total increase of \$0.003 million)
- decrease the Environment Contribution paid to the Department of Environment, Land, Water and Planning by an average of \$0.001 million per year (a total of \$0.004 million)
- set our commission licence fee at an average of \$0.016 million per year (in total, a \$0.02 million reduction)

Overall, non-controllable expenditure will remain at a similar level from 2019-20 to 2020-21.

Prior to making our final decision, we will adjust South Gippsland Water’s forecast non-controllable operating expenditure for the latest inflation data.

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<sup>28</sup> The Department of Health and Human Services and the Environmental Protection Agency Victoria provided their latest 2018-19 licence fees for making our draft decision. We have also based our forecast on our 2018-19 commission licence fee.

**Table 2.5 Adjustments to operating expenditure**

(\$ million 2019-20)

|   | 2020-21       | 2021-22       | 2022-23       | Total         |
|---|---------------|---------------|---------------|---------------|
| <b>Proposed total operating expenditure</b>         | <b>20.7</b>   | <b>20.7</b>   | <b>20.6</b>   | <b>61.9</b>   |
| – Licence fees – Essential Services Commission      | -0.010        | -0.010        | -0.003        | -0.023        |
| – Licence fees – Department of Human Services       | 0.001         | 0.001         | 0.001         | 0.003         |
| – Licence fees – Environment Protection Authority   | 0.001         | 0.001         | 0.001         | 0.003         |
| – Environment contribution                          | -0.001        | -0.001        | -0.002        | -0.004        |
| <b>Adjustments to non-controllable costs</b>        | <b>-0.009</b> | <b>-0.009</b> | <b>-0.003</b> | <b>-0.021</b> |
| <b>Draft decision – total operating expenditure</b> | <b>20.6</b>   | <b>20.7</b>   | <b>20.6</b>   | <b>61.9</b>   |

Note: numbers have been rounded.

## Regulatory asset base

The regulatory asset base is used to estimate the return on assets and regulatory depreciation in the revenue requirement. Our guidance required South Gippsland Water to propose its:

- closing regulatory asset base at 30 June 2019
- forecast regulatory asset base for each year of the regulatory period from 1 July 2020.

### Closing regulatory asset base

We update the regulatory asset base to reflect actual gross capital expenditure, less government and customer contributions, and asset disposals for the period to 30 June 2019. This helps to ensure prices reflect the actual net expenditure of a water corporation.<sup>29</sup>

<sup>29</sup> Net capital expenditure is calculated by deducting government and customer contributions from gross capital expenditure. Customer contributions reflects revenue earned from new connections made to the water corporation's water, sewerage or recycled water networks.

We compared South Gippsland Water’s actual net capital expenditure for 2017-18 to 2018-19 with the forecast used to approve maximum prices for the period from 1 July 2018. We undertake a prudency and efficiency review where a water corporation’s net capital expenditure is more than 10 per cent above the forecast used to approve maximum prices for the period from 1 July 2018. We believe this approach is reasonable given capital expenditure can be ‘lumpy’ in nature.

South Gippsland Water’s price submission reported \$21.4 million net capital expenditure over the period from 2017-18 to 2018-19. However, the figure provided for 2017-18 did not match South Gippsland Water’s audited regulatory account figure – correcting for this error decreased net capital expenditure to \$21.2 million. This corrected figure is 22.4 per cent lower than the forecast used to approve maximum prices for the two-year period from 1 July 2018. This is well below the 10 per cent threshold identified above, so we have not undertaken a prudency and efficiency review of its past net capital expenditure.

Other than this correction for past net capital expenditure, South Gippsland Water calculated its closing regulatory asset base in accordance with the requirements of our guidance. For these reasons, our draft decision proposes to approve a closing regulatory asset base for 30 June 2019 of \$161.9 million.

Table 2.6 sets out our draft decision on South Gippsland Water’s regulatory asset base at 30 June 2019.

**Table 2.6 Closing regulatory asset base**

(\$ million 2019-20)

|                                | 2017-18      | 2018-19      |
|--------------------------------|--------------|--------------|
| Opening RAB 1 July             | 149.4        | 159.7        |
| Plus gross capital expenditure | 33.4         | 15.1         |
| Less government contributions  | 18.0         | 7.2          |
| Less customer contributions    | 0.6          | 1.5          |
| Less proceeds from disposals   | 0.1          | 0.01         |
| Less regulatory depreciation   | 4.4          | 4.1          |
| <b>Closing RAB 30 June</b>     | <b>159.7</b> | <b>161.9</b> |

Some of the numbers differ from the price submission due to a correction in 2017-18 gross capital expenditure

Note: numbers have been rounded

### Forecast regulatory asset base

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

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Table 2.7 sets out our draft decision on South Gippsland Water’s proposed forecast regulatory asset base from 1 July 2020.<sup>30</sup> Later sections provide an overview of our assessment of the components of the forecast regulatory asset base.

**Table 2.7 Forecast regulatory asset base**

(\$ million 2019-20)

|                                | 2019-20      | 2020-21      | 2021-22      | 2022-23      |
|--------------------------------|--------------|--------------|--------------|--------------|
| Opening RAB 1 July             | 161.9        | 172.2        | 178.0        | 182.8        |
| Plus gross capital expenditure | 17.2         | 13.5         | 13.0         | 14.5         |
| Less government contributions  | 0.0          | 0.0          | 0.0          | 0.0          |
| Less customer contributions    | 2.1          | 2.5          | 2.7          | 2.6          |
| Less proceeds from disposals   | 0.4          | 0.4          | 0.3          | 0.3          |
| Less regulatory depreciation   | 4.5          | 4.8          | 5.2          | 5.7          |
| <b>Closing RAB 30 June</b>     | <b>172.2</b> | <b>178.0</b> | <b>182.8</b> | <b>188.7</b> |

Some of the numbers differ from the price submission due to a correction in 2017-18 gross capital expenditure

Note: numbers have been rounded

## Capital expenditure

Capital expenditure is an input to estimating the regulatory asset base. South Gippsland Water proposed total gross capital expenditure of \$41 million over the three-year regulatory period – its forecast capital expenditure and supporting information is provided at pages 33 to 45 of its price submission. This is summarised in Figure 2.2.

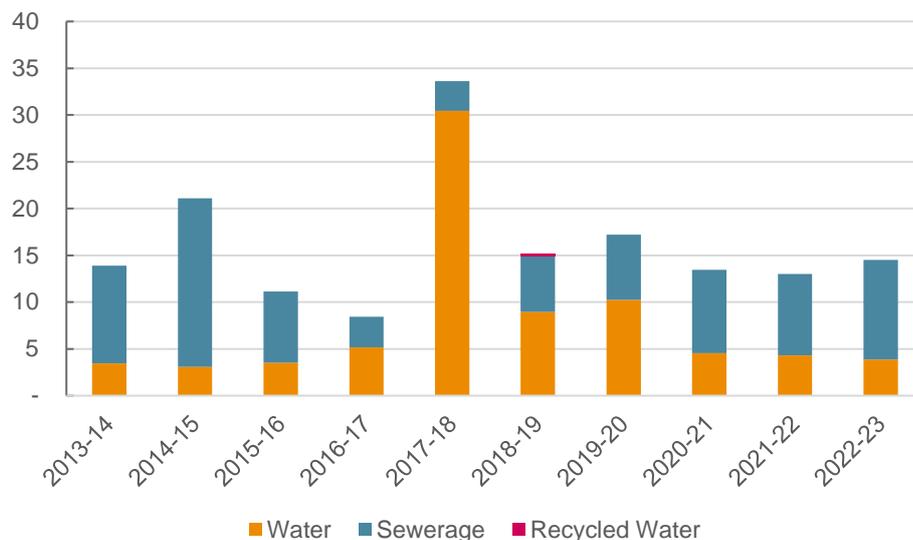
We engaged Deloitte Access Economics to provide expert advice to inform our assessment of capital expenditure. Deloitte’s report on its assessment of South Gippsland Water’s expenditure forecast is available on our website.<sup>31</sup>

<sup>30</sup> Our guidance required South Gippsland Water to provide an estimate of the components of its regulatory asset base for 2019-20. This is so we can assess the opening asset base for 1 July 2020. Our guidance noted that where the 2019-20 forecasts for net capital expenditure (gross capital expenditure less government and customer contributions) is lower than the forecast benchmark for that year in its 2018 price determination, the lower amount must be used (otherwise the 2018 determination forecast applies). The estimates for 2019-20 will be confirmed at the price review following the 2020 water price review.

<sup>31</sup> Deloitte Access Economics 2020, *Expenditure review – South Gippsland Water*, February.

**Figure 2.2 Gross capital expenditure by service category**

(\$ million 2019-20)



Note: actuals for 2013-14 and 2018-19 and forecasts for 2019-20 to 2022-23.

For the reasons set out below, we propose to adopt South Gippsland Water’s proposed capital expenditure forecast to establish a benchmark gross capital expenditure of \$41.0 million.

- The annual capital expenditure is in line with or below South Gippsland Water’s long-term capital expenditure (Figure 2.2). The proposed \$41.0 million is \$2.4 million less than the forecast for the corresponding years in its 2018 price submission.
- Deloitte’s review found that South Gippsland Water has recently implemented significant improvements in its capital planning and asset management approach, namely:
  - A capital prioritisation process which aims to enable the prioritisation and selection of projects and programs based on the best (least) cost to maintain or reduce risk. The prioritisation process includes consideration of project driver, corporate risk drivers, customer risks, number of customers impacted, estimated capital cost, consequence of failure (e.g. failure to complete project or if risk was to eventuate), and a weighted score based on these inputs. Based on the score on each individual project, the projects are ranked according to risk and cost with the highest ranking being included within the capital program.
  - A more robust condition, consequence and prioritisation process for renewals works than was evidenced by Deloitte in the 2018 price review. This includes the development of new asset management modelling of water and sewer mains including condition and consequence ratings for every asset, condition assessments of every treatment plant and pump station, and preparation of detailed asset class plans. Deloitte noted this is a significant improvement from the last review and has enabled South Gippsland Water to demonstrate prudent and efficient expenditure, particularly on its renewals programs.

- Deloitte requested selected documents from South Gippsland Water as a representative sample to demonstrate its asset management processes and justification for its capital expenditure program. Based on the sample of documents reviewed, Deloitte was satisfied these demonstrate that South Gippsland Water has a reasonable approach for developing and managing its capital program. South Gippsland Water has used its P50 cost estimates from its business cases for its price submission, consistent with our guidance.<sup>32</sup>
- Of the major projects and programs reviewed, Deloitte found only two that appeared to have slightly conservative cost forecasts (water storage basin liner/cover replacements and vehicle renewal). It recommended reducing these by \$0.25 million and \$0.07 million respectively. This adjustment represents less than 1 per cent of South Gippsland Water's total capital program for the three-year regulatory period. Given the price submission's proposal to under-recover \$1.7 million in revenue (see page 11), adjusting the capital forecasts by this small amount will not reduce the proposed revenue collection and therefore will not impact prices.
- We consider the planned capital expenditure program is achievable, given South Gippsland Water's past track record delivering its capital expenditure program. Of the 10 major projects identified in its 2018 price submission (five of these carry over into the 2020–23 period), three have been deferred due to changes in scope, and the remainder are all on schedule.
- Where there is uncertainty in timing and scope of capital expenditure, South Gippsland Water says it has included these projects in future regulatory periods, rather than the 2020–23 period. It has identified a number of projects at page 35 of its price submission that have been excluded at this time, but will likely be required over the next 10 years. This approach is consistent with our guidance for managing uncertain expenditure. For our draft decision, we accept South Gippsland Water's proposal for addressing uncertainty, noting the following:
  - South Gippsland Water will need to demonstrate the prudence and efficiency of any additional costs if they are indeed incurred during the 2020–23 period if seeking to include them in the regulatory asset base.
  - Variations in capital expenditure from forecast during the 2020–23 period will form a key part of our assessment of the Performance element of PREMO at the next price review.

Accordingly, we have proposed no adjustments to South Gippsland Water's forecast to establish our draft decision benchmark for gross capital expenditure of \$41.0 million, consistent with our guidance and WIRO principles.<sup>33</sup> This benchmark is used to calculate the forecast regulatory asset base (Table 2.7) and the revenue requirement (Table 2.1).

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<sup>32</sup> A P50 cost estimate is where there is an equal likelihood of project costs being higher or lower than forecast.

<sup>33</sup> Essential Services Commission 2016, *Guidance paper*, op. cit., p. 35.

The benchmark that we adopt for South Gippsland Water does not represent the amount that the water corporation is required to spend or allocate to particular capital projects. Rather, it represents assumptions about the overall level of capital expenditure (to be recovered through prices) that we consider sufficient to operate the business and to maintain or improve services over the regulatory period. South Gippsland Water determines how to best manage the allocation of its revenue and priority of its capital expenditure within a regulatory period.

### Revenue from customer contributions

Revenue from customer contributions is deducted from gross capital expenditure so it is not included in the regulatory asset base.<sup>34</sup>

We compared South Gippsland Water’s forecast for customer contributions with past outcomes, and its forecasts for growth in customer connections.<sup>35</sup> We consider South Gippsland Water’s forecast contributions are reasonable, having regard to past trends and its growth forecasts.

Our draft decision proposes to accept South Gippsland Water’s forecasts for customer contributions (see Table 2.7).

### Cost of debt

Our guidance required South Gippsland Water to use estimates of the cost of debt provided by the commission to estimate its revenue requirement. South Gippsland Water used the cost of debt values we specified to calculate its revenue requirement. For this reason, our draft decision accepts the cost of debt proposed by South Gippsland Water, as set out in Table 2.8.

**Table 2.8** Trailing average cost of debt

|                        | 2010-11 | 2011-12 | 2012-13 | 2013-14 | 2014-15 | 2015-16 | 2016-17 | 2017-18 | 2018-19 | 2019-20           |
|------------------------|---------|---------|---------|---------|---------|---------|---------|---------|---------|-------------------|
| Cost of debt (nominal) | 7.0%    | 6.3%    | 5.3%    | 7.1%    | 5.4%    | 5.3%    | 4.9%    | 4.5%    | 4.6%    | 4.6% <sup>a</sup> |

<sup>a</sup> Estimated cost of debt – we will update the 2019-20 figure to reflect the latest actual data before the final decision and price determination.

Note: numbers have been rounded.

From 2016, we accepted a ten-year trailing average approach to estimating the benchmark cost of debt, changing from an on-the-day approach. The trailing average approach better aligns the actual cost of debt for an efficient business to the regulated benchmark, compared with an on-the-

<sup>34</sup> Revenue from new customer contributions reflects revenue raised from new connections made to a water corporation’s water, sewerage or recycled water networks.

<sup>35</sup> Growth in customer connections can be used as an indicator of growth in customer contributions.

day approach.<sup>36</sup> We consider the ten year trailing average approach helps to minimise risk to water corporations and provides better incentives for long-term investment.

## **Return on equity**

Consistent with our guidance, South Gippsland Water was not required to self-assess and give itself a PREMO rating. South Gippsland Water is satisfied that it has met the requirements of our guidance and our assessment reflects the same (see our discussion in Chapter 3). For this reason, we have set South Gippsland Water's return on equity at 4.5 per cent per annum (in real terms, after tax). This reflects the rate of return a 'Standard' corporation would receive under the PREMO incentive mechanism.<sup>37</sup> It is also similar to the range of rates set in recent regulatory decisions for the water sector.

## **Regulatory depreciation**

Regulatory depreciation is an input to calculating the regulatory asset base. Regulatory depreciation allows a water corporation to recover the cost of investing in assets.

South Gippsland Water's forecast regulatory depreciation was calculated using a straight line depreciation profile. We noted in our guidance that we prefer this approach.<sup>38</sup> South Gippsland Water also calculated regulatory depreciation in a manner consistent with our guidance.

For these reasons, our draft decision accepts South Gippsland Water's forecast for regulatory depreciation of \$15.7 million.

## **Tax allowance**

The tax allowance is an input into the revenue requirement. South Gippsland Water has proposed no allowance for tax in its revenue requirement. Our draft decision is to accept the forecast as it was calculated consistently with the method required by our guidance.<sup>39</sup>

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<sup>36</sup> For more detail on the trailing average and on the day approaches to the cost of debt, see Essential Services Commission 2016, *Water pricing framework and approach*, op. cit., p.27.

<sup>37</sup> Under the PREMO incentive mechanism, return on equity is linked to a water corporation's level of ambition – 'Leading', 'Advanced', 'Standard' or 'Basic'. However, this mechanism does not apply to South Gippsland Water in this instance. More information on the PREMO mechanism is available in Essential Services Commission 2016, *Guidance paper*, November.

<sup>38</sup> Essential Services Commission 2018, op. cit., p. 30.

<sup>39</sup> Essential Services Commission 2018, op. cit., p. 32.

## **Demand**

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

South Gippsland Water's demand forecasts are set out at pages 19 to 24 and page 59 of its price submission, and are also included in its financial model. Our draft decision proposes to accept South Gippsland Water's demand forecasts for the purpose of approving maximum prices because we consider they were estimated in a manner that is consistent with the requirements of our guidance. This includes basing demand forecasts on the latest Victoria In Future population growth forecasts issued by the Victorian Government.

## **Form of price control**

South Gippsland Water proposed a price cap form of price control. It currently uses a price cap.

Our draft decision is to accept South Gippsland Water's proposed form of price control.

A price cap provides customers with price certainty, and means a water corporation is managing demand risk on behalf of its customers. We consider demand risk is more efficiently managed by a water corporation, rather than its customers.<sup>40</sup> Our guidance requires South Gippsland Water to demonstrate it has identified risk and, if appropriate, specify mechanisms to manage risk.<sup>41</sup> We consider South Gippsland Water has appropriately managed demand risk in this case.

## **Tariff structures**

South Gippsland Water proposed to maintain its existing tariff structures, which are:

- for residential and non-residential water customers, a two-part tariff with a fixed service charge and a variable usage component.
- for residential sewerage services, a fixed charge only.
- for non-residential sewerage services, a fixed access fee and volumetric cistern fees.

We consider a two-part structure for water services will promote efficient use. It also provides customers a signal about their water use costs, and is an approach that is commonly applied in

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<sup>40</sup> We note our determinations will allow water corporations flexibility to apply to change from a price cap to a weighted average price cap or tariff basket within a regulatory period.

<sup>41</sup> Essential Services Commission 2018, op. cit., p. 12.

other states and territories.<sup>42</sup> This form of tariff structure is well understood by South Gippsland Water’s customers, having been used for many years.<sup>43</sup>

### Price and bill levels

South Gippsland Water proposes to increase prices by five per cent in 2020-21, two per cent in 2021-22 and two per cent again in 2022-23. South Gippsland Water proposes to apply this increase uniformly across residential and non-residential tariffs, so bills will typically increase by the same increments. Through South Gippsland Water’s engagement with customers and stakeholders at the Mini Public deliberative sessions this was found to be the preferred price path, should South Gippsland Water adopt the moderate price increase. It was also considered the best price path option to minimise the impact of a price increase for low income and vulnerable customers.

South Gippsland Water engaged with customers on their preference for the level of spending it should adopt, noting the impact on service levels. South Gippsland Water found “strong customer desire to maintain service levels has remained consistent during the process.”<sup>44</sup> South Gippsland Water’s proposal to increase prices to maintain service levels is consistent with the findings of its engagement.

Whilst we accept in principle the proposed price path, supported by its customer engagement processes, we welcome further customer feedback on the proposed price path before making our final decision.

### Draft decision on tariff structures

We consider South Gippsland Water’s current tariff structures provide signals to customers about efficient water use and efficient costs. Given the price submission proposes no change to tariff structure, our draft decision accepts South Gippsland Water’s proposed tariff structures as set out in pages 66 and 67 of its price submission.

Prior to our final decision and price determination, South Gippsland Water must submit updated prices to reflect our updates to cost of debt and inflation estimates, which we will provide in late April 2020, and changes to its forecast bulk water charges arising from changes to Melbourne Water’s prices.

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<sup>42</sup> Includes the tariffs of Icon Water, Sydney Water, Hunter Water, Central Coast Council, Power and Water Corp, Urban Utilities, Unity Water, SA Water and TasWater.

<sup>43</sup> WIRO, Clause 11(d)(i) requires the ESC to have regard to whether South Gippsland Water’s prices ‘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’.

<sup>44</sup> South Gippsland Water 2019, Price Submission 2020–2023, 7 November, p. 1.

## Adjusting prices

South Gippsland Water proposed to continue with its existing price adjustment mechanisms identified in the 2018 Price Determination, as set out on page 46 of its price submission. It proposed:

- to continue with its existing uncertain and unforeseen events mechanism
- a 'pass through' of changes in costs such as taxes or environmental contribution during the regulatory period
- an annual cost of debt adjustment mechanism.

In our guidance, we allowed South Gippsland Water to take into account differences between forecast and actual non-controllable costs associated with Melbourne Water. We will work with South Gippsland Water to include an adjustment mechanism for this in our final decision.

Our draft decision accepts South Gippsland Water's proposal on its existing mechanisms. We have approved them on the basis that they are consistent with efficiency objectives, and reflect a continuation of current arrangements.<sup>45</sup>

## New customers contribution charges

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

South Gippsland Water's proposed charges for new customer contributions are set out at pages 50 and 51 of its price submission. South Gippsland Water undertook a review of location-specific NCC charges but decided against proposing location-specific NCC charges to avoid price shocks for customers in those specific areas.<sup>46</sup> It also updated its standardised NCC calculation using the Commission's NCC model and estimated an individual water and sewerage NCC charge of \$3,137.

South Gippsland Water proposed to maintain the standard water and sewerage new customer contribution charge at the 2019-20 level in real terms until 2022-23. In other words, its standard

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<sup>45</sup> WIRO clauses 8(b)(i)(ii) and (iii).

<sup>46</sup> In accordance with WIRO clause 11(d)(ii).

water and sewerage new customer contribution charge would increase annually by inflation. In addition, customers will be charged directly at cost for connections to pressured sewer systems.

**Table 2.9 Proposed standard NCC's per lot**  
(\$2019-20)

|                  | Current level | 2020-21  | 2021-22  | 2022-23  |
|------------------|---------------|----------|----------|----------|
| Water NCC charge | 2,318.47      | 2,318.47 | 2,318.47 | 2,318.47 |
| Sewer NCC charge | 2,318.47      | 2,318.47 | 2,318.47 | 2,318.47 |

For negotiated new customer contributions, South Gippsland Water proposed to continue to calculate a charge in accordance with the requirements of our new customer contribution pricing principles.<sup>47</sup>

We have reviewed South Gippsland Water's proposed charges and consider they are consistent with the requirements of our guidance, the WIRO and the NCC pricing principles.<sup>48</sup> For this reason, our draft decision proposes to accept the continuation of South Gippsland Water's existing standard water and wastewater new customer contribution charges at existing levels (plus inflation).

## Financial position

In approving prices, we must have regard to the financial viability of the water industry.<sup>49</sup> We interpret the financial viability requirements under the *Essential Services Commission Act 2001* and the Water Industry Regulatory Order (2014) to mean that the prices we approve should provide a high level of certainty that each water corporation can generate sufficient cash flow to deliver on service commitments, including financing costs arising from investments to meet service expectations.

South Gippsland Water's price submission and the supporting financial model provided estimates for key indicators of financial performance. These estimates were based on South Gippsland Water's assumptions about revenue and expenditure, including its proposed under-recovery of revenue compared with the forecast revenue requirement (see pages 10 and 11).

<sup>47</sup> Essential Services Commission 2018, op. cit., p. 40.

<sup>48</sup> Essential Services Commission 2012, Guidance paper, New Customer Contributions, p. 13.

<sup>49</sup> WIRO clause 8(b)(ii) and ESC Act s.8A(1)(b).

We have reviewed these financial indicators across the three-year regulatory period and assessed that South Gippsland Water will generate sufficient cash flow to deliver on service commitments, including financing costs arising from investments to meet service expectations.



### 3. PREMO rating

PREMO is an incentive mechanism that links the return on equity to a water corporation's level of ambition in delivering value to its customers. South Gippsland Water was not required to give itself a PREMO rating for this regulatory period. Instead, our guidance outlined minimum requirements for meeting a 'Standard' PREMO rating.

We consider that South Gippsland Water has met the requirements of our guidance, and in Chapter 2 we noted our draft decision proposes to set its return of equity at 4.5 per cent per annum in line with a 'Standard' rated corporation.

In support of a 'Standard' rating for South Gippsland Water's price submission, we note the following.

For Outcomes and Engagement:

- South Gippsland Water engaged extensively with its customers, using a range of engagement programs, including a Mini Public deliberative process. The price submission provides clear evidence that the views of customers were taken into account and informed the final proposals.
- The customer outcomes, measures and targets established following the 2018 price review were reviewed in consultation with customers, and were largely confirmed as being appropriate for the next three years. South Gippsland Water's proposal includes refinements to its outcomes commitments reflecting this work.

For Management and Risk:

- South Gippsland Water's price submission was of a high quality and well presented, with consistent and accurate information across the written submission and the financial template. Its price submission clearly demonstrated the links between its customer engagement processes and proposed outcomes, and provided sufficient information for us to assess its proposals.
- The clarity and strong supporting justifications for its proposals allowed us to complete our assessment and verification quickly and efficiently, such that we can make and release this draft decision earlier than expected.
- Deloitte found that South Gippsland Water has implemented significant improvements to its capital planning and its asset management and renewals program since the 2018 price review. These both help deliver greater efficiencies and have resulted in prudent and efficient cost forecasts.
- South Gippsland Water's cited controllable operating expenditure efficiency improvement rate is 1.0 per cent per annum, which is the minimum for a 'Standard' rating, however it is evident the corporation has assumed considerable risk in setting its expenditure forecasts. It has also proposed to forego \$1.7 million in revenue (based on a prudent and efficient cost forecast)

which effectively challenges the corporation to outperform the expenditure benchmarks we have established for this draft decision.

## 4. We invite feedback on our draft decision

We invite feedback from stakeholders on our draft decision before we make a final decision and price determination. Our final decision and price determination will be made in June 2020.

Stakeholders may comment on any aspect of our draft decision, including the information we have relied upon in our assessment (such as South Gippsland Water's price submission). Feedback may also cover:

- additional matters or issues we should consider before making our final decision
- whether our draft decision on South Gippsland Water's price submission has adequate regard to the matters in clause 11 of the WIRO and our guidance.

How to provide feedback:

### **Attend a public forum**

We will hold a public forum in Wonthaggi on Tuesday 24 March 2020. Forums provide an opportunity for interested parties to discuss key features of our draft decisions. Find details about our public forums at [www.esc.vic.gov.au/waterpricereview](http://www.esc.vic.gov.au/waterpricereview).

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

Written comments or submissions in response to this draft decision are due on 24 April 2020.

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

We would prefer to receive comments and submissions via our website at [www.esc.vic.gov.au/waterpricereview](http://www.esc.vic.gov.au/waterpricereview).

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

2018 Water Price Review  
Essential Services Commission  
Level 37, 2 Lonsdale Street  
Melbourne VIC 3000

We usually make all comments and submissions publicly available in the interests of transparency. If you wish part or all of your submission to be private, please discuss with commission staff.

If you cannot access documents related to our price review, please contact us to make alternative arrangements (phone (03) 9032 1300).

We invite feedback

## Next steps

Indicative dates are provided below. To keep up-to-date, visit our website at [www.esc.vic.gov.au/waterpricereview](http://www.esc.vic.gov.au/waterpricereview).

- Tuesday 24 March 2020 – public forum.
- 24 April 2020 – closing date for submissions on our draft decision.
- June 2020 – release of final decision and price determination.

## Appendix A: Our consideration of legal requirements

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

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

In addition to the mandatory factors set out below, clause 11 of the WIRO requires the commission to have regard to the matters specified in the commission's guidance.<sup>50</sup> We have had regard to the matters specified in our guidance in reaching our preliminary view. Our draft decision provides further information on where we have considered our guidance, and South Gippsland Water's compliance with our guidance, in reaching our preliminary view.

Note: all page numbers referenced below refer to our draft decision for South Gippsland Water.

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<sup>50</sup> Essential Services Commission 2018, op. cit.

## **Economic efficiency and viability matters**

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

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

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

- Our consideration of customer engagement (pages 6 to 7).
- Our assessment of the revenue requirement (pages 9 to 11).
- Our assessment of efficient operating expenditure (pages 11 to 18) and capital expenditure (pages 20 to 23).
- Our assessment of tariffs (pages 25 to 26).

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

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

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

- Our consideration of customer engagement (pages 6 to 7).
- Our assessment of the revenue requirement (pages 9 to 11).
- Our assessment of efficient operating expenditure (pages 11 to 18) and capital expenditure (pages 20 to 23).
- Our assessment of tariffs (pages 25 to 26).
- Our assessment of financial viability (pages 28 to 29).

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

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

- Our consideration of customer engagement (pages 6 to 7).
- Our consideration of outcomes (pages 7 to 8).
- Our assessment of the revenue requirement (pages 9 to 11).

Appendix A: Our consideration of legal requirements

- Our assessment of efficient operating expenditure (pages 11 to 18) and capital expenditure (pages 20 to 23).
- Our assessment of tariffs (pages 25 to 26).

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

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

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

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

- Our consideration of customer engagement (pages 6 to 7).
- Our consideration of outcomes (pages 7 to 8).
- Our assessment of the revenue requirement (pages 9 to 11).
- Our assessment of efficient operating expenditure (pages 11 to 18) and capital expenditure (pages 20 to 23).
- Our assessment of tariffs (pages 25 to 26).

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

- A ten-year trailing average approach to estimating the benchmark cost of debt (see pages 23 to 24).
- A regulatory rate of return that we consider will enable South Gippsland Water to recover costs associated with its investment in services.<sup>51</sup>

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

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

We have had regard to this matter on pages 9 to 11 and pages 28 to 29.

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<sup>51</sup> The regulatory rate of return is comprised of the cost of debt and the return on equity.

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

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

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

- Our consideration of customer engagement (pages 6 to 7).
- Our assessment of the revenue requirement (pages 9 to 11).
- Our assessment of efficient operating expenditure (pages 11 to 18) and capital expenditure (pages 20 to 23).
- Our assessment of tariffs (pages 25 to 26).

## **Industry specific matters**

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

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

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

- Our consideration of customer engagement (pages 6 to 7).
- Our consideration of outcomes (pages 7 to 8).
- Our assessment of the revenue requirement (pages 9 to 11).
- Our assessment of efficient operating expenditure (pages 11 to 18) and capital expenditure (pages 20 to 23).
- Our assessment of tariffs (pages 25 to 26).

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

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

Our draft decision provides for South Gippsland Water to generate a return on assets through:

Appendix A: Our consideration of legal requirements

- Our consideration of the regulatory asset base (pages 18 to 23).
- Our consideration of the cost of debt (pages 23 to 24).
- Our consideration of the return on equity (page 24).

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

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

- indicative bills paid by customers in other jurisdictions in Australia<sup>52</sup>
- operating and capital expenditure costs per connection throughout Australia<sup>53</sup>
- tariff structures applied by water corporations throughout Australia<sup>54</sup>
- the regulatory rate of return set by other regulators.<sup>55</sup>

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

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

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

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

- Our consideration of customer engagement (pages 6 to 7).
- Our consideration of outcomes (pages 7 to 8).
- Our assessment of the revenue requirement (pages 9 to 11).
- Our assessment of efficient operating expenditure (pages 11 to 18) and capital expenditure (pages 20 to 23).
- Our assessment of tariffs (pages 25 to 26).

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

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<sup>52</sup> Bureau of Meteorology 2018, *National performance report 2017-18; urban water utilities, part A*, Melbourne.

<sup>53</sup> Ibid.

<sup>54</sup> Includes Icon Water, Sydney Water, Hunter Water, Gosford City Council, Wyong Shire Council, Power and Water Corp, Urban Utilities, Unity Water, SA Water and TasWater.

<sup>55</sup> Essential Services Commission of South Australia 2018, *SA Water Our Plan 2020–24*, December; Independent Pricing and Regulatory Tribunal 2019, *WACC biannual update*, August.

## **Customer matters**

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

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

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

- Our consideration of customer engagement (pages 6 to 7).
- Our consideration of outcomes (pages 7 to 8).
- Our assessment of the revenue requirement (pages 9 to 11).
- Our assessment of efficient operating expenditure (pages 11 to 18) and capital expenditure (pages 20 to 23).
- Our assessment of tariffs (pages 25 to 26).

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

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

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

- Our consideration of the revenue requirement (pages 9 to 11).
- Our assessment of efficient operating expenditure (pages 11 to 18) and capital expenditure (pages 20 to 23).
- Our consideration of demand (page 25).
- Our consideration of tariffs (pages 25 to 26).

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

- Our consideration of customer engagement (pages 6 to 7).
- Our consideration of outcomes (pages 7 to 8).

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

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

- feedback from customers during a water corporation's engagement
- the structure of individual tariffs
- the proposed form of price control
- any changes to tariffs and how water corporations explain them to customers.
- The following sections of our draft decision involved consideration of this factor:
- Our consideration of the form of price control and tariffs (pages 25 to 26).

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

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

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

- Our consideration of customer engagement (pages 6 to 7).
- Our assessment of the revenue requirement (pages 9 to 11).
- Our assessment of efficient operating expenditure (pages 11 to 18) and capital expenditure (pages 20 to 23).
- Our assessment of tariffs (pages 25 to 26).

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

In considering the above factor, we had regard to:

- South Gippsland Water demonstrated through its engagement program that customers supported the price increases in order to maintain service standards and ensure water security for the region (pages 6 to 7).
- South Gippsland Water proposed to maintain its customer support programs, offers a range of payment options, debt elimination schemes and employs a dedicated support officer to assist customers experiencing difficulty paying bills. We consider these options and advice provide avenues for low income and vulnerable customers to seek assistance.

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

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

Our draft decision proposes to approve a revenue requirement that will enable South Gippsland Water to deliver on its legal and regulatory obligations.

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

- Our assessment of the revenue requirement (pages 9 to 11).
- Our assessment of efficient operating expenditure (pages 11 to 18) and capital expenditure (pages 20 to 23).
- Our assessment of the form of price control (page 25).

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

Our draft decision proposes to approve a revenue requirement that will enable South Gippsland Water to deliver on its health, safety, environmental sustainability and social obligations.

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

- Our assessment of the revenue requirement (pages 9 to 11).
- Our assessment of efficient operating expenditure (pages 11 to 18) and capital expenditure (pages 20 to 23).
- Our assessment of tariffs (pages 25 to 26).

## **Other matters**

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

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

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

- Our assessment of engagement (pages 6 to 7)
- Our assessment of outcomes (pages 7 to 8)
- Our assessment of efficient operating expenditure (pages 11 to 18) and capital expenditure (pages 20 to 23).

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We consider that our pricing approach helps to address market power and information asymmetries relating to the water corporations. Our PREMO water pricing approach provides incentives for a water corporation to provide its “best offer” to customers in its price submission. This is described in further detail in a report we released in 2016.<sup>56</sup>

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

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

- Focusing our assessments of price submissions on the materiality of proposals to customer interests (including low income and vulnerable services), including in terms of price, bill and service impacts.
- Designing our guidance so we minimise the compliance costs for water corporations. Our guidance noted that much of the information required in price submissions should be readily available to water corporations as it would be relevant for other purposes such as corporate planning and project prioritisation and justification.<sup>57</sup>

A benchmarking study found that the cost of the commission’s price reviews in the past has been lower than those of regulators in other Australian jurisdictions (after being normalised for revenue covered by price decisions).<sup>58</sup>

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

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

- uses the building block method to estimate a water corporation’s revenue requirement
- allows water corporations to implement various forms of price control, including price caps and revenue caps
- allows for consultation with key stakeholders during a price review, including through the release of a draft decision.

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<sup>56</sup> Essential Services Commission 2016, *Water Pricing Framework and Approach, Implementing PREMO from 2018*, October, pp. 11–13.

<sup>57</sup> Essential Services Commission 2016, *South Gippsland Water’s 2020 water price review, Guidance paper*, op. cit., p. 3.

<sup>58</sup> Essential Services Commission 2014, *Information paper for the Independent Review of the Economic Regulatory Framework*, April.

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

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

- Implementing a price review process so that water corporations may receive streamlined price reviews if they submit a high quality price submission. This reduces the costs of regulation for water corporations and the commission.
- Focusing our assessments of price submissions on the materiality of proposals to customer interests (including low income and vulnerable services), including in terms of price, bill and service impacts.
- Designing our guidance so we minimise the compliance costs for water corporations. Our guidance noted that much of the information required in price submissions should be readily available to water corporations as it would be relevant for other purposes such as corporate planning and project prioritisation and justification.<sup>59</sup>

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<sup>59</sup> Essential Services Commission 2016, *South Gippsland Water’s 2020 water price review, Guidance paper*, op. cit., p.3.