



# GWMWater draft decision

2018 Water Price Review

28 March 2018



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# Summary

## **In September 2017, GWMWater provided a submission to us proposing prices for a five year period starting 1 July 2018**

This draft decision sets out our preliminary views on Grampians Wimmera Mallee Water's (GWMWater's) price submission.<sup>1 2</sup>

We invite interested parties to comment on our preliminary views in this draft decision before we make a final decision and issue a price determination in June 2018. Details on how to make a submission on our draft decision are provided in Chapter 4.

## **Our draft decision on the revenue requirement will allow GWMWater to deliver key service improvements**

Our draft decision proposes to approve a revenue requirement that will allow GWMWater to deliver on its customer service commitments, government policy, and obligations monitored by Environment Protection Authority Victoria and Department of Health and Human Services.<sup>3</sup>

Some of the ways GWMWater plans to improve outcomes for customers are by:

- extending digital metering to urban customers
- introducing a town sewer scheme for Goroke
- providing access to drinking water in Kaniva, Moyston, Ultima and Elmhurst.

We propose to approve a revenue requirement of \$317.7 million for GWMWater over the five year period starting 1 July 2018. This is the same as the amount proposed in GWMWater's price submission. Based on our draft decision, on average GWMWater's prices over 2018-19 to 2022-23 will be the same as those proposed in its price submission.<sup>4</sup>

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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> GWMWater's price submission is available on our website at [www.esc.vic.gov.au](http://www.esc.vic.gov.au).

<sup>3</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.

<sup>4</sup> This is an indicative percentage change on prices based on the percentage change in draft decision revenue requirement compared to the proposed revenue requirement.

## **Our draft decision is to accept GMMWater’s tariff structures for urban services, but our draft decision does not accept some proposals for environmental and irrigation water**

Our draft decision accepts GMMWater’s proposed tariff structures for its urban services. For residential and non-residential water tariffs, GMMWater proposed a fixed service charge and a variable component that depends on water use. For sewerage services, GMMWater proposed a fixed service charge. We note these are a continuation of GMMWater’s current approach.

We propose not to accept some of GMMWater’s proposed changes to tariffs, including:

- its proposal to increase the price paid by the Commonwealth Environmental Water Holder (CEWH) – on the basis that GMMWater’s proposed tariff does not send appropriate signals about the costs of the irrigation entitlements held by CEWH
- the price path for the proposed increase in recreation water supply charge – on the basis that the proposed prices do not take into account the interests of low income and vulnerable customers.

Also, our draft decision proposes not to approve GMMWater’s proposed tariff for environmental water services provided to the Victorian Environmental Water Holder. We do not have the power to approve the tariff proposed by GMMWater.

More detail is available in the tariff structure section from page 27.

### **GMMWater’s price submission is rated as ‘Advanced’ under PREMO**

Our draft decision is to accept GMMWater’s PREMO self-rating of its price submission as ‘Advanced’ (Table A). Our draft decision agrees with GMMWater’s PREMO self-ratings for Risk, Engagement, and Outcomes.

For Management, we considered the correction GMMWater made to regulatory depreciation during our review. We also note GMMWater’s proposed operating expenditure incorporated less ambitious assumptions (relative to other water corporations) regarding the improvement in controllable operating costs. As a result, our draft decision rates the Management element of PREMO as ‘Standard’, rather than ‘Leading’ as proposed by GMMWater. Despite this, GMMWater’s overall rating remains unchanged at ‘Advanced’.

See page 35 for more information.

Our PREMO rating is an assessment of the water corporation’s price submission. It is not an assessment of the water corporation itself.

**Table A**      **PREMO Rating**

	Overall PREMO rating	Risk	Engagement	Management	Outcomes
GWMWater’s rating	<b>Advanced</b>	Advanced	Leading	Leading	Advanced
Commission’s rating	<b>Advanced</b>	Advanced	Leading	Standard	Advanced

Among the 15 draft decisions we have released so far, GWMWater is one of eight corporations for which we propose to approve an ‘Advanced’ rating (Table B).

**Table B**      **Draft decision on PREMO – overall rating**

Leading	Advanced	Standard	Basic
Goulburn Valley Water	Barwon Water	Coliban Water	Wannon Water
	Central Highlands Water	East Gippsland Water	
	City West Water	Gippsland Water	
	GWMWater	Lower Murray Water (urban)	
	North East Water	Westernport Water	
	South East Water		
	Southern Rural Water		
	Yarra Valley Water		





# 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* (Vic) (WI Act) and sits within the broader context of the *Essential Services Commission Act 2001* (Vic) (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 17 water corporations propose to charge customers from 1 July 2018**

Our review of the prices proposed by the water corporations covers the prescribed services listed in the WIRO.<sup>5</sup> The prescribed services include retail water and sewerage services, and bulk water and sewerage services delivered by the water corporations.<sup>6</sup>

In September 2017, GWMWater provided a submission to us proposing prices for a five year period starting 1 July 2018. 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 2018. The price determination will specify the maximum prices GWMWater 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 sections 8 and 8A of the ESC Act and section 4C of the WI Act

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<sup>5</sup> The review excludes Melbourne Water and Goulburn-Murray Water. In 2016 we approved prices for Melbourne Water to 30 June 2021 and for Goulburn-Murray Water to 30 June 2020.

<sup>6</sup> The prescribed services are listed at clause 7(b) of the WIRO.

- the matters specified in our guidance<sup>7</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.

A separate document lists the specific objectives and the various matters the commission must have regard to when making a price determination and provides a guide to where the commission has done so in this draft decision.<sup>8</sup>

In 2016, we issued guidance to GWMWater to inform its price submission. The guidance set out how we will assess GWMWater'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 GWMWater'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 is the first we've 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 (in November) 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

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<sup>7</sup> Essential Services Commission 2016, *2018 Water Price Review, Guidance paper*, November.

<sup>8</sup> Essential Services Commission 2018, *GWMWater's draft decision, 2018 Water Price Review – commission's consideration of legal requirements*, 28 March. This is located on our website at [www.esc.vic.gov.au](http://www.esc.vic.gov.au)

<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.

inform their submissions. Submissions were supportive of the overall proposal, in particular the greater focus on customer engagement and value.

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

Our new pricing approach builds on many aspects of the previous approach. We continue to use the building blocks to estimate the revenue requirement for a water corporation.<sup>14</sup> Our guidance explains the building blocks and how we use it to estimate the revenue requirement.<sup>15</sup>

Among the key changes, the new approach introduces new incentives to help ensure water corporations deliver the outcomes most valued by customers. Our new PREMO framework rewards stronger customer value propositions in price submissions, and an early draft decision is available for price submissions we can assess in a short timeframe.<sup>16</sup> The PREMO incentive is described next.

Our consultation on the pricing approach informed the guidance we issued water corporations in November 2016 to inform price submissions for the 2018 water price review.

## **PREMO**

PREMO stands for **P**erformance, **R**isk, **E**ngagement, **M**anagement, and **O**utcomes. The purpose of PREMO is to provide an incentive for water corporations to deliver outcomes most valued by customers. It includes incentives for a water corporation to engage with customers to understand their priorities and concerns, and take these into account.

PREMO links the return on equity allowed in the revenue requirement to the value delivered by a water corporation to its customers. Under PREMO, a higher level of ambition in terms of delivering customer value results in a higher return on equity.

Our PREMO rating is an assessment of the water corporation's price submission. It is not an assessment of the water corporation itself.

The 2018 water price review is the first time we've applied our PREMO incentive mechanism.

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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> The revenue requirement is the forecast amount that 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.

<sup>15</sup> Essential Services Commission 2016, *Guidance Paper*, op. cit., pp. 8–9.

<sup>16</sup> In December 2017 we issued early draft decisions for East Gippsland Water, South East Water, Westernport Water and Yarra Valley Water.

For the 2018 water price review, a water corporation's ambition in terms of delivering customer value is being assessed against four elements of PREMO – Risk, Engagement, Management and Outcomes.<sup>17</sup>

A water corporation must self-assess and propose a rating for its price submission as 'Leading', 'Advanced', 'Standard' or 'Basic'. Its proposed return on equity will then reflect its PREMO rating. A 'Leading' submission has the highest return on equity, and a 'Basic' submission the lowest. We assess the justification for the PREMO rating, and also rate the price submission. This process determines the return on equity reflected in the revenue requirement.<sup>18</sup>

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<sup>17</sup> The Performance element of PREMO will be assessed at the review following the 2018 water price review.

<sup>18</sup> Essential Services Commission 2016, *Guidance paper*, op. cit., pp. 45–49.

## 2. Our assessment of GMMWater's price submission

We have made our draft decision on GMMWater's price submission after considering: GMMWater's price submission, its responses to our queries, and written submissions from interested parties (a list of submissions is provided in Appendix A).

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

Our guidance included a number of matters water corporations must address in their price submissions. GMMWater's price submission addressed each of these matters. Our preliminary assessment of these matters is provided in this chapter.

GMMWater must submit a response to our draft decision and provide an updated financial model by 8 May 2018 (via email to [water@esc.vic.gov.au](mailto:water@esc.vic.gov.au)). The response will be published on our website. We also invite other interested parties to make a submission.

We intend to make a price determination for GMMWater in June 2018.

All financial values referred to in this chapter are in \$2017-18.

## **Regulatory period**

GMMWater proposed a five year regulatory period. Our draft decision accepts GMMWater's proposal as it is consistent with our guidance. Our guidance proposed to approve a five year regulatory period, subject to any alternative and justified proposal.<sup>19</sup>

## **Customer engagement**

Our guidance required GMMWater to engage with customers to inform its price submission.

The engagement by GMMWater:

- took place between November 2015 and September 2017, and was informed by its 2013 Community Engagement Strategy
- used a range of methods such as a deliberative panel that met over four days, workshops, information booths at community events, online and paper surveys and social media
- included councils, farmers, urban property owners and tenants, agricultural operators, manufacturers, welfare agencies and committees for recreational and irrigation water use
- led to recommendations by deliberative panel on pricing and guaranteed service levels which were fully adopted in the price submission
- covered topics such as water quality, affordability, tariff structures, recreational water and rural pipeline tariff.

More detail on GMMWater's engagement is available in its price submission.<sup>20</sup>

Evidence that GMMWater's engagement influenced its proposals includes:

- improving water quality in Kaniva, Moyston and Ultima with support from the deliberative panel
- adopting a deliberative panel recommendation to pay \$100 to affected customers when it issues a boil water notice
- extending recreational water discounts to schools and adjusting the recreation contribution charge in line with recommendations from the deliberative panel.

The influence of GMMWater's engagement on its proposals supports the objectives in our pricing framework relating to efficiency and the interests of consumers.<sup>21</sup>

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<sup>19</sup> For detail on the reasons for using five years as the default regulatory period, see: Essential Services Commission 2016, *Guidance paper*, op. cit., p. 21.

<sup>20</sup> GMMWater's price submission is available on our website at [www.esc.vic.gov.au](http://www.esc.vic.gov.au).

## Outcomes

The outcomes GMMWater proposes to deliver over the five year period starting 1 July 2018 are:

- safe and clean water
- reliable and affordable services
- healthy and liveable region.

GMMWater proposed measures and targets that it will use to report on performance against each outcome. These are set out at pages 39 to 41 of its price submission. To report on its performance GMMWater proposes to publish performance against its service standards on its website.

We will engage with GMMWater to finalise the measures and targets used to assess performance against its outcomes, and how it will report this publicly. Performance against these measures will inform our assessment during future price reviews.

## 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.

GMMWater's proposed GSLs are set out on page 43 of its price submission and in appendix A1. It has made no changes to existing GSLs, including its hardship GSL. It will introduce one new GSL relating to water quality, requiring it to pay \$100 to customers affected by a boil water notice.

GMMWater's GSLs were considered and recommended by the deliberative panel. Its justification for its proposed GSLs is included on pages 43 to 45 of its price submission.<sup>22</sup>

We propose to accept GMMWater's proposed GSLs as they were developed in consultation with its customers. Final GSLs will be subject to our consideration of any feedback following the release of our 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

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<sup>21</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>22</sup> Justification for GMMWater's proposed GSLs is set out in its price submission and Appendix 1 – its price submission is available at [www.esc.vic.gov.au](http://www.esc.vic.gov.au).

Environment Protection Authority Victoria and the Department of Health and Human Services. Along with forecast demand, it is an input to calculating prices.<sup>23</sup>

GWMWater proposed a revenue requirement of \$317.7 million over a five year period starting 1 July 2018. Our draft decision proposes to approve a revenue requirement of \$317.7 million, the same amount proposed by GWMWater. While we found expenditure savings, this was offset by a correction made by GWMWater to its forecasts for regulatory depreciation, after lodging its original price submission.

Our draft decision on the revenue requirement is set out at Table 2.1.

**Table 2.1 Draft decision – revenue requirement**  
\$ million 2017-18

	2018-19	2019-20	2020-21	2021-22	2022-23	Total
Operating expenditure	33.8	33.8	33.4	33.3	33.1	167.5
Return on assets	16.9	17.0	17.2	17.4	17.4	85.9
Regulatory depreciation	11.3	12.1	13.0	13.6	14.3	64.3
<b>Draft decision – revenue requirement</b>	<b>62.0</b>	<b>62.9</b>	<b>63.6</b>	<b>64.4</b>	<b>64.8</b>	<b>317.7</b>

Note: Numbers have been rounded

Table 2.2 summarises proposed changes to the revenue requirement, compared with GWMWater’s original proposal.

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, GWMWater must update its revenue requirement and prices to reflect our April 2018 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

<sup>23</sup> We met with 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 GWMWater in the regulatory period from 1 July 2018. We had regard to their views in our draft decision.



revenue requirement, GWMWater should update its price submission and also provide us with an updated financial model. Any updates will be publicly available on our website.

**Table 2.2 Adjustments to revenue requirement**  
\$ million 2017-18

	2018-19	2019-20	2020-21	2021-22	2022-23	Total
<b>Proposed revenue requirement</b>	<b>62.0</b>	<b>62.9</b>	<b>63.6</b>	<b>64.4</b>	<b>64.8</b>	<b>317.7</b>
Operating expenditure	-1.0	-1.0	-1.2	-1.3	-1.3	-5.8
Return on assets	0.6	0.4	0.4	0.3	0.2	1.8
Correction to regulatory depreciation	0.4	0.6	0.9	1.0	1.1	3.9
<b>Total adjustments</b>	<b>0.0</b>	<b>0.0</b>	<b>0.0</b>	<b>0.0</b>	<b>0.0</b>	<b>0.0</b>
<b>Draft decision – revenue requirement</b>	<b>62.0</b>	<b>62.9</b>	<b>63.6</b>	<b>64.4</b>	<b>64.8</b>	<b>317.7</b>

Note: Numbers have been rounded

## Operating expenditure

Operating expenditure is an input to the revenue requirement. GWMWater’s price submission provides detail on its forecast operating expenditure from pages 53 to 57, with a cost breakdown shown in figure 5-19 on page 57.

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 (that is, 2016-17). 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

Our assessment

expenditure. Deloitte's report on its assessment of GWMWater's expenditure forecast is available on our website.<sup>24</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 2.3 sets out our draft decision on GWMWater'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 GWMWater's proposal follow, with a summary of our adjustments shown at Table 2.4.

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 GWMWater's price submission.

The benchmark operating expenditure that we propose to adopt for GWMWater does not represent the amount that GWMWater 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>24</sup> Deloitte Access Economics 2018, *GWMWater – expenditure review for 2018 water price review*, February.

**Table 2.3 Draft decision – operating expenditure**

\$ million 2017-18

	2018-19	2019-20	2020-21	2021-22	2022-23	Total
<b>Controllable costs</b>	<b>31.3</b>	<b>31.3</b>	<b>31.0</b>	<b>30.9</b>	<b>30.7</b>	<b>155.2</b>
<b>Non-controllable costs</b>	<b>2.5</b>	<b>2.5</b>	<b>2.4</b>	<b>2.4</b>	<b>2.4</b>	<b>12.2</b>
Bulk services <sup>a</sup>	0.2	0.2	0.2	0.2	0.2	1.2
Environmental contribution <sup>b</sup>	2.2	2.2	2.1	2.1	2.0	10.6
Licence fees - ESC <sup>c</sup>	0.038	0.038	0.038	0.038	0.055	0.206
Licence fees - DHHS <sup>c</sup>	0.017	0.017	0.017	0.017	0.017	0.086
Licence fees - EPA <sup>c</sup>	0.046	0.046	0.046	0.046	0.046	0.231
<b>Draft decision – operating expenditure</b>	<b>33.8</b>	<b>33.8</b>	<b>33.4</b>	<b>33.3</b>	<b>33.1</b>	<b>167.5</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

GWMWater proposed a total forecast controllable operating expenditure of \$161.1 million over a five-year regulatory period, consisting of \$142.5 million (88 per cent) for its urban services and \$18.6 million (12 per cent) for its rural services. For the reasons set out below, we propose to reduce the total by \$5.9 million to establish a benchmark controllable operating expenditure of \$155.2 million.

Correction to its price submission:

- During our initial assessment of GWMWater's price submission and financial template, we identified a number of errors in its operating expenditure data which GWMWater subsequently corrected. The 2016-17 baseline year total operating expenditure was reduced by \$0.29 million to remove a non-regulatory cost item (interest allocation), decreasing the reported figure from \$31.49 million to \$31.20 million. GWMWater confirmed this incorrect cost item was not included

Our assessment

in its forecast operating expenditure for 2018–23, so no corresponding adjustment to the forecast was required. In its resubmitted financial template, GMMWater increased its 2018–23 forecast for major scheduled maintenance and operations from a total of \$6.37 million to \$7.76 million, effectively rebalancing its input to produce the same total controllable operating expenditure as its original submission before removing the baseline year error.

#### Baseline controllable operating expenditure:

- GMMWater proposed upwards adjustments of \$0.30 million to its corrected 2016-17 baseline year controllable operating expenditure to reflect the lower than usual energy consumption. The resultant baseline figure of \$31.50 million is 1 per cent below the benchmark of \$31.79 million allowed for 2016-17 in the previous price determination. Deloitte reviewed the adjusted baseline and recommended no adjustments. We agree with Deloitte's view as we consider this reflects an efficient baseline cost to forecast annual operating expenditure.

#### Efficiency improvement for urban services:

- GMMWater's proposed efficiency improvement rate on its urban controllable operating costs is 1.5 per cent per annum. This is greater than its past performance (where it met our mandated 1 per cent efficiency rate). It also exceeds GMMWater's forecast connection growth rate of only 0.5 per cent per annum, giving a declining annual baseline operating cost.
- We note the rural component of GMMWater's controllable operating expenditure is not subject to an annual efficiency improvement, but nor does it receive a customer growth allowance. This produces a flat baseline for rural costs across the 2018–23 period, consistent with our guidance.

#### Proposed cost changes:

- GMMWater has sought additional operating expenditure of \$9.82 million above its annual baseline cost, with \$7.76 million of maintenance and operational costs (labour, electricity and additional activities) and \$2.06 million for new operating costs not captured in the baseline. Any other costs decreases or savings will be managed within GMMWater's growth-adjusted baseline and efficiency improvements.
- Deloitte reviewed the additional \$2.85 million for maintenance labour above GMMWater's baseline, relating to wage increases above inflation resulting from its enterprise agreement and four additional full time equivalent (FTE) staff.
  - Deloitte's assessment of wage increases above inflation is that these should be managed by the water corporation through productivity improvements or through the growth allowance applied to the baseline, as most other water corporations have proposed. Deloitte recommended a reduction of \$0.65 million for the wage growth above inflation.

- Deloitte accepted the additional four FTEs as GWMWater had an abnormally high vacancy rate in 2016-17.
- We agree with Deloitte’s view as it reflects more efficient labour expenditure. We expect GWMWater will meet its EBA requirements through the inflation and growth allowances, with any shortfall funded by efficiency or productivity improvements.
- Deloitte assessed the \$0.79 million of additional electricity costs above the baseline due to forecast higher prices. Deloitte compared the forecast electricity costs above the baseline with its latest forecasts for electricity prices, and recommended an indicative reduction of \$0.47 million as it did not agree with GWMWater’s forecasted higher electricity prices continuing beyond 2019-20 through to 2022-23.<sup>25</sup> We accept Deloitte’s recommendation as we consider it reflects a more accurate forecast of efficient electricity costs during the 2018–23 regulatory period. However we do acknowledge that there is currently uncertainty in forecasting electricity prices and GWMWater’s electricity contract expires during 2017-18. We request that GWMWater proposes a revised electricity forecast based on its new contract prices in response to our draft decision.
- Deloitte reviewed the \$4.12 million for additional maintenance activities.
  - Deloitte found the additional \$0.99 million of expenditure for the wastewater lagoon de-sludging program and SCADA system maintenance was justified.<sup>26</sup>
  - GWMWater identified some duplicated expenditure in its cost build-up during Deloitte’s review of costs for condition assessments. This equated to \$0.25 million per year or a total of \$1.25 million for 2018–23, which Deloitte has removed from the forecast.
  - Deloitte reviewed the remaining condition assessment expenditure against GWMWater’s network reliability performance. It considered there was sufficient evidence to support the additional costs for sewers but not for water assets. Deloitte recommended an adjustment of \$1.24 million.
  - Across the various activities, Deloitte recommend an adjustment of \$2.49 million for the water asset condition assessments and the error correction.<sup>27</sup> We agree with Deloitte’s recommendation as it reflects more efficient operating expenditure and is consistent with our guidance requirement for expenditure above the baseline to be clearly justified.
- GWMWater proposed \$0.97 million of urban operating expenditure resulting from the completion of its major capital projects. It also forecast an additional \$1.09 million in rural

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<sup>25</sup> Deloitte Access Economics, op. cit., pp. 16–19.

<sup>26</sup> Supervisory control and data acquisition (SCADA)

<sup>27</sup> Deloitte Access Economics 2018, op. cit., pp. 20–21.

operating expenditure for the operation of the new South West Loddon rural water supply project. Deloitte considered the community support for the projects and the quality of the project business cases, and recommended no adjustments.<sup>28</sup> We agree with Deloitte's view and consider that these costs reflect prudent and efficient operating expenditure.

- GWMWater had included costs for providing state environmental water in its baseline expenditure, with the forecast totalling \$2.28 million across 2013–18. The provision of environmental water is not a prescribed service, as defined under the WIRO.<sup>29</sup> Accordingly, we have removed the associated costs from operating expenditure, as well as removing the corresponding revenue from prescribed revenue recovery (this is explained further in our prices and tariff structures section).

We consider applying our proposed adjustment of \$5.91 million to GWMWater's total proposed controllable operating expenditure forecast better meets the requirements of the WIRO and the criteria for prudent and efficient expenditure outlined in our guidance.<sup>30</sup> This will bring about a decrease (in real terms) in controllable operating expenditure relative to the baseline year, as shown in Figure 2.1.

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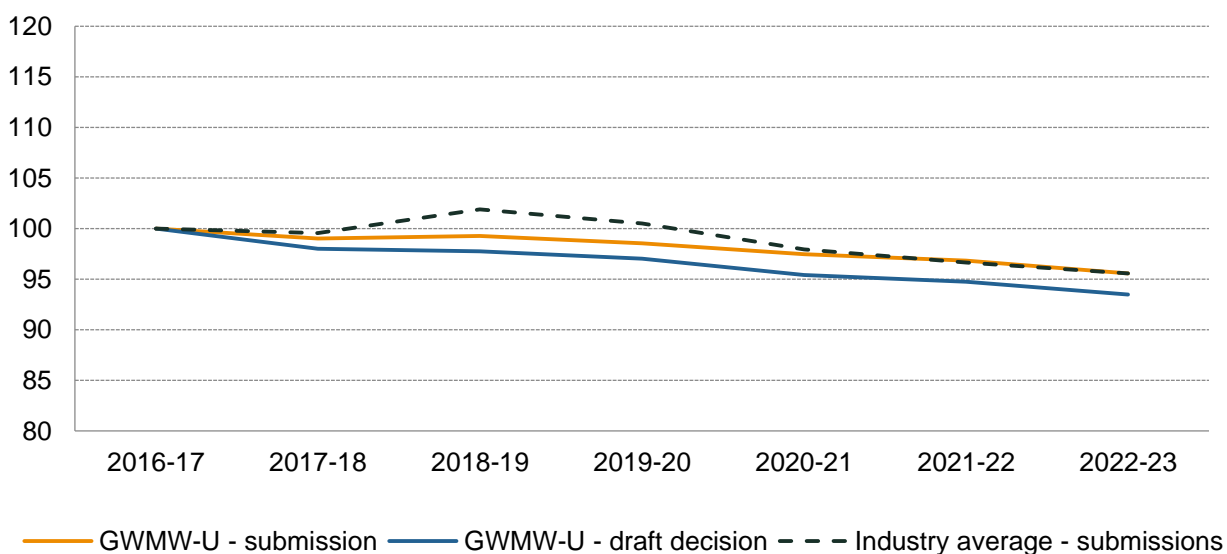
<sup>28</sup> Deloitte Access Economics, op. cit., pp. 21–22.

<sup>29</sup> See section 'Victorian environmental water' under Tariff structures on page 29. Based on our legal advice, we have transferred any costs or revenues related to the Victorian environmental water charge from prescribed (regulated), to non-prescribed services in the financial model.

<sup>30</sup> Essential Services Commission 2016, *Guidance paper*, op. cit., p. 31.

**Figure 2.1 Controllable operating expenditure per water connection**

Index: 2016-17=100



Note: Only urban controllable operating expenditure per water connection is graphed. The split of rural and urban controllable operating expenditure is not readily available prior to 2016-17.  
 Submission – based on actual historical and forecast values provided by the water corporation in its price submission.  
 Draft decision – includes any corrections or adjustments to historical and forecast values arising from our assessment.  
 Industry average – drawn from the price submissions for all urban water corporations (excludes rural expenditure).

For non-controllable operating expenditure, we have adjusted GWMWater’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 2.3 above.

For the environment contribution, we have used the 2018-19 value provided by the Department of Environment, Land, Water and Planning and assumed that this will remain flat in nominal terms (decline in real terms) across the 2018–23 regulatory period.

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 regulatory review cycle.<sup>31</sup>

We have increased GWMWater’s forecast non-controllable operating expenditure by \$0.15 million across the 2018–23 period, resulting from our adjustments to:

<sup>31</sup> The Department of Health and Human Services and the EPA Victoria provided their latest 2016-17 licence fees for making our draft decision. We have also based our forecast on our 2016-17 commission licence fee.

- decrease the Department of Health and Human Services licence fee from \$0.05 million to \$0.02 million per year (a total reduction of \$0.14 million)
- increase our commission licence fee by \$0.02 million in 2022-23
- increase the Environment Protection Authority Victoria licence fee by \$0.03 million per year (a total increase of \$0.15 million)
- increase the environment contribution from \$2.08 million up to \$2.21 million for 2018-19 and decline this value across the period (a total increase of \$0.13 million).

Overall, non-controllable operating expenditure will increase by \$0.51 million from 2017-18 to 2018-19, due to the increase in the environment contribution from \$1.68 million to \$2.21 million.

Prior to making our final decision, we will adjust GMMWater's forecast non-controllable operating expenditure for the latest inflation and external bulk charges data. We will verify GMMWater's forecast external bulk water charges against the current price determination for Goulburn-Murray Water.

Table 2.4 sets out our proposed adjustments to both controllable and non-controllable operating expenditure.



**Table 2.4 Adjustments to operating expenditure**

\$ million 2017-18

	2018-19	2019-20	2020-21	2021-22	2022-23	Total
<b>Proposed total operating expenditure</b>	<b>34.8</b>	<b>34.8</b>	<b>34.6</b>	<b>34.6</b>	<b>34.4</b>	<b>173.2</b>
State environmental water	-0.5	-0.5	-0.5	-0.5	-0.5	-2.3
Labour	-0.1	-0.1	-0.1	-0.1	-0.1	-0.7
Electricity	0.0	0.0	-0.2	-0.2	-0.2	-0.5
Additional maintenance activities	-0.5	-0.5	-0.5	-0.5	-0.5	-2.5
<b>Total adjustments to controllable costs</b>	<b>-1.1</b>	<b>-1.1</b>	<b>-1.2</b>	<b>-1.2</b>	<b>-1.2</b>	<b>-5.9</b>
Licence fees	0.001	0.001	0.001	0.001	0.018	0.021
Environmental contributions	0.123	0.074	0.025	-0.022	-0.069	0.131
<b>Total adjustments to non-controllable costs</b>	<b>0.1</b>	<b>0.1</b>	<b>0.03</b>	<b>-0.02</b>	<b>-0.1</b>	<b>0.2</b>
<b>Draft decision - total operating expenditure</b>	<b>33.8</b>	<b>33.8</b>	<b>33.4</b>	<b>33.3</b>	<b>33.1</b>	<b>167.5</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 GMMWater to propose its:

- closing regulatory asset base at 30 June 2017
- forecast regulatory asset base for each year of the regulatory period from 1 July 2018.

Our assessment

## 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 2017. This helps to ensure prices reflect the actual net expenditure of a water corporation.<sup>32</sup>

We compared GMMWater's actual net capital expenditure for 2012-13 to 2016-17 with the forecast used to approve maximum prices for the period from 1 July 2013. We undertake a prudence 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 2013. We believe this approach is reasonable given capital expenditure can be relatively 'lumpy' in nature.

In its price submission, GMMWater proposed \$97.3 million net capital expenditure over the period from 2012-13 to 2016-17. We identified some adjustments to the estimates adopted by GMMWater, which increased this to \$101.2 million. This figure is 0.8 per cent lower than the forecast used to approve maximum prices for the period from 1 July 2013. This is well below the 10 per cent threshold identified above, so we have not undertaken a prudence and efficiency review of its past net capital expenditure.

Other than this correction for past net capital expenditure, GMMWater 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 2017 of \$358.9 million.

Table 2.5 sets out our draft decision on GMMWater's regulatory asset base at 30 June 2017.

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<sup>32</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.

**Table 2.5 Closing regulatory asset base**  
\$ million 2017-18

	2012-13	2013-14	2014-15	2015-16	2016-17
Opening RAB 1 July	319.6	337.2	352.2	357.2	363.2
Plus gross capital expenditure	28.0	30.9	20.4	23.7	22.5
Less government contributions	0.3	3.7	1.2	2.4	12.2
Less customer contributions	1.1	0.3	1.7	0.8	0.7
Less proceeds from disposals	0.9	1.3	1.1	2.2	1.1
Less regulatory depreciation	8.2	10.5	11.5	12.3	12.8
<b>Closing RAB 30 June</b>	<b>337.2</b>	<b>352.2</b>	<b>357.2</b>	<b>363.2</b>	<b>358.9</b>

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.

Table 2.6 sets out our draft decision on GWMWater's opening regulatory asset base from 1 July 2018.<sup>33</sup> Our review of items that determine the forecast regulatory asset base are discussed below.

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<sup>33</sup> Our guidance required water corporations to provide an estimate of the components of its regulatory asset base for 2017-18. This is so we can assess the opening asset base for 1 July 2018. Our guidance noted that where the 2017-18 forecasts for net capital expenditure (gross capital expenditure less government and customer contributions) is lower than the forecast benchmark for that year in its 2013 price determination, the lower amount must be used. The estimates for 2017-18 will be confirmed at the price review following the 2018 water price review.

**Table 2.6 Forecast regulatory asset base**  
\$ million 2017-18

	2017-18	2018-19	2019-20	2020-21	2021-22	2022-23
Opening RAB 1 July	358.9	402.1	402.7	407.3	413.1	414.9
Plus gross capital expenditure	109.0	16.5	18.6	20.7	17.4	14.9
Less government contributions	48.0	0.0	0.1	0.0	0.0	0.0
Less customer contributions	3.5	3.7	0.9	0.9	0.9	0.9
Less proceeds from disposals	1.0	1.0	0.9	1.0	1.1	1.1
Less regulatory depreciation	13.2	11.3	12.1	13.0	13.6	14.3
<b>Closing RAB 30 June</b>	<b>402.1</b>	<b>402.7</b>	<b>407.3</b>	<b>413.1</b>	<b>414.9</b>	<b>413.6</b>

Note: Numbers have been rounded

### 2017-18 net capital expenditure

In our guidance paper, we noted we would use the 2013 determination forecast for 2017-18 net capital expenditure to establish the forecast regulatory asset base (the exception was where actual net capital expenditure was lower than the 2013 forecast, when the lower amount would be used).

This approach helps to limit the incentive for a water corporation to delay capital works until the last year of a regulatory period.<sup>34</sup> Consistent with our approach in past price reviews, we considered allowing higher amounts where justified by the water corporation.

GMMWater proposed higher 2017-18 capital expenditure than the 2013 determination forecast. The amounts above forecast reflected two projects, the South West Loddon rural water supply project, and the Mallee towns treated water supply project. We reviewed the business cases for both projects. Both projects have received state government funding and are related to securing future water supply.

<sup>34</sup> Even if unintentional, delayed projects provide an undue benefit to a water corporation, as customer prices assume capital works proceed to schedule.

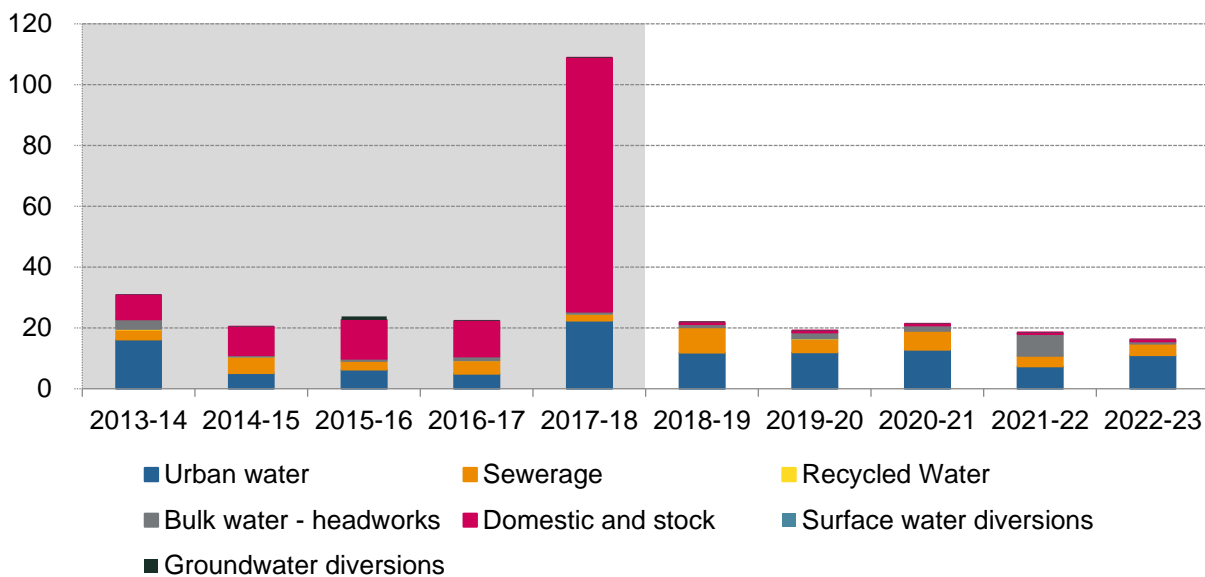
We therefore consider both projects reflect prudent and efficient expenditure and we propose to include the amounts in GMMWater’s forecast regulatory asset base.

### Capital expenditure

Capital expenditure is an input to estimating the regulatory asset base. GMMWater’s forecast capital expenditure and supporting information is provided at pages 57 to 65 of its price submission. This is summarised in Figure 2.2, for the current 2013–18 period, and as proposed by the water corporation for the 2018–23 period.

We engaged Deloitte Access Economics to provide expert advice to inform our assessment of capital expenditure. Deloitte’s report on its assessment of GMMWater’s expenditure forecast is available on our website.<sup>35</sup>

**Figure 2.2 Gross capital expenditure by service category**  
\$ million 2017-18



Note: actuals for 2013-14 to 2016-17 and water corporation forecasts for 2017-18 to 2022-23

GMMWater proposed a total gross capital expenditure of \$97.5 million over a five-year regulatory period, consisting of \$94.1 million (96.5 per cent) for its urban services and \$3.4 million (3.5 per cent) for its rural services. For the reasons set out below, we propose to reduce this by \$9.3 million to establish a benchmark gross capital expenditure of \$88.2 million:

<sup>35</sup> Deloitte Access Economics, op. cit.

- GWMWater’s forecast gross capital expenditure for 2018–23 is \$109.0 million (52.8 per cent) lower than the \$206.5 million incurred in 2013–18, which was higher than the benchmark in the last price determination. GWMWater completed two additional major projects in 2017-18 (South West Loddon rural water supply, and water quality upgrades to five Mallee towns) that were not included in pricing at the last price determination. A significant proportion of the costs for these new projects came through government funding. We note that over 63 per cent of the gross capital expenditure forecast for 2018–23 is driven by renewals.
- We note that during our initial financial model review GWMWater identified \$3,000 of missing costs for its Domestic and Stock expenditure category and this number has been accepted and included in the financial model. The magnitude of the change has negligible impact on total gross capital expenditure.
- Deloitte requested selected documents from GWMWater as a representative sample to demonstrate its asset management processes and justification for its capital expenditure program. Based on the sample of documents reviewed, these demonstrate that GWMWater has a robust approach for developing project scope, the timing of works and cost estimates.
  - Deloitte reviewed the business cases and capital planning documents for the renewals programs, the urban remote (digital) metering project and the decommissioning of redundant assets.
- Deloitte considered there was sufficient justification for the prudence and efficiency of the capital expenditure on the remote metering and decommissioning projects, and recommended no adjustments.<sup>36</sup> We accept Deloitte’s view as the documentation and justification for cost inclusions are consistent with our guidance. With regards GWMWater’s proposed digital metering program, we note:
  - GWMWater already has operating digital metering infrastructure for its rural digital network, and it proposes to expand this to its urban customer network. The scope of work is therefore different than for other water corporations proposing to implement new, standalone urban systems.
  - GWMWater has identified that this project has a positive net present value and has committed to ensuring the project is revenue neutral for 2018–23. Its customers support more timely water usage information, as the current meter read process takes nine weeks to complete each quarter.

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<sup>36</sup> Deloitte Access Economics, op. cit., pp. 28–29.

- GWMWater proposed \$61.5 million for its renewals program, a 72 per cent increase from the 2013–18 allowance. This increase was to reflect both a catch up and re-focus of its renewals following the current period. Deloitte considered the large increase was not adequately supported by the information provided by GWMWater – instead, it has proposed a 45 per cent increase better reflects the level of GWMWater’s justification. Deloitte recommended a \$9.34 million reduction to renewals forecast expenditure, applied across the three renewals categories.<sup>37</sup> We agree with Deloitte’s recommendation, and we have removed this amount from the forecast because it is not fully justified as required by our guidance.
- We consider the planned capital expenditure program is achievable, given GWMWater’s past track record delivering its capital expenditure program. Over the current 2013–18 regulatory period, GWMWater completed most of its major projects, with the upgrade of the Donald wastewater and reuse system deferred until 2019-20 to allow time to assess the impact of interim works. GWMWater also completed the Wimmera Mallee Pipeline augmentation project, which was identified as a new major project during the period.<sup>38</sup>
- GWMWater’s price submission did not specifically identify how it would manage uncertainty in timing, scope and cost from capital works, however it did note that rural pipeline expenditure may increase pending the outcome of several feasibility assessments and the development of business cases. It did not identify the potential costs associated with these projects, or any other costs it had specifically excluded from its capital expenditure forecast. Regarding uncertain expenditure, we note the following:
  - GWMWater will need to demonstrate the prudence and efficiency of any additional costs if they are indeed incurred during the 2018–23 period if seeking to include them in the regulatory asset base.
  - Variations in capital expenditure from forecast during the 2018–23 period will form a key part of our assessment of the Performance element of PREMO at the next price review.

Table 2.7 below sets out our proposed adjustments to GWMWater’s forecast to establish our draft decision benchmark for gross capital expenditure, consistent with our guidance and WIRO principles.<sup>39</sup> This benchmark is used to calculate the forecast regulatory asset base (Table 2.6) and the revenue requirement (Table 2.1).

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<sup>37</sup> Deloitte Access Economics, op. cit., pp. 25–28.

<sup>38</sup> Essential Services Commission 2018, *Status of major projects supplement: Water performance report 2016-17*, 1 March, p. 19.

<sup>39</sup> Essential Services Commission 2016, *Guidance paper*, op. cit., p. 35.

**Table 2.7 Draft decision – gross capital expenditure**

\$ million 2017-18

	2018-19	2019-20	2020-21	2021-22	2022-23	Total
<b>Proposed gross capital expenditure</b>	<b>22.0</b>	<b>19.2</b>	<b>21.4</b>	<b>18.6</b>	<b>16.3</b>	<b>97.5</b>
Asset renewal water	-1.8	-0.2	-0.3	-0.4	-0.5	-3.1
Asset renewal wastewater	-2.0	-0.2	-0.2	-0.3	-0.4	-3.1
Other capital expenditure	-1.6	-0.3	-0.3	-0.5	-0.5	-3.2
<b>Total adjustments to gross capital expenditure</b>	<b>-5.5</b>	<b>-0.6</b>	<b>-0.7</b>	<b>-1.2</b>	<b>-1.4</b>	<b>-9.3</b>
<b>Draft decision – gross capital expenditure</b>	<b>16.5</b>	<b>18.6</b>	<b>20.7</b>	<b>17.4</b>	<b>14.9</b>	<b>88.2</b>

Note: Numbers have been rounded

The benchmark that we adopt for GMMWater does not represent the amount that the water corporation is required to spend or allocate to particular projects. Where we have made an adjustment to exclude a project's capital expenditure from GMMWater's revenue requirement, we are not requiring the corporation to remove that project. Rather, it represents assumptions about the overall level of expenditure (to be recovered through prices) that we consider sufficient to operate the business and to maintain or improve services over the regulatory period. GMMWater determines how to best manage the allocation of its revenue and priority of its expenditure within a regulatory period.

### Customer contributions

Revenue from customer contributions is deducted from gross capital expenditure so it is not included in the regulatory asset base.



We compared GMMWater’s forecast for customer contributions with past outcomes, and its forecasts for growth in customer connections.<sup>40</sup> We consider GMMWater’s forecast contributions are reasonable, having regard to past trends and its growth forecasts.

Our draft decision proposes to accept GMMWater’s forecasts for customer contributions.

## Cost of debt

Our guidance required GMMWater to use estimates of the cost of debt provided by the commission to estimate its revenue requirement. GMMWater 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 GMMWater, as set out in Table 2.8.

**Table 2.8** Trailing average cost of debt

	2008-09	2009-10	2010-11	2011-12	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18
Cost of debt (nominal)	6.9%	7.4%	7.0%	6.3%	5.3%	7.1%	5.4%	5.3%	4.9%	4.9%*

\* Estimated cost of debt – we will update the 2017-18 figure 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-day approach.<sup>41</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 – PREMO rating

GMMWater rated its price submission as ‘Advanced’. Based on its PREMO self-rating, GMMWater proposed a rate of return on equity of 4.9 per cent per annum. This reflects the maximum return rate allowed in our guidance for a price submission rated as ‘Advanced’.<sup>42</sup>

<sup>40</sup> Growth in customer connections can be used as an indicator of growth in customer contributions.

<sup>41</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>42</sup> Essential Services Commission 2016, *Guidance paper*, op. cit., p. 49.

The return on equity is similar to rates we have approved in past reviews for the water industry. We have also had regard to the return on equity allowed or estimated by regulators in other Australian jurisdictions recently for the water industry.<sup>43</sup>

Our draft decision accepts GWMWater's PREMO self-rating and proposed return on equity of 4.9 per cent per annum. Our assessment of GWMWater's proposed PREMO rating is set out in Chapter 3.

## **Regulatory depreciation**

Regulatory depreciation is an input to calculating the regulatory asset base. GWMWater's forecast regulatory depreciation was calculated using a straight line depreciation profile.<sup>44</sup> We noted in our guidance that we prefer this approach.<sup>45</sup>

Our draft decision on regulatory depreciation differs from GWMWater's original price submission mainly due to corrections it made to the calculation of forecast regulatory depreciation. During our review, GWMWater sought to increase the amount it recovered via regulatory depreciation. We propose to cap the increase resulting from the correction, to an amount that results in our draft decision revenue requirement matching the revenue requirement proposed by GWMWater in its price submission.

Our draft decision on regulatory depreciation is shown in Table 2.1.

GWMWater must respond to our draft decision with justification for its forecast regulatory depreciation.

## **Tax allowance**

The tax allowance is an input into the revenue requirement. GWMWater 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>46</sup>

## **Demand**

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

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<sup>43</sup> Essential Services Commission of South Australia 2016, *SA Water regulatory determination 2016, Final determination*, June; Independent Pricing and Regulatory Tribunal 2017, *WACC biannual update*, August.

<sup>44</sup> For the period from 2018-19 to 2022-23, GWMWater proposed a regulatory depreciation of \$60.4 million.

<sup>45</sup> Essential Services Commission 2016, *Guidance paper*, op. cit., p. 42.

<sup>46</sup> Essential Services Commission 2016, *Guidance paper*, op. cit., pp. 50–51.

GMMWater's demand forecasts are set out at pages 45 to 52 of its price submission, and are also included in its financial model. Our draft decision proposes to accept GMMWater's demand forecasts for the purpose of approving maximum prices as 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**

GMMWater initially proposed a weighted average price cap form of price control. It currently uses a revenue cap. We requested further information from GMMWater on the strategy supporting this change. GMMWater responded proposing a price cap form of price control.<sup>47</sup>

A price cap will allow GMMWater to recover sufficient revenue to cover the forecast efficient costs of providing services. A price cap also 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.

For these reasons, our draft decision is to accept GMMWater's proposed price cap form of price control.

## **Tariff structures**

GMMWater's proposed tariffs for its urban and rural services are set out at pages 73 to 78 and appendices 4 and 5 of its price submission. On average, GMMWater proposed a reduction in its prices from 1 July 2018.

As outlined in our guidance, we have provided the water corporations with a large degree of discretion to decide on individual tariff structures.<sup>48</sup> This recognises water corporations are often best placed to consider the interests of customers in designing tariffs, and that existing tariff structures have been developed over time to deal with a variety of local circumstances.

Apart from customers in Elmhurst, Kaniva, Moyston, Ultima and Goroke, GMMWater proposed to maintain its existing tariff structures for urban and rural customers:

- For residential and non-residential urban water services, GMMWater proposed a two-part tariff with a fixed service charge and a variable usage component that depends on water use.

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<sup>47</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>48</sup> Essential Services Commission 2016, *Guidance paper*, op. cit., p. 55.

- For residential and non-residential urban sewerage services, GMMWater proposed a fixed service charge only.
- For Elmhurst, Kaniva, Moyston and Ultima, GMMWater proposed to introduce a tariff for the supply of fully treated drinking water.
- For Goroke, GMMWater proposed to introduce a sewerage tariff for the provision of a common effluent drainage system.

We consider the two-part structure proposed by GMMWater for its urban water tariffs will promote the efficient use of services. The two-part structure for urban water tariffs sends customers a signal about the costs of their water use, and is an approach that is commonly applied in other states and territories.<sup>49</sup> We also consider two-part tariff structures are easy to understand.

We also consider:

- customers demonstrated support for the proposal to introduce a tariff that reflects the cost of supplying fully treated drinking water to the towns of Elmhurst, Kaniva, Moyston and Ultima.<sup>50</sup>
- the proposed introduction of a sewerage tariff to the town of Goroke was supported by customers, and reflects the cost of GMMWater providing a common effluent drainage system for Goroke.<sup>51</sup>

### Unique services

GMMWater has confirmed its proposed tariffs for recycled water, trade waste and miscellaneous services are calculated in accordance with the pricing principles referenced in our guidance.

### Urban prices

Submissions by the Consumer Action Law Centre and Gerard Mallon highlighted the impact price changes may have on some customers, particularly those with low or fixed incomes who 'already carefully manage their consumption and budget'.<sup>52</sup> On this we note GMMWater proposed a minor reduction to its residential and non-residential urban water prices and these prices reflect the efficient costs of providing the services.

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<sup>49</sup> Includes the tariffs of 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>50</sup> Reflected in GMMWater's outcome to provide safe and clean water.

<sup>51</sup> Refer to appendix 7 of GMMWater's price submission for the deliberative panel report, specifically pages A-54 and A-55. The price submission appendices are available on our website.

<sup>52</sup> Consumer Action Law Centre 2017, *Initial Feedback: 2018 Water Price Review*, 15 November; Gerard Mallon 2017, *Submission*, November

## Rural prices

The majority of GMMWater's proposed rural water prices will not change. But GMMWater proposed to increase maximum prices for water provided to the Commonwealth Environmental Water Holder (CEWH) and recreation water.

## Commonwealth environmental water

The Commonwealth purchased an irrigation water entitlement in 2012 to provide environmental water to the Wimmera-Mallee system. As such, the Commonwealth holds irrigation water shares, which are regulated under the WIRO, to use for environmental water. The Commonwealth is charged an irrigation charge for its entitlement, consistent with the agreement.

In its price submission GMMWater proposed an increase of 19.3 per cent in the variable charge and 19.2 per cent increase in the fixed charge over 2018-19 to 2019-20. GMMWater's calculation of the proposed price increase was based on its cost estimates for environmental water and not the irrigation entitlement purchased by the Commonwealth. We requested further information from GMMWater on the signal it proposes to send to the Commonwealth based on its proposed price increases. GMMWater indicated that the price increase will ensure the charge paid by CEWH better reflects the cost for environmental water services.

We received a submission from the CEWH<sup>53</sup> which raised concerns about the proposed price increase and GMMWater's assumption that the CEWH will use 50 per cent of its water entitlement for environmental water during 2018-19 to 2022-23. During 2012-13 to 2017-18 the Commonwealth used about 10 per cent of its entitlement.<sup>54</sup>

GMMWater provided a submission to us responding to the CEWH's submission outlining that:<sup>55</sup>

- current irrigation charges are not cost reflective
- GMMWater are adopting pricing policies of the National Water Initiative to achieve cost recovery.

We assessed GMMWater's proposal, including additional information provided to the commission, and historic arrangements on the purchase of the irrigation entitlements by CEWH in 2012. We consider that:

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<sup>53</sup> Commonwealth Environmental Water Holder 2017, *Review of prices for GMMWater 2018-23 water price submission*, December.

<sup>54</sup> Refer to GMMWater's 2018 financial model for its price submission, which is available on our website.

<sup>55</sup> GMMWater 2018, *Bulk water pricing – irrigation water held by the Commonwealth Environmental Water Holder*, February.

- GMMWater’s proposal is not based on an irrigation entitlement which the CEWH purchased in 2012.<sup>56</sup>
- GMMWater’s proposed cost increases are based on its cost estimates for environmental water and not the costs of the Commonwealth’s irrigation entitlements.
- GMMWater’s charges should be calculated based on the WIRO, and the pricing principles set out in our guidance.

For the above reasons, we do not consider the increase in costs proposed by GMMWater signals the costs of the irrigation entitlements held by the CEWH.

We consider that any increase in the charges to the CEWH should be supported by increases in expenditure associated with the CEWH irrigation entitlements.

### Victorian environmental water

A submission by the Victorian Environmental Water Holder (VEWH) noted inconsistencies in charging arrangements for environmental water between water corporations.<sup>57</sup> It also noted inconsistent approaches to how water corporations charged for environmental water services (mainly differences in whether corporations’ treated environmental water services as a prescribed or alternatively, a non-prescribed service).

Our draft decision proposes not to approve GMMWater’s proposed tariff for environmental water services provided to the Victorian Environmental Water Holder. We do not have the power to approve the tariff proposed by GMMWater, as the services not defined as a prescribed service in the WIRO.<sup>58</sup>

### Recreation water

GMMWater proposed:

- an increase in the recreation water contribution charge from \$16 to \$18 per urban and rural residential customer, with a 50 per cent discount applied to concession card holders

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<sup>56</sup> We note that in 2004-05, the Victorian water minister advised us that rural water authorities will not be required to generate a return on past investments. This position recognised that the costs in constructing rural water infrastructure were largely sunk. For this reason, we set the regulatory asset value of GMMWater’s rural assets at zero in 2004-05 – see Essential Services Commission 2006, *Rural water price review – rural and urban water businesses water plans 2006-07 to 2007-08 final decision GMMWater*, p. 19.

<sup>57</sup> Victorian Environment Water Holder 2017, *Submission on water corporation water pricing proposals*, November.

<sup>58</sup> The commission has never regulated Victorian environmental water charges. The charge was implemented by businesses during 2012-13 to 2017-18 as a ministerial directive.

- an increase in the recreation lake water supply charge<sup>59</sup> by 23 per cent during the next regulatory period, from \$20 per megalitre to \$25 per megalitre
- to provide schools with subsidised non-residential water prices funded by the increase to the recreation water contribution charge.

The recreation water contribution charge also subsidises the recreation lake water supply charge and is levied on all residential customers. We approved this tariff structure in our 2013 decision and noted it was supported by customers.<sup>60</sup> We note the continued community support for the retention of, and increase to the recreation water contribution charge from \$16 to \$18.

We sought further information from GMMWater on its proposed increase to the recreation water supply charge. GMMWater responded stating that the price increases for recreation water relate to the cost of service.

We received a submission from the Buloke Shire Council supporting the continuation of the recreation water contribution charge, but opposing the increase to the recreation lake water supply charge. Buloke Shire Council suggested that users of recreation water are already struggling to meet the annual cost of water supply.<sup>61</sup> We consider that GMMWater could propose a transition to the increase in recreation water supply charge that takes into account the interests of low income and vulnerable customers.

### Draft decision

For the reasons set out above, our draft decision proposes to accept GMMWater's proposed tariff structures.

Our draft decision proposes not to approve GMMWater's proposed:

- increase in the charges to the CEWH as we do not consider the increase in costs proposed by GMMWater signals the costs of the irrigation entitlements of the CEWH<sup>62</sup>
- charge applying to environmental water services provided to the VEWH
- price path for the proposed increase in recreation water supply charge as we do not consider the proposed price path takes into account the interests of low income and vulnerable

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<sup>59</sup> The recreation water supply charge is a charge for providing water to recreation lakes and sporting clubs in the region. The charge is mainly levied on councils.

<sup>60</sup> Essential Services Commission 2013, *Price review 2013 – regional urban water businesses final decision*, May.

<sup>61</sup> Buloke Shire Council 2018, *Submission to the GMMWater price submission*, February.

<sup>62</sup> WIRO clauses 11(d)(ii)

customers.<sup>63</sup> We request GMMWater resubmit a price path that takes into account the interests of low income and vulnerable customers.

Prior to our final decision and price determination, GMMWater must submit updated prices in response our draft decision on the revenue requirement, and to reflect our updates to cost of debt and inflation estimates, which we will provide in late April 2018.

## **Adjusting prices**

GMMWater proposed to continue with its existing price adjustment mechanism as set out on page 78 of its price submission.

Our draft decision accepts GMMWater'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>64</sup>

GMMWater has not included adjustments to reflect movements in the cost of debt, as set out in our guidance. We require GMMWater to resubmit revised price adjustment formulas, allowing for adjustments to reflect movements in the cost of debt.

## **New customer contributions**

New customer contributions (or 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 businesses and developers to negotiate a site-specific arrangement.

GMMWater's proposed charges for new customer contributions are set out at pages 78 and 79 of its price submission. GMMWater proposes a baseline assumption that new customer contributions will attract a zero charge, due to low regional growth.

Where a development is of a scale that it requires an increase in capacity, GMMWater will assess the NCC on a 'case by case' basis in line with our NCC pricing principles, as approved in our 2013 determination.<sup>65</sup>

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<sup>63</sup> WIRO clauses 11(d)(iii).

<sup>64</sup> WIRO clauses 8(b)(i)(ii) and (iii).

<sup>65</sup> Essential Services Commission 2016, *Guidance paper*, op. cit., p. 62.



We have reviewed GMMWater’s proposed method of assessing new customer contribution charges on a ‘case by case’ basis in line with our principles and consider this method consistent with the requirements of our guidance. For this reason, our draft decision proposes to accept GMMWater’s proposed method of calculating new customer contribution charges.

## **Financial position**

In approving prices, we must have regard to the financial viability of the water industry.<sup>66</sup> We interpret the financial viability requirements under the *Essential Services Commission Act 2001* (Vic) 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.

GMMWater’s price submission and the supporting financial model provided estimates for key indicators of financial performance. These estimates were based on GMMWater’s assumptions about revenue and expenditure. Our draft decision proposes adjustments to revenue and expenditure. We have reviewed the key indicators of financial performance based on our draft decision. Under our draft decision, we consider GMMWater will generate sufficient cash flow to deliver on service commitments, including financing costs arising from investments to meet service expectations.

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<sup>66</sup> WIRO clause 8(b)(ii) and ESC Act s.8A(1)(b).



### 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.

For the 2018 price review, a water corporation must rate its price submission as 'Leading', 'Advanced', 'Standard' or 'Basic'. The rating is based on an assessment against the Risk, Engagement, Management and Outcomes elements of PREMO. A 'Leading' price submission is allowed the highest return on equity, and a 'Basic' the lowest.

The assessment tool included in our guidance directs a water corporation to consider its level of ambition in relation to matters covered in its price submission, such as proposals related to operating and capital expenditure, the form of price control, and tariffs.

In Chapter 2, we noted our draft decision is to accept GWMWater's proposed return on equity of 4.9 per cent, based on the justification provided for the level of ambition in its price submission. Below, we set out our preliminary assessment of GWMWater's proposed PREMO rating.

#### Our review of GWMWater's PREMO self-rating

GWMWater's proposed PREMO rating, and our draft decision is summarised below.

**Table 3.1** PREMO Rating

	Overall PREMO rating	Risk	Engagement	Management	Outcomes
GWMWater's rating	<b>Advanced</b>	Advanced	Leading	Leading	Advanced
Commission's rating	<b>Advanced</b>	Advanced	Leading	Standard	Advanced

We agree with GWMWater's proposed overall PREMO self-rating of 'Advanced'. This is reflected in the return on equity we propose to approve for GWMWater at page 25. We agree with GWMWater's proposed self-rating for the Risk, Engagement and Outcomes elements of PREMO.

In support of its proposed Engagement, Outcomes Risk self-ratings, we note:

- GWMWater's engagement started early relative to other corporations and provided customers from all parts of its extensive service area with an opportunity to participate and to influence its proposals

- The influence GMMWater's customers had on its proposals. GMMWater's gave its customers a high degree influence on its proposals in the form of its deliberative panel which it authorised to make recommendations to GMMWater's board. The board gave an undertaking to consider all recommendations made by the panel and ultimately accepted most recommendations. Recommendations not accepted were addressed in GMMWater's price submission. Areas of influence included its approach to GSLs, recreation water, and prioritising investments to improve water quality for a number of towns.
- GMMWater's proposed to change from a revenue cap to price cap form of price control, which means the corporation has accepted demand risk on behalf of customers. It also proposed to introduce a new water quality related guaranteed service level, increasing the revenue risk to the water corporation (and increasing accountability for delivering outcomes expected by customers).

Our draft decision proposes a rating of 'Standard' for the Management element of PREMO, rather than the 'Leading' rating proposed by GMMWater.

The Management element of PREMO includes a focus on a water corporation's management of its costs. As part of our review of Management, we look at the direction of controllable costs, a water corporation's commitment to improve efficiency, and whether any proposed increases in costs are justified. We also review the accuracy and reasonableness of the data used to support proposals.

Our main reason for proposing a 'Standard' rating for the Management element of PREMO is that GMMWater's proposed operating expenditure incorporated less ambitious assumptions (relative to others) regarding the improvement in controllable operating costs per connection. We note that its proposed self-rating for Management may have been better supported if it decided to incorporate its aspirational efficiency target (of 2.5 per cent, compared with the assumption included in its forecasts of 1.5 per cent) into its operating expenditure forecasts.

GMMWater also made corrections to its forecast for regulatory depreciation after lodging its price submission. This had the effect of raising GMMWater's forecast of its revenue requirement above the level proposed in its original submission. It also made corrections to expenditure data. For these reasons, our draft decision is to propose a rating of 'Standard' for the Management element of PREMO.

## 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 2018.

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

- additional matters or issues we should consider before making our final decision
- whether our draft decision on GWMWater'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 April or May 2018. Forums provide an opportunity for interested parties to discuss key features of our draft decisions. We will publish details of 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 will be due in early May 2018.

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.

We invite feedback

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

## **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).

- April or May 2018 – public forum.
- 8 May 2018 – closing date for submissions on our draft decision.
- June 2018 – release date for final decision and price determination.

## APPENDIX A – submissions received

Name or organisation	Date received
Buloke Shire Council	27 February 2018
Commonwealth Environmental Water Holder	20 December 2017
Environment Protection Authority Victoria	12 December 20127
Consumer Action Law Centre	15 November 2017
Victorian Environmental Water Holder	9 November 2017
Mr G Mallon	7 November 2017