



# East Gippsland Water draft decision

2023 Water Price Review

30 March 2023



## Acknowledgement

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

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

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

### An appropriate citation for this paper is:

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## Summary

### **Our draft decision considers East Gippsland Water’s proposed prices for a 5-year period starting 1 July 2023**

This draft decision sets out our preliminary views on East Gippsland Water’s price submission.<sup>1</sup> Our draft decision should be read together with East Gippsland Water’s price submission.



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 2023. For details of how to provide feedback, see our dedicated Engage Victoria page: <https://engage.vic.gov.au/water-price-review-2023>.

### **East Gippsland Water will continue to adapt to climate change, and deliver other key customer priorities over the next 5 years**

East Gippsland Water plans to deliver the following outcomes for customers:

- Reliable services, done well
- Fair prices for all
- Improved environmental outcomes
- Prepare for population growth and a changing climate
- Contributing to community.<sup>2</sup>

Among the key initiatives to deliver on its commitments, East Gippsland Water plans to invest in additional water storage to adapt to a changing climate. It also plans to improve environmental outcomes by upgrading wastewater networks and treatment plants to cope with more intense rain events, and continue taking action to achieve net zero emissions by 2035.

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<sup>1</sup> Clause 16 of the Water Industry Regulatory Order 2014 requires the Essential Services Commission to issue a draft decision; East Gippsland Water’s price submission is available on our website at [www.esc.vic.gov.au](http://www.esc.vic.gov.au).

<sup>2</sup> East Gippsland Water, 2023 water price submission, September 2022, p. 33

## **Our draft decision adopts a lower revenue requirement than proposed by East Gippsland Water**

Our draft decision adopts a revenue requirement that will allow East Gippsland Water to deliver on its customer service commitments, government policy, statements of obligations, and obligations monitored by the Environment Protection Authority Victoria and the Department of Health.

East Gippsland Water's approved 2021-22 regulatory accounts identified relatively minor corrections were needed to estimated contributions, affecting the closing regulatory asset base. Our preliminary review also identified a reduction of \$1.9 million to forecast operating expenditure over the 5-year period, compared to East Gippsland Water's proposal (Section 4.1.1).

Adopting these adjustments noted would result in a revenue requirement of \$187.9 million, lower than the \$189.5 million proposed by East Gippsland Water.

In its response to our draft decision, East Gippsland Water must reflect our proposed adjustment to its forecast operating expenditure in its proposed revenue requirement and prices.

East Gippsland Water's revenue requirement may also be impacted by our ongoing review of other elements of its proposals including new customer contributions, energy cost forecasts, and its controllable operating expenditure efficiency improvement rate.

## **In response to our draft decision, East Gippsland Water must consider the inflation environment and the impact on customer prices and bills**

East Gippsland Water, unlike some other water businesses, proposes to increase prices in real terms over the 2023–28 regulatory period, noting under its proposal prices would rise by around 0.3 per cent per year more than inflation, on average. Given this and given that since lodgement of its price submission it has become increasingly likely that a relatively high inflation adjustment will be incorporated into 2023-24 prices, East Gippsland Water must provide us with further information illustrating how it intends to address the impacts of relatively high inflation on its proposed prices and customer bills for 2023-24.<sup>3</sup>

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<sup>3</sup> This is relevant to clause 11(d)(ii) of the Water Industry Regulatory Order 2014 which states that when making a price determination, the commission, in considering the manner in which a regulated entity's prices are to be calculated, determined or otherwise regulated, must have regard to whether prices provide signals about the efficient costs of providing prescribed services to customers (either collectively or to an individual customer or class of customers) while avoiding price shocks where possible.

Prices and estimated bills will also change following our draft decision to reflect updates for inflation and the cost of debt. The March Quarter 2023 annual outcome for the consumer price index due for release in late April 2023, will be added to 2023-24 real prices.<sup>4</sup>

Based on recent inflation outcomes and market expectations, the annual outcome for the March Quarter 2023 consumer price index is likely to be relatively high, noting the rate is expected to fall through 2023 and 2024.<sup>5</sup> For the 2023–28 regulatory period, we have assumed an inflation rate of 3 per cent per year, which is significantly lower than near-term inflation expectations.

Many of the drivers of higher inflation (such as fuel, food and travel) are not major cost items for water businesses. Some high-cost growth areas specific to the water sector such as insurance and chemicals have been accounted for in uplifts to their opening base costs for the 2023–28 regulatory period. Accordingly, it may be the case that the inflation that is added to prices in 2023-24 provides an uplift in revenue that is well above a business's actual costs for the year.

## **Tariff structures will generally remain the same**

For water services, East Gippsland Water proposed a fixed service charge and a variable component that depends on water use. For residential and non-residential sewerage services, East Gippsland Water proposed a fixed service charge only.

Our draft decision is to approve East Gippsland Water's proposed tariff structures, on the basis that they are a continuation its current approach and meet the criteria in our guidance. Specifically, the tariff structures ensure a sustainable revenue stream and are simple to understand. Our review of East Gippsland Water's proposed tariff structures is set out in Section 5.3.1.

East Gippsland Water proposed a price cap form of price control for its water and sewerage tariffs, and a tariff basket form of price control for its major trade waste tariffs. It currently applies a price cap form of price control across all water, sewerage and trade waste tariffs.

Our draft decision is to accept East Gippsland Water's proposed price cap form of price control for water and sewerage tariffs., given this is a continuation of its current approach.

Our draft decision is to accept East Gippsland Water's proposed change to a tariff basket form of price control for its major trade waste tariffs, because it will provide East Gippsland Water with the flexibility for it to propose changes to these tariffs following further engagement with trade waste

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<sup>4</sup> Published by the Australian Bureau of Statistics (All Groups – Australia)

<sup>5</sup> The latest (February 2023) Reserve Bank of Australia Quarterly Statement on Monetary Policy forecast the consumer price index to change (over the year) fall to around 4.8 per cent by December 2023 and 3.2 per cent by December 2024.

customers.<sup>6</sup> Under a tariff basket, any proposed changes would be assessed by us as part of our annual tariff approvals, based on criteria set out in East Gippsland Water's price determination.

East Gippsland Water has proposed a negotiated new customer contribution which would apply when unplanned infrastructure is required to service a connection application. As noted in Section 5.4, we require further information from East Gippsland Water to inform our final decision and determination for its new customer contributions.

## **Our draft decision rates East Gippsland Water's price submission as 'Standard' under the PREMO framework**

Our draft decision is to rate East Gippsland Water's price submission as 'Standard' under the PREMO framework (Table B). This is the same as the business's self-rating of its price submission.

Key factors supporting this PREMO rating include:

- East Gippsland Water generally met expectations for delivery against outcome commitments in the current regulatory period, in a period where it responded to major challenges such as bushfires, very wet conditions in 2021 and the coronavirus pandemic
- East Gippsland Water managed its capital program within the 2018 price review benchmarks and reprioritised during the period to respond to events outside of its control
- the overall suitability of East Gippsland Water's engagement program and the level of influence customers had on its proposals
- evidence that the outcomes proposed by East Gippsland Water were informed by customer feedback on their priorities, such as future droughts, fires and more people living in the region
- the outcomes proposed by East Gippsland Water suggest an improvement in customer services
- the business has committed to reporting annually to customers on how it has performed against its outcome commitments, with its performance against measures and targets reported through the publication of a scorecard on its website.

At its 2018 water price review, we approved a PREMO rating of 'Standard' for East Gippsland Water, which is the same rating proposed in this draft decision.

See Section 1.4 and Chapter 7 for an explanation of the PREMO framework.

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<sup>6</sup> East Gippsland Water noted its intention to undertake a reform of its major trade waste tariffs during the 2023–28 regulatory period following engagement with customers. When proposing to implement its major trade waste reforms, East Gippsland Water should provide the commission with its customer consultation prior to implementing the reform, as part of the annual tariff review and approval of its updated prices.



Our PREMO rating is an assessment of the water business’s price submission and its ambition to deliver outcomes valued by its customers. It is not an assessment of the water business itself.

**Table B** PREMO rating

	Overall PREMO rating	Performance	Risk	Engagement	Management	Outcomes
East Gippsland Water’s self-rating	Standard	Standard	Standard	Standard	Standard	Standard
Commission’s rating	Standard	Standard	Standard	Standard	Standard	Standard

Among the 9 draft decisions we have released so far, East Gippsland Water is one of 4 businesses for which we propose to approve a ‘Standard’ rating (Table C).

**Table C** Draft decision on PREMO — overall rating

Leading	Advanced	Standard	Basic
	Barwon Water Gippsland Water GWMWater South East Water Yarra Valley Water	East Gippsland Water Lower Murray Water South Gippsland Water Westernport Water	

## 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. We expect to release our final decision and price determination in June 2023.

Stakeholders may comment on any aspect of our draft decision, including:

- the information we have relied upon in our assessment (such as East Gippsland Water’s price submission):
- additional matters or issues we should consider before making our final decision
- whether our draft decision on East Gippsland Water’s price submission has adequate regard to the matters in clause 11 of the Water Industry Regulatory Order 2014 and our guidance.

## How to provide feedback and stay up to date

You can stay up to date with our review via the dedicated Engage Victoria website:

<https://engage.vic.gov.au/water-price-review-2023>

You can provide feedback by:

- taking part in a public forum
- providing written comments or submissions.

### Taking part in a public forum

We plan to hold a public forum on 1 May 2023. Forums provide an opportunity for interested parties to discuss key features of our draft decisions. Details of our public forums will be published on the Engage Victoria website.

### Provide written comments or submissions

Written comments or submissions in response to this draft decision will be due by 9 May 2023.

We require submissions by this date so that 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 the dedicated [Engage Victoria website](#).

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

2023 Water Price Review  
Essential Services Commission  
Level 8, 570 Bourke Street  
Melbourne VIC 3000

### Submission and privacy statement

We encourage transparency in our review processes. It is our policy to publish all submissions to the 2023 water price review on the Essential Services Commission website unless the submitter has requested confidentiality. When we publish a submission, we will also include some details about the submitter (your name, not your address) unless the submitter has requested anonymity (does not want to be identified).

You can request confidentiality in relation to your submission. Requesting this may affect the weight we can give to your submission. You may also request anonymity.

## Next steps

Activity	Indicative date
Public forum	1 May 2023
Closing date for submissions on our draft decision	9 May 2023
Release date for our final decision and price determination	June 2023

# 1. Our role and approach to water pricing

## 1.1 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 18 water businesses operating in Victoria.

## 1.2 We are reviewing the proposed prices of 14 water businesses

Our review is of the prices that the 14 water businesses propose to charge customers for prescribed services from 1 July 2023.<sup>7</sup> The prescribed services include retail water and sewerage services, and bulk water and sewerage services delivered by the water businesses.<sup>8</sup>

East Gippsland Water provided a submission to us proposing prices for a 5-year period starting 1 July 2023. Our task is to assess the price submission using the legal framework and make a price determination that takes effect from 1 July 2023. The price determination will specify the maximum prices East Gippsland Water may charge for prescribed services, or the manner in which prices are to be calculated, determined or otherwise regulated. We will also issue a final decision that explains the reasons for our price determination.

## 1.3 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>7</sup> The review excludes Melbourne Water, Goulburn-Murray Water, North East Water and Greater Western Water. In 2021 we approved prices for Melbourne Water to 30 June 2026 and in 2020 we approved prices for Goulburn-Murray Water to 30 June 2024. In 2018, we approved prices for North East Water to 30 June 2026. We have approved an extension to the regulatory period for Greater Western Water to 30 June 2024.

<sup>8</sup> The prescribed services are listed at clause 7(b) of the WIRO.

- the matters set out in section 33(3) of the ESC Act, which include the return on assets, relevant benchmarking and any other matters that the ESC considers relevant
- the matters specified in our guidance<sup>9</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 B 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. Table 1.1 summarises the matters we must have regard to and groups them into themes.

In October 2021, we issued guidance to East Gippsland Water to inform its price submission. The guidance set out how we would assess East Gippsland Water's submission against the matters we must consider under clause 11 of the WIRO. It also outlined our expectation that East Gippsland Water would comply with certain requirements and specified information that East Gippsland Water must provide to us when submitting its price submission.

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 East Gippsland Water's proposed prices.<sup>10</sup>

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

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<sup>9</sup> Essential Services Commission, *2023 water price review: Guidance paper*, 26 October 2021.

<sup>10</sup> This is a requirement of the WIRO, clause 14(b).

<sup>11</sup> This is provided for under the WIRO, clause 14(b)(i).

**Table 1.1 Matters businesses and the commission must have regard to**

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

Continued next page

Table 1.1 (continued)

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

**Note:** References in the table are to the Water Industry Regulatory Order 2014 (WIRO), the Essential Services Commission Act 2001 (ESC Act), and the Water Industry Act 1995 (WI Act).

## 1.4 PREMO

PREMO stands for **P**erformance, **R**isk, **E**ngagement, **M**anagement, and **O**utcomes. Each element of PREMO is summarised in Box 1.1.

### Box 1.1 PREMO

Water businesses must demonstrate their level of ambition in delivering value for money for customers in their price submissions across the five PREMO elements:

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

First introduced at our 2018 water price review, the purpose of PREMO is to provide incentives for water businesses to deliver outcomes most valued by customers. PREMO includes reputation incentives, via the rating of price submissions as Leading (the highest available rating), Advanced, Standard or Basic, depending on the level of ambition expressed by a water business in its price submission. Financial incentives are provided by linking the return on equity to the PREMO rating.

A key priority under PREMO is to provide incentives for a water business to engage with customers to understand their priorities and concerns and take these into account in forming its proposals, as outlined in its price submission. These should be evidenced in price submissions by linking the outcomes proposed with findings from a business's engagement.

Our guidance specifies the way in which we expect water businesses to assess themselves by reference to the PREMO elements.

Our 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>12</sup>

For the 2023 water price review, a water business's ambition in terms of delivering customer value is being assessed against all five elements of PREMO — Performance, Risk, Engagement, Management and Outcomes. This is the first water price review where we are assessing the Performance element of the PREMO framework. The Performance element assesses businesses against their Outcomes and proposals from the previous price review (for our 2023 review, this means proposals at the 2018 water price review). We did not assess the Performance element in 2018 because it was the first time that we had applied the PREMO framework and so we did not have a set of approved Outcomes to inform our assessment.

Taking into account all five elements of PREMO, a water business 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 proposed PREMO rating. A 'Leading' submission has the highest return on equity, and a 'Basic' submission the lowest. We assess the self-rating and also assess the price submission more broadly, including the water business's justification for the proposed PREMO rating, and form our own view of the appropriate rating. This process determines the PREMO rating adopted and the return on equity reflected in the revenue requirement.<sup>13</sup>

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<sup>12</sup> In December 2022, we issued early draft decisions for Yarra Valley Water and Westernport Water.

<sup>13</sup> Essential Services Commission, *2023 water price review: Guidance paper*, pp. 41–46.

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

We have made our draft decision on East Gippsland Water's price submission after considering:

- East Gippsland Water's price submission
- East Gippsland Water's responses to our queries
- our consultants' reports
- written submissions from interested parties (a list of submissions is provided in Appendix A).

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

Our guidance included matters water businesses must address in their price submissions. East Gippsland Water's price submission addressed each of these matters. Our preliminary assessment of these matters is provided in this draft decision.

We found East Gippsland Water's price submission generally presented clear and comprehensive information to support its proposals. East 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 Section 3.1 on customer engagement).

Unless otherwise noted, all financial values referred to in this draft decision paper are in \$2022-23, which means inflation is excluded.



East Gippsland Water must submit a response to our draft decision and provide an updated financial model by 9 May 2023 (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 East Gippsland Water in June 2023.

### 2.1 Draft decision paper outline

This draft decision paper is structured around the steps we take to arrive at our price determination. In summary, these steps are:

- Determine the regulatory period (Section 2.2).
- Confirm the customer outcomes and service levels that East Gippsland Water has committed to over the regulatory period (Chapter 3).

Our assessment of East Gippsland Water's price submission

- Establish East Gippsland Water’s revenue requirement using a building block methodology (Chapter 4).
- Use demand forecasts and the form of price control to convert the revenue requirement to tariffs and prices (Chapter 5).

Chapter 6 outlines our consideration of East Gippsland Water’s financial position, which we have also had regard to.

Chapter 7 outlines our preliminary assessment of East Gippsland Water’s price submission under the PREMO framework.

## 2.2 Regulatory period

Our draft decision is to approve a regulatory period of 5 years from 1 July 2023.

We are required to set the term of the regulatory period over which a water business’s price determination will apply.<sup>14</sup> Our guidance proposed that we set a 5-year regulatory period, but also noted we were open to justified alternatives proposed in a price submission.<sup>15</sup>

East Gippsland Water proposed a regulatory period of 5 years. Accordingly, consistent with the reasons outlined in our guidance, our draft decision proposes to set a regulatory period of 5 years.

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

<sup>15</sup> For detail on the reasons for using 5 years as the default regulatory period, see: Essential Services Commission, *2023 water price review: Guidance paper*, p. 18.

## 3. Customer outcomes

The customer outcomes East Gippsland Water plans to deliver over the regulatory period are a key component of its price submission – confirming its commitments to customers, underpinning its revenue requirement, and feeding in to its PREMO assessment.

This chapter:

- examines East Gippsland Water’s engagement with its customers in preparing its price submission
- reviews whether East Gippsland Water has delivered on the outcomes it committed to for the current regulatory period (2018–23) and examines the customer outcomes East Gippsland Water is committing to for the next regulatory period
- outlines East Gippsland Water’s service standards
- outlines East Gippsland Water’s proposed guaranteed service levels.

### 3.1 Customer engagement

Our guidance required East Gippsland Water to engage with customers to inform its price submission. Our guidance also identified principles to guide East Gippsland Water’s engagement.<sup>16</sup>

We consider East Gippsland Water’s engagement aligned with these principles in a number of ways. East Gippsland Water’s engagement:

- took place between February 2021 and September 2022 and was informed by annual customer surveys and its ongoing work with its customer committee
- included a range of methods such as surveys, focus groups, attendance at community events across the region, face-to-face conversations, discussions with its customer committee and a 3-day deliberative forum
- obtained the views of more than 900 community members and incorporated joint workshops with the East Gippsland Shire Council, business owners and community groups
- covered matters that had a material impact on prices, such as managing ageing assets and growth while maintaining service, and how best to respond to the challenges of climate change
- was inclusive of the experiences of First Nations people and of customers experiencing vulnerability through the input of its local community organisations (Gippsland Lakes Complete Health and Lakes Entrance Aboriginal Health Association, and Anglicare), targeted approaches

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<sup>16</sup> Essential Services Commission, *2023 water price review: Guidance paper*, p. 20.

to disability service providers in East Gippsland, and through the life experiences provided by members of the deliberative forum.

More detail on East Gippsland Water's engagement is available in its price submission.<sup>17</sup>

Actions proposed to be taken by East Gippsland Water provide evidence that its engagement influenced its proposals. For example, in its price submission, East Gippsland Water proposed:

- bringing forward capital works programs (and associated costs) – in response to feedback from the deliberative forum that earlier and gradual price increases would be more manageable for customers
- an increase in funding of hardship support (from \$150,000 each year to \$250,000 each year) – in response to feedback from the deliberative panel that targeted support to people in need would be more helpful to people in need than lower overall prices<sup>18</sup>
- securing more water for the region through investment in additional water storage – to address customer concerns about climate change and population growth.

The influence of East Gippsland Water's engagement on its proposals supports the objectives in our pricing framework relating to efficiency and the interests of consumers.

Our preliminary view is that East Gippsland Water has designed and delivered an engagement program that was sensitive to the experiences of its customers still recovering from the compounding effects of the 2019-20 bushfires and the pandemic. The variety of engagement methods and extensive promotion of its engagement meant customers from across its geographical area had equal opportunity for involvement in a channel and engagement method of their choice. East Gippsland Water involved its Customer Committee early in the planning of its price review process as well as on key aspects of its engagement approach.

We requested further information from East Gippsland Water in relation to how it had tailored its engagement method to suit the content on which it was seeking to engage, specifically its use of deliberation on its forecast expenditure. In giving effect to the principle regarding tailored engagement set out in our guidance, we expect water businesses to use deliberative processes for more collaborative and empowered forms of engagement that offer customers meaningful opportunities to influence the outcome of the engagement. However, in its price submission we saw no evidence that East Gippsland Water had considered the outcomes of its deliberative engagement in developing its forecast expenditure. East Gippsland Water provided further information that satisfied us that customer preferences gained through the deliberative forum did in

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<sup>17</sup> East Gippsland Water's price submission is available on our website at [www.esc.vic.gov.au](http://www.esc.vic.gov.au).

<sup>18</sup> These figures are in nominal terms, that is, they will not increase further with inflation.

fact influence how costs are spread across the regulatory periods and our preliminary view is that its engagement is consistent with the principles set out in our guidance.

We also considered feedback from the Consumer Action Law Centre regarding the limited scope and duration of East Gippsland Water’s deliberative forum, and the need for visibility over information and expertise available to forum members in forming their views. We agree that issues explored in its deliberative forum were narrow in focus. Yet as mentioned above, we also recognise those issues had substantive effects on services and the affordability of bills, which is consistent with the objectives of the framework.

During our review, East Gippsland Water provided further information showing the instructions and information it provided to its engagement participants, including members of its deliberative forum. We found the material to be of a high quality and conducive to good decision making on these key issues.

Based on the above, our preliminary view is that we agree with East Gippsland Water’s self-rating of ‘Standard’ for its price submission engagement. See Chapter 7 for more detail on our PREMO assessment of East Gippsland Water’s price submission.

## **3.2 Outcomes**

### **3.2.1 Performance against outcome commitments 2018–23**

As part of our 2018 water price review, East Gippsland Water established ‘outcomes’ it would deliver customers over the following 5 years. These outcomes were reflected in the prices we approved for the period 1 July 2018 to 30 June 2023. Progress against these outcome commitments can indicate whether customers got what they paid for.

A business’s price submission should account for its actual performance against its outcome commitments for the current period, from 1 July 2018 to 30 June 2023.<sup>19</sup>

We acknowledge that East Gippsland Water accounted for both its annual performance for each measure in its price submission, as well as its overall rating against each outcome for the period to date.

Table 3.1 lists East Gippsland Water’s outcome commitments and includes its annual performance results and period-to-date rating as reported in its price submission.<sup>20</sup> The information in this table informs our assessment under the Performance element of PREMO, which is discussed in Chapter 7.

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<sup>19</sup> Essential Services Commission, 2023 water price review: Guidance paper, 26 October 2021, p. 23.

<sup>20</sup> East Gippsland Water, 2023 water price submission, September 2022, p. 9.

**Table 3.1 Business self-assessment of performance against Outcome commitments**

Outcome	2018-19	2019-20	2020-21	2021-22	Period to date <sup>a</sup>
Current levels of water and sewerage services maintained	Green	Amber	Green	Amber	Green
Safe, high quality drinking water supplies delivered	Green	Green	Amber	Green	Green
No increase in the average customer bill	Green	Green	Green	Green	Green
Supporting environmental sustainability	Amber	Red	Green	Amber	Amber
Enhanced liveability and resilience in our region	Green	Green	Green	Green	Green

**Note:** Green = achieved target; Amber = close to achieving target; Red = failed to meet target. <sup>a</sup> This is East Gippsland Water’s self-assessment of its performance across the first 4 years of the current regulatory period. East Gippsland Water’s performance against Outcome commitments in the final year of the current regulatory period (2022-23) will be published in our 2022-23 Outcomes Report.

East Gippsland Water considers it has performed well for the period to date, particularly noting bushfires and wet weather affecting its region during the regulatory period, meeting its outcome commitments for four of its five customer outcomes. Its customer committee endorsed its period to date outcome ratings for its price submission.<sup>21</sup>

East Gippsland Water almost met its ‘supporting environmental sustainability’ outcome for the period to date. In its 2021-22 outcomes report it noted that failure to meet this outcome was due to falling short on its targets for the value of grants it issued under its native vegetation fund, which was primarily driven by a lack of community appetite to take up the grants. Additionally, East Gippsland Water did not meet its CO<sub>2</sub> emission targets for the first 2 years of the regulatory period, which affected its overall rating. Despite this, we acknowledge that East Gippsland Water has met its CO<sub>2</sub> emission targets in 2020-21 and 2021-22.<sup>22</sup>

East Gippsland water’s traffic light scores for each outcome are endorsed annually by its customer committee, demonstrating its commitment to transparent and honest performance reporting. We also consider its self-assessments for the 4 reporting years were reasonable and well explained.

In the current regulatory period, East Gippsland Water demonstrated ownership of its performance by reporting its annual performance results prominently on the homepage of its website.

<sup>21</sup> East Gippsland Water, 2023 water price submission, September 2022, pp. 9 and 10.

<sup>22</sup> East Gippsland Water, 2023 water price submission, September 2022, p. 10; Essential Services Commission, East Gippsland Water’s outcomes performance 2021-22, October 2022, p. 7.

On the basis that its self-assessment is consistent with our reviews included in our Outcomes reporting during the current regulatory period, our draft decision is that we agree with East Gippsland Water's self-assessment that it has, overall, met its outcome commitments for the period to date.

### 3.2.2 Outcome commitments for 2023–28

East Gippsland Water engaged with its customers to refine its outcomes for the period from 1 July 2023 to 30 June 2028. It has established five customer outcomes it proposes to deliver:

- Reliable services, done well
- Fair prices for all
- Improved environmental outcomes
- Prepare for population growth and a changing climate
- Contributing to community.<sup>23</sup>

Among the key initiatives to deliver on its commitments, East Gippsland Water will invest in additional water storage to adapt to a changing climate. It will also improve environmental outcomes by upgrading wastewater networks and treatment plants to cope with more intense rain events and it will continue taking action to achieve net zero emissions by 2035.

### 3.2.3 Our assessment of measures and targets

East Gippsland Water proposed a set of 15 measures and targets that it will use to report on performance across the 5 outcomes. These are set out in Appendix A, page 81 of its price submission. Performance against these measures will inform our assessment during future price reviews.

We have assessed East Gippsland Water's proposed measures against the criteria set out in our guidance which states that proposed output measures for each outcome must:

- be relevant to, or be a reasonable proxy for, the delivery of the outcome they represent
- be measurable
- be clearly defined and unambiguous
- be easy for customers to understand
- have performance targets listed for each year of the regulatory period.<sup>24</sup>

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<sup>23</sup> East Gippsland Water, 2023 water price submission, Appendix A, September 2022, p. 81.

<sup>24</sup> Essential Services Commission, 2023 water price review: *Guidance paper*, 26 October 2021, p. 23

Evidence provided by East Gippsland Water demonstrates that these measures and targets were developed in consultation with its customers, and that they are supported by its customers.

Generally, we consider East Gippsland Water's intentions are clear, and its measures and targets will provide a sound basis to track performance and delivery against each outcome. However, we identified a small number of targets require greater clarity.

We will provide East Gippsland Water with our standard Outcomes Reporting Template, identifying the matters to be addressed, to complete and submit with its response to this draft decision.

In our preliminary view, East Gippsland Water's proposed targets for its outcome measures suggest an improvement in customer value.

East Gippsland Water has committed to reporting annually to customers on how it has performed against its outcome commitments. Its performance against its measures and targets will continue to be reported through the publication of a scorecard on its website.<sup>25</sup>

Our draft decision is to accept East Gippsland Water's self-assessment of 'Standard' for the Outcome element of PREMO, which is discussed further in Chapter 7.

### **3.3 Service Standards related to service reliability and faults**

Service Standards are a common set of services applicable to all Victorian consumers required under Clause 18.2 of the Water Industry Standard – Urban Customer Service (Water Industry Standard). Each water business must specify its own targets against each of these Service Standards. Rather than performance measures, these Service Standards and corresponding service levels are the minimum level of service customers can expect to receive.

East Gippsland Water's Service Standards relating to reliability and faults can be found in its Proposed Service Standards 2023–28 document.<sup>26</sup>

The service standards proposed by East Gippsland Water are the same as those for the current 2018–23 regulatory period (with some wording changes required by the updated Urban Water Industry Standard). East Gippsland Water has also provided the minimum flow rates as required by the Urban Water Industry Standard.

East Gippsland Water has updated four of the specified service levels to reflect actual average response time to ensure that it is a more realistic reflection of its current performance. This has been informed by customer preferences.

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<sup>25</sup> East Gippsland Water, 2023 water price submission, September 2022, p. 33.

<sup>26</sup> East Gippsland Water, Proposed Service Standards 2023–28 document, 10 February 2023. This document is available on our website.

Our preliminary assessment is that the Service Standards relating to reliability and faults proposed by East Gippsland Water comply with the requirements of the Urban Water Industry Standard.

Service Standards are approved in our Water Industry Standard. Accordingly, in early 2023-24, we will update the Water Industry Standard to reflect approved Service Standards.

### 3.4 Guaranteed service levels

Our draft decision is to accept East Gippsland Water's proposed guaranteed service levels.

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

East Gippsland Water's proposed guaranteed service levels are set out on pages 33 to 35 of its price submission. East Gippsland Water empowered its customer committee to review and settle its guaranteed service level scheme.<sup>27</sup> It has proposed six guaranteed services, five of which are the same as the current regulatory period in terms of the description of the service and the level of the rebate.

East Gippsland Water has proposed to replace the service level relating to native vegetation grants with water efficiency rebates, reflecting the advice of its customer committee.

The water efficiency rebate is a program to encourage customers to claim rebates on water efficient products. This is a planned program rather than a commitment to a specified level of service with accountability through a rebate or payment to customers or the community. As such, we propose not to include the water efficiency rebate commitment in the list of approved guaranteed service level payments in Schedule Two of the Water Industry Standard – Urban Customer Service. East Gippsland Water has committed to report on the allocation of funds for the water efficiency rebates at least annually.<sup>28</sup>

For the reasons set out above, our draft decision is to accept East Gippsland Water's proposed guaranteed service levels, with the exception of the inclusion of the water efficiency rebate program. Final guaranteed service levels will be subject to our consideration of any feedback following the release of our draft decision.

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<sup>27</sup> East Gippsland Water, 2023 water price submission, September 2022, p. 33.

<sup>28</sup> East Gippsland Water, 2023 water price submission, September 2022, p. 39.

Guaranteed service levels are approved in our water industry standards. Accordingly, in early 2023-24, we will update the standards to reflect the guaranteed service levels published in our final decision.

## 4. Revenue requirement

The revenue requirement is the forecast amount a water business needs to deliver on customer outcomes, government policy, statements of obligations, and obligations monitored by technical regulators including the Environment Protection Authority Victoria and the Department of Health.<sup>29</sup> Along with forecast demand, it is an input to calculating prices.

We have used a building block methodology to establish the revenue requirement. This chapter outlines our assessment of East Gippsland Water's revenue requirement based on the following steps:

- establish an efficient benchmark level of forecast operating expenditure for the next regulatory period (Section 4.1)
- establish an efficient benchmark level of forecast capital expenditure for the next regulatory period (Section 4.2)
- roll-forward the regulatory asset base (Section 4.3)
- apply a rate of return to the regulatory asset base, calculated using:
  - a benchmark cost of debt estimated using a 10-year trailing average approach (Section 4.4.1)
  - a benchmark return on equity value determined by East Gippsland Water's PREMO rating (Section 4.4.2)
- establish a return of capital through a regulatory depreciation allowance (Section 4.5)
- establish a benchmark tax allowance (Section 4.6).

Our draft decision adopts a revenue requirement of \$187.9 million, which is lower than the \$189.5 million proposed by East Gippsland Water.

East Gippsland Water's price submission proposed a revenue requirement of \$189.5 million over a 5-year period starting 1 July 2023.

In East Gippsland Water's approved regulatory accounts for 2021-22 we identified relatively minor corrections were needed to estimated contributions, affecting the closing regulatory asset base, which in turn affects regulatory depreciation, and the return on assets (the adjustments add around \$0.2 million to the revenue requirement in the 2023–28 regulatory period).

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<sup>29</sup> We met with officers of the Department of Energy, Environment and Climate Action, the Department of Health, and the Environment Protection Authority Victoria, to discuss their expectations of East Gippsland Water in the regulatory period from 1 July 2023. We had regard to their views in arriving at our draft decision.

Our preliminary review also identified reductions of \$1.9 million to forecast operating expenditure over the 5-year period, compared to East Gippsland Water’s proposal (see Section 4.1.1).

Our draft decision adopts a revenue requirement of \$187.9 million, reflecting these proposed adjustments (Table 4.1). The individual adjustments we propose are set out at Table 4.2

**Table 4.1 Draft decision on East Gippsland Water’s revenue requirement**  
\$ million 2022-23

	2023-24	2024-25	2025-26	2026-27	2027-28	Total
Operating expenditure	25.01	24.96	25.04	25.03	25.02	125.06
Return on assets	4.84	4.86	5.04	5.19	5.41	25.35
Regulatory depreciation	5.89	6.61	7.39	8.08	8.93	36.91
Non-prescribed revenue offset of revenue requirement	-0.06	-0.06	-0.06	-0.06	-0.06	-0.30
Tax allowance	0.04	0.10	0.17	0.23	0.29	0.83
<b>Draft decision – revenue requirement</b>	<b>35.73</b>	<b>36.47</b>	<b>37.58</b>	<b>38.47</b>	<b>39.60</b>	<b>187.85</b>

**Note:** Numbers have been rounded.

East Gippsland Water’s revenue requirement may also be impacted by our ongoing review of other elements of its proposals including new customer contributions and its controllable operating expenditure efficiency improvement rate.

Our final decision on East Gippsland Water’s revenue requirement will be based on the latest available information. Accordingly, as well as responding to our draft decision and providing an updated price schedule, East Gippsland Water must update its revenue requirement and prices to reflect our updates to estimates for the cost of debt and inflation, which we will advise in April 2023.

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 that impact on its forecast costs and the revenue requirement, East Gippsland Water should update its price submission and provide us with an updated financial model. It also should notify us of any material changes that impact its forecast costs, revenue requirement or prices (including demand). Any updates to its submission or pricing model will be made publicly available on our website.

**Table 4.2 Our proposed adjustments to East Gippsland Water’s proposed revenue requirement**

\$ million 2022-23

	2023-24	2024-25	2025-26	2026-27	2027-28	Total
<b>A. East Gippsland Water’s proposed revenue requirement</b>	<b>35.95</b>	<b>36.75</b>	<b>37.92</b>	<b>38.87</b>	<b>40.05</b>	<b>189.55</b>
B. Operating expenditure	-0.27	-0.33	-0.38	-0.44	-0.49	-1.91
C. Return on assets	0.02	0.02	0.02	0.01	0.01	0.08
D. Regulatory depreciation	0.02	0.02	0.02	0.02	0.02	0.12
E. Tax allowance	0.003	0.003	0.003	0.003	0.003	0.016
<b>F. Draft decision – revenue requirement (A+B+C+D+E)</b>	<b>35.73</b>	<b>36.47</b>	<b>37.58</b>	<b>38.47</b>	<b>39.60</b>	<b>187.85</b>

**Notes:** Our proposed adjustments are the differences between our draft decision and what East Gippsland Water proposed in its price submission. Row A shows the total revenue requirement proposed by East Gippsland Water in its price submission. We have arrived at our draft decision (row F) by proposing the relevant adjustments to the components of the revenue requirement shown in rows B to E. Numbers have been rounded.

## 4.1 Operating expenditure

Our draft decision is to adopt a forecast operating expenditure benchmark of \$125.1 million, which is \$1.9 million lower than proposed by East Gippsland Water.

Operating expenditure is a component of the revenue requirement. East Gippsland Water’s price submission provides detail on its forecast operating expenditure from pages 45 to 51.

We assess both:

- controllable operating expenditure – comprising all costs that can be directly or indirectly influenced by a water business’s decisions
- non-controllable operating expenditure – comprising all costs that cannot be directly or indirectly influenced by a water business’s decisions.

We engaged FTI Consulting to provide expert advice to inform our assessment of controllable operating expenditure. FTI Consulting’s report on its assessment of East Gippsland Water’s expenditure forecast is available on our website.<sup>30</sup>

Table 4.3 sets out our draft decision on East Gippsland Water’s forecast operating expenditure, for the purpose of establishing the revenue requirement outlined in Table 4.1.

**Table 4.3 Draft decision – operating expenditure**  
\$ million 2022-23

	2023-24	2024-25	2025-26	2026-27	2027-28	Total
<b>Controllable operating expenditure</b>	<b>23.34</b>	<b>23.38</b>	<b>23.51</b>	<b>23.57</b>	<b>23.56</b>	<b>117.36</b>
<b>Non-controllable operating expenditure</b>	<b>1.67</b>	<b>1.58</b>	<b>1.53</b>	<b>1.46</b>	<b>1.46</b>	<b>7.70</b>
Environmental contribution <sup>b</sup>	1.60	1.51	1.47	1.40	1.40	7.37
Licence fees – Essential Services Commission <sup>c</sup>	0.02	0.02	0.02	0.02	0.02	0.12
Licence fees – Department of Health <sup>c</sup>	0.01	0.01	0.01	0.01	0.01	0.06
Licence fees – Environmental Protection Authority <sup>c</sup>	0.03	0.03	0.03	0.03	0.03	0.14
<b>Draft decision – operating expenditure</b>	<b>25.01</b>	<b>24.96</b>	<b>25.04</b>	<b>25.03</b>	<b>25.02</b>	<b>125.06</b>

**Notes:** Numbers have been rounded. <sup>a</sup> Bulk services covers the supply of bulk water and sewerage services.

<sup>b</sup> Environmental contributions are funds collected from water businesses under the *Water Industry Act 1994*. <sup>c</sup> Licence fees are paid to cover costs incurred by the Department of Health, the Environment Protection Authority Victoria, and the Essential Services Commission in their regulatory activities related to the water business.

Table 4.4 summarises how our draft decision on East Gippsland Water’s operating expenditure (row D) and its two components differ from the operating expenditure proposed by East Gippsland Water in its price submission (row A). Rows B and C of the table summarise our proposed adjustments to East Gippsland Water’s proposed controllable and non-controllable operating expenditure.

Details of our assessment and reasons for our proposed adjustments to East Gippsland Water’s proposal are included in Section 4.1.1 (controllable operating expenditure) and Section 4.1.2 (non-controllable operating expenditure).

<sup>30</sup> FTI Consulting, *East Gippsland Water – Expenditure Review for 2023 water price review*, February 2023.

We consider the operating expenditure proposed in our 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 East Gippsland Water's price submission.

The operating expenditure that we propose to adopt for East Gippsland Water does not represent the amount that East Gippsland Water is required to spend or allocate to particular operational, maintenance and administrative activities. Rather, it is a benchmark that 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.

**Table 4.4 Our proposed adjustments to East Gippsland Water's proposed operating expenditure**  
\$ million 2022-23

	2023-24	2024-25	2025-26	2026-27	2027-28	Total
<b>A. East Gippsland Water's proposed total operating expenditure</b>	<b>25.3</b>	<b>25.3</b>	<b>25.4</b>	<b>25.5</b>	<b>25.5</b>	<b>127.0</b>
<b>B. Our total proposed adjustments to controllable operating costs (B1+B2)</b>	<b>-0.3</b>	<b>-0.3</b>	<b>-0.4</b>	<b>-0.4</b>	<b>-0.5</b>	<b>-1.9</b>
B1 – annual efficiency rate lift to 1 per cent p.a.	-0.1	-0.1	-0.2	-0.2	-0.3	-0.8
B2 – salary increases beyond baseline year	-0.2	-0.2	-0.2	-0.2	-0.2	-1.1
<b>C. Our total proposed adjustments to non-controllable operating costs</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>D. Draft decision – total operating expenditure (D = A + B + C)</b>	<b>25.0</b>	<b>25.0</b>	<b>25.0</b>	<b>25.0</b>	<b>25.0</b>	<b>125.1</b>

**Notes:** Our proposed adjustments are the differences between our draft decision and what East Gippsland Water proposed in its price submission. Row A shows the total operating expenditure proposed by East Gippsland Water in its price submission. We have arrived at our draft decision (row D) by proposing the relevant adjustments to controllable operating costs and non-controllable operating costs shown in rows B and C (and itemised in rows B1 and B2). Numbers have been rounded.

### 4.1.1 Controllable operating expenditure

East Gippsland Water proposed a total forecast controllable operating expenditure of \$119.27 million over a 5-year regulatory period. For the reasons set out below, we propose to adopt a forecast operating expenditure of \$117.36 million for the 2023–28 regulatory period, which is \$1.90 million lower than proposed by East Gippsland Water.

East Gippsland Water's forecast controllable operating expenditure for the period from 1 July 2023 is estimated through a series of steps:

1. Establish a controllable operating expenditure baseline – the baseline comprises the efficient recurring costs from the last full year of data (2021-22) after non-controllable expenditure, one-off items are removed or normally occurring items are added in.
2. Apply a growth rate for operating expenditure for the regulatory period – assumed by East Gippsland Water to be 1.48 per cent per year.
3. Apply an annual cost efficiency improvement rate – assumed by East Gippsland Water to be 0.75 per cent per year.
4. Make adjustments for additional costs or cost saving expected in future years.

#### 4.1.1.1 Baseline controllable operating expenditure

East Gippsland Water has proposed a controllable operating expenditure baseline of \$21.7 million, after removing \$1.6 million in non-recurring operating expenditure that occurred in 2021-22. East Gippsland Water's proposed baseline is \$1.8 million (or 9 per cent) higher than the benchmark figure of \$19.9 million of controllable operating expenditure for 2021-22 used for our 2018 price determination.

Under the commission's framework, a business bears the risk of operating expenditure above the benchmark figure (in other words, the expenditure above the benchmark is not reflected in customer prices in a regulatory period). However, a key step in our review is to ensure that a business's proposed expenditure in the 2021-22 year reflects only ongoing prudent and efficient costs, as this is used as the baseline to estimate future operating costs.

Our expenditure consultant requested substantiation of East Gippsland Water's proposed increase to its baseline year operating expenditure benchmark.<sup>31</sup> East Gippsland Water explained the increase was due to a number of factors including shifting priorities due to bushfires, the coronavirus pandemic, wet weather and trade shortages.

Our expenditure consultant verified these additional costs were recurring and found East Gippsland Water's substantiation of these costs to be reasonable. Accordingly, it recommended

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<sup>31</sup> FTI Consulting, *East Gippsland Water – Expenditure Review for 2023 water price review*, February 2023, pp. 15–18.

accepting East Gippsland Water's proposed baseline increase with no adjustments required. We reviewed East Gippsland Water's proposal and the advice from our expenditure consultant.

Based on our own review of East Gippsland Water's proposals and advice from FTI Consulting, we consider East Gippsland Water's proposal reflects an efficient baseline cost to forecast annual operating expenditure for the purpose of our draft decision.

#### **4.1.1.2 Efficiency improvement and growth rate**

East Gippsland Water proposed an average efficiency improvement rate on its controllable operating costs of 0.75 per cent per annum. This is lower than many other businesses in the current price review.

The efficiency improvement rate is also lower than East Gippsland Water's proposed average cost growth rate of 1.48 per cent per annum, effectively delivering a net annual increase to its controllable annual baseline operating costs in each year of the regulatory period.

The PREMO framework provides water businesses with flexibility to propose the efficiency rate to be reflected in their controllable operating expenditure forecasts. We consider it is reasonable to expect businesses to improve the efficiency of delivery for ongoing or business-as-usual expenditure, consistent with the objectives related to efficiency in the Water Industry Regulatory Order 2014.<sup>32</sup>

The efficiency improvement rate reflected in a business's operating expenditure forecast are a key element for the assessment of the Management element of PREMO. Our guidance noted that an efficiency rate of around 1.4 per cent would be an example of a 'Standard' price submission.<sup>33</sup>

Our draft decision is to not accept East Gippsland Water's proposed efficiency rate.

Our draft decision adopts an efficiency improvement rate of 1 per cent per annum, instead of the 0.75 per cent adopted by East Gippsland Water. We have adopted 1 per cent per annum given that most other water businesses in the current review have identified an efficiency rate of at least 1 per cent per annum. This suggests a rate of 1 per cent should be achievable by East Gippsland Water. It is also the minimum rate we expected water businesses to incorporate prior to PREMO. We have also not adopted a rate higher than 1 per cent in our draft decision noting the business has had to respond in the current period to drought, bushfires and flooding, and because East Gippsland Water's price submission also identified that in addition to its 0.75 per cent efficiency rate, savings from energy efficiency projects and improvements in asset management were

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<sup>32</sup> See for example, clauses 8(b)(ii) and 8(b)(iii) of the Water Industry Regulatory Order.

<sup>33</sup> Essential Services Commission, *2023 water price review: Guidance paper*, 26 October 2021, p. 82

separately embedded into its operating cost forecasts.<sup>34</sup> However, it is not clear to us how these have been reflected in East Gippsland Water's operating cost forecasts.

In response to our draft decision, East Gippsland Water must resubmit its forecasts for controllable operating expenditure, reflecting an efficiency rate of at least 1 per cent per annum.

Alternatively, it must demonstrate how its proposed efficiency improvement rate meets the efficiency objectives of the Water Industry Regulatory Order 2014 – in part, this may be achieved by providing us with greater clarity on how its efficiencies from energy efficiency projects and improvements in asset management have been reflected in its forecasts.

#### **4.1.1.3 Cost adjustments**

East Gippsland Water has proposed additional forecast operating expenditure above the annual baseline, including:

- \$1.79 million in IT security enhancements to address cyber security requirements
- \$1.06 million for IT foundation architecture expenditure to implement its ICT Strategy, Data Strategy and Roadmap
- \$0.88 million in Software as a Service (SaaS) fees
- \$1.20 million for additional electricity costs and to meet Victorian Government requirements on sourcing renewable energy
- \$1.09 million for further salary increases above the baseline forecast to attract and retain staff
- \$0.79 million for additional sewerage team members and \$0.45 million for a Trade Waste Officer to meet service standards and compliance obligations
- \$0.70 million for a Process and Performance Improvement Specialist to focus on activities in relation to treatment, including compliance and efficiency
- \$0.50 million for an Emissions Offset position as identified under its Climate Change Strategy
- \$0.45 million for additional customer hardship support
- \$0.40 million in operating expenditure associated with the Groundwater Monitoring project
- \$0.19 million in operating expenditure associated with new capital projects
- \$0.02 million for Professional Engineers registration fees

The above costs represent an additional \$9.2 million over the regulatory period, or an average of \$1.8 million per annum.

Our expenditure consultant reviewed each of the proposed forecast variations above the baseline and requested further information from East Gippsland Water, including a further breakdown by

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<sup>34</sup> East Gippsland Water, 2023 water price submission, September 2022, p. 49

individual cost item where required, along with documentation that supported the prudence and efficiency of each cost item.

Our expenditure consultant assessed each forecast variation against criteria for prudent and efficient operating expenditure and was satisfied each item was appropriately costed and supported by internal documentation, which included evidence of its prudence and efficiency. It therefore considered that East Gippsland Water's proposed additions were mostly reasonable and recommended only one change to the regulatory costs step change listed above.

Our consultant recommending removing the \$0.02 million for Professional Engineers registration fees because it was an immaterial amount and covered within the baseline expenditure allowance. While we agree with this view, we consider our proposed adjustment to the operating efficiency improvement rate is more appropriate than removing minor expenditure claims.

We have considered the advice from our expenditure consultant, and East Gippsland Water's proposal.

Our draft decision is to not accept East Gippsland Water's proposed variation above the baseline to accommodate salary increases to attract and retain staff, because we consider wage increases above inflation should be managed by water businesses through productivity improvements or through the growth allowance applied to 2021-22 baseline year costs. This is consistent with our approach in past price reviews.<sup>35</sup>

Since East Gippsland Water's price submission lodgement, and our receipt of FTI Consulting's final expenditure review report, it has become increasingly likely that inflation will remain relatively high, and well above the 3.0 per cent forecast we have assumed for the 2023-24 regulatory period. East Gippsland Water's current enterprise agreement allows for a 2 per cent per year increase (noting this expires in September 2025). We consider the higher inflation outcome to be added to real prices in 2023-24 will likely help cover any increases in salary rates.

#### **4.1.2 Non-controllable operating expenditure**

Our process for establishing non-controllable operating expenditure involves:

- obtaining the most recent information from the relevant regulatory authorities on their licence fees and the environmental contribution
- adjusting the forecasts proposed by East Gippsland Water where required.

The values we have adopted for our draft decision are set out above in Table 4.3.

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<sup>35</sup> See for example, Essential Services Commission 2018, Central Highlands Water draft decision: 2018 Water Price Review, 28 March, p. 13

East Gippsland Water has proposed \$7.7 million in non-controllable operating expenditure over the 2023–28 regulatory period. This is a decrease of \$1.03 million compared to the 2018–23 regulatory period, driven by a decrease of \$1.06 million due to forecast decreases in the real value of the environmental contribution.

Our guidance paper sets out our approach for businesses to forecast their non-controllable operating costs. We consider businesses should forecast licence fees for the Department of Health, the Environment Protection Authority Victoria and the Essential Services Commission to remain flat in real terms, and for the environmental contribution to remain flat in nominal terms (decline in real terms) across the 2023–28 regulatory period. East Gippsland Water has followed this approach in its price submission.

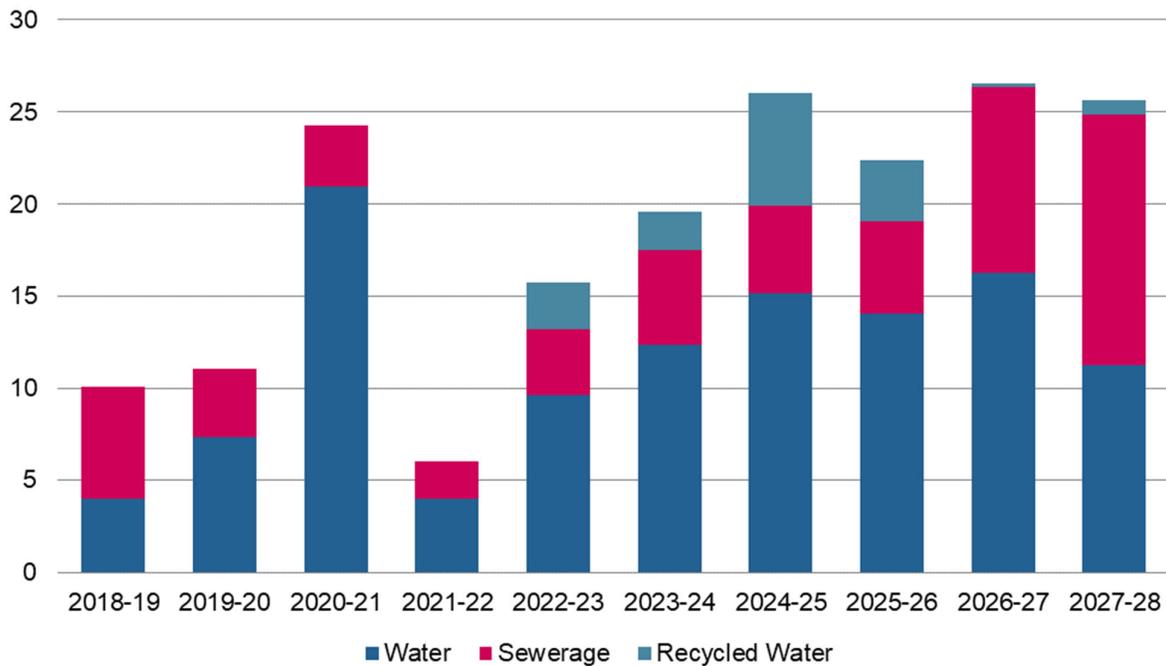
Based on the above, and consistent with the reasoning in our guidance paper, our draft decision is to accept East Gippsland Water’s proposed non-controllable operating expenditure. Prior to making our final decision, we will update the forecast licence fee and environmental contribution values with the relevant regulatory bodies and adjust where necessary for the latest inflation data.

## 4.2 Capital expenditure

Our draft decision is to accept East Gippsland Water’s proposed forecast capital expenditure of \$120.2 million between 2023-24 and 2027-28.

Capital expenditure is an input to estimating the regulatory asset base, which is an input to the revenue requirement. East Gippsland Water’s forecast capital expenditure and supporting information is provided at pages 52 to 64 of its price submission. Figure 4.1 shows East Gippsland Water’s actual gross capital expenditure for 2017-18 and the first 4 years of the current regulatory period (2018-19 to 2021-22) and forecast gross capital expenditure from 2022-23 to 2027-28. The first 5 years of actual expenditure shown in Figure 4.1 (2017-18 to 2021-22) is relevant to the calculation of the closing regulatory asset base discussed in Section 4.3.1.

**Figure 4.1 Gross capital expenditure by service category**  
\$ million 2022-23



**Note:** This graph shows actual figures for 2017-18 to 2021-22, and East Gippsland Water's forecasts for 2022-23 to 2027-28.

We engaged FTI Consulting to provide expert advice to inform our assessment of capital expenditure. FTI Consulting's report on its assessment of East Gippsland Water's expenditure forecast is available on our website.<sup>36</sup>

#### 4.2.1 Actual capital expenditure

The PREMO framework involves reviewing a business's actual performance over the current regulatory period, against its proposals and commitments made to its customers in its previous price submission. This includes a comparison of its actual capital expenditure against the benchmark expenditure forecasts for the current regulatory period.

Over the period from 2017-18 to 2021-22, East Gippsland Water incurred capital expenditure in net terms of \$60.5 million, \$3.8 million or 6 per cent below the benchmarks adopted at the 2018 price review. For 2022-23 (which represents a forecast), it is expected to incur expenditure of \$15.8 million, consistent with its benchmark forecast.

<sup>36</sup> FTI Consulting, *East Gippsland Water: Review of expenditure forecasts – 2023 water price review*, February 2023.

East Gippsland Water's price submission included an explanation of its performance in delivering its capital expenditure program in the current regulatory period, relative to its benchmark. It noted that its performance has been significantly impacted by several factors outside of its control, including drought and subsequent bushfires and the need to undertake unplanned works to respond to these events, the impacts of the coronavirus pandemic, and subsequent supply chain issues and increasing input costs (fuel, materials, and labour costs).

East Gippsland Water's price submission also provided an updated summary of its top 10 capital projects and their status compared to the project timelines noted in its major capital projects report as at the end of June 2022.<sup>37</sup> The main change to the expected project timelines noted in its 2021-22 status of major projects supplement has been the completion of one delayed project. As at September 2022, East Gippsland Water reported that of the 10 major projects proposed for the 2018–23 regulatory period, 4 were completed, 2 are on schedule, 1 is delayed (but on track for completion in 2022-23) and the following 3 projects are delayed or deferred to 2023–28:

- Lindenow storage water quality improvement project is delayed due to a change in scope requiring additional tank volume following a revision of system demand. It is now expected to be completed in 2023-24.
- Paynesville recycled water storage and irrigation augmentation is delayed due to unplanned discharges in 2021 and 2022 highlighting the need for greater storage capacity to respond to wet weather conditions, protect the environment and manage increased inflows. The project is expected to be completed in 2024-25.
- Dinner Plain recycled water storage augmentation is deferred pending the finalisation of its design following the completion of some sewer network works that may reduce the volume of storage required. The project is expected to be completed over 2027–30.

In addition to the above, 2 projects were carried over from 2013–18 with the Bairnsdale wastewater treatment plant upgrade completed in 2018-19 and the Paynesville main supply pipeline (stage 2) project re-scoped and rescheduled as a new project that was completed in 2021-22.

#### 4.2.2 Forecast Capital Expenditure

For the reasons set out below, our draft decision is to accept the forecast capital expenditure of \$120.2 million proposed by East Gippsland Water for the purpose of calculating its revenue requirement:

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<sup>37</sup> Essential Services Commission, *Status of Major Projects Supplement: Outcomes report 2021-22*, 18 October 2022, pp. 9–11. East Gippsland Water's major projects are reported by the business as part of our annual outcomes reporting process, as part of its commitment to communicate the delivery of its major projects to its customers. The business's comments are not audited by the commission.

- East Gippsland Water’s price submission provided evidence that its forecasts for capital expenditure are prudent and efficient. It’s total proposed capital expenditure is \$52.9 million (78.6 per cent) higher than its capital expenditure in the current 2018–23 period and \$41.1 million (51.9 per cent) higher than the forecast East Gippsland Water provided for the 2023–2028 period at the 2018 price review. The higher forecast is due to \$63.2 million in expenditure required to meet regulatory compliance obligations and improve environmental outcomes (52.6 per cent of its proposed capital forecast) and \$49.2 million to renew ageing infrastructure (40.9 per cent of its proposed capital forecast). East Gippsland Water has forecast \$76 million of expenditure on its top 10 major projects over the next regulatory period. This is 63.2 per cent of its forecast capital expenditure for the regulatory period.
- Our expenditure consultant requested selected documents from East Gippsland Water as a representative sample to demonstrate its asset management processes and justification for its capital expenditure program.<sup>38</sup> Based on the sample of documents reviewed and East Gippsland Water’s responses to questions, our expenditure consultant found that East Gippsland Water has a robust approach for developing project scope, the timing of works and cost estimates.
- Two major projects (the Woodglen water storage project and the Paynesville recycled water storage project) are forecast to incur \$39.6 million of capital expenditure, over half of the expenditure forecast for East Gippsland Water’s top 10 major projects in the next regulatory period. Given this, our consultant requested further information on both projects. Our consultant considered the information provided by East Gippsland Water, including its cost estimation and delivery approach, demonstrated the prudence and efficiency of these projects. Our consultant recommended no adjustments to East Gippsland Water’s forecast capital expenditure.<sup>39</sup> We agree with our consultant’s view as we consider that, for the purposes of our draft decision, the prudence and efficiency of the expenditure has been justified, consistent with our guidance.
- Our preliminary view is that the planned capital expenditure program is achievable, given East Gippsland Water’s delivery of the majority of its capital expenditure program over the current regulatory period while experiencing significant unforeseen events, along with the approach it has adopted to develop and deliver its forecast capital expenditure in the upcoming regulatory period. As discussed in Section 4.2.1 above, over the current 2018–23 regulatory period East Gippsland Water has delivered four major projects with two other major projects on schedule. Three major projects are delayed while one has been deferred. East Gippsland Water explained in its price submission that its ability to deliver the full program has been significantly impacted by drought, major bushfires, the impacts of coronavirus and subsequent supply chain and

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<sup>38</sup> FTI Consulting, *East Gippsland Water: Review of expenditure forecasts – 2023 water price review*, pp. 29–33.

<sup>39</sup> FTI Consulting, *East Gippsland Water: Review of expenditure forecasts – 2023 water price review*, February 2023, pp. 35.

market conditions. East Gippsland Water also identified in its price submission a number of activities it is undertaking to increase its capital project delivery capability, in order to deliver its increased overall program in the next regulatory period.<sup>40</sup>

- East Gippsland Water has not specifically identified projects it has excluded from its price submission where there is uncertainty in timing, cost, scope and benefits of capital expenditure. We note the following:
  - East Gippsland Water will need to demonstrate the prudence and efficiency of any additional costs incurred during the 2023–28 regulatory period if seeking to include them in the regulatory asset base for the 2028–33 price review.
  - Deviations from forecasted capital expenditure during the 2023–28 regulatory period will form a key part of our assessment of the Performance element of PREMO at the next price review.

We received an anonymous submission regarding unplanned wastewater discharges from four of East Gippsland Water’s wastewater treatment plants, noting it seemed only the Paynesville treatment plant was being upgraded.<sup>41</sup> A submission from the Concerned Waterways Alliance also stated the impact of recent rainfall events led to sewage overflow and treated and untreated discharges by East Gippsland Water.<sup>42</sup>

The listed top 10 major capital projects in East Gippsland Water’s price submission provide for \$11.1 million to increase storage at the Paynesville facility, and \$14 million for upgrades to the Bairnsdale wastewater facility in two stages. In addition, our expenditure consultant found during its review that design works are underway for augmentation projects at several of the business’s other wastewater treatment facilities to ensure compliance with environmental regulatory requirements now and in future periods.

East Gippsland Water has included \$4.1 million in its capital expenditure forecast for design and development works for these wastewater upgrade projects, with delivery expected early in the 2028–33 regulatory period.

We also note East Gippsland Water has included a further \$1.3 million to progress the design and development of several other high priority projects, which will enable better upfront planning and cost forecasts for these projects, to be delivered as part of the 2028–33 capital works program.

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<sup>40</sup> East Gippsland Water, 2023 water price submission, September 2022, pp. 62–63.

<sup>41</sup> Anonymous, submission to the Essential Services Commission on East Gippsland Water’s 2023 price submission, 6 October 2022.

<sup>42</sup> Concerned Waterways Alliance submission to the Essential Services Commission Water Price Review 2023, 21 December 2022.

The commencement of this design and delivery work reflects customer preferences on how costs are spread across the regulatory periods, as found through its deliberative forum.

We have reviewed East Gippsland Water's proposals and advice from our consultant. Our preliminary view is that we agree with our consultant's assessment and consider East Gippsland Water's approach to forecasting its capital expenditure is consistent with the requirements of our guidance and the principles in the Water Industry Regulatory Order 2014.<sup>43</sup>

Our draft decision is therefore to accept East Gippsland Water's proposed benchmark for total gross capital expenditure, as set out in Table 4.6.

The benchmark that we propose to adopt for East Gippsland Water does not represent the amount that East Gippsland Water is required to spend or allocate to particular projects. 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. Where we have made an adjustment to exclude a project's capital expenditure from East Gippsland Water's revenue requirement, we are not requiring the business to remove that project. East Gippsland Water determines how to best manage the allocation of its revenue and priority of its expenditure within a regulatory period.

### **4.3 Regulatory asset base**

A water business's regulatory asset base is the value of the business's assets for regulatory purposes.<sup>44</sup> The regulatory asset base is used to estimate the return on assets (discussed in Section 4.4), and regulatory depreciation (discussed in Section 4.5). Both the return on assets and regulatory depreciation are components of the revenue requirement.

Our guidance required East Gippsland Water to propose:

- the closing value of its regulatory asset base at 30 June 2022 (using actual data)
- the opening value of its regulatory asset base at 1 July 2023 (calculated according to the criteria outlined in the guidance)
- the forecast value of its regulatory asset base for each year of the regulatory period (2023-24 to 2027-28), in accordance with the prudence criteria outlined in the guidance.

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<sup>43</sup> Essential Services Commission, *2023 water price review: Guidance paper*, pp. 32–37.

<sup>44</sup> These values were set initially for the water businesses by the Minister for Water and are adjusted on an ongoing basis to account for new investments, asset disposals, depreciation and inflation.

### 4.3.1 Closing regulatory asset base

Our draft decision is to adopt a closing regulatory asset base of \$177.6 million at 30 June 2022, compared to the \$176.8 million proposed by East Gippsland Water.

We update the regulatory asset base to reflect actual gross capital expenditure, less government and customer contributions, and asset disposals for the period from 2017-18 to 2021-22.<sup>45</sup> This helps to ensure prices reflect the actual net expenditure of a water business.<sup>46</sup>

East Gippsland Water's proposed closing regulatory asset base at 30 June 2022 is provided at page 65 of its price submission.<sup>47</sup> We made an adjustment to correct for a minor error in government contributions identified during our review and approval of East Gippsland Water's 2021-22 regulatory accounts.

As a consequence, East Gippsland Water's closing regulatory asset base increases from the \$176.8 million proposed in its submission to \$177.6 million.

We also compared East Gippsland Water's actual net capital expenditure for 2017-18 to 2021-22 with the forecast used to approve maximum prices for the period from 1 July 2018. Typically, if a water business's net capital expenditure was more than 10 per cent above the forecast, we consider the business's justification for the additional expenditure before including it in the closing regulatory asset base. We consider this approach is reasonable given capital expenditure can be 'lumpy' in nature.

As noted in Section 4.2.1, East Gippsland Water's net capital expenditure over the period from 2017-18 to 2021-22 was 6 per cent lower than the forecast used to approve maximum prices for the period from 1 July 2018. This is well below the 10 per cent threshold identified above, so we propose to accept this amount for the purpose of calculating East Gippsland Water's closing regulatory asset base at 30 June 2022 (Table 4.5).

Table 4.5 sets out our draft decision on East Gippsland Water's closing regulatory asset base at 30 June 2022. Consistent with the above, our draft decision adopts a closing regulatory asset base of \$177.6 million at 30 June 2022.

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<sup>45</sup> See Section 4.2 for a discussion of East Gippsland Water's capital expenditure.

<sup>46</sup> Net capital expenditure is calculated by deducting government and customer contributions from gross capital expenditure. Customer contributions reflect revenue earned from new connections made to the water business's water, sewerage or recycled water networks.

<sup>47</sup> Available at [www.esc.vic.gov.au](http://www.esc.vic.gov.au).

**Table 4.5 Draft decision – closing regulatory asset base (RAB)**  
\$ million 2022-23

	2017-18	2018-19	2019-20	2020-21	2021-22
<b>Opening RAB 1 July</b>	<b>163.15</b>	<b>163.07</b>	<b>164.97</b>	<b>166.64</b>	<b>181.57</b>
Plus gross capital expenditure	9.83	10.12	11.10	24.28	6.01
Less government contributions	0.00	0.00	0.84	-0.07 <sup>a</sup>	0.00
Less customer contributions	0.06	0.01	0.00	0.00	0.00
Less proceeds from disposals	0.56	0.36	0.12	0.17	0.17
Less regulatory depreciation	9.29	7.84	8.47	9.24	9.85
<b>Closing RAB 30 June</b>	<b>163.07</b>	<b>164.97</b>	<b>166.64</b>	<b>181.57</b>	<b>177.57</b>

**Note:** Numbers have been rounded. <sup>a</sup> An amount of \$0.07 million was refunded in relation to a project that did not proceed, but for which a government contribution had already been received.

### 4.3.2 Forecast regulatory asset base

Our draft decision is to not accept East Gippsland Water’s proposed forecast regulatory asset base, reflecting our preliminary views on its closing regulatory asset base.

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

Reflecting our preliminary views on East Gippsland Water’s closing regulatory asset base, our draft decision is to not accept East Gippsland Water’s forecast regulatory asset base.

Table 4.6 sets out our draft decision on East Gippsland Water’s forecast regulatory asset base from 1 July 2023.<sup>48</sup> Our assessments of the components of the forecast regulatory asset base are also outlined in different sections of this draft decision paper as follows:

- Section 4.2 (capital expenditure)
- Section 4.3.2.1 (customer contributions)
- Section 4.5 (regulatory depreciation).

**Table 4.6** Draft decision – forecast regulatory asset base (RAB)  
\$ million 2022-23

	2022-23	2023-24	2024-25	2025-26	2026-27	2027-28
<b>Opening RAB 1 July</b>	<b>177.57</b>	<b>183.17</b>	<b>196.46</b>	<b>215.56</b>	<b>230.38</b>	<b>248.41</b>
Plus gross capital expenditure	15.77	19.57	26.05	22.38	26.55	25.64
Less government contributions	0.00	0.00	0.00	0.00	0.00	0.00
Less customer contributions	0.00	0.00	0.00	0.00	0.00	0.00
Less proceeds from disposals	0.29	0.39	0.34	0.16	0.44	0.29
Less regulatory depreciation	9.87	5.89	6.61	7.39	8.08	8.93
<b>Closing RAB 30 June</b>	<b>183.17</b>	<b>196.46</b>	<b>215.56</b>	<b>230.38</b>	<b>248.41</b>	<b>264.83</b>

**Note:** Numbers have been rounded.

#### 4.3.2.1 Customer contributions

Our draft decision is to not accept East Gippsland Water’s forecasts for customer contributions, given our draft decision on its regulatory asset base.

Revenue from customer contributions is deducted from gross capital expenditure so it is not included in the regulatory asset base.<sup>49</sup>

<sup>48</sup> Our guidance required water businesses to provide an estimate of the components of their regulatory asset base for 2022-23. This was so we could assess the opening asset base for 1 July 2023. Our guidance noted that where the 2022–23 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. The estimates for 2022 23 will be confirmed at the price review following the 2023 water price review. Essential Services Commission, *2023 water price review: Guidance paper*, p. 38.

<sup>49</sup> Revenue from new customer contributions reflects revenue earned from new connections made to the water business’s water, sewerage or recycled water networks.

We compared East Gippsland Water’s forecast for customer contributions with past outcomes and our preliminary view is that East Gippsland Water’s forecast contributions were calculated on a reasonable basis.

For the purposes of calculating the regulatory asset base and revenue requirement in our draft decision, we have adopted East Gippsland Water’s proposed customer contributions forecast.

However, we note that our final decision is subject to our ongoing review of East Gippsland Water’s new customer contributions (Section 5.4).

## 4.4 Rate of return

In establishing the return on assets component of East Gippsland Water’s revenue requirement, we have applied a rate of return to East Gippsland Water’s regulatory asset base. The rate of return is calculated using a benchmark cost of debt (discussed in Section 4.4.1) and a benchmark return on equity value (discussed in Section 4.4.2).

### 4.4.1 Cost of debt

Our draft decision is to accept the cost of debt proposed by East Gippsland Water.

Our guidance required East Gippsland Water to use estimates of the cost of debt provided by the commission to estimate its revenue requirement. East Gippsland Water used the cost of debt values we specified to calculate its revenue requirement. For this reason, as set out in Table 4.7, our draft decision is to accept the cost of debt proposed by East Gippsland Water, noting that the cost of debt estimates will be updated following the release of the Australian Bureau of Statistics March Quarter 2023 consumer price index.

**Table 4.7 Draft decision – cost of debt**

	2013-14	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20	2020-21	2021-22	2022-23
Cost of debt (nominal)	7.05%	5.36%	5.27%	4.91%	4.53%	4.61%	3.31%	3.05%	3.75%	3.75% <sup>a</sup>

**Note:** Numbers have been rounded. <sup>a</sup> Estimated cost of debt – we will update the 2022-23 figure before the final decision and price determination.

### 4.4.2 Return on equity

Our draft decision is to accept a return on equity of 4.1 per cent, which reflects East Gippsland Water’s PREMO self-rating.

Under our PREMO incentive mechanism, which we have applied since 2018, the return on equity we adopt to calculate the revenue requirement is linked to a business's PREMO rating. See Chapter 7 for an explanation of PREMO and our assessment of East Gippsland Water's PREMO rating. As outlined in our guidance, the return on equity we adopt depends on a water business's self-rating and whether we accept that rating.

Our guidance included a matrix proposing the return on equity we would adopt, based on the combination of the business's self-rating and our rating.<sup>50</sup> We reviewed the return on equity values in the matrix in mid-2022 given the change in market conditions that has occurred since we published our guidance in October 2021. We consider that the values in our matrix reflect the medium-term real rates of return.<sup>51</sup>

East Gippsland Water rated its price submission as 'Standard'. Based on this PREMO self-rating, East Gippsland Water proposed a return on equity of 4.1 per cent per annum. This reflects the maximum return rate allowed in our guidance for a price submission rated as 'Standard'.<sup>52</sup>

As outlined in Chapter 7, our draft decision is to agree with East Gippsland Water's PREMO self-rating and accept its proposed return on equity.

## 4.5 Regulatory depreciation

Our draft decision is to not accept East Gippsland Water's forecast regulatory depreciation.

Regulatory depreciation is a component of East Gippsland Water's revenue requirement and is also an input to calculating the regulatory asset base. East Gippsland Water's forecast regulatory depreciation was calculated using a straight-line depreciation profile.<sup>53</sup> We noted in our guidance that we prefer this approach.<sup>54</sup>

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<sup>50</sup> Essential Services Commission, *2023 water price review: Guidance paper*, pp. 42–43.

<sup>51</sup> We will continue to monitor market conditions and may amend the return on equity matrix values to reflect any changes to the medium-term outlook prior to releasing our final decision. We have had regard to the return on equity adopted by interstate regulators in the following publications: Independent Pricing and Regulatory Tribunal NSW, *Final Report - Review of WaterNSW's rural bulk water prices*, 9 September 2021; Independent Pricing and Regulatory Tribunal NSW, *Final Report - Review of prices for Sydney Water*, June 2020; Essential Services Commission of South Australia, *SA Water's water and sewerage retail services: 1 July 2020 - 30 June 2024*, Price Determination, 1 July 2020; Queensland Competition Authority, *Final report - Seqwater bulk water price review 2022–26*, March 2022; Queensland Competition Authority (QCA), *Final report - Rural irrigation price review 2020–24, Part A: Overview*, January 2020; Office of the Tasmanian Economic Regulator, *Final report - Investigation into TasWater's prices and services for the period 1 July 2022 to 30 June 2026*, May 2022.

<sup>52</sup> Essential Services Commission, *2023 water price review: Guidance paper*, p. 42.

<sup>53</sup> For the period from 2022-23 to 2027-28, East Gippsland Water proposed a regulatory depreciation of \$46.7 million.

<sup>54</sup> Essential Services Commission, *2023 water price review: Guidance paper*, p. 39.

However, our draft decision is to not accept East Gippsland Water's forecast for regulatory depreciation, noting our draft decision on its forecast regulatory asset base (Section 4.2.2). We note that East Gippsland Water's average asset life has been extended from 25.2 years in the current regulatory period, to 35.1 years in the 2023–28 regulatory period. This has the effect of reducing customer prices in the near term.

Our draft decision on regulatory depreciation is shown in Table 4.6 in Section 4.3.2. In addition to the above, this reflects an updated estimate for depreciation reflecting our draft decision on East Gippsland Water's forecast regulatory asset base, using the asset lives proposed by East Gippsland Water.

## **4.6 Tax allowance**

Our draft decision is to adopt a forecast tax allowance of \$0.83 million for the 2023–28 regulatory period.

The tax allowance is a component of the revenue requirement. East Gippsland Water has proposed a tax allowance of \$0.82 million in its revenue requirement for the 2023–28 regulatory period. Our draft decision is to not accept the forecast as our draft decision has adopted a different revenue requirement to East Gippsland Water's proposal, reflecting our proposed adjustments to its forecast costs and revenue (Table 4.2)

## 5. Demand, tariffs and prices

Once East Gippsland Water's revenue requirement is established, demand forecasts and the form of price control are used to translate the revenue requirement into tariffs and prices.

### 5.1 Demand

Our draft decision is to accept East Gippsland Water's demand forecasts.

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

East Gippsland Water's demand forecasts are set out at pages 69 to 71 of its price submission and are also included in its financial model.

Our draft decision is to accept East Gippsland Water's demand forecasts for the purpose of approving maximum prices because they were developed consistently with the requirements of our guidance. Since lodgement of its price submission, updated Victorian Government population and dwelling growth estimates have been made available to water businesses.

In its response to our draft decision, East Gippsland Water must demonstrate how it has considered these updated estimates and if required, identify and justify any changes to its demand forecasts (any updates must also be included in its pricing model submitted in response to our draft decision).

### 5.2 Form of price control

Our draft decision is to accept East Gippsland Water's proposed a price cap form of price control for its water and wastewater tariffs and a tariff basket form of price control for its major trade waste tariffs.

Our guidance indicated we would have particular regard to whether a business proposed to continue its existing form of price control or introduce a new form of price control.<sup>55</sup>

East Gippsland Water proposed a price cap form of price control for its water and wastewater tariffs and a tariff basket form of price control for its major trade waste tariffs as set out on page 72 of its price submission. It currently applies a price cap form of price control across all water, wastewater and trade waste tariffs. East Gippsland Water's proposed transition from a price cap to a tariff basket form of price control for major trade waste tariffs is to allow for tariff reform during the

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<sup>55</sup> Essential Services Commission, *2023 water price review: Guidance paper*, p. 50.

2023–28 regulatory period that aims to improve the cost reflectivity of East Gippsland Water’s major trade waste tariffs.

Under the price cap form of price control, maximum prices for each prescribed service for the 2023–28 regulatory period are determined at the start of the regulatory period. Under a tariff basket form of price control, a weighted-average price cap following a predetermined price path is applied to a basket of prescribed services with a rebalancing constraint applied to limit year-to-year movements in individual prices. Under both approaches, adjustments to account for movements in inflation (measured by the consumer price index published by the Australian Bureau of Statistics), return on assets and any approved pass-through mechanisms will be made during the regulatory period.

Our draft decision is to accept East Gippsland Water’s proposed price cap form of price control for water and wastewater services because:

- it is the same as its current approach for these tariffs, which we have previously approved
- it provides sufficient revenue to cover the forecast efficient costs of providing services and for East Gippsland Water to deliver on any health, safety and environmental obligations
- it provides East Gippsland Water’s customers with price certainty
- it is easy to explain to customers
- demand risk is more efficiently managed by East Gippsland Water than by its customers
- it is otherwise consistent with the requirements of our guidance.

Our draft decision is also to accept East Gippsland Water’s proposed change to a tariff basket form of price control for major trade waste services because it will provide East Gippsland Water with the flexibility to implement structural changes and rebalance tariffs within the basket. This will improve signals about the efficient costs of providing services to customers.<sup>56</sup> East Gippsland Water may wish to consider whether a broader tariff basket is appropriate, have regard to any cross subsidies affecting its trade waste tariffs.

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<sup>56</sup> East Gippsland Water noted its intention to undertake a reform of its major trade waste tariffs during the 2023–28 regulatory period following engagement with customers and improvements to internal processes. When proposing to implement its major trade waste reforms, East Gippsland Water should provide the commission with its customer consultation prior to implementing the reform, as part of the annual tariff review and approval of its updated prices.

## 5.3 Tariff structures and prices

Our draft decision is to accept East Gippsland Water's proposed tariff structures.

East Gippsland Water's proposed tariffs are set out at pages 73 to 77 of its price submission.

Our draft decision does not approve prices for each tariff because, as indicated above, prices will need to be updated by East Gippsland Water to reflect our updates to inflation and cost of debt estimates prior to our final decision, and our draft decision on its revenue requirement. Rather, our draft decision considers proposals related to tariff structures, the price path proposed, and any submissions on the level of prices or bills.

### 5.3.1 Tariff structures

As outlined in our guidance, we have provided the water businesses with a large degree of discretion to decide on individual tariff structures.<sup>57</sup> This recognises water businesses 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.

East Gippsland Water proposed to maintain its existing tariff structures, save for reforming the structure of its major trade waste tariffs during the 2023–28 regulatory period, following customer engagement.<sup>58</sup>

For residential and non-residential water services, it proposed a two-part tariff with a fixed service charge and a variable usage component that depends on water use. For residential and non-residential sewerage services, East Gippsland Water proposed a fixed service charge only.

East Gippsland Water intends to undertake a tariff reform during 2023–28 with the aim of improving the cost reflectivity of its major trade waste tariffs to better align with the Water Industry Regulatory Order. We will assess East Gippsland Water's application to amend the tariff schedule against the requirements of the Water Industry Regulatory Order 2014 and its determination when all supporting information is provided to us during the regulatory period.

A submission from the Concerned Waterways Alliance considered all water businesses should adopt tiered water use tariffs or inclining block tariffs for residential customers to encourage water

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<sup>57</sup> Essential Services Commission, *2023 water price review: Guidance paper*, p. 51.

<sup>58</sup> We will assess its proposal to reform its major trade waste tariffs during the regulatory period.

conservation. East Gippsland Water has not proposed any changes to its current single tier tariff structure for the 2023-24 to 2027–28 regulatory period, consistent with customer preferences.<sup>59</sup>

Our draft decision is to accept East Gippsland Water’s proposed tariff structures on the basis that they are a continuation of its current approach and are generally supported by its customers.

Our preliminary view is that the two-part tariff structure proposed by East Gippsland Water for its water services will promote the efficient use of services. It also 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>60</sup> We also consider two-part tariff structures are easy to understand.

For sewerage services, we consider East Gippsland Water’s proposed fixed charge is easy to understand.<sup>61</sup>

East Gippsland Water will continue to supply recycled water to a small number of customers under unique pricing arrangements. These customers are usually charged a fee per megalitre.

### 5.3.2 Prices

The prices proposed by East Gippsland Water for water and sewerage services are set out on pages 73 to 77 of its price submission.

Under East Gippsland Water’s proposal, generally prices (excluding inflation) will be higher. Residential water and sewerage prices for a typical household and for non-residential customers will increase by 0.3 per cent (before inflation) in each year of the 2023–28 regulatory period.

In May 2023, we intend to determine prices for East Gippsland Water in \$2023-24 terms. This means we will add the annual change in the March Quarter 2023 consumer price index (published by the Australian Bureau of Statistics) to its 2023-24 prices, which will also flow through to customer bills.

Based on recent inflation outcomes and market expectations, the annual outcome for the March Quarter 2023 consumer price index is likely to be relatively high.<sup>62</sup> For the 2023–28 regulatory period, we have assumed an inflation rate of 3 per cent per year, which is significantly lower than near-term inflation expectations.

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<sup>59</sup> Concerned Waterways Alliance, Concerned Waterways Alliance submission to the Essential Services Commission Water Price Review 2023, 1 December 2022.

<sup>60</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>61</sup> Our reasons are outlined in our 2013 draft decisions on price review 2013-14 to 2017-18.

<sup>62</sup> The latest (February 2023) Reserve Bank of Australia Quarterly Statement on Monetary Policy forecast the consumer price index to change (over the year) fall to around 4.8 per cent by December 2023 and 3.2 per cent by December 2024.

Many of the drivers of higher inflation (such as fuel, food and travel) are not major cost items for water businesses. Some high-cost growth areas specific to the water sector such as insurance and chemicals have been accounted for in uplifts to their opening base costs for the 2023–28 regulatory period. Considering this, and East Gippsland Water’s proposal for increasing prices in real terms over the 2023–28 regulatory period, we are seeking further information from East Gippsland Water in response to our draft decision on how it intends to address the impacts of relatively high inflation on its proposed prices and customer bills for 2023-24.<sup>63</sup>

As part of its response to our draft decision, East Gippsland Water must demonstrate how it has considered the impacts of inflation on its forecast expenditure in 2023-24, and whether these are reasonable taking into account that some of its key costs (such as labour) are unlikely to increase as much as near-term inflation.

East Gippsland Water’s prices will also be affected by our draft decision on its new customer contributions, which is outlined in Section 5.4.

In response to our draft decision, East Gippsland Water will need to propose updated prices that reflect our draft decision and any updates to its revenue requirement.

### **5.3.3 Addressing the interests of low income and vulnerable customers**

In making our price determination, we must have regard to whether East Gippsland Water took into account the interests of customers, including low income and vulnerable customers.<sup>64</sup>

There is evidence that East Gippsland Water has sought to address the interests of low income and vulnerable customers because East Gippsland Water proposed:

- increasing its funding of customer hardship support from \$150,000 each year to \$250,000 each year in line with customer preferences elicited in its deliberative panel<sup>65</sup>
- developing more formal arrangements and increasing interaction with external agencies supporting vulnerable customers (as recommended by the deliberative forum)
- implementing a water efficiency rebate program
- increasing communication about payment flexibility options.

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<sup>63</sup> This is relevant to clause 11(d)(ii) of the Water Industry Regulatory Order 2014 which states that when making a price determination, the commission must have regard to principles that the manner in which a regulated entity’s prices are to be calculated, determined or otherwise regulated, should provide signals about the efficient costs of providing prescribed services to customers (either collectively or to an individual customer or class of customers) while avoiding price shocks where possible.

<sup>64</sup> Water Industry Regulatory Order 2014 clause 11(d)(iii).

<sup>65</sup> These figures are in nominal terms, that is, they will not increase further with inflation.

### 5.3.4 Unique services

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

## 5.4 New customer contributions

Our draft decision is to not accept East Gippsland Water's proposed standard new customer contributions.

Our draft decision is to accept East Gippsland Water's proposed negotiated new customer contribution framework.

New customer contributions (or developer charges) are levied by water businesses 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.

East Gippsland Water's proposed new customer contributions are set out at page 79 of its price submission. East Gippsland Water proposed to continue to have no standard new customer contribution charge and a negotiated new customer contribution charge that may apply when a development is out of sequence with East Gippsland Water's infrastructure projects.<sup>66</sup>

East Gippsland Water's proposal of no standard new customer contributions was based on its 2018 new customer contributions model. East Gippsland Water did not provide an updated customer contributions model for the 2023 price review, which is a requirement of our guidance.<sup>67</sup>

Without an updated model, we cannot assess whether its proposal is consistent with the new customer contributions pricing principles outlined in our guidance. For this reason, our draft decision is to not accept East Gippsland Water's proposed standard new customer contributions.

In response to our draft decision, East Gippsland Water must provide an updated customer contributions model and supporting information so we can verify its new customer contributions proposal.

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<sup>66</sup> In this case, East Gippsland Water may charge a developer a non-scheduled charge that will recover the most efficient costs associated with bringing forward the provision of the necessary shared assets.

<sup>67</sup> Essential Services Commission, *2023 water price review: Guidance paper*, p. 58.

East Gippsland Water has provided its negotiating framework for negotiated new customer contribution contracts. We have reviewed East Gippsland Water's proposed negotiating framework and consider it is consistent with the new customer contributions pricing principles outlined in our guidance.<sup>68</sup> For this reason, our draft decision is to accept East Gippsland Water's proposed negotiated new customer contributions framework.

## 5.5 Adjusting prices

Our draft decision is to accept East Gippsland Water's proposed price adjustment mechanisms.

East Gippsland Water's proposed price adjustment mechanisms are set out at page 78 of its price submission. In response to our queries, East Gippsland Water confirmed that it does not propose any changes to its current pass-through mechanisms and listed a number of events that may materially affect the revenue it recovers and trigger the uncertain and unforeseen events mechanism in its determination.<sup>69</sup>

Our draft decision is to accept East Gippsland Water's proposed pass-through mechanism as it is the same as the current regulatory period and has worked well in the past.

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<sup>68</sup> Essential Services Commission, *2023 water price review: Guidance paper*, p. 59.

<sup>69</sup> East Gippsland Water, Response to request for information, 28 October 2022. We will assess an application to amend the 2023 price determination, to reflect a material increase or decrease in revenue and expenditure against our guidance and WIRO requirements, if and when any uncertain or unforeseen event occurs during a regulatory period.

## 6. Financial position

We have reviewed key indicators of East Gippsland Water's financial performance and our preliminary view is that East Gippsland Water will generate sufficient cash flow to deliver on its service commitments.

In approving prices, we must have regard to the financial viability of the water industry.<sup>70</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 business can generate sufficient cash flow to deliver on its service commitments, including financing costs arising from investments to meet service expectations.

East Gippsland Water's price submission and the supporting financial model provided estimates for key indicators of financial performance. These estimates were based on East Gippsland Water's assumptions about its revenue and expenditure. We have reviewed the key indicators of financial performance and our preliminary view is that we consider East Gippsland Water will generate sufficient cash flow to deliver on its service commitments, including financing costs arising from investments to meet service expectations.

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<sup>70</sup> WIRO clause 8(b)(ii) and ESC Act s.8A(1)(b).

## 7. PREMO rating

PREMO is an incentive mechanism that links the return on equity used to calculate a water business's revenue requirement to that business's level of ambition expressed in its price submission. Our guidance required East Gippsland Water to self-assess the level of ambition of its price submission for each element of the PREMO mechanism and arrive at an overall self-rating.<sup>71</sup> We required East Gippsland Water to self-rate its price submission as either 'Leading', 'Advanced', 'Standard' or 'Basic', with 'Leading' being the most ambitious and 'Basic' the least.

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

We also assessed and rated East Gippsland Water's price submission. As outlined in our guidance, the combination of East Gippsland Water's self-rating and our rating has determined the return on equity we have adopted to calculate East Gippsland Water's revenue requirement in our draft decision.

### 7.1 Our PREMO assessment of East Gippsland Water's price submission

Our draft decision is to rate East Gippsland Water's price submission as 'Standard' under PREMO, which is the same as East Gippsland Water's self-rating.

East Gippsland Water's self-rating for each of the PREMO elements and its overall self-rating are shown in Table 7.1. This table also includes our proposed ratings following our assessment of East Gippsland Water's price submission.

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<sup>71</sup> This is the first price review we have done where the rating has been based on all five elements of PREMO. In our 2018 price review, our PREMO assessment was against only four of the elements — Risk, Engagement, Management and Outcomes.

**Table 7.1**      **PREMO rating**

	Overall PREMO rating	Performance	Risk	Engagement	Management	Outcomes
East Gippsland Water's self-rating	Standard	Standard	Standard	Standard	Standard	Standard
Commission's rating	Standard	Standard	Standard	Standard	Standard	Standard

Our preliminary view is that we agree with East Gippsland Water's proposed overall PREMO self-rating of 'Standard'. This is reflected in the return on equity we propose to approve for East Gippsland Water (see Section 4.4.2). We have formed this view after reviewing East Gippsland Water's proposed self-rating for each of the five PREMO elements, with a summary of our assessment provided below.

### 7.1.1 Performance

For the 2023 price review, a business's rating for the Performance element of PREMO is based on a combination of its overall PREMO rating at its most recent price review, and its level of performance based on achievement of outcomes (related to service targets and performance against expenditure benchmarks set at the previous price review) and customer sentiment.<sup>72</sup>

Our preliminary view as noted in Section 3.2 is that we agree with East Gippsland Water's self-assessment that it has, overall, met its outcome commitments for the period to date. This was achieved in a period where the business supported customers following the 2020 bushfires, a historically wet 2021 and the coronavirus pandemic. In support of its PREMO rating, East Gippsland Water's customer committee endorsed its period to date outcome ratings for its price submission.<sup>73</sup>

In terms of customer perceptions, East Gippsland Water's results on the commission's survey of customer sentiment – covering measures of overall satisfaction, value for money, trust, and reputation in the community – placed it among the better performing businesses for much of the 2018–23 regulatory period. However, more recently, its scores have generally declined and in the

<sup>72</sup> As set out in Essential Services Commission 2021, *2023 Water Price Review: Guidance Paper*, pp. 74–75. Guiding questions are set out on page 45.

<sup>73</sup> East Gippsland Water, 2023 water price submission, September 2022, pp. 9 and 10.

January 2023 results it was within the bottom two to four businesses on each of the four survey measures.<sup>74</sup>

East Gippsland Water's controllable operating costs during the current regulatory period are forecast to be higher than the benchmark established at the 2018 water price review.

In 2021-22 (the last available year of audited results), its expenditure was \$21.7 million, 9 per cent higher than the 2018 price review benchmark of \$19.9 million; around the average of all businesses in the current price review. As noted in Section 4.1.1, the higher than benchmark outcome mainly reflected shifting priorities due to bushfires, pandemic response, wet weather, and trade shortages resulting in increased staffing costs. We have considered the specific context facing East Gippsland Water in our review.

In terms of capital expenditure, East Gippsland Water is one of the few businesses forecast to record lower capital expenditure over the period from 2018-19 to 2022-23, compared to the benchmarks established at its 2018 water price review. Our preliminary view is that we consider East Gippsland Water has sufficiently evidenced that its capital program and major projects were impacted by several factors outside of its control, including drought and subsequent bushfires and the need to undertake unplanned works to respond to these events.

Our draft decision is to accept East Gippsland Water's self-rating of 'Standard' for the Performance element of PREMO, on the basis that we consider it:

- met expectations for delivery against outcome commitments (in a challenging period for the business and its customers),
- managed its capital program within the 2018 price review benchmarks and reprioritised during the period to respond to events outside of its control, and
- justified increases in its operating costs relative to the 2018 price review benchmarks.

We consider these factors support its assessment that it met expectations in the current period (noting it achieved an overall PREMO rating of 'Standard' for its price submission in 2018).

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<sup>74</sup> The commission's customer perception survey results are available on our website. See <https://www.esc.vic.gov.au/water/sector-performance-and-reporting/how-customers-rate-their-water-business#tabs-container2>.

### 7.1.2 Risk

The Risk element of PREMO is assessed against guiding questions focused on the appropriate allocation of risk (so that customers don't pay more than they need to), and the business's proposed guaranteed service level scheme (including that it provides incentives for the business to deliver valued services efficiently).<sup>75</sup>

In support of its self-rating of 'Standard' for the Risk element of PREMO, East Gippsland Water's price submission provided an overview of key risks, and how these would be managed. Other key factors supporting its self-rating include:

- continuing with a price cap form of price control for most services, which means the business is bearing demand risk on behalf of its customers
- testing its guaranteed service level scheme with its customer committee, and generally maintaining the set of service commitments and accountabilities established for the current 2018-23 period.

On the basis of the above, our draft decision is to accept East Gippsland Water's self-rating of 'Standard' for Risk.

### 7.1.3 Engagement

The Engagement element of PREMO is assessed against guiding questions such as the form, timing, and nature of matters engaged on by the water business, and the influence of engagement on proposals. We also consider the extent to which a business has undertaken inclusive engagement, including with First Nations peoples and those experiencing vulnerability.<sup>76</sup>

Our draft decision is to accept East Gippsland Water's self-rating of 'Standard' for the Engagement element of PREMO on the basis of the overall suitability of its engagement program and the level of influence afforded to customers particularly at the early planning stages through its engagement with its customer committee. We also note the content of its deliberative forum, while narrow in focus, was influential on services and prices, which aligns with our principles of good engagement. See Section 3.1 for more detail.

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<sup>75</sup> Essential Services Commission 2021, *2023 Water Price Review: Guidance Paper*, p. 45.

<sup>76</sup> Essential Services Commission 2021, *2023 Water Price Review: Guidance Paper*, p. 45.

### 7.1.4 Management

The Management element of PREMO is assessed against guiding questions that cover matters such as the efficiency of proposed expenditure and prices, the quality of the business's submission and supporting information to justify proposals, and evidence that there is senior-level ownership and commitment to the proposals contained in the submission.<sup>77</sup>

In support of its self-rating of 'Standard' for the Management element of PREMO, we consider East Gippsland Water's price submission provided clear justification for its proposals, and its financial model contained no substantive errors and was consistent with its written submission. Its price submission was well presented and clearly linked the outcomes of its engagement to planned outcomes and expenditure. The East Gippsland Water Board has also attested to the accuracy of the information contained in its submission, as required by our guidance.

As noted in Section 4.1.1, East Gippsland Water proposed an average efficiency improvement rate on its controllable operating costs of 0.75 per cent per annum. This is lower than many other businesses in the current price review and well below the rate specified as an example of a 'Standard' PREMO rating in our current review (approximately 1.4 per cent per annum).

Our draft decision adopts an efficiency improvement rate of 1 per cent per annum, instead of the 0.75 per cent adopted by East Gippsland Water.

East Gippsland Water's price submission also identified that in addition to its 0.75 per cent efficiency rate, savings from energy efficiency projects and improvements in asset management were separately embedded into its operating cost forecasts.<sup>78</sup> It is not clear to us how these have been reflected in East Gippsland Water's operating cost forecasts.

In response to our draft decision, East Gippsland Water must resubmit its forecasts for controllable operating expenditure, reflecting our assumptions on the efficiency rate above.

Alternatively, it must demonstrate how its proposed efficiency improvement rate meets the efficiency objectives of the Water Industry Regulatory Order 2014 – in part, this may be achieved by providing us with greater clarity on how its efficiencies from energy efficiency projects and improvements in asset management have been reflected in its forecasts.

We will consider the Management rating following further review of material provided by East Gippsland Water as part of our ongoing review for our final decision.

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<sup>77</sup> Essential Services Commission 2021, *2023 Water Price Review: Guidance Paper*, p. 45.

<sup>78</sup> East Gippsland Water, 2023 water price submission, September 2022, p. 49

### 7.1.5 Outcomes

The Outcomes element of PREMO is assessed against guiding questions focused on:

- the alignment of proposed outcomes with customer priorities and expenditure forecasts
- whether the proposed outcomes are measurable
- the processes established to measure performance and report to customers.<sup>79</sup>

Our preliminary view is that East Gippsland Water has provided evidence that demonstrates its outcome measures and targets were developed in consultation with its customers, and that they are supported by customers.

As noted in Section 3.2, East Gippsland Water through its customer engagement found that its customers are concerned about addressing the challenges of future droughts, fires and more people living in the region. Its proposed Outcomes reflect these priorities. Further, East Gippsland Water's proposed targets for its outcome measures suggest an improvement in customer services.

The business has also committed to reporting annually to customers on how it has performed against its outcome commitments. Its performance against its measures and targets will continue to be reported through the publication of a scorecard on its website.

Our draft decision is to accept East Gippsland Water's self-rating of its price submission as 'Standard' for the Outcomes element of PREMO.

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<sup>79</sup> Essential Services Commission 2021, *2023 Water Price Review: Guidance Paper*, p. 45.

# Appendix A — Submissions received

Name or organisation	Date received
Anonymous	6 October 2022
Anonymous	7 October 2022
Consumer Action Law Centre	30 November 2022
Concerned Waterways Alliance	1 December 2022
Concerned Waterways Alliance	21 December 2022

## Appendix B — Commission’s 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 East 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>80</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 East Gippsland Water’s compliance with our guidance, in reaching our preliminary view.

Note: all chapter and section numbers referenced below refer to our draft decision for East Gippsland Water.

### **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 chapters and sections of our draft decision involved consideration of this factor:

- Our consideration of customer engagement (Section 3.1).
- Our assessment of the revenue requirement (Chapter 4).
- Our assessment of efficient operating expenditure (Section 4.1) and capital expenditure (Section 4.2).
- Our assessment of tariffs (Section 5.3).

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<sup>80</sup> Essential Services Commission, *2023 water price review: Guidance paper*, 26 October 2021.

**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 East 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 chapters and sections of our draft decision involved consideration of this factor:

- Our consideration of customer engagement (Section 3.1).
- Our assessment of the revenue requirement (Chapter 4).
- Our assessment of efficient operating expenditure (Section 4.1) and capital expenditure (Section 4.2).
- Our assessment of tariffs (Section 5.3).
- Our assessment of financial viability (Chapter 6).

**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 chapters and sections of our draft decision involved consideration of this factor:

- Our consideration of customer engagement (Section 3.1).
- Our consideration of outcomes (Section 3.2).
- Our assessment of the revenue requirement (Chapter 4).
- Our assessment of efficient operating expenditure (Section 4.1) and capital expenditure (Section 4.2).
- Our assessment of tariffs (Section 5.3).

Additionally, our pricing approach allows a water business to retain the benefits of any cost efficiencies it generates until the end of its regulatory period. In other words, a water business 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 businesses 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 business promotes efficiency in the water industry.

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

- Our consideration of customer engagement (Section 3.1).
- Our consideration of outcomes (Section 3.2).
- Our assessment of the revenue requirement (Chapter 4).
- Our assessment of efficient operating expenditure (Section 4.1) and capital expenditure (Section 4.2).
- Our assessment of tariffs (Section 5.3).

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

- A 10-year trailing average approach to estimating the benchmark cost of debt (see Section 4.4.1).
- A regulatory rate of return that we consider will enable East Gippsland Water to recover borrowing costs associated with its investment in services, and generate a return on assets.<sup>81</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 business can maintain an investment grade credit rating. Further, prices should enable each business to generate cash flow to service financing costs arising from investments to meet service expectations.

We have had regard to this matter in Chapter 6.

**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 East 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 chapters and sections of our draft decision involved consideration of this factor:

- Our consideration of customer engagement (Section 3.1).
- Our assessment of the revenue requirement (Chapter 4).
- Our assessment of efficient operating expenditure (Section 4.1) and capital expenditure (Section 4.2).

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<sup>81</sup> The regulatory rate of return is comprised of the cost of debt and the return on equity.

- Our assessment of tariffs (Section 5.3).

## **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 business to propose outcomes, tariff structures and expenditure that reflect its particular circumstances. We consider that taking into account the particular circumstances of each water business is consistent with taking into account the particular circumstances of the water industry.

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

- Our consideration of customer engagement (Section 3.1).
- Our consideration of outcomes (Section 3.2).
- Our assessment of the revenue requirement (Chapter 4).
- Our assessment of efficient operating expenditure (Section 4.1) and capital expenditure (Section 4.2).
- Our assessment of tariffs (Section 5.3).

We have had regard to the prescribed services listed in the WIRO in making our draft decision. This includes adopting operating and capital expenditure benchmarks that we consider will allow East 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 East Gippsland Water to generate a return on assets through:

- Our consideration of the regulatory asset base (Section 4.3).
- Our consideration of the cost of debt (Section 4.4.1).
- Our consideration of the return on equity (Section 4.4.2).

**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>82</sup>
- operating and capital expenditure costs per connection throughout Australia<sup>83</sup>
- tariff structures applied by water businesses throughout Australia<sup>84</sup>
- the regulatory rate of return set by other regulators.<sup>85</sup>

We are not aware of any international benchmarks that are relevant to our draft 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 business to propose outcomes, a revenue requirement, expenditure and tariffs that reflect its particular circumstances and operating environment.

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

- Our consideration of customer engagement (Section 3.1).
- Our consideration of outcomes (Section 3.2).
- Our assessment of the revenue requirement (Chapter 4).
- Our assessment of efficient operating expenditure (Section 4.1) and capital expenditure (Section 4.2).
- Our assessment of tariffs (Section 5.3).

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

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<sup>82</sup> Bureau of Meteorology, *National performance report 2020-21; urban water utilities, part A*, February 2022.

<sup>83</sup> Bureau of Meteorology, *National performance report 2020-21; urban water utilities, part A*.

<sup>84</sup> Includes Icon Water, Sydney Water, Hunter Water, Central Coast Council, Power and Water Corp, Urban Utilities, Unity Water, SA Water and TasWater.

<sup>85</sup> Independent Pricing and Regulatory Tribunal NSW, *Final Report - Review of WaterNSW’s rural bulk water prices*, 9 September 2021; Independent Pricing and Regulatory Tribunal NSW, *Final Report - Review of prices for Sydney Water*, June 2020; Essential Services Commission of South Australia, *SA Water’s water and sewerage retail services: 1 July 2020 - 30 June 2024*, Price Determination, 1 July 2020; Queensland Competition Authority, *Final report - Seqwater bulk water price review 2022–26*, March 2022; Queensland Competition Authority (QCA), *Final report - Rural irrigation price review 2020–24, Part A: Overview*, January 2020; Office of the Tasmanian Economic Regulator, *Final report - Investigation into TasWater’s prices and services for the period 1 July 2022 to 30 June 2026*, May 2022.

## 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 chapters and sections of our draft decision involved consideration of this factor:

- Our consideration of customer engagement (Section 3.1).
- Our consideration of outcomes (Section 3.2).
- Our assessment of the revenue requirement (Chapter 4).
- Our assessment of efficient operating expenditure (Section 4.1) and capital expenditure (Section 4.2).
- Our assessment of tariffs (Section 5.3).

**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 chapters and sections of our draft decision involved consideration of this factor:

- Our consideration of the revenue requirement (Chapter 4).
- Our assessment of efficient operating expenditure (Section 4.1) and capital expenditure (Section 4.2).
- Our consideration of demand (Section 5.1).
- Our consideration of tariffs (Section 5.3).

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 (Section 3.1).
- Our consideration of outcomes (Section 3.2).

**WIRO Clause 11(d)(i) requires us to have regard to whether East 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 East 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 business's engagement
- the structure of individual tariffs
- the proposed form of price control
- any changes to tariffs and how water businesses explain them to customers.

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

- Our consideration of tariffs and the form of price control (Section 5.2 and Section 5.3).

**WIRO Clause 11(d)(ii) requires us to have regard to whether East 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 chapters and sections of our draft decision involved consideration of this factor:

- Our consideration of customer engagement (Section 3.1).
- Our assessment of the revenue requirement (Chapter 4).
- Our assessment of efficient operating expenditure (Section 4.1) and capital expenditure (Section 4.2).
- Our assessment of tariffs (Section 5.3).

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

We consider that customer value established through prices and customer outcomes, as well as tariff structures, and assistance available to customers having difficulty paying bills is relevant to this objective.

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

- Our consideration of customer engagement (Section 3.1)

Commission's consideration of legal requirements

- Our consideration of outcomes (Section 3.2)
- Our consideration of guaranteed service levels (Section 3.4)
- Our consideration of tariff structures and prices (Chapter 5)

## **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 East Gippsland Water to deliver the outcomes valued by customers, and on its legal and regulatory obligations.

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

- Our assessment of the revenue requirement (Chapter 4).
- Our assessment of efficient operating expenditure (Section 4.1) and capital expenditure (Section 4.2).
- Our assessment of the form of price control (Section 5.2).

**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 East Gippsland Water to deliver the outcomes valued by customers, and on its health, safety, environmental sustainability and social obligations.

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

- Our assessment of the revenue requirement (Chapter 4).
- Our assessment of efficient operating expenditure (Section 4.1) and capital expenditure (Section 4.2).
- Our assessment of tariffs (Section 5.3).

## **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, East 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 (Section 3.1)
- Our assessment of outcomes (Section 3.2)
- Our assessment of efficient operating expenditure (Section 4.1) and capital expenditure (Section 4.2).

We consider that our pricing approach helps to address market power and information asymmetries relating to the water businesses. Our PREMO water pricing approach provides incentives for a water business 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>86</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:

- Implementing a price review process so that water businesses may receive streamlined price reviews if they submit a high quality price submission. This reduces the costs of regulation for water businesses 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 businesses. Our guidance noted that much of the information required in price submissions should be readily available to water businesses as it would be relevant for other purposes such as corporate planning and project prioritisation and justification.<sup>87</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 business’s revenue requirement
- allows water businesses to implement various forms of price control, including price caps and revenue caps

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<sup>86</sup> Essential Services Commission 2016, Water Pricing Framework and Approach, Implementing PREMO from 2018, October, pp. 11–13.

<sup>87</sup> Essential Services Commission, 2023 water price review: Guidance paper, p. 2.

- allows for consultation with key stakeholders during a price review, including through the release of a draft decision.

**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 businesses may receive streamlined price reviews if they submit a high quality price submission. This reduces the costs of regulation for water businesses 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 businesses. Our guidance noted that much of the information required in price submissions should be readily available to water businesses as it would be relevant for other purposes such as corporate planning and project prioritisation and justification.<sup>88</sup>

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<sup>88</sup> Essential Services Commission, 2023 water price review: *Guidance paper*, p. 2.