



South 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.

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Summary

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

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

South Gippsland Water has committed to delivering a number of key outcomes for its customers

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

- Reliability: plan for the future, be reliable and minimise unplanned interruptions to services
- Water: provide safe, clean drinking water
- Wastewater: provide a safe wastewater service that contributes to the liveability of our communities
- Environment: be environmentally sustainable and adapt to a future impacted by climate variability
- Integrity: act with honesty, respect and strive to balance affordability, value-for money and fairness.²

Among the key initiatives to deliver on South Gippsland Water’s commitments are projects to protect the environment and ensure that it continues to provide reliable services to its customers.

It will also continue to target 100 per cent renewable electricity by 2025 and achieving net zero emissions by 2035. South Gippsland Water will also introduce new programs such as its co-payment scheme, to help re-engage with customers with outstanding payments and help them reduce debt.

¹ Clause 16 of the Water Industry Regulatory Order 2014 requires the Essential Services Commission to issue a draft decision; South Gippsland Water’s price submission is available on our website at www.esc.vic.gov.au.

² South Gippsland Water, 2023 water price submission, September 2022, pp. 26–28.

Our draft decision approves a revenue requirement that will enable South Gippsland Water to deliver on its obligations and customer outcomes

Our draft decision approves a revenue requirement that will allow South 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.

South Gippsland Water proposed a revenue requirement of \$199.9 million over a 5-year period starting 1 July 2023. Our draft decision is to adopt a revenue requirement of \$198.2 million.

Our preliminary view is that South Gippsland Water's forecast expenditure generally reflected prudent and efficient costs. However, we have proposed a relatively small adjustment to forecast operating expenditure (Section 4.1.1), with some minor corrections to reflect its approved regulatory accounts for 2021-22.

Under South Gippsland Water's proposal, generally prices (excluding inflation) will be higher.

However, to address customer affordability, South Gippsland Water proposes to charge prices that are lower (on average) than the amount it could under its proposed revenue requirement (that is, it would under-recover its forecast costs). This proposal is reflected in South Gippsland Water's proposed prices and its estimated bills. Based on South Gippsland Water's price submission, before inflation the typical annual water and sewerage bill for a residential owner-occupier rises from \$1,154 currently, to \$1,177 in 2023-24 and \$1,312 in 2027-28. Bills for household tenants rise in real terms from \$437 in 2022-23 to \$445 in 2023-24 and \$497 in 2027-28. These estimates exclude inflation (they are in \$2022-23 terms).

South Gippsland Water must respond to our draft decision on its revenue requirement. There are some areas (noted below) that may impact South Gippsland Water's revenue requirement and prices approved in our final decision and determination, which could impact estimated customer bills.

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

South Gippsland Water, unlike some other water businesses, proposes to increase prices in real terms over the 2023–28 regulatory period. Under its proposal, residential water and sewerage would increase by 2 per cent in both 2023-24 and 2024-25, and by a further 3 per cent each year between 2025-26 and 2027-28. Non-residential water and sewerage prices are proposed to follow a similar path. 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 2022-23 prices, South 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.³ We note that South Gippsland Water has proposed to charge lower prices than it could under its proposed revenue requirement in order to address affordability.

Prices and estimated bills will 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 index⁴ due for release in late April 2023, will be added to 2023-24 real prices.

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 2024.⁵ 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, South Gippsland Water proposed a fixed service charge and a variable component that depends on water use. For residential sewerage services, South Gippsland Water proposed a fixed charge only. For recycled water services, South Gippsland Water proposed to continue with only a variable usage charge.

Our draft decision is to accept South Gippsland Water's proposed tariff structures, on the basis that they are a continuation of South Gippsland Water's current approach and are generally supported by its customers. Specifically, the tariff structures ensure a sustainable revenue stream and are simple to understand. Our review of South Gippsland Water's proposed tariff structures is set out in Section 5.3.1

Our draft decision is to accept South Gippsland Water's proposed price cap form of price control, including because it reflects a continuation of current arrangements, which we have previously

³ 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.

⁴ Published by the Australian Bureau of Statistics (All Groups – Australia)

⁵ 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.

approved (Section 5.2). This means its maximum prices are fixed subject to updates for inflation and cost of debt, and any other price adjustments we approve in our price determination.

Our draft decision rates South Gippsland Water’s price submission as ‘Standard’ under the PREMO framework

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

Key factors supporting this PREMO rating include:

- Proposing to charge amounts below its revenue requirement, taking on risk and helping to manage affordability for customers
- South Gippsland water generally met expectations for delivery against outcome commitments.
- South Gippsland Water’s proposal to charge lower than its forecast revenue requirement to help address affordability for its customers.
- South Gippsland Water engaged broadly with its customers, providing opportunities for participation across its service areas, and its engagement was inclusive of customers facing vulnerability.
- South Gippsland Water was able to achieve strong alignment between consumer preferences and the proposals in its submission, including its proposals for additional support for customers who may be experiencing vulnerability.
- South Gippsland Water proposed an efficiency improvement rate for controllable operating expenditure over the 2023–28 regulatory period of 1.4 per cent, slightly higher than the average of all businesses in the current price review.
- Our preliminary assessment is that South Gippsland Water developed its proposed outcomes in consultation with its customers, and they are supported by customers.

It also provided a price submission and supporting model that were generally of a high quality.

At its 2020 water price review, we approved a PREMO rating of ‘Standard’ for South Gippsland Water, which is the same rating proposed in this draft decision.

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



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 A **PREMO rating**

	Overall PREMO rating	Performance	Risk	Engagement	Management	Outcomes
South 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, South Gippsland Water is one of 4 businesses for which we propose to approve a 'Standard' rating (Table B).

Table B **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 South Gippsland Water's price submission)
- additional matters or issues we should consider before making our final decision
- whether our draft decision on South Gippsland Water's price submission has adequate regard to the matters in clause 11 of the Water Industry Regulatory Order 2014 and our guidance.

Table C lists specific issues we are seeking feedback on to inform our final decision and price determination for South Gippsland Water.

Table C Specific topics we are particularly interested in stakeholder feedback on

Topic	Specific issue	Draft report reference
New customer contributions	South Gippsland Water's proposed standard new customer contributions.	Section 5.4

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 28 April 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	28 April 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 2023.⁶ The prescribed services include retail water and sewerage services, and bulk water and sewerage services delivered by the water businesses.⁷

South 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 South 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

⁶ 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.

⁷ 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 guidance⁸
- 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 South Gippsland Water to inform its price submission. The guidance set out how we would assess South Gippsland Water's submission against the matters we must consider under clause 11 of the WIRO. It also outlined our expectation that South Gippsland Water would comply with certain requirements and specified information that South 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 South Gippsland Water's proposed prices.⁹

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.¹⁰

⁸ Essential Services Commission, *2023 water price review: Guidance paper*, 26 October 2021.

⁹ This is a requirement of the WIRO, clause 14(b).

¹⁰ 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"> • promotion of efficient use of prescribed services by customers [cl 8(b)(i), WIRO] • promotion of efficiency in regulated entities as well as efficiency in, and the financial viability of, the regulated water industry [cl 8(b)(ii), WIRO] • provision to regulated entities of incentives to pursue efficiency improvements [cl 8(b)(iii), WIRO] • efficiency in the industry and incentives for long term investment [s. 8A(1)(a), ESC Act] • efficient costs of producing or supplying regulated goods or services and of complying with relevant legislation and relevant health, safety, environmental and social legislation applying to the regulated industry [s. 33(3)(b), ESC Act] • financial viability of the industry [s. 8A(b)(1), ESC Act] 	<ul style="list-style-type: none"> • particular circumstances of the regulated industry and the prescribed goods and services for which the determination is being made [s. 33(3)(a), ESC Act] • return on assets in the regulated industry [s. 33(3)(c), ESC Act] • ensure that regulatory decision making and regulatory processes have regard to any differences between the operating environments of regulated entities [s. 4C(b), WI Act] 	<ul style="list-style-type: none"> • in performing its functions and exercising its powers, the objective of the Commission is to promote the long term interests of Victorian consumers [s. 8(1), ESC Act] without derogating from that objective. The Commission must in seeking to achieve the objective have regard to the price, quality and reliability of essential services [s. 8(2), ESC Act] • enable customers or potential customers of the regulated entity to easily understand the prices charged by the regulated entity for prescribed services or the manner in which such prices are calculated, determined or otherwise regulated [cl 11(d)(i), WIRO] • provide signals about the efficient costs of providing prescribed services to customers (either collectively or to an individual customer or class of customers) while avoiding price shocks where possible [cl 11(d)(ii), WIRO] • take into account the interests of customers of the regulated entity, including low income and vulnerable customers [cl 11(d)(iii), WIRO]

Continued next page

Table 1.1 (continued)

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

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.¹¹

¹¹ In December 2022, we issued early draft decisions for Yarra Valley Water and Westernport Water.

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

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.¹²

¹² Essential Services Commission, *2023 water price review: Guidance paper*, pp. 41–46.

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

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

- South Gippsland Water's price submission
- South 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 South 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. South Gippsland Water's price submission addressed each of these matters. Our preliminary assessment of these matters is provided in this draft decision.

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



South 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). 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 South 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 South Gippsland Water has committed to over the regulatory period (Chapter 3).

Our assessment of South Gippsland Water's price submission

- Establish South 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 South Gippsland Water’s financial position, which we have also had regard to.

Chapter 7 outlines our preliminary assessment of South 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.¹³ 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.¹⁴

South 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.

¹³ This is a requirement of the WIRO, clause 9.

¹⁴ 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 and value South 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 South Gippsland Water’s engagement with its customers in preparing its price submission
- reviews whether South Gippsland Water has delivered on the outcomes it committed to for the 2018–23 period and examines the customer outcomes South Gippsland Water is committing to for the next regulatory period
- outlines South Gippsland Water’s proposed service standards
- outlines South Gippsland Water’s proposed guaranteed service levels.

3.1 Customer engagement

Our guidance required South Gippsland Water to engage with customers to inform its price submission. Our guidance also identified principles to guide South Gippsland Water’s engagement.¹⁵

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

- South Gippsland Water engaged early, building on its Urban Water Strategy engagement in 2021 as a starting point for engagement on its price submission.
- It engaged widely, drawing on feedback from 900 customers across 20 of its 21 serviced towns through surveys, social media interactions, community workshops, formal committee meetings, face-to-face interviews, town visits, phone polling, its Community Advisory Committee and deliberative workshops.
- South Gippsland Water’s engagement was reflective of the diversity of its customer base, engaging across different age groups, locations and customer types (including landlords and renters). It engaged extensively with customers experiencing vulnerability, their advocates, and local support services, initially to better understand customer needs.
- South Gippsland Water’s engagement was inclusive, ensuring it had a good understanding of the issues facing its customer base, including its Traditional Owners. It spent time with

¹⁵ Essential Services Commission, *2023 water price review: Guidance paper*, p. 20.

Gunaikurnai Land and Water Aboriginal Business working on their whole-of-country self-determination plan as well as a Memorandum of Understanding (which seeks social justice through economic development opportunities).

- It engaged on matters that could influence services and prices, including safe clean water, reliability, wastewater management, environment, customers experiencing vulnerability, small businesses, bill impacts and price paths.

More detail on South Gippsland Water's engagement is available in its price submission.¹⁶

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

- expanding eligibility for its customer support program – in response to feedback from the Community Advisory Committee and the deliberative workshops that any price increase had to include increased assistance to customers experiencing vulnerability¹⁷
- introducing a co-payment program for residential and small business customers – in response to feedback from community workers and consumers facing vulnerability that this would be an effective way of helping customers who are struggling to pay their bills¹⁸
- improving wastewater reuse at its Foster treatment plant – in response to its deliberative panel's view that South Gippsland Water should look more closely at the reuse of wastewater¹⁹
- purchasing additional water from the Melbourne supply system for its Lance Creek system – in response to the deliberative panel's support of this approach to ensuring water security²⁰
- introducing a new guaranteed service level that would provide a \$10,000 Community Resilience Grant to any community affected by a Boil Water Advisory – in response to support from the Consumer Advisory Committee and deliberative panel for funds to be directed to the community rather than individual rebates.²¹

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

Overall, our preliminary view is that South Gippsland Water has designed and delivered an engagement program that was appropriate in the context of the real price increases it proposed in its price submission.

¹⁶ South Gippsland Water's price submission is available on our website at www.esc.vic.gov.au.

¹⁷ South Gippsland Water, 2023 water price submission, September 2022, p. 22

¹⁸ South Gippsland Water, 2023 water price submission, September 2022, p. 3

¹⁹ South Gippsland Water, 2023 water price submission, September 2022, p. 21

²⁰ South Gippsland Water, 2023 water price submission, September 2022, p. 13

²¹ South Gippsland Water, 2023 water price submission, September 2022, p. 29

The appropriateness of South Gippsland Water’s engagement is evidenced by the detailed research South Gippsland Water undertook on the experiences of customers facing vulnerability in its service area, the impact on these customers of its services and prices, and the likely impact on these customers of any price increase.²² The appropriateness of South Gippsland Water’s engagement is also supported by its extensive engagement with people experiencing vulnerability and their advocates; it conducted 77 separate in-depth interviews that included residential customers, support agencies, small businesses customers and business advocates.²³ We consider this engagement method was sensitive and appropriate, consistent with the expectations set out in our guidance.

In forming our view of the level of participation South Gippsland Water was able to achieve, we consider it demonstrated there were many opportunities for customers to participate in the development of its price submission. South Gippsland Water engaged broadly across its service areas, using methods that supported customers’ engagement preferences. It achieved good participation across its in-depth processes, such as its Community Advisory Committee, in-depth interviews (with 171 unique customer participants), as well as its full day and two evening deliberative workshops. Customer feedback about the quality of participation across its processes was favourable, including feedback from its Community Advisory Committee that strong voices were present in the sessions and that these were effectively managed by facilitators.²⁴

We also consider that South Gippsland Water was able to demonstrate customer influence on the proposals in its submission. For example, by adopting the feedback of customers to increase assistance to customers experiencing vulnerability, and the Consumer Advisory Committee’s strong endorsement of the balance in price, services and sustainability that South Gippsland Water was to achieve.

We consider South Gippsland Water’s engagement with customers experiencing vulnerability was appropriate in the context of its proposed real price increases.

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

²² South Gippsland Water engaged Bartley Consulting to undertake research on the needs and expectations of vulnerable and disadvantaged customers and to prepare a report documenting the findings of the research. South Gippsland Water provided us this report, which we reviewed as part of our assessment.

²³ South Gippsland Water engaged Bartley Consulting to undertake interviews with customers experiencing vulnerability, and to detail the process and outcomes of the interviews. South Gippsland Water provided us two reports (phase 1, and phase 2) which we reviewed as part of our assessment.

²⁴ South Gippsland Water’s *Customer Engagement Process and Outcomes – SGW, September 2022* detailed its engagement program for its price submission. The report included additional material about the Community Advisory Committee, including a detailed statement of support from a committee member.

3.2 Outcomes

3.2.1 Performance against outcome commitments 2018–23

As part of our 2018 and 2020 water price reviews, South Gippsland Water established ‘outcomes’ it would deliver customers across the period to 2023. These outcomes were reflected in the prices we approved for the period 1 July 2018 to 30 June 2020 and 1 July 2020 to 30 June 2023.

Progress against these outcomes can indicate whether customers got what they paid for.

Our guidance required businesses to account for actual performance against outcome commitments for the period from 1 July 2018 to 30 June 2023.²⁵

We consider South Gippsland Water accounted for its annual performance for each measure in its price submission. Table 3.1 lists South Gippsland Water’s outcome commitments and includes its annual performance results as reported in its price submission and the period-to-date rating published in our 2021-22 Outcomes report.²⁶ The information in this table informs our assessment under the Performance element of PREMO, which is discussed in Chapter 7.

²⁵ Essential Services Commission, 2023 water price review: Guidance paper, 26 October 2021, p. 23.

²⁶ South Gippsland Water provided a period-to-date rating for the purpose of compiling our 2021-22 Outcomes report. South Gippsland Water has advised its overall period to date rating for outcomes 3 and 5 were incorrectly rated as ‘amber’ in its 2021-22 outcome report. In addition, outcome 4 was incorrectly rated as ‘green’. Table 3.1 reflects its corrected period to date ratings.

Table 3.1 Business self-assessment of performance against Outcome commitments

Outcome	2018-19	2019-20	2020-21	2021-22	Period to date ^a
1. We will partner with community, local government and business to plan for future years ^b	Amber	Green			
2. Reliability: We will plan for the future, be reliable, minimise unplanned interruptions to services	Amber	Green	Green	Green	Green
3. Water: Provide safe, clean drinking water for the benefit of our customers and communities	Amber	Green	Green	Amber	Green
4. Wastewater: Provide a safe wastewater service that contributes to the health and liveability of our communities and environment	Green	Red	Red	Green	Amber
5. Environment: Be environmentally responsible, sustainable and adapt to a future impacted by climate variability	Green	Green	Amber	Amber	Green
6. Integrity: Treat all customers/community with honesty, respect and strive to balance affordability, value-for-money and fairness	Green	Green	Green	Green	Green

Note: Green = achieved target; Amber = close to achieving target; Red = failed to meet target. ^a This is South Gippsland Water’s self-assessment of its performance across the 4 years from 1 July 2018 to 30 June 2022. South 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. ^b South Gippsland Water revised its outcomes at its 2020 price review and Outcome 1 was merged with Outcome 2.

Source: South Gippsland Water, 2023 water price submission, September 2022, p. XX; Essential Services Commission, South Gippsland Water’s outcomes performance 2021-22, October 2022.

South Gippsland Water considers it has achieved or exceeded its targets for 39 of its 50 reported measure results over the first 4 years of the period from 2018-23. Of these 50 performance measures, 7 (14 per cent) have been rated as amber ‘close to achieving target’ and 4 (8 per cent) as red ‘failed to meet’ in the period to date.²⁷

²⁷ South Gippsland Water, 2023 water price submission, September 2022, pp. 4–8.

South Gippsland Water was close to achieving its ‘wastewater’ outcome commitment for the period to date. In its price submission, South Gippsland Water noted that the Environmental Protection Authority issued enforcement action notices in relation to two of its wastewater treatment plants:

- in 2019-20, at the Foster Wastewater Treatment Plant for an emergency discharge, due to a high rainfall event
- in 2020-21, at the Korumburra Wastewater Treatment Plant due to a high concentration of non-compliant industrial waste that was illegally discharged into the sewer network, which critically impacted plant operations.

In its price submission, South Gippsland Water noted one of the remedial actions it took to address its licence compliance was to review and adapt its capital investment program to monitor and augment ‘at-risk’ wastewater systems in preparation for high rainfall events, and increased population and industry growth.²⁸

South Gippsland Water performed well against its ‘integrity’ outcome commitment. Its two measures for this outcome track how its customers rate South Gippsland Water in terms of ‘value-for-money’ and overall satisfaction, via its customer satisfaction survey.²⁹

For the period to date, South Gippsland Water published its performance results prominently on the homepage of its website, and each quarter publishes a customer scorecard on its performance. Based on the above, our preliminary view is that we agree with South Gippsland Water’s self-assessment that it has, overall, met its outcome commitments.

3.2.2 Outcome commitments for 2023–28

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

- Reliability: plan for the future, be reliable and minimise unplanned interruptions to services
- Water: provide safe, clean drinking water
- Wastewater: provide a safe wastewater service that contributes to the liveability of our communities
- Environment: be environmentally sustainable and adapt to a future impacted by climate variability
- Integrity: act with honesty, respect and strive to balance affordability, value-for money and fairness.³⁰

²⁸ South Gippsland Water, 2023 water price submission, September 2022, p. 7.

²⁹ South Gippsland Water, 2023 water price submission, September 2022, p. 8.

³⁰ South Gippsland Water, 2023 water price submission, September 2022, pp. 26-28.

Among the key initiatives to deliver on its commitments are major projects to support regional growth, protect the environment and ensure that it continues to provide reliable services to its customers. It will also continue its focus on the environment with projects to ensure it sources 100 per cent renewable electricity by 2025 and achieves net zero emissions by 2035.

In relation to supporting customers experiencing payment difficulty, it will introduce new programs such as its co-payment scheme.

3.2.3 Our assessment of measures and targets

South Gippsland Water proposed a set of 13 measures and targets that it will use to report on performance across the 5 outcomes. These are set out on pages 26 to 28 of its price submission. Performance against these measures will inform our assessment during future price reviews.

We have assessed South 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.³¹

Evidence provided by South Gippsland Water demonstrates that these measures and targets were developed in consultation with its customers, and that they are supported by its customers. Its engagement program included a diverse range of methods, including but not limited to open surveys, town visits and community workshops. In developing its price submission, a Community Advisory Committee was established to provide advice on a range of topics including customer outcomes. Following its engagement program, the committee was supportive of its investment proposals and felt they reflected South Gippsland Water's customer outcomes.³²

Generally, we consider South Gippsland Water's intentions are clear, and its measures and targets will provide a sound basis to track performance and delivery against each outcome. We identified some matters for follow up that we consider South Gippsland Water will need to address in its response to our draft decision. These relate to clarifying measures and targets.

We will provide South Gippsland Water with our standard Outcomes Reporting Template, identifying these issues, to complete and submit with its response to this draft decision.

³¹ Essential Services Commission, 2023 water price review: Guidance paper, 26 October 2021, p. 23.

³² South Gippsland Water, 2023 water price submission, September 2022, p. 16–23.

South Gippsland Water's proposed targets for its outcome measures suggest customer service levels will be maintained for most measures, with some targets indicating improved customer value.

There are some instances where South Gippsland Water has set targets well below current performance levels, which suggests this is an easily achieved outcome commitment. For example, its measure for average response time to water bursts and leaks (priority 1) has an annual target of 30 minutes. For the upcoming period, it has retained its annual target of 30 minutes, however its average performance for the 4 years in the period to date is 17.9 minutes.³³

South Gippsland Water has committed to reporting annually to customers on how it has performed against its outcome commitments. It will continue to publish its quarterly performance scorecard on its website, as well as report its performance via its social media channels.³⁴

South Gippsland Water's proposal maintains current target levels for most of its output targets, it has proposed higher service levels for some, and its proposed outcomes appear to be supported by customers. On that basis, our draft decision is to accept South 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 service levels 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.

South Gippsland Water's proposed service standards relating to reliability and faults can be found in its proposed service standards 2023–28 document.³⁵

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

³³ South Gippsland Water, 2023 water price submission, September 2022, p. 26; Essential Services Commission, South Gippsland Water's outcomes performance 2021-22, October 2022.

³⁴ South Gippsland Water, 2023 water price submission, September 2022, p. 25.

³⁵ South Gippsland Water, Proposed service standards 2023–28, February 2023

On the basis of the above, our preliminary assessment is that the service standards relating to reliability and faults proposed by South Gippsland Water comply with the requirements of the 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 South 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.

South Gippsland Water's proposed guaranteed service levels are set out on page 29 of its price submission.

South Gippsland Water consulted on its guaranteed service levels with its Community Advisory Committee and in a focussed workshop. For two guaranteed service levels currently in place, it proposed no changes. For the remaining guaranteed service level currently in place, which relates to a sewage spill in a customer's property, it has proposed replacing the word 'property' with 'house' to provide a clearer definition of responsibilities. This change makes it clear that South Gippsland Water will pay the affected customer \$1,000 if it causes a sewage spill within a customer's house. It will also clean up the house and provide alternative accommodation as required.

South Gippsland Water identified a gap in its existing guaranteed service levels for water quality following a boil water advisory event in 2022. As a result, it has proposed a fourth guaranteed service level to reflect water quality incidents in which boil water advice is issued. This will be in the form of a community grant of \$10,000 targeting specific projects.

Our draft decision is to accept South Gippsland Water's proposed guaranteed service levels, on the basis that they have been agreed with customers during its engagement. Final guaranteed service levels and rebates will be subject to our consideration of any feedback following the release of our draft decision.

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.³⁶ 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 South 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 South 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 \$198.2 million, lower than the \$199.9 million proposed by South Gippsland Water.

South Gippsland Water proposed a revenue requirement of \$199.9 million over a 5-year period starting 1 July 2023. Our draft decision proposes a revenue requirement of \$198.2 million – 0.8 per cent lower than proposed by South Gippsland Water (Table 4.1). This reflects our assessment of each element of the revenue requirement, including forecast operating and capital expenditure.

³⁶ 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 South Gippsland Water in the regulatory period from 1 July 2023. We had regard to their views in arriving at our draft decision.

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

	2023-24	2024-25	2025-26	2026-27	2027-28	Total
Operating expenditure	24.8	25.7	25.7	25.9	25.8	127.9
Return on assets ^a	5.9	6.2	6.4	6.3	6.3	31.0
Regulatory depreciation ^a	6.3	7.1	7.9	9.0	10.2	40.5
Non-prescribed revenue offset of revenue requirement ^b	-0.2	-0.2	-0.2	-0.2	-0.2	-1.1
Tax allowance	0.0	0.0	0.0	0.0	0.0	0.0
Draft decision – revenue requirement	36.8	38.7	39.7	41.0	42.0	198.2

Note: Numbers have been rounded. ^a Forecasts for return on assets and regulatory depreciation are indicative, subject to South Gippsland Water’s response to our draft decision on new customer contributions and revenue from customer contributions, and our consideration of its response (see Sections 4.3.2.1 and 4.5). ^b This reflects non-prescribed net rental income.

Table 4.2 summarises how our draft decision on South Gippsland Water’s revenue requirement differs to the revenue requirement proposed by South Gippsland Water in its price submission.

Our proposed changes reflect South Gippsland Water’s approved regulatory accounts for 2021-22, which impacted its capital expenditure and therefore, depreciation and return on assets. It also reflects our proposed adjustments to forecast operating expenditure, and our assumptions for the asset life assumed for its water entitlements (Section 4.5).

Our final decision on South 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, South 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, South 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 South Gippsland Water’s proposed revenue requirement
\$ million 2022-23

	2023-24	2024-25	2025-26	2026-27	2027-28	Total
A. South Gippsland Water’s proposed revenue requirement	37.17	39.07	40.03	41.36	42.31	199.94
B. Operating expenditure	-0.05	-0.05	-0.05	-0.05	-0.05	-0.25
C. Return on assets	-0.05	-0.04	-0.03	-0.02	-0.02	-0.16
D. Regulatory depreciation	-0.26	-0.26	-0.26	-0.26	-0.26	-1.28
E. Tax liability	0.00	0.00	0.00	0.00	0.00	0.00
F. Draft decision – revenue requirement (A + B + C + D + E)	36.82	38.72	39.69	41.03	41.98	198.25

Notes: Our proposed adjustments are the differences between our draft decision and what South Gippsland Water proposed in its price submission. Row A shows the total revenue requirement proposed by South 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 not accept South Gippsland Water’s forecast operating expenditure of \$128.1 million and instead propose a benchmark of \$127.9 million.

Operating expenditure is a component of the revenue requirement. South Gippsland Water’s price submission provides detail on its forecast operating expenditure from pages 34 to 41.

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 South Gippsland Water’s expenditure forecast is available on our website.³⁷

³⁷ FTI Consulting, *South Gippsland Water – Expenditure Review for 2023 water price review*, February 2023.

Since lodging its price submission with us, we identified that South Gippsland Water’s 2021-22 regulatory account figure for total operating expenditure had incorrectly included an accounting provision for decommissioning costs incurred in previous years, which reduced the total reported figure by \$1.6 million to \$24.3 million. To address this shortfall in actual expenditure required, South Gippsland Water had reinstated this amount through a \$1.6 million addition to the controllable operating expenditure baseline.

We requested South Gippsland Water provide an updated financial model that used the correct starting total operating expenditure figure of \$25.9 million for 2021-22 and removed the \$1.6 million upward adjustment to the baseline expenditure. This correction to the input data results in no net change to the expenditure forecasts and is the basis for our assessment discussion below.

Table 4.3 sets out our draft decision on South 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
Controllable operating expenditure	22.74	22.89	22.96	23.22	23.10	114.92
Non-controllable operating expenditure	2.01	2.79	2.75	2.72	2.68	12.95
Bulk services ^a	0.59	1.42	1.42	1.42	1.42	6.26
Environmental contribution ^b	1.33	1.29	1.25	1.22	1.18	6.27
Licence fees – Essential Services Commission ^c	0.02	0.02	0.02	0.02	0.02	0.12
Licence fees – Department of Health ^c	0.01	0.01	0.01	0.01	0.01	0.07
Licence fees – Environmental Protection Authority ^c	0.05	0.05	0.05	0.05	0.05	0.24
Draft decision – operating expenditure	24.75	25.68	25.71	25.94	25.78	127.87

Notes: Numbers have been rounded. ^a Bulk services covers the supply of bulk water and sewerage services.

^b Environmental contributions are funds collected from water businesses under the *Water Industry Act 1994*. ^c 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.

Details of our assessment of South Gippsland Water’s proposal are included in Section 4.1.1 (controllable operating expenditure) and Section 4.1.2 (non-controllable operating expenditure).

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 South Gippsland Water's price submission.

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

4.1.1 Controllable operating expenditure

South Gippsland Water proposed a total forecast controllable operating expenditure of \$128.1 million over a 5-year regulatory period. For the reasons set out below, we propose to accept South Gippsland Water's forecast operating expenditure for the 2023–28 regulatory period.

South 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 South Gippsland Water to be 1.7 per cent per year from 2023-24 to 2025-26 and 1.5 per cent per year from 2026-27 to 2027-28.
3. Apply an annual cost efficiency improvement rate – assumed by South Gippsland Water to be 1.4 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

South Gippsland Water has proposed a controllable operating expenditure baseline of \$22.4 million, after removing \$1.3 million in non-recurring operating expenditure that occurred in 2021-22. This baseline figure remains unchanged following the subsequent amendment for the treatment of the \$1.6 million decommissioning cost provision reduction, as described above.

South Gippsland Water's proposed baseline is \$1.9 million (or 9 per cent) higher than the benchmark figure of \$20.5 million of controllable operating expenditure for 2021-22 used for our 2020 price determination.

Our expenditure consultant requested substantiation of South Gippsland Water's proposed increase to its baseline year operating expenditure benchmark.³⁸ South Gippsland Water explained the increase was due to a number of factors including increases in staff to maintain water supply reliability, meeting regulatory obligations, and enhanced IT security and capability.

Our expenditure consultant verified these additional costs were recurring and found South Gippsland Water's substantiation of these costs to be reasonable.³⁹ Accordingly, it recommended accepting South Gippsland Water's proposed baseline increase with no adjustments required.

We reviewed South Gippsland Water's proposal and the advice from our expenditure consultant and given the above, we consider South 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

South Gippsland Water proposed an average efficiency improvement rate on its controllable operating costs of 1.4 per cent per annum. This is slightly higher than the average rate proposed by water businesses in the current price review.

South Gippsland Water proposed to deliver these efficiencies through several key programs including an Operating Model Review, Intelligent Metering Systems, digital enablement, fleet strategy, Strategic Asset Management Plan, and a Customer Experience Strategy.

The efficiency improvement rate is lower than South Gippsland Water's proposed average cost growth rates of 1.7 per cent per annum for 2023–26 and 1.5 per cent per annum for 2026–28, effectively delivering a net annual increase to its controllable annual baseline operating costs in each year of the regulatory period. This net annual increase is averaged to be 0.2 per cent per annum (average cost growth rate minus average efficiency improvement rate) in the next regulatory period, which is an improvement compared to the 0.6 per cent per annum for the current regulatory period.

4.1.1.3 Cost adjustments

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

- \$0.25 million for consultancy fees to assist in developing its next Urban Water Strategy
- \$0.32 million for its Carbon Management Strategy and commitment to implement 100 per cent renewable energy by 2025 and achieve net zero emissions by 2035

³⁸ FTI Consulting, *South Gippsland Water – Expenditure Review for 2023 water price review*, February 2023 pp. 21-22.

³⁹ FTI Consulting, *South Gippsland Water – Expenditure Review for 2023 water price review*, February 2023 p. 22.

- \$1.0 million for cyber security costs
- \$0.25 million to accommodate Victorian Public Sector Executive Reforms and Executive Remuneration costs.

The above costs represent an additional \$1.3 million over the regulatory period ((\$0.27 million per annum) after including forecast variations for savings to price submission consultancy costs (-\$0.47 million).

FTI Consulting reviewed each of the proposed forecast variations above the baseline and requested further information from South Gippsland Water, including for project-related costs. FTI Consulting considered that South Gippsland Water provided solid reasoning and evidence for its additional costs and did not recommend adjusting South Gippsland Water's proposed forecast.

We have considered the advice from our expenditure consultant, and South Gippsland Water's proposal. Our preliminary view is that South Gippsland Water's approach to forecasting its operating expenditure is generally consistent with the requirements of our guidance.

Our draft decision is to accept South Gippsland Water's proposed adjustments, except for the proposed adjustment to accommodate Victorian Public Sector Executive Reforms and Remuneration costs 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.⁴⁰

Further, since South 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, at well above the 3 per cent forecast we have assumed for the 2023-24 regulatory period. We consider this should contribute to funding any increase in salaries.

Other than this proposed adjustment, we are satisfied that its proposed forecast represents efficient controllable operating expenditure. There is evidence that South Gippsland Water has tested its controllable expenditure requirements, resulting in a forecast overall decline (excluding inflation) in controllable operating expenditure per customer connection across the 2023–28 regulatory period.

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

⁴⁰ See for example, Essential Services Commission 2018, Central Highlands Water draft decision: 2018 Water Price Review, 28 March, p. 13.

- adjusting the forecasts proposed by South Gippsland Water where required.

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

South Gippsland Water has proposed \$12.9 million in non-controllable operating expenditure over the 2023–28 regulatory period. This is an increase of \$1.7 million compared to the 2018–23 period, driven by a \$2.4 million increase in external bulk charges due to the proposed purchase of an additional 2 gigalitres of bulk entitlement for the Lance Creek system; partly offset by a \$0.7 million forecast decrease 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. South Gippsland Water has followed this approach in its price submission.

Accordingly, consistent with the reasoning in our guidance paper, our draft decision is to accept South Gippsland Water’s proposed non-controllable operating expenditure. We have verified that South Gippsland Water’s forecast bulk charges are consistent with Melbourne Water’s 2021 price determination and 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 and external bulk charges data.

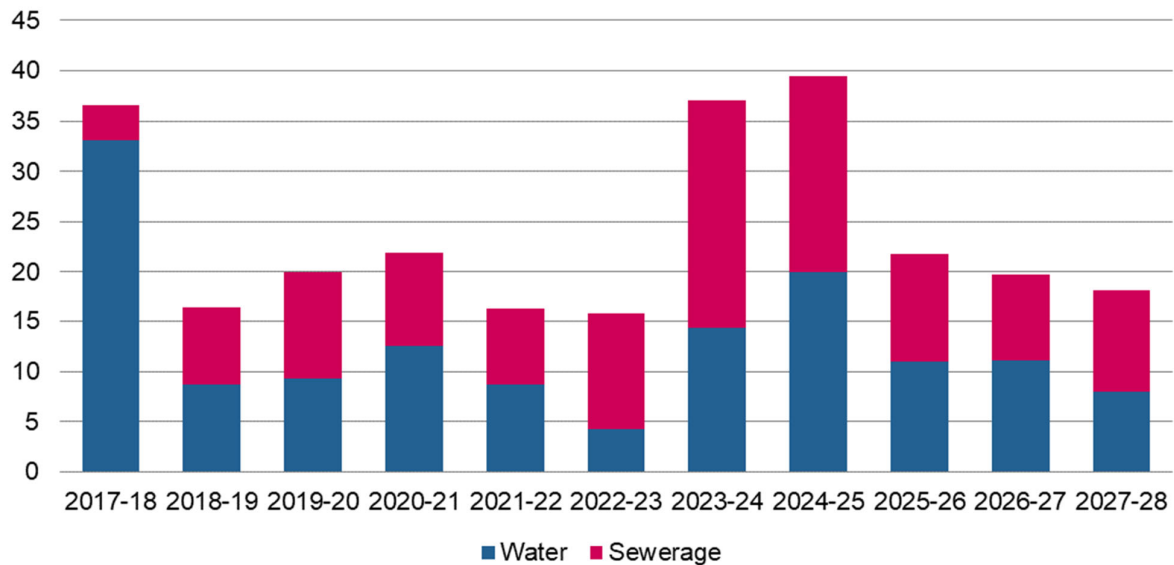
4.2 Capital expenditure

Our draft decision is to accept South Gippsland Water’s proposed forecast capital expenditure of \$136.3 million.

Capital expenditure is an input to estimating the regulatory asset base, which is an input to the revenue requirement. South Gippsland Water’s forecast capital expenditure and supporting information is provided at pages 42 to 51 of its price submission.

Figure 4.1 shows South Gippsland Water’s actual gross capital expenditure for the period from 2017-18 to 2021-22 and forecast gross capital expenditure from 2022-23 to 2027-28. Note that South Gippsland Water’s current regulatory period commenced in 2020-21.

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 South 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 South Gippsland Water’s expenditure forecast is available on our website.⁴¹

4.2.1 Actual capital expenditure

The PREMO framework involves reviewing a business’s actual performance against its proposals and commitments made to its customers in its price submission. This includes a comparison of its actual capital expenditure against the approved expenditure forecasts.

Since lodging its price submission, we identified in South Gippsland Water’s annual regulatory accounts audit some necessary changes to the reported capital expenditure (Table 4.4).

South Gippsland Water has advised us of these changes to its financial model to align with its revised regulatory accounts, which results in a \$2.0 million decrease in actual capital expenditure in 2018-19. We propose to accept this change because it is consistent with the audited regulatory accounts (see Section 4.3.1). Our assessment below reflects these revised figures.

⁴¹ FTI Consulting, *South Gippsland Water: Review of expenditure forecasts - 2023 Water Price Review*, February 2023, pp. 25–33.

Table 4.4 Draft decision adjustments – total prescribed capital expenditure
\$ million 2022-23

	2017-18	2018-19	2019-20	2020-21	2021-22	2022-23	Total
South Gippsland Water price submission – Total prescribed capital expenditure	36.52	18.45	20.00	21.93	16.31	15.77	128.98
Adjustments – regulatory accounting reconciliation	0.00	-2.04	0.00	0.00	0.00	0.00	-2.04
Draft decision – Total prescribed capital expenditure	36.52	16.42	20.00	21.93	16.31	15.77	126.95

Note: Actual total prescribed capital expenditure from 2017-18 to 2021-22, forecast in 2022-23.

Focusing on the period from 2019-20 to 2021-22, South Gippsland Water’s net capital expenditure was around \$12.8 million or 32.4 per cent higher than the benchmarks adopted at its 2020 price review. Most of the additional expenditure has funded discrete projects that were brought forward to protect the environment, address wastewater compliance risks, and ensure ongoing service reliability (in response to unexpected wastewater spills during high rainfall events), treated effluent quality and water quality reliability. Our expenditure consultant found good supporting information justifying South Gippsland Water’s increased capital expenditure over the current regulatory period.⁴² We considered our expenditure consultant’s findings and agree with their view.

To inform our assessment of its major capital project performance over the 2018-20 and 2020-23 regulatory periods, we referred to South Gippsland Water’s most recent major capital projects report and requested additional detail on the progress of several projects.

South Gippsland Water reported that of the 17 major projects reported over the 2018–20 and 2020–23 regulatory periods, six were completed, five are on schedule (including one project that was rescope and combined with an ongoing project) and the remaining five are delayed with only one expected to be completed within 2018–23.⁴³

South Gippsland Water has delayed several projects due to uncertainty around timing and/or changed scope and has only included the cost of preliminary works or design and development in

⁴² FTI Consulting, *South Gippsland Water: Review of Expenditure Forecasts – 2023 Water Price Review*, February 2022, pp. 26–27.

⁴³ Essential Services Commission, *Status of Major Projects Supplement: Outcomes report 2021-22*, 18 October 2022, pp. 51–53. South 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.

the capital expenditure forecast over the 2018–23 period. Our preliminary view is that this approach is reflective of prudent and efficient management of South Gippsland Water’s capital program.

4.2.2 Forecast Capital Expenditure

For the reasons set out below, our draft decision is to accept the forecast capital expenditure of \$136.3 million proposed by South Gippsland Water for the purpose of calculating its revenue requirement:

- South Gippsland Water’s price submission provided evidence that its forecasts for capital expenditure are prudent and efficient. It’s total proposed capital expenditure is \$43.81 million (47.4 per cent) higher than capital expenditure in the preceding 5 years. This is largely due to an increase in growth-related expenditure (\$46.9 million, or 34.4 per cent of the proposed capital program) compared to the previous regulatory period, and continued spending renewals (\$58.3 million, 42.7 per cent). South Gippsland Water’s top 10 major projects accounts for \$67.9 million, or 49.8 per cent of its total forecast capital expenditure.
- Our expenditure consultant requested selected documents from South Gippsland Water as a representative sample to demonstrate its asset management processes and justification for its capital expenditure program.⁴⁴ Based on the sample of documents reviewed and South Gippsland Water’s responses to our consultant’s questions, our consultant found that South Gippsland Water has a robust approach for developing project scope, the timing of works and cost estimates.⁴⁵
- Our consultant reviewed information provided by South Gippsland Water regarding the top 10 major projects proposed in South Gippsland Water’s price submission, and requested further information on the Venus Bay Outfall Upgrade and Renewal project, the Lance Creek Water Storage Upgrade project and the Leongatha Water Supply System Upgrade. Our consultant considered the business cases and supporting information for each project provided a high level of confidence the proposed expenditure was prudent and efficient.⁴⁶
- Our consultant observed that the Venus Bay Outfall upgrade is predominantly required to service two major trade waste customers, and South Gippsland Water was renegotiating these customers’ contracts to include recovery of the capital and operating costs associated with this

⁴⁴ FTI Consulting, *South Gippsland Water: Review of expenditure forecasts - 2023 Water Price Review*, February 2022, p. 26.

⁴⁵ FTI Consulting, *South Gippsland Water: Review of expenditure forecasts - 2023 Water Price Review*, February 2022, p. 29–31.

⁴⁶ FTI Consulting, *South Gippsland Water: Review of expenditure forecasts - 2023 Water Price Review*, February 2022, p. 32–54.

project.⁴⁷ This is consistent with South Gippsland Water’s price submission, however it is not clear how this expenditure has been ring-fenced from pricing for other customers (this is discussed further in Section 5.2.2) and we require South Gippsland Water to explain and justify how it proposes to recover the costs associated with the project, in response to our draft decision.⁴⁸

- Our consultant also reviewed South Gippsland water’s forecast capital expenditure on major programs, and found the information provided by South Gippsland Water provided sufficient evidence these programs have been developed and prioritised appropriately.⁴⁹
- Our preliminary view is that the planned capital expenditure program is achievable given South Gippsland Water’s past track record delivering its capital expenditure program. As discussed in Section 4.2.1, over the 2018-2020 and 2021–23 regulatory periods, South Gippsland Water has incurred capital expenditure closely in line with the benchmarks set in its 2018 and 2020 price determinations and is expected to deliver most of its planned major projects.⁵⁰
- South Gippsland Water has identified in its price submission where it has excluded project costs from its price submission where there is uncertainty in timing, cost, scope and benefits of capital expenditure. It has excluded up to \$4 million for a billing system renewal project and \$8 million for its facilities strategy. These projects are approximately \$12 million in value, which equates to about 8.8 per cent of the forecast capital expenditure. It has also deferred 25 projects and \$21.5 million of capital expenditure into future regulatory periods through its prioritisation process. This approach is consistent with our guidance for managing uncertain expenditure. Our draft decision is to accept South Gippsland Water’s proposal for addressing uncertainty, noting the following:
 - South Gippsland Water will need to demonstrate the prudence and efficiency of these costs if they are incurred during the 2023–28 regulatory period if it is 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.

Overall, our expenditure consultant considered South Gippsland Water’s forecasts were well developed and that its forecast capital expenditure program has been robustly forecast and is

⁴⁷ FTI Consulting, *South Gippsland Water: Review of expenditure forecasts - 2023 Water Price Review*, February 2022, p. 34.

⁴⁸ South Gippsland Water, 2023 water price submission, September 2022, pp. 33, 48.

⁴⁹ FTI Consulting, *South Gippsland Water: Review of expenditure forecasts - 2023 Water Price Review*, February 2022, p. 35.

⁵⁰ Essential Services Commission, *Status of Major Projects Supplement: Outcomes report 2021-22*, 18 October 2022, pp. 51–53.

prudent, efficient and deliverable. Based on the information reviewed, FTI Consulting recommended no adjustments to South Gippsland Water's forecast capital expenditure.⁵¹ We agree with our consultant's view because we consider that, for the purposes of our draft decision, the prudence and efficiency of the expenditure has been justified, consistent with our guidance.

We have reviewed South Gippsland Water's proposals and advice from FTI Consulting and our preliminary view is that we consider South 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 2014.⁵²

Our draft decision for total gross capital expenditure is therefore to accept South Gippsland Water's proposed benchmark. The benchmark we propose to adopt is set out in Table 4.6.

The benchmark that we propose to adopt for South Gippsland Water does not represent the amount that South Gippsland Water is required to spend or allocate to particular 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 South Gippsland Water's revenue requirement, we are not requiring the business to remove that project. South 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.⁵³ 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 South 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)

⁵¹ FTI Consulting, *South Gippsland Water: Review of expenditure forecasts - 2023 Water Price Review*, February 2023, pp. 33.

⁵² Essential Services Commission, *2023 water price review: Guidance paper*, pp. 32–37.

⁵³ 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.

- 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.

4.3.1 Closing regulatory asset base

Our draft decision is to adopt a closing regulatory asset base of \$211.9 million at 30 June 2022, which is lower than the \$213.9 million proposed by South 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 2019-20 to 2021-22.⁵⁴ This helps to ensure prices reflect the actual net expenditure of a water business.⁵⁵

South Gippsland Water's proposed closing asset base at 30 June 2022 is provided at page 52 of its price submission.⁵⁶

South Gippsland Water proposed a closing regulatory asset base of \$213.9 million. We propose to make a \$2 million adjustment to that figure to align South Gippsland Water's capital expenditure with its approved 2021-22 regulatory accounts. Accordingly, our draft decision is to adopt a closing regulatory asset base of \$211.9 million.

We compared South Gippsland Water's actual net capital expenditure for 2019-20 to 2021-22 with the forecast used to approve maximum prices for the period from 1 July 2020.⁵⁷ 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.

South Gippsland Water's net capital expenditure over the period from 2019-20 to 2021-22 was \$52.4 million, \$12.8 million or 32.4 per cent higher than the forecast used to approve maximum prices for the period from 1 July 2020. As noted in Section 4.2.1, we considered our expenditure consultant's findings verifying this expenditure and agree with their views.

Based on the above, our draft decision is to accept the higher capital expenditure amounts for inclusion in South Gippsland Water's closing regulatory asset base.

⁵⁴ See Section 4.2 for a discussion of South Gippsland Water's capital expenditure.

⁵⁵ 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.

⁵⁶ Available at www.esc.vic.gov.au.

⁵⁷ South Gippsland Water's most recent determination covers the period from 2020-21 to 2022-23.

Table 4.5 sets out our draft decision on South Gippsland Water’s closing regulatory asset base at 30 June 2022.

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

	2019-20	2020-21	2021-22
Opening RAB 1 July	175.8	189.1	203.6
Plus gross capital expenditure	20.0	21.9	16.3
Less government contributions	0.0	0.0	0.0
Less customer contributions	1.8	1.9	2.2
Less proceeds from disposals	0.1	0.2	0.2
Less regulatory depreciation	4.8	5.3	5.7
Closing RAB 30 June	189.1	203.6	211.9

Note: Numbers have been rounded.

4.3.2 Forecast regulatory asset base

Our draft decision is to not accept South Gippsland Water’s proposed forecast 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.

Based on our proposed adjustments to South Gippsland Water’s closing regulatory asset base (Section 4.3.1), and our draft decision to not accept South Gippsland Water’s proposed standard new customer contributions (Section 5.4), our draft decision is to not accept South Gippsland Water’s proposed forecast regulatory asset base.

Table 4.6 sets out an indicative forecast regulatory asset base reflecting our draft decision on South Gippsland Water’s closing regulatory asset base, noting that the forecast customer contributions (and regulatory depreciation) may change, subject to South Gippsland Water’s

response to our draft decision on its new customer contributions.⁵⁸ As outlined in Sections 4.3.2.1, South Gippsland Water must provide updated justification and estimates for its forecast customer contributions and regulatory depreciation.

Our assessments of the components of the forecast regulatory asset base are 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 – indicative forecast regulatory asset base (RAB)
\$ million 2022-23

	2022-23	2023-24	2024-25	2025-26	2026-27	2027-28
Opening RAB 1 July	211.9	219.5	246.9	275.8	286.3	294.4
Plus gross capital expenditure	15.8	37.1	39.4	21.8	19.8	18.2
Less government contributions	0.0	0.0	0.0	0.0	0.0	0.0
<i>Less customer contributions (indicative)^a</i>	<i>2.0</i>	<i>3.0</i>	<i>3.1</i>	<i>3.1</i>	<i>2.3</i>	<i>2.3</i>
Less proceeds from disposals	0.1	0.3	0.3	0.3	0.3	0.3
<i>Less regulatory depreciation (indicative)^b</i>	<i>6.1</i>	<i>6.3</i>	<i>7.1</i>	<i>7.9</i>	<i>9.0</i>	<i>10.2</i>
Closing RAB 30 June	219.5	246.9	275.8	286.3	294.4	299.8

Note: Numbers have been rounded. ^a Forecast customer contributions are subject to South Gippsland Water's response to our draft decision on its new customer contributions, and our consideration of its response. These forecasts are indicative only (see Section 4.3.2.1). ^b Regulatory depreciation is calculated based on the opening regulatory asset base of the given year. Therefore, regulatory depreciation forecasts are indicative only and may change in response to any changes to the indicative customer contributions forecasts shown.

⁵⁸ 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.

4.3.2.1 Customer contributions

Our draft decision is to not accept South Gippsland Water's forecasts for revenue from customer contributions.

Revenue from customer contributions is deducted from gross capital expenditure so it is not included in the regulatory asset base.⁵⁹

Our draft decision is to not accept South Gippsland Water's forecasts for customer contributions because:

- New customer contributions are a key input to revenue from customer contributions and, as described in Section 5.4, our draft decision is to not accept South Gippsland Water's new customer contributions.
- South Gippsland Water's forecasts for customer contributions in the financial model and the new customer contributions model do not match.

For the purposes of calculating the regulatory asset base and revenue requirement in our draft decision, we have used South Gippsland Water's proposed customer contributions forecasts, based on its financial model. However, South Gippsland Water must update and justify its customer contribution forecasts in response to our draft decision. South Gippsland Water must also ensure that the forecast customer contributions in the financial model and new customer contributions model can be reconciled.

4.4 Rate of return

In establishing the return on assets component of South Gippsland Water's revenue requirement, we have applied a rate of return to South 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 South Gippsland Water.

Our guidance required South Gippsland Water to use estimates of the cost of debt provided by the commission to estimate its revenue requirement.

⁵⁹ Revenue from new customer contributions reflects revenue earned from new connections made to the water business's water, sewerage or recycled water networks.

South 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 South 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% ^a

Note: Numbers have been rounded. ^a 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 adopt a return on equity of 4.1 per cent, which reflects South 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 South 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.⁶⁰ 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.⁶¹

⁶⁰ Essential Services Commission, *2023 water price review: Guidance paper*, pp. 42–43.

⁶¹ 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.

South Gippsland Water rated its price submission as 'Standard'. Based on this PREMO self-rating, South 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'.⁶²

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

4.5 Regulatory depreciation

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

Regulatory depreciation is a component of South Gippsland Water's revenue requirement and is also an input to calculating the regulatory asset base.

South Gippsland Water's forecast regulatory depreciation was calculated using a straight-line depreciation profile.⁶³ We noted in our guidance that we prefer this approach.⁶⁴ South Gippsland Water also calculated regulatory depreciation in a manner consistent with our guidance.

However, as our draft decision proposes adjustments to South Gippsland Water's 2021-22 capital expenditure, which impacts the regulatory asset base, our draft decision is to not accept South Gippsland Water's forecast regulatory depreciation.

Our draft decision also adopts a 1,000-year average asset life for water entitlements held by South Gippsland Water, rather than its proposed (near) 18-year life. We have proposed this as bulk entitlements should be treated as a non-depreciating asset for pricing purposes.

Table 4.6 in Section 4.3.2 sets out an indicative forecast of regulatory depreciation, which reflects our proposed adjustment to its closing regulatory asset base, and our proposed adjustment to the assumed asset life for its bulk water entitlements. However, in our final decision, we may make further adjustments to its forecast regulatory asset base and depreciation, as a result of our final decision on South Gippsland Water's customer contributions (see Section 4.3.2.1).

4.6 Tax allowance

Our draft decision is to accept South Gippsland Water's proposed forecast of no tax allowance for the 2023–28 regulatory period.

⁶² Essential Services Commission, *2023 water price review: Guidance paper*, p. 42.

⁶³ For the period from 2022-23 to 2027-28, South Gippsland Water proposed a regulatory depreciation of \$47.9 million.

⁶⁴ Essential Services Commission, *2023 water price review: Guidance paper*, p. 39.

The tax allowance is a component of the revenue requirement.

South Gippsland Water has proposed no tax allowance in its revenue requirement for the 2023–28 regulatory period as it will not be in a tax paying position during the 2023–28 regulatory period. Our draft decision is to accept the forecast as it was calculated consistently with the method required by our guidance.⁶⁵

⁶⁵ Essential Services Commission, *2023 water price review: Guidance paper*, pp. 47–48.

5. Demand, tariffs and prices

Once South 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 South Gippsland Water's demand forecasts.

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

South Gippsland Water's demand forecasts are set out at pages 30 to 33 of its price submission and are also included in its financial model.

Our draft decision is to accept South 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 South Gippsland Water's price submission, updated Victorian Government population and dwelling growth estimates have been made available to water businesses.

In its response to our draft decision, South 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 South Gippsland Water's proposed price cap form of price control.

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.⁶⁶

South Gippsland Water proposed a price cap form of price control as set out on page 54 of its price submission. This is the same as its current approach.

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. Adjustments to

⁶⁶ Essential Services Commission, *2023 water price review: Guidance paper*, p. 50.

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 South Gippsland Water's proposed form of price control because:

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

5.3 Tariff structures and prices

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

South Gippsland Water's proposed tariffs are set out at pages 55 to 56 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 South Gippsland Water to reflect our updates to inflation and cost of debt estimates prior to our final decision. They may also need to be updated depending on our further review of its new customer contributions and revenue from customer contributions. 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.⁶⁷ 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.

South Gippsland Water proposed to maintain its existing two-part tariff structures. For residential and non-residential water services, it proposed a two-part tariff with a fixed service charge and a variable component that depends on water use. For residential sewerage services, South Gippsland Water proposed a fixed service charge only. For non-residential sewerage services

⁶⁷ Essential Services Commission, *2023 water price review: Guidance paper*, p. 51.

South Gippsland Water proposed a two-part tariff with a fixed service charge and a variable usage component.

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

Our preliminary view is that the two-part tariff structure proposed by South 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.⁶⁸ We also consider two-part tariff structures are easy to understand. Based on our review of South Gippsland Water's findings from its engagement program, we are satisfied that South Gippsland Water's proposed changes in tariffs are in line with customer preferences.

For sewerage services, we consider South Gippsland Water's proposed fixed charge for residential customers is easy to understand. A two-part tariff for non-residential customers sends these customers signals about efficient costs.⁶⁹

For recycled water services, South Gippsland Water proposed to continue with only a variable usage charge.

5.3.2 Prices

The prices proposed by South Gippsland Water for water and sewerage services are set out on pages 54 to 56 of its price submission.

Under South Gippsland Water's proposal, generally prices (excluding inflation) will be higher. However, to address customer affordability, South Gippsland Water proposes to charge prices that are lower (on average) than the amount it could charge under its proposed revenue requirement (that is, it would under-recover its costs).

Residential water and sewerage prices are proposed by South Gippsland Water to increase by 2 per cent more than inflation in both 2023-24 and 2024-25, and by 3 per cent more than inflation each year between 2025-26 and 2027-28. Non-residential water and sewerage prices are proposed to follow a similar path.

The Consumer Action Law Centre submitted concerns about South Gippsland Water's increased prices in relation to whether the increased prices would place undue pressure on customers experiencing vulnerability and whether they had been proposed following meaningful customer

⁶⁸ 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.

⁶⁹ Our reasons are outlined in our 2013 draft decisions on price review 2013-14 to 2017-18.

consultation.⁷⁰ We reviewed South Gippsland Water's engagement program and our preliminary view is that we are satisfied that South Gippsland Water has tested the proposed price path with customers, including customers experiencing vulnerability.

In May 2023, we intend to determine prices for South 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.⁷¹ 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. Considering this, and South Gippsland Water's proposal for increasing prices in real terms over the 2023–28 regulatory period, we are seeking further information from South 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 2023-24.⁷²

As part of its response, South Gippsland Water must demonstrate how it has considered the impacts of inflation on its forecast expenditure in 2023-24, and whether they are reasonable taking into account that some of its key costs are unlikely to increase as much as near-term inflation.

As noted in Section 4.2.2, South Gippsland Water proposed capital expenditure for the Venus Bay Outfall upgrade. The main beneficiaries of the upgrade are two major trade waste customers and FTI Consulting's report states that South Gippsland Water is negotiating contracts with the two customers to recover the capital and operating expenses associated with this project. However, it is not clear how South Gippsland Water has reflected the forecast costs associated with the upgrade in its proposed prices. Our expectations, in line with the efficiency objectives of the Water

⁷⁰ Consumer Action Law Centre, Initial Feedback: 2023–28 Water Price Review, Essential Services Commission, 30 November 2022.

⁷¹ 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.

⁷² 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.

Industry Regulatory Order 2014, is that the costs associated with the project would be borne by the beneficiaries, and not the broader customer base. Accordingly, we require South Gippsland Water, in response to our draft decision, to explain and justify how it proposes to recover the costs associated with the project.

South Gippsland Water's prices will also be affected by our draft decision on the revenue requirement, which is outlined in Chapter 4. In response to our draft decision, South 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 South Gippsland Water's prices take into account the interests of customers, including low income and vulnerable customers.⁷³

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

- tariffs that are forecast to collect less than its proposed revenue requirement
- tariffs that were informed by an extensive customer engagement program
- a 2 per cent price increase upfront with a gradual approach to further price increases that had been tested with customers experiencing vulnerability
- implementation of a targeted co-payment program designed to re-engage customers with outstanding payments and assist in reducing their debt
- extending customer supports to non-residential customers
- continuing to provide additional funds to the state government-funded Community Rebate Scheme, to allow additional customers to access the scheme and receive repairs or plumbing upgrades with the aim to reduce their water use and bills.

In its submission, the Consumer Action Law Centre noted that only 11 per cent of residential customers with whom South Gippsland Water engaged were tenants, with 75 per cent being owners, and suggested that this was concerning because of the impact pricing and tariff changes can have on renters.

We acknowledge that low-income renters can be disproportionately affected by increases in variable charges and our preliminary view is that South Gippsland Water has appropriately addressed the interests of low income and vulnerable tenants. In forming that preliminary view, we considered the avenues for participation and the outcomes of the engagement. We consider South

⁷³ Water Industry Regulatory Order 2014 clause 11(d)(iii).

Gippsland Water's overall engagement program provided sufficient avenues for the participation of tenants and the surfacing of tenant's issues via community workers and that it has appropriately addressed the needs of tenant customers. South Gippsland Water chose not to propose changes to the structure of its residential tariffs due to broader customer affordability concerns, including the impact on tenants and vulnerable customers.⁷⁴ Further, South Gippsland Water's proposal to expand its assistance available to customer's experiencing payment difficulty will be equally accessible to tenants as it is to property owners.

As noted in Section 3.1, South Gippsland Water's price submission was informed by engagement that was inclusive of customers in vulnerable circumstances. South Gippsland Water commissioned two independent reports that explored the experiences and needs of customers in the South Gippsland region who are facing vulnerability, including appropriate support initiatives. Given the proposed price increases, we consider the focus on engaging with customers experiencing vulnerability was appropriate.

5.3.4 Unique services

South Gippsland Water has confirmed that its proposed tariffs for trade waste 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 South Gippsland Water's proposed standard new customer contributions.

Our draft decision is to accept South Gippsland Water's proposed negotiated new customer contributions 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 and manage unforeseen connection demands.

South Gippsland Water's proposed new customer contributions are set out at page 57 of its price submission. South Gippsland Water proposed to increase its new customer contributions from water and sewer services from \$2,517 in 2022-23 to \$2,971 in 2023-24 (18 per cent increase).

⁷⁴ South Gippsland Water's *Customer Engagement Process and Outcomes – SGW, September 2022* detailed its engagement program for its price submission. The report included additional material about its deliberative engagement – Finding the Balance workshop, which included consideration of pricing and volumetric water pricing.

South Gippsland Water's new customer contributions will remain flat in real terms during the 2023–28 period.

South Gippsland Water engaged with its 17 developers via a letter, a copy of which was forwarded to the commission.⁷⁵ However, it did not receive any enquiry or feedback from developers on the proposed new customer contributions and methodology used. The Consumer Action Law Centre supported increases in new customer contributions being charged to developers rather than unduly burdening existing residential customers with the costs of new developments.⁷⁶

South Gippsland Water has included a portion of historical (or sunk) costs (going back to 2013-14). We will undertake a further review of South Gippsland Water's proposed new customer contributions prior to our final decision and as part of that review, we will assess whether the level of sunk costs included in the new customer contributions are reasonable and compliant with our guidance.⁷⁷

South Gippsland Water's data showed that the growth capital expenditure and new customer contributions revenue included in the new customer contributions and financial models from 2023-24 to 2032-33 do not match.⁷⁸

Based on the above, our draft decision is to not accept South Gippsland Water's proposed new customer contributions.

We are seeking feedback from developers and customers regarding the proposed new customer contributions charges.

We consider South Gippsland Water's proposed negotiated new customer contribution contracts comply with the requirements of our new customer contribution pricing principles.⁷⁹ Therefore, our draft decision is to accept South Gippsland Water's proposed negotiated new customer contribution framework.

⁷⁵ Response to request for information, 12 December 2022.

⁷⁶ Consumer Action Law Centre, Initial Feedback: 2023–28 Water Price Review, 30 November 2022, p. 5.

⁷⁷ The inclusion of sunk capital expenditure is not a requirement of our existing net cash flow framework to calculate new customer contribution charges. We note that very few businesses since 2013, when we commenced using our net cash flow framework, have included sunk costs in their calculation of new customer contributions. Our 2013 explanatory note regarding new customer contributions explained that these costs should only be included where they were built in anticipation of connections growth and needed to be justified as such. We stated: 'Incremental cost can include an allocation of costs of assets that the business had prudently built in expectation of future growth. If such costs are included, they should be explicitly revealed.' Essential Services Commission, New Customer Contributions Explanatory Note, December 2013, p. 5.

⁷⁸ South Gippsland Water's RFI response dated 12 December 2022 noted some projects may have more than one cost driver, which is potentially a reason for the variation.

⁷⁹ Essential Services Commission, 2023 water price review: Guidance paper, p. 59.

5.5 Adjusting prices

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

South Gippsland Water's proposed price adjustment mechanisms are set out at page 54 of its price submission. It proposed the following price adjustment mechanisms, which are similar to those in the current regulatory period:

- a continuation of its existing uncertain and unforeseen events mechanism
- accounting for the difference between forecast and actual non-controllable costs associated with Melbourne Water
- annual changes to the benchmark cost of debt and Consumer Price Index.

It also proposed to pass-through taxes, such as environmental contributions, during the regulatory period. South Gippsland Water's uncertain and unforeseen mechanism provides for changes in taxes during the regulatory period to be passed-through at the discretion of the commission. South Gippsland Water can apply to pass-through material changes in taxes during the regulatory period under this mechanism.

Our draft decision is to accept South Gippsland Water's proposed price adjustment mechanisms because they reflect a continuation of current arrangements and otherwise satisfy the requirements of our guidance.

6. Financial position

We have reviewed key indicators of South Gippsland Water's financial performance and our preliminary view is that South 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.⁸⁰ 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.

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

⁸⁰ 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 South 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.⁸¹ We required South 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 South 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 South Gippsland Water's price submission. As outlined in our guidance, the combination of South Gippsland Water's self-rating and our rating has determined the return on equity we have adopted to calculate South Gippsland Water's revenue requirement in our draft decision.

7.1 Our PREMO assessment of South Gippsland Water's price submission

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

South 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 South Gippsland Water's price submission.

⁸¹ 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
South 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 South Gippsland Water's proposed overall PREMO self-rating of 'Standard'. This is reflected in the return on equity we propose to approve for South Gippsland Water (see Section 4.4.2). We have formed this view after reviewing South 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, 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.⁸²

As noted in Section 3.2, our preliminary view is that we agree with South Gippsland Water's self-assessment that it has, overall, met its outcome commitments for the period to date.

In terms of customer perceptions, South 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 – generally compared favourably with other businesses over the regulatory period. In our most recent survey, it ranked in the top five among businesses, and ranked second on value for money.⁸³

South 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. South

⁸² As set out in Essential Services Commission, 2023 water price review: Guidance paper, 26 October 2021, pp. 74-75. Guiding questions are set out on page 45.

⁸³ 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>.

Gippsland Water's controllable operating expenditure in 2021-22 was around 9 per cent higher than the benchmark adopted at the 2018 review. This increase is around the industry average.

For the period from 2017-18 to 2021-22, South Gippsland Water's capital expenditure (in net terms) is forecast to be \$1.5 million or around 2 per cent higher than the benchmarks established at the 2018 water price review. We consider this is a reasonable outcome given the lumpiness of capital expenditure.

South Gippsland Water's overall delivery on its outcome commitments, performance on our customer perception survey, and the management of its capital program close to 2018 price review benchmarks, helped to offset the impacts of its higher operating costs in the current period in our assessment.

Based on the above, our draft decision is to accept South Gippsland Water's self-rating of 'Standard' for the Performance element of PREMO. We consider South Gippsland Water met expectations for delivery against outcome commitments, and achieved an overall rating of 'Standard' for PREMO in 2018; to maintain a rating of Standard in the current regulatory period, South Gippsland Water needed to generally meet performance expectations.

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).⁸⁴

In support of its self-rating of 'Standard' for the Risk element of PREMO, South Gippsland Water's price submission provided an overview of key risks and how these would be managed.⁸⁵

Key factors supporting its rating include its continued use of a price cap form of price control (which means the business bears demand risk), the proposal to include a new guaranteed service level to reflect water quality incidents, and its proposal to charge lower than its forecast revenue requirement to help address affordability for its customers.

Our preliminary view is therefore that we accept South Gippsland Water's self-rating of 'Standard' for risk.

⁸⁴ Essential Services Commission, 2023 water price review: Guidance paper, p. 45.

⁸⁵ South Gippsland Water, 2023 water price submission, September 2022, p. 13–15.

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.⁸⁶

Our draft decision is to accept South Gippsland Water's self-rating of 'Standard' for the Engagement element of PREMO on the basis of the overall suitability of the engagement methods for the issues it is engaged on, and the level of influence it afforded its stakeholders. South Gippsland Water's engagement with customers facing vulnerability and their advocates was extensive and was informed by a deep understanding of the circumstances of customers experiencing vulnerability in its service area, including the impact any proposed increase in real prices would have on these customers.

South Gippsland Water was able to achieve strong alignment between consumer preferences and the proposals in its submission, including its proposals for additional support for customers who may be experiencing vulnerability during this regulatory period.

Finally, we acknowledge the strength of the endorsement provided by a member of its Community Advisory Committee on the balance in price, services and sustainability that South Gippsland Water was about to achieve. See Section 3.1 for more detail.

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.⁸⁷

In support of its self-rating of 'Standard' for the Management element of PREMO, as noted in Section 4.1.1, South Gippsland Water proposed one of the highest efficiency improvement rates for controllable operating expenditure over the next regulatory period (1.4 per cent). Based on advice from FTI Consulting, we have also tested South Gippsland Water's assumptions for forecast operating and capital expenditure, and our preliminary view is that they generally reflect efficient expenditure, but for relatively minor adjustments.

We consider South Gippsland Water's price submission provided clear justification for its proposals. There were some adjustments necessary to its model reflecting corrections to align with

⁸⁶ Essential Services Commission, 2023 water price review: Guidance paper, p. 45.

⁸⁷ Essential Services Commission, 2023 water price review: Guidance paper, p. 45.

the regulatory accounts we have approved. The South Gippsland Water Board has also attested to the accuracy of the information contained in its submission, as required by our guidance.

Our draft decision is to accept South Gippsland Water's self-rating of 'Standard' for Management because of its higher than average annual operating cost efficiency hurdle, and our assessment that its proposed expenditure, in the main, reflected prudent and efficient costs.

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.⁸⁸

As noted in Section 3.2, our preliminary view is that South 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. In developing its price submission, a Community Advisory Committee was established to provide advice on a range of topics including customer outcomes. The Community Advisory Committee was supportive of South Gippsland Water's investment proposals and felt they reflected its customer outcomes.

Our preliminary view is that South Gippsland Water's proposed targets for its outcomes indicate that customer value will generally be maintained, with some targets indicating an improvement in customer value.

South Gippsland Water has committed to reporting annually to its customers on its performance against its outcome commitments. It will continue to publish its quarterly performance scorecard on its website, as well as report its performance via its social media channels.⁸⁹

Based on the above, our draft decision is to accept South Gippsland Water's self-rating of 'Standard' for the Outcomes element of PREMO.

⁸⁸ Essential Services Commission, 2023 water price review: Guidance paper, p. 45.

⁸⁹ South Gippsland Water, 2023 water price submission, September 2022, p. 25.

Appendix A — Submissions received

Name or organisation	Date received
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 South Gippsland Water.

In addition to the mandatory factors set out below, clause 11 of the WIRO requires the commission to have regard to the matters specified in the commission’s guidance.⁹⁰ We have had regard to the matters specified in our guidance in reaching our preliminary view. Our draft decision provides further information on where we have considered our guidance, and South Gippsland Water’s compliance with our guidance, in reaching our preliminary view.

Note: all chapter and section numbers referenced below refer to our draft decision for South 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).

⁹⁰ 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 South Gippsland Water has demonstrated its proposed outcomes reflect customer service priorities, and whether its tariffs and forecast costs reflect efficient levels of expenditure.

The following 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 South Gippsland Water to recover borrowing costs associated with its investment in services, and generate a return on assets.⁹¹

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 South Gippsland Water has demonstrated its forecasts reflect efficient costs to deliver services valued by customers, and to deliver on relevant legislation and relevant health, safety, environmental and social obligations.

The following 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).

⁹¹ 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 South Gippsland Water to deliver services that are covered by the prescribed services listed in the WIRO.

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

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

- 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 Australia⁹²
- operating and capital expenditure costs per connection throughout Australia⁹³
- tariff structures applied by water businesses throughout Australia⁹⁴
- the regulatory rate of return set by other regulators.⁹⁵

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 South Gippsland Water’s proposals, including through submissions and public meetings.

⁹² Bureau of Meteorology, *National performance report 2020-21; urban water utilities, part A*, February 2022.

⁹³ Bureau of Meteorology, *National performance report 2020-21; urban water utilities, part A*.

⁹⁴ Includes Icon Water, Sydney Water, Hunter Water, Central Coast Council, Power and Water Corp, Urban Utilities, Unity Water, SA Water and TasWater.

⁹⁵ 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 South Gippsland Water’s prices ‘enable customers or potential customers of the regulated entity to easily understand prices charged by the regulated entity for prescribed services or the manner in which such prices are calculated, determined or otherwise regulated’.

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

- feedback from customers during a water 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 South Gippsland Water’s prices ‘provide signals about the efficient costs of providing prescribed services to customers while avoiding price shocks where possible’.

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

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

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

- Our assessment of engagement (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 2016.⁹⁶

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.⁹⁷

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

⁹⁶ Essential Services Commission 2016, Water Pricing Framework and Approach, Implementing PREMO from 2018, October, pp. 11–13.

⁹⁷ 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.⁹⁸

⁹⁸ Essential Services Commission, 2023 water price review: *Guidance paper*, p. 2.