

# East Gippsland Water final decision

2018 Water Price Review

29 May 2018

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# Summary

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

In December 2017, we released our draft decision on East Gippsland Water's price submission.<sup>1</sup> The draft decision set out our preliminary views on East Gippsland Water's proposals, and invited interested parties to make further submissions. We also held a public meeting in February 2018. In addition to a response from East Gippsland Water, we received five written submissions on our draft decision, which are available on our website. A list of these submissions is included in Attachment A to this final decision.

After considering feedback, we have made a price determination for East Gippsland Water.<sup>2</sup> The price determination sets out the maximum prices East Gippsland Water may charge for prescribed services (or the manner in which its prices are to be calculated, determined, or otherwise regulated) for the five year period from 1 July 2018 (2018–23). This final decision paper sets out our supporting reasons and analysis for the price determination.

Where our final decision on a particular aspect is unchanged from our draft decision, we have not detailed the supporting reasons in our final decision. Rather, we have noted that our final decision confirms the reasons and position we reached in the draft decision.

Where we have reached a different decision to that proposed in our draft decision, or where new information required our consideration, we have set out our reasons in full in this final decision. This final decision should be read in conjunction with our draft decision.

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<sup>1</sup> Clause 16 of the Water Industry Regulatory Order (WIRO) 2014 requires us to issue a draft decision. East Gippsland Water's price submission and our draft decision are available at [www.esc.vic.gov.au/waterpricereview](http://www.esc.vic.gov.au/waterpricereview).

<sup>2</sup> Before the commencement of a regulatory period, clause 10 of the WIRO 2014 requires us to make a price determination which determines the maximum prices a water corporation may charge, or the manner in which its prices are to be calculated, determined or otherwise regulated during the regulatory period. See Essential Services Commission 2018, *East Gippsland Water Determination: 1 July 2018 – 30 June 2023*, 29 May.

## Our final decision has updated the revenue requirement for East Gippsland Water

Our final decision approves a revenue requirement of \$169.9 million over the five year period starting 1 July 2018 (see pages 9 to 10).<sup>3</sup> This is \$0.9 million or 0.5 per cent lower than our draft decision, and mainly reflects updates to forecast operating expenditure and the cost of debt.

A summary of approved maximum prices for major services provided by East Gippsland Water is set out on pages 24 and 25. The estimated typical bills for residential customer groups under our final decision are provided in Table A. Not including inflation, compared with 2017–18, the estimated annual bill for a residential owner occupier will fall by around \$5 in 2018–19, and rise by around \$10 for a residential tenant. The bill paid by a customer will vary depending on water use, prices for fixed and variable tariffs, and other charges.

**Table A**      **Estimated typical residential water and sewerage bills**  
\$ million 2018-19

Customer group	Average consumption (kL p.a.)	2017-18 annual bill	2018-19 annual bill	2022-23 annual bill
Residential (Owner occupier)	146	\$1,189 <sup>a</sup>	\$1,184	\$1,184
Residential (Tenant)	146	\$304 <sup>a</sup>	\$314	\$314

<sup>a</sup> Includes a \$28 rebate paid to customers from a government efficiency review

Note: Typical bills include water and sewerage charges and any applicable rebates based on average water use. Annual bills exclude the parks and drainage charges. Numbers have been rounded

## The services provided to customers will improve in key areas

Our final decision approves prices that will allow East Gippsland Water to deliver on its customer service commitments, government policy, and obligations monitored by the Environment Protection Authority Victoria and the Department of Health and Human Services.

Some of the ways East Gippsland Water plans to improve outcomes for customers are by:

- investing in water and sewerage assets to address future demand
- improving awareness about its assistance for customers experiencing payment difficulty
- providing a bill rebate for outdoor community recreation groups

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<sup>3</sup> The revenue requirement is the forecast amount a water corporation needs to deliver on customer outcomes, government policy, and obligations monitored by technical regulators including the Environment Protection Authority Victoria and the Department of Health and Human Services. Along with forecast demand, it is an input to calculating the prices to be charged by a water corporation.

- offering grants to schools and community groups to support native revegetation projects.

### Tariff structures are the same

Our final decision approves East Gippsland Water’s proposed tariff structures, which are the same as its current structures. For water services, East Gippsland Water proposed a fixed service charge and a variable component that depends on water used. For sewerage services, East Gippsland Water proposed a fixed charge only. More detail is provided from page 22.

Our final decision also approves East Gippsland Water’s proposed price cap form of price control (see page 22). This means its maximum prices are fixed subject to updates for inflation, and any other price adjustments we approve in our price determination.

### East Gippsland Water’s price submission is rated as ‘Standard’ under PREMO

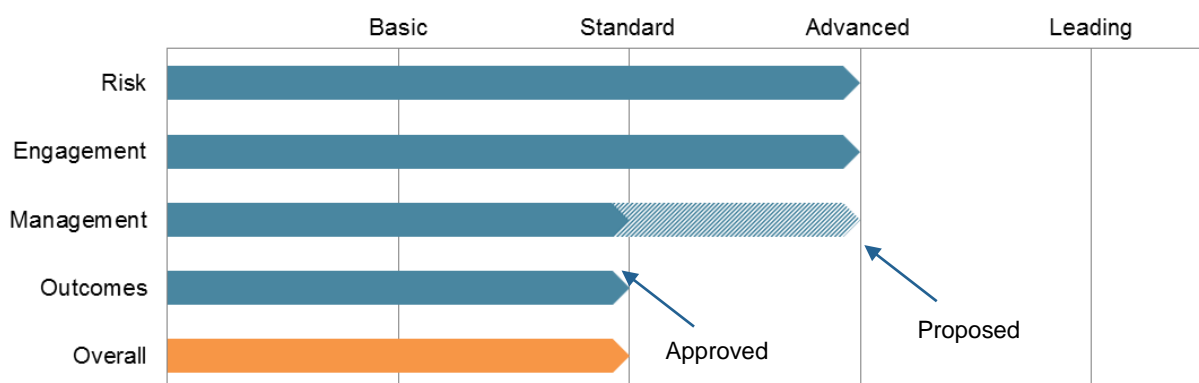
Consistent with our draft decision, our final decision is to accept East Gippsland Water’s PREMO self-rating of ‘Standard’. In support of its proposed PREMO rating, we note the high quality of East Gippsland Water’s price submission, which was clearly set out and provided sufficient justification for its proposals. East Gippsland Water also accepted greater risk on behalf of its customers, proposing to change to a price cap form of price control, from a weighted average price cap.

East Gippsland Water also demonstrated that its engagement findings influenced its proposals.

Our final decision considers a rating of ‘Standard’ is more appropriate for the Management element of PREMO, rather than the ‘Advanced’ rating proposed by East Gippsland Water.

Figure A summarises our final decision on PREMO. More detail on our assessment of East Gippsland Water’s PREMO rating is provided in Chapter 3.

**Figure A** PREMO – East Gippsland Water final decision summary



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





# 1. Our role and approach to water pricing

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

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

## **We are reviewing the prices 17 water corporations propose to charge customers from 1 July 2018**

Our review of the prices proposed by the water corporations covers the prescribed services listed in the WIRO.<sup>4</sup> The prescribed services include retail water and sewerage services, and bulk water and sewerage services delivered by the water corporations.<sup>5</sup>

Our task is to assess price submissions by water corporations against the legal framework that governs our role, and make a price determination that takes effect from 1 July 2018. We make a price determination after issuing a draft decision, and considering feedback from interested parties.

The price determination specifies the maximum prices a water corporation may charge for prescribed services, or the manner in which prices are to be calculated, determined or otherwise regulated. We also issue a final decision that sets out the supporting reasons for our price determination.

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

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

- the objectives and matters specified in clause 8 of the WIRO, which include economic efficiency and viability matters, industry specific matters, customer matters, health, safety, environmental and social matters, and other matters which are specified in sections 8 and 8A of the ESC Act and section 4C of the WI Act

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<sup>4</sup> The review excludes Melbourne Water and Goulburn-Murray Water. In 2016 we approved prices for Melbourne Water to 30 June 2021 and for Goulburn-Murray Water to 30 June 2020.

<sup>5</sup> The prescribed services are listed at clause 7(b) of the WIRO.

- the matters specified in our guidance<sup>6</sup>
- the principle that prices should be easily understood by customers and provide signals about the efficient costs of providing services, while avoiding price shocks where possible
- the principle that prices should take into account the interests of customers of the regulated entity, including low income and vulnerable customers.

Our consideration of legal requirements document lists the specific objectives and the various matters the commission must have regard to when making a price determination and provides a guide to where we have done so for our price determination for East Gippsland Water.<sup>7</sup>

In 2016, we issued guidance to East Gippsland Water to inform its price submission. The guidance set out how we will assess East Gippsland Water's submission against the matters we must consider under clause 11 of the WIRO.

If we consider the price submission has adequate regard for the matters in clause 11 of the WIRO and complies with our guidance, we must approve East Gippsland Water's proposed prices.<sup>8</sup>

If we consider the submission does not have adequate regard for the matters specified in clause 11 of the WIRO or comply with our guidance, we may specify maximum prices, or the manner in which prices are to be calculated, determined or otherwise regulated.<sup>9</sup>

The power for water corporations to impose fees is set out in the *Water Act 1989 (Vic)* (Water Act). Provisions in the Water Act also govern the manner in which water corporations may impose fees, and it is for each water corporation to ensure that it complies with them.<sup>10</sup>

## **The 2018 price review is the first we've undertaken under our new water pricing approach**

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

<sup>6</sup> Essential Services Commission 2016, *2018 Water Price Review: Guidance paper*, November.

<sup>7</sup> Essential Services Commission 2018, *East Gippsland Water final decision: 2018 Water Price Review – commission's consideration of legal requirements*, 29 May. This is available at [www.esc.vic.gov.au/waterpricereview](http://www.esc.vic.gov.au/waterpricereview)

<sup>8</sup> This is a requirement of the WIRO, clause 14(b).

<sup>9</sup> This is provided for under the WIRO, clause 14(b)(i).

<sup>10</sup> See Part 13, Division 5 of the Water Act.

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

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

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

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

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

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

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

## **PREMO**

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

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

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

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

<sup>14</sup> The revenue requirement is the forecast amount that a water corporation needs to deliver on customer outcomes, government policy, and obligations monitored by technical regulators including the Environment Protection Authority Victoria and the Department of Health and Human Services.

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

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

The 2018 water price review is the first time we've applied our PREMO incentive mechanism. A water corporation's ambition in terms of delivering customer value is being assessed against four elements of PREMO – Risk, Engagement, Management and Outcomes.<sup>17</sup>

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

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

<sup>18</sup> The PREMO process is described in: Essential Services Commission 2016, *Guidance paper*, op. cit., pp. 44–49.

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

We have made our price determination for East Gippsland Water after considering: East Gippsland Water's price submission, its responses to our queries and our draft decision, and written submissions from interested parties, including in response to our draft decision (a list of submissions responding to our draft decision is provided in Appendix A). We also held a public meeting in February on our draft decision to receive feedback.

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

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

Our guidance included a number of matters water corporations must address in their price submissions. East Gippsland Water's price submission addressed each of these matters, with our preliminary assessment set out in our draft decision. Our final decision on these matters is set out on the following pages.

All financial values referred to in this chapter are in \$2017-18, unless otherwise specified.

## Regulatory period

Our draft decision accepted the five year regulatory period (1 July 2018 to 30 June 2023) proposed by East Gippsland Water in its price submission. Our guidance proposed to approve a five year regulatory period, subject to any alternative and justified proposal.<sup>19</sup>

In response to our draft decision, Consumer Action Law Centre recommended the regulatory period should be the same for all water corporations, unless there are special circumstances.<sup>20</sup> In support of this, it noted factors such as greater community attention when all price reviews are undertaken at the same time.

Our final decision is to approve the five year regulatory period proposed by East Gippsland Water. This is the same period we have approved for the other three final decisions released at this time.

## Customer engagement

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

The engagement by East Gippsland Water:

- took place between November 2015 and September 2017
- used a range of methods including face-to-face conversations, online and paper surveys, and pop-up water cafes held at school fairs and community markets
- sought views from customer groups including Indigenous organisations, year nine students, sporting groups and a disability organisation
- was informed by a customer committee that reviewed engagement material, conducted community surveys, and made recommendations on pricing and guaranteed service levels
- covered topics such as prices and service levels, the nature of its customer financial assistance program, service levels and East Gippsland Water's contribution to liveability.

More detail on East Gippsland Water's engagement is available in its price submission.<sup>21</sup>

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

<sup>20</sup> Consumer Action Law Centre 2018, *Submission: Comment on Early Draft Decisions*, 13 March, pp. 5–6.

<sup>21</sup> East Gippsland Water's price submission is available on our website at [www.esc.vic.gov.au/waterpricereview](http://www.esc.vic.gov.au/waterpricereview). See pages 12–15.

Evidence that East Gippsland Water's engagement influenced its price submission includes:

- East Gippsland Water proposing to maintain service levels, in response to feedback that customers did not want to pay more for more or better services
- introducing email billing in response to customer feedback
- responding to feedback there is low awareness of existing programs for customers experiencing financial hardship by increasing its education efforts.

The influence of East Gippsland Water's engagement on its proposals supports the objectives in our pricing framework relating to efficiency and the interests of consumers.<sup>22</sup>

In a submission responding to our draft decision, Consumer Action Law Centre suggested we could play a greater role to promote best practice customer engagement and identify areas for improvement.<sup>23</sup> We note that following our price review, we will continue to work with water corporations to promote best practice customer engagement.

## Outcomes

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

- current levels of water and sewerage services maintained
- safe, high quality drinking water supplies delivered
- no increase to average customer bills (beyond inflation)
- commitment to environmental sustainability
- enhanced liveability and resilience in its region.

Some of the ways East Gippsland Water plans to improve outcomes for customers are by:

- improving awareness about its assistance for customers experiencing payment difficulty
- providing a bill rebate for outdoor community recreation groups
- offering grants to schools and community groups to support native revegetation projects.

East Gippsland Water's proposed measures and targets for reporting against outcomes are listed at pages 18 to 21 of its price submission. East Gippsland Water has committed to reporting on its performance of outcomes annually to customers via a public scorecard.

During 2018-19, we will engage with East Gippsland Water to finalise the set of measures, targets and how it will report to customers on its performance against Outcomes. Its performance will

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<sup>22</sup> See for example, WIRO clauses 8(b)(i), 8(b)(ii), 8(b)(iii), 11(d)(iii), and ESC Act Sections 8(1), 8A(1)(a).

<sup>23</sup> Consumer Action Law Centre 2018, *Early Draft Decisions*, op. cit., p. 4.

inform our assessment during future price reviews as part of the Performance element of future PREMO assessments.

## Service Standards

East Gippsland Water also provided a list of service standards relating to reliability and attending faults that it will include in its customer charter. These service standards and East Gippsland Water's targets for the five year period to June 2023 are set out in Appendix B.

In a submission on our draft decision Consumer Action Law Centre noted a range of ambitions by water corporations when it comes to proposed service standards and that water corporations should be encouraged to 'improve service standards over time'.<sup>24</sup> We note that East Gippsland Water proposed standards for reliability and attending faults improve on past targets.

Service standards relating to reliability and attending faults are set out in Appendix B and form part of the manner in which East Gippsland Water's services are regulated.

## Guaranteed service levels

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

East Gippsland Water's proposed GSLs and its justification for these are set out on page 23 of its price submission. It has made no changes to the payment difficulty GSL, and proposed to retain its GSL relating to sewage spills within a dwelling. New GSLs were developed by its customer committee and relate to notification about planned interruptions, greenhouse gas emission reduction and native vegetation planting.

In our draft decision we provided an overview of East Gippsland Water's proposed GSLs.

In a submission responding to our draft decision, the Consumer Action Law Action Centre supported increasing payments for GSLs so they are 'not losing their value over time'.<sup>25</sup> We note that East Gippsland Water has proposed two new GSLs and maintained the same payments for two existing GSLs.

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<sup>24</sup> Consumer Action Law Centre 2018, *Early Draft Decisions*, op. cit., p. 7.

<sup>25</sup> Consumer Action Law Centre 2018, *Early Draft Decisions*, ibid.



We confirmed with East Gippsland Water’s customer committee members that the proposed GSLs and the payment amounts were developed and independently set by the committee. We consider East Gippsland Water’s approach provides assurance that its proposed GSLs, including payment amounts, reflect the most important aspects of service delivery identified by customers.

For these reasons, our final decision approves East Gippsland Water’s proposed GSLs.

East Gippsland Water GSLs are set out in Appendix C.

East Gippsland Water’s commitment to GSL payments should these service levels not be met, forms part of the manner in which East Gippsland Water is regulated.

## Revenue requirement

The revenue requirement is the forecast amount a water corporation needs to deliver on customer outcomes, government policy, and obligations monitored by technical regulators including the Environment Protection Authority Victoria and the Department of Health and Human Services.<sup>26</sup> Along with forecast demand, it is an input to calculating prices.

Our draft decision accepted East Gippsland Water’s proposed revenue requirement of \$170.8 million over a five year period starting 1 July 2018.

Our final decision approves a slightly lower revenue requirement of \$169.9 million. This reflects our final decision on each element that comprises the revenue requirement, as set out in Table 2.1.

The reduction for our final decision mainly reflects updates to forecast operating expenditure (arising from adjustments to forecast payroll tax payments and non-controllable costs) and updates to the cost of debt (affecting return on assets) which was anticipated in our draft decision.

Adjustments to the revenue requirement since our draft decision are set out at Table 2.2, with the reasons set out in the following sections.

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<sup>26</sup> We met with officers of the Department of Environment, Land, Water and Planning, Department of Health and Human Services, and Environment Protection Authority Victoria, to discuss their expectations of East Gippsland Water in the regulatory period from 1 July 2018. We had regard to their views in our draft and final decisions.

**Table 2.1 Final decision – Revenue requirement**

\$ million 2017-18

	2018-19	2019-20	2020-21	2021-22	2022-23	Total
Operating expenditure	19.8	19.7	19.2	19.2	19.3	97.2
Return on assets	5.9	6.1	6.3	6.4	6.6	31.2
Regulatory depreciation	7.0	7.6	8.2	8.8	8.8	40.4
Non-prescribed revenue offset of revenue requirement	-0.2	-0.2	-0.2	-0.2	-0.2	-0.9
Tax allowance	0.0	0.0	0.4	0.8	0.8	2.0
<b>Final decision – revenue requirement</b>	<b>32.5</b>	<b>33.2</b>	<b>34.0</b>	<b>35.0</b>	<b>35.3</b>	<b>169.9</b>

Note: Numbers have been rounded

**Table 2.2 Adjustments to draft decision revenue requirement**

\$ million 2017-18

	2018-19	2019-20	2020-21	2021-22	2022-23	Total
<b>Draft decision – revenue requirement</b>	<b>32.7</b>	<b>33.4</b>	<b>34.1</b>	<b>35.2</b>	<b>35.5</b>	<b>170.8</b>
Operating expenditure	-0.15	-0.13	-0.13	-0.13	-0.12	-0.65
Return on assets	-0.04	-0.05	-0.05	-0.05	-0.05	-0.24
Tax allowance	0.0	0.0	-0.01	-0.002	-0.002	-0.01
<b>Total adjustments</b>	<b>-0.2</b>	<b>-0.2</b>	<b>-0.2</b>	<b>-0.2</b>	<b>-0.2</b>	<b>-0.9</b>
<b>Final decision – revenue requirement</b>	<b>32.5</b>	<b>33.2</b>	<b>34.0</b>	<b>35.0</b>	<b>35.3</b>	<b>169.9</b>

Note: Numbers have been rounded

## Operating expenditure

Operating expenditure is an input to the revenue requirement. In our draft decision (pages 9 to 12), we proposed to accept East Gippsland Water's operating expenditure forecast of \$97.89 million for the 2018–23 period. The reasons for this were:

- Evidence indicating its baseline controllable operating expenditure reflects an efficient benchmark.<sup>27</sup>
- East Gippsland Water justified the additional operating cost items above its annual baseline cost, particularly forecast energy price increases, annual lagoon desludging costs, grants for tree planting and a small increase in wages above inflation.
- The rate of the forecast decline in controllable operating expenditure per customer connection is greater than the average of all urban water corporations in our review.

We noted in our draft decision that we would update the forecast non-controllable operating expenditure for our final decision, and also adjust for the latest inflation data.<sup>28</sup>

East Gippsland Water's response to our draft decision did not provide any new information on our draft decision for operating expenditure. No other new considerations were presented in submissions received following the draft decision, which caused us to change our views on operating expenditure.

When we released our draft decision, East Gippsland Water had not finalised its electricity contract beyond 30 June 2018. After submitting its response to our draft decision, East Gippsland Water advised its new electricity contract prices for 2018–21 are consistent with its forecast energy costs in its price submission. For the remaining two years of the period, increased energy costs will be offset by electricity savings from its proposed solar projects. We accept that no change is required to the forecast operating expenditure in our draft decision, noting East Gippsland Water bears the risk if its solar projects do not deliver the expected savings.

The Victorian budget 2018-19 was released after East Gippsland Water submitted its response to our draft decision. This budget reduced the payroll tax rate from 3.65 per cent to 2.425 per cent for regional corporations from 1 July 2018. As a result, East Gippsland Water advised us of a \$0.52 million reduction over the 2018–23 period. This is consistent with our draft decision requirement to be provided with updated forecasts if there is a change in laws or government policy.

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<sup>27</sup> Controllable costs are those that can be directly or indirectly influenced by a water corporation's decisions.

<sup>28</sup> Non-controllable costs are those that cannot be directly or indirectly influenced by a water corporation's decisions.

For non-controllable operating expenditure, we have adjusted East Gippsland Water's forecasts where required based on the latest information received from the relevant regulatory authorities on their licence fees and the environmental contribution. We have also taken into account the latest data on inflation.

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

We have assumed the licence fees for the Department of Health and Human Services, the Environment Protection Authority Victoria and the Essential Services Commission remain flat in real terms across the period, but with a 50 per cent increase for our commission fee in 2022-23 to align with our regulatory review cycle.<sup>29</sup>

We have reduced East Gippsland Water's forecast non-controllable operating expenditure by \$0.13 million across the 2018–23 period, resulting from the following adjustments:

- increasing the Department of Health and Human Services licence fee by \$0.001 million per year (a total increase of \$0.01 million)
- adopting a forecast for our commission licence fee of \$0.02 million per year from 2018-19 to 2021-22, and \$0.03 million in 2022-23 (in total, a \$0.01 million reduction)
- increasing the Environment Protection Authority Victoria licence fee by \$0.002 million per year (a total increase of \$0.01 million)
- adopting a forecast for the environmental contribution of \$1.47 million in 2018-19, and assuming this declines in real terms across the remainder of the period (a total reduction of \$0.13 million).

Overall, non-controllable operating expenditure will increase by \$0.26 million from 2017-18 to 2018-19, due primarily to the increase in the environmental contribution from \$1.20 million to \$1.47 million.

Table 2.3 sets out our proposed adjustments for controllable and non-controllable operating expenditure. Table 2.4 sets out the benchmark values for licence fees we have adopted for our final decision.

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<sup>29</sup> The Department of Health and Human Services and the Environment Protection Authority Victoria provided their latest 2016-17 licence fees. We have also based our forecast on our 2016-17 commission licence fee.

**Table 2.3 Adjustments to operating expenditure**

\$ million 2017-18

	2018-19	2019-20	2020-21	2021-22	2022-23	Total
<b>Draft decision – total operating expenditure</b>	<b>19.9</b>	<b>19.9</b>	<b>19.3</b>	<b>19.3</b>	<b>19.4</b>	<b>97.9</b>
Payroll tax rate change	-0.10	-0.10	-0.10	-0.10	-0.10	-0.52
<b>Total adjustments to controllable costs</b>	<b>-0.10</b>	<b>-0.10</b>	<b>-0.10</b>	<b>-0.10</b>	<b>-0.10</b>	<b>-0.52</b>
Licence fees	-0.02	0.003	0.003	0.003	0.01	0.01
Environment contribution	-0.03	-0.03	-0.03	-0.03	-0.03	-0.13
<b>Total adjustments to non-controllable costs</b>	<b>-0.04</b>	<b>-0.02</b>	<b>-0.02</b>	<b>-0.02</b>	<b>-0.01</b>	<b>-0.13</b>
<b>Final decision – total operating expenditure</b>	<b>19.8</b>	<b>19.7</b>	<b>19.2</b>	<b>19.2</b>	<b>19.3</b>	<b>97.2</b>

Note: Numbers have been rounded

We have adopted the benchmark for operating expenditure set out in Table 2.4 for the purpose of making our final decision on East Gippsland Water's revenue requirement (Table 2.1). We consider East Gippsland Water's approach to forecasting controllable operating expenditure, alongside the \$0.65 million reduction to the non-controllable expenditure, is consistent with the requirements of the Water Industry Regulatory Order (WIRO) and the criteria for prudent and efficient expenditure outlined in our guidance.<sup>30</sup>

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

**Table 2.4 Final decision – Operating expenditure**

\$ million 2017-18

	2018-19	2019-20	2020-21	2021-22	2022-23	Total
<b>Controllable costs</b>	<b>18.3</b>	<b>18.2</b>	<b>17.8</b>	<b>17.8</b>	<b>17.9</b>	<b>89.9</b>
<b>Non-controllable costs</b>	<b>1.5</b>	<b>1.5</b>	<b>1.5</b>	<b>1.4</b>	<b>1.4</b>	<b>7.3</b>
Bulk services <sup>a</sup>	0.0	0.0	0.0	0.0	0.0	0.0
Environmental contribution <sup>b</sup>	1.5	1.4	1.4	1.4	1.3	7.0
Licence fees – ESC <sup>c</sup>	0.020	0.020	0.020	0.020	0.029	0.108
Licence fees – DHHS <sup>c</sup>	0.011	0.011	0.011	0.011	0.011	0.057
Licence fees – EPA <sup>c</sup>	0.024	0.024	0.024	0.024	0.024	0.122
<b>Final decision – operating expenditure</b>	<b>19.8</b>	<b>19.7</b>	<b>19.2</b>	<b>19.2</b>	<b>19.3</b>	<b>97.2</b>

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

<sup>b</sup> The Environmental Contribution collects funds from water corporations under the Water Industry Act 1994

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

Note: Numbers have been rounded

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

## Regulatory asset base

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

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

Our assessment

## Closing regulatory asset base

We update the regulatory asset base to reflect actual capital expenditure, government and customer contributions, and asset disposals for the period to 30 June 2017. This helps to ensure prices reflect the actual expenditure of a water corporation.

Our draft decision accepted East Gippsland Water's proposed closing regulatory asset base for 30 June 2017 of \$145.5 million because:

- East Gippsland Water's actual net capital expenditure for the period from 2012-13 to 2016-17 was \$0.5 million lower than the forecast used to approve prices for the period from 1 July 2013.<sup>31 32</sup>
- East Gippsland Water calculated its closing regulatory asset base in accordance with the requirements of our guidance.

No other new considerations were presented in submissions received following the draft decision, which caused us to change our views on the closing regulatory asset base.

Our final decision approves a closing regulatory asset base at 30 June 2017 of \$145.5 million. The calculations are provided at Table 2.5.

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<sup>31</sup> Net capital expenditure is calculated by deducting government and customer contributions from gross capital expenditure.

<sup>32</sup> We take a risk-based approach to including past capital expenditure in the regulatory asset base. We undertake a prudence and efficiency review where a water corporation has exceeded its net capital expenditure forecasts by more than 10 per cent. We believe this approach is reasonable given capital expenditure can be relatively 'lumpy' in nature.

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

	2012-13	2013-14	2014-15	2015-16	2016-17
Opening RAB at 1 July	136.6	140.2	144.6	143.1	144.1
Plus gross capital expenditure	10.7	11.6	6.4	9.0	9.6
Less government contributions	0.0	0.0	0.0	0.0	0.0
Less customer contributions	0.6	0.4	0.6	0.4	0.1
Less proceeds from disposals	0.3	0.3	0.2	0.1	0.1
Less regulatory depreciation	6.2	6.5	7.0	7.5	7.9
<b>Closing RAB at 30 June</b>	<b>140.2</b>	<b>144.6</b>	<b>143.1</b>	<b>144.1</b>	<b>145.5</b>

Note: Numbers have been rounded

### Forecast regulatory asset base

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

Our draft decision accepted East Gippsland Water's forecast regulatory asset base for the period from 1 July 2018, because we were satisfied it met the requirements of our guidance.

Table 2.6 sets out our final decision on East Gippsland Water's forecast regulatory asset base from 1 July 2018, which is the same as our draft decision.<sup>33</sup> We are satisfied that East Gippsland Water's proposed forecast regulatory asset base meets the requirements of our guidance.

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



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

	2017-18	2018-19	2019-20	2020-21	2021-22	2022-23
Opening RAB at 1 July	145.5	146.7	149.0	156.9	160.1	162.5
Plus gross capital expenditure	9.6	9.4	15.5	11.5	11.3	14.1
Less government contributions	0.0	0.0	0.0	0.0	0.0	0.0
Less customer contributions	0.0	0.0	0.0	0.0	0.0	0.0
Less proceeds from disposals	0.1	0.1	0.1	0.1	0.1	0.1
Less regulatory depreciation	8.3	7.0	7.6	8.2	8.8	8.8
<b>Closing RAB at 30 June</b>	<b>146.7</b>	<b>149.0</b>	<b>156.9</b>	<b>160.1</b>	<b>162.5</b>	<b>167.7</b>

Note: Numbers have been rounded

### Capital expenditure

Capital expenditure is an input to estimating the regulatory asset base. In our draft decision (pages 15 to 17), we proposed to accept East Gippsland Water’s capital expenditure forecast of \$61.83 million for the 2018–23 period. The reasons for this were:

- East Gippsland Water’s price submission and business cases provided evidence that its forecasts for capital expenditure are efficient.
- We consider the planned capital expenditure program is achievable, given East Gippsland Water’s past track record delivering its capital expenditure program.
- East Gippsland Water has an appropriate approach for managing expenditure associated with uncertain projects.
- We consider East Gippsland Water’s approach to forecasting its capital expenditure is consistent with the requirements of our guidance.

East Gippsland Water’s response to our draft decision did not provide any new information on our draft decision for gross capital expenditure. No new considerations were presented in submissions received following the draft decision, which caused us to change our views on capital expenditure.

Accordingly, we consider it appropriate to maintain the views we expressed in our draft decision in relation to the gross capital expenditure benchmark, for the same reasons proposed in our draft

Our assessment

decision. We consider this benchmark is consistent with our guidance and WIRO principles,<sup>34</sup> and is reflected in our final decision on East Gippsland Water's forecast regulatory asset base (Table 2.6) and its revenue requirement (Table 2.1).

The benchmark that we adopt for East Gippsland Water does not represent the amount that the water corporation 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. East Gippsland Water determines how to best manage the allocation of its revenue and priority of its expenditure within a regulatory period.

In our draft decision, we accepted East Gippsland Water's approach for addressing uncertain capital expenditure. We reiterate that East Gippsland Water will need to demonstrate the prudence and efficiency of additional costs incurred during the 2018–23 period if seeking to include them in the regulatory asset base.

### **Customer contributions**

Customer contributions are deducted from gross capital expenditure so they are not included in the regulatory asset base.

Our draft decision accepted East Gippsland Water's forecast for zero revenue from customer contributions over the five years from 1 July 2018. We considered the forecast was reasonable given East Gippsland Water's transition to a zero charge for standard new customer contributions during the current regulatory period.

No other new considerations were presented in submissions received following the draft decision which caused us to change our views on revenue from customer contributions.

For the reasons set out above, we consider it appropriate to maintain the views we expressed in our draft decision. Our final decision accepts the position in our draft decision for the same reasons, and adopts the benchmark revenue from customer contributions as set out at Table 2.6.

### **Cost of debt**

In our draft decision we proposed to approve the cost of debt proposed by East Gippsland Water as it used the cost of debt values we specified in our guidance to calculate its revenue

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<sup>34</sup> Essential Services Commission 2016, *Guidance Paper*, op. cit., p. 35; WIRO clause 8(b)

requirement. We also noted that we will update the value of the estimated cost of debt for 2017-18 with our calculation of the actual cost, applying the method outlined in our guidance.<sup>35</sup>

A submission from the Consumer Action Law Centre recommends that we set the benchmark cost of debt at five per cent or around one per cent lower than the amount allowed in our draft decision (6.05 per cent per annum in nominal terms).<sup>36</sup> CALC submits that government owned water corporations carry less risk than private corporations and as such, the allowed cost of debt and the return on equity should be lowered compared with the rates allowed in our draft decision. These recommendations are based on a report prepared by CME for CALC.<sup>37</sup>

A submission by the Water Services Association Australia (WSAA) addressed CALC's submission.<sup>38</sup> Among other things, WSAA's submission noted that competitive neutrality principles have been embedded in government policy, including in Victoria via the Financial Accommodation Levy. As a result, water corporations face a cost of debt that reflects the commercial cost of debt.

In keeping with government policy, the approach we take to the cost of debt is to adopt a benchmark rate that applies to all water corporations. The benchmark reflects our estimate of the efficient financing costs for a privately owned business facing a similar degree of economic risk to a regulated water corporation. We consider this is consistent with the requirements of the WIRO.<sup>39</sup>

In our view, adopting the approach recommended by CALC would mean a benchmark efficient water corporation may not have a reasonable opportunity to recover their debt costs.

A more detailed response to the issues raised by CALC is set out at Appendix D.

Our final decision adopts the benchmark cost of debt as set out in Table 2.7.<sup>40</sup>

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<sup>35</sup> We received data on the actual trailing average cost of debt for 2017-18 from Treasury Corporation Victoria in April 2018.

<sup>36</sup> Consumer Action Law Centre 2018, *Submission: Cost of debt and allowed return on equity in the 2018 Water Price Review*, 26 March.

<sup>37</sup> Consumer Action Law Centre 2018, *Cost of debt*, op cit., Appendix A.

<sup>38</sup> WSAA 2018, *WSAA Submission to ESC Cost of debt*, May.

<sup>39</sup> Including, in particular, the requirements that our decision have regard to: the promotion of efficiency in regulated industries and the financial viability of the regulated water industry (cl 8(b)(ii) WIRO); efficiency in the industry and incentives for long term investment (s 8A(1)(a) ESC Act); and consistency in regulation between States and on a national basis (s 8A(1)(f) ESC Act).

<sup>40</sup> We received data on the actual trailing average cost of debt for 2017-18 from the Treasury Corporation Victoria in April 2018, and we updated the 2017-18 estimates for our final decision.

**Table 2.7 Trailing average cost of debt**

	2008-09	2009-10	2010-11	2011-12	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18
Cost of debt (nominal)	6.9%	7.4%	7.0%	6.3%	5.3%	7.1%	5.4%	5.3%	4.9%	4.5%

Note: Numbers have been rounded

## Return on equity – PREMO rating

East Gippsland Water rated its price submission as ‘Standard’. Based on its PREMO self-rating, East Gippsland Water proposed a return on equity of 4.5 per cent per annum. This reflects the maximum return rate allowed in our guidance for a price submission rated as ‘Standard’.<sup>41</sup>

Our draft decision proposed to accept East Gippsland Water’s proposed return on equity. This reflected our preliminary review of its PREMO self-rating.

A submission from the Consumer Action Law Centre (CALC) recommended a one per cent reduction to each return on equity value in the PREMO matrix.<sup>42</sup> CALC’s recommendation is based on the findings of a report prepared by CME. The main reason CME proposed the reduction is due to comparisons with returns allowed for UK water entities, and that government owned water corporations carry less risk than private corporations.

The most relevant comparisons for the return on equity are other economic regulators in Australia. The rate for the return on equity (and the regulatory rate of return, comprising the cost of debt and the return on equity) approved in our draft decision are similar to rates recently estimated by other Australian-based regulators of the water sector.<sup>43</sup> We also consider the allowed return on equity should not be adjusted to reflect government ownership, as the exposure of a water corporation to market risk will not be materially affected by government ownership.

A more detailed response to the issues raised by CALC is set out at Appendix D.

We consider our approach to the return on equity is consistent with our requirements under the WIRO, and in particular, that our estimate provides water corporations with an incentive to invest efficiently, and that our approach has regard to the financial viability of the water industry.

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

<sup>42</sup> Consumer Action Law Centre 2018, *Cost of debt*, op cit.

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

Our final decision accepts East Gippsland Water's proposed return on equity of 4.5 per cent per annum, reflecting our views above, and our final decision on its PREMO rating (see Chapter 3).

## **Regulatory depreciation**

Regulatory depreciation is an input to calculating the regulatory asset base. Our draft decision proposed to accept East Gippsland Water's forecast regulatory depreciation, as it was calculated using a straight line depreciation profile and in a manner consistently with the requirements of our guidance. No new considerations were presented in submissions received following the draft decision which caused us to change our views on depreciation.

For the reasons set out above, we consider it appropriate to maintain the views we expressed in our draft decision. Our final decision accepts the position in our draft decision for the same reasons, and adopts East Gippsland Water's forecast regulatory depreciation, as set out in Table 2.1.

## **Tax allowance**

The tax allowance is an input to the revenue requirement. East Gippsland Water's forecast tax payments were calculated consistently with the requirements of our guidance.<sup>44</sup>

Our draft decision proposed to accept East Gippsland Water's proposal to assume a company tax rate of 27.5 per cent per annum from year three of its five year regulatory period from 1 July 2018. This is lower than the current company tax rate of 30 per cent and is based on the anticipated passing of a bill.<sup>45</sup> In the event that this bill does not pass or is delayed or amended, East Gippsland Water advised that it will not seek to recover the additional expense from customers.

No new considerations were presented in submissions received following the draft decision which caused us to change our views on the tax allowance.

For the reasons set out above, we consider it appropriate to maintain the views we expressed in our draft decision. Our final decision accepts the position in our draft decision for the same reasons, and accepts East Gippsland Water's forecast tax allowance, as set out in Table 2.1.

## **Demand**

In our draft decision, we proposed to accept East Gippsland Water's demand forecasts (including its revisions to forecast water connections) for the purpose of approving maximum prices. We

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<sup>44</sup> Essential Services Commission 2016, *Guidance paper*, op. cit., pp. 50–51.

<sup>45</sup> Based on Treasury Laws Amendment (Enterprise Tax Plan No. 2) Bill 2017. As of 26 March 2018, the Treasury Laws Amendment (Enterprise Tax Plan No. 2) Bill 2017 is at the second reading stage in the Senate.

considered the forecasts were estimated in a manner consistently with the requirements of our guidance. No new considerations were presented in submissions received following the draft decision which caused us to change our views on demand.

For the reasons set out above, we consider it appropriate to maintain the views we expressed in our draft decision. Our final decision accepts the position in our draft decision for the same reasons, and accepts East Gippsland Water's demand forecasts for the purpose of approving its maximum prices.

East Gippsland Water's price determination includes the benchmark demand forecasts adopted for our final decision.

## **Form of price control**

Our draft decision accepted East Gippsland Water's proposed price cap form of price control. We considered that a price cap provides customers with price certainty, and means a water corporation is managing demand risk on behalf of its customers. We also noted that we consider demand risk is more efficiently managed by a water corporation, rather than its customers.<sup>46</sup>

No other new considerations were presented in submissions received following the draft decision which caused us to change our views on the form of price control.

For the reasons set out above, we consider it appropriate to maintain the views we expressed in our draft decision. Our final decision accepts the position in our draft decision for the same reasons, and approves East Gippsland Water's proposed price cap form of price control.

## **Tariff structures and prices**

Our draft decision accepted East Gippsland Water's proposal to maintain its existing tariff structures, comprising:

- For residential and non-residential water services – a two-part tariff structure with a fixed service charge and a variable component that depends on water use.
- For residential sewerage services – a fixed service charge only.
- For non-residential sewerage services – a fixed service charge based on equivalent tenement (EQT) methodology. One EQT is the equivalent to the amount of wastewater collected, discharged and treated by an average residential customer. The EQT is calculated having regard to the three year average for water use, and an industry discharge factor which varies depending on the sector (for example, a different rate applies to motels, units, restaurants).

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<sup>46</sup> We note our determinations allow water corporations flexibility to apply to change from a price cap to a weighted average price cap or tariff basket within a regulatory period.

We considered the two-part structure for water services will promote efficient use. It also provides customers a signal about their water use costs, and is an approach that is commonly applied in other states and territories.<sup>47</sup> We also considered two-part tariff structures are easy to understand.

Our draft decision also accepted East Gippsland Water's proposal to calculate tariffs for recycled water, trade waste and miscellaneous services in accordance with the pricing principles referenced in our guidance. These pricing principles promote cost reflectivity of tariffs.

In our draft decision, we noted that we considered East Gippsland Water's proposed tariffs will allow it to recover revenue sufficient to cover efficient costs.

A submission responding to our draft decision queried East Gippsland Water's application of the fixed service charge to undeveloped properties on vacant land.<sup>48</sup> Our powers relate to assessing and approving maximum prices for prescribed services delivered by water corporations. The *Water Act 1989* (Vic) allows East Gippsland Water to apply the tariff described in the submission.<sup>49</sup>

A submission from CALC noted that East Gippsland Water proposed to keep its current tariff structures in place for the 2018–23 period and did not appear to engage on tariff design during its consultation for this price submission.<sup>50</sup> We note East Gippsland Water engaged extensively with its tariff structures with customers for its 2013–18 price submission, and implemented tariff reform.

During early engagement by East Gippsland Water on its 2018–23 price submission, tariff structures were not among the views and values raised by its customers. We have not received any submissions from East Gippsland Water customers raising concerns about existing tariff structures.

In its response to our draft decision, East Gippsland Water proposed tariffs reflecting our draft decision on its revenue requirement. We consider these proposed tariffs take into account customers' interests, including low income and vulnerable customers, because:

- the proposed tariffs reflect the forecast efficient costs of delivering services
- the proposed two-part structure for water services tariffs will promote efficient water use, and provide customers a signal about the costs of their water use
- the proposed tariffs would allow the corporation to recover revenue sufficient to cover forecast efficient costs

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<sup>47</sup> Includes the tariffs of Icon Water, Sydney Water, Hunter Water, Gosford City Council, Wyong Shire Council, Power and Water Corp, Urban Utilities, Unity Water, SA Water and TasWater.

<sup>48</sup> Rene Blin 2018, *Submission*, 14 February.

<sup>49</sup> See Part 13, Division 5 of the *Water Act 1989* (Vic).

<sup>50</sup> Consumer Action Law Centre 2018, *Early Draft Decisions*, op. cit., p. 3.

- East Gippsland Water has payment options and assistance for customers experiencing difficulty paying bills.

For the reasons set out above, our final decision approves East Gippsland Water's proposed tariffs.

Our price determination for East Gippsland Water sets out the maximum prices it may charge for the five year period from 1 July 2018 (or the manner in which its prices are to be calculated, determined, or otherwise regulated for each tariff). Approved maximum prices for water and sewerage services applying to most residential and non-residential customers are set out at Tables 2.8 and 2.9.

**Table 2.8** Final decision – water prices  
\$ 2018-19

	2018-19	2019-20	2020-21	2021-22	2022-23
<b>Residential</b>					
Variable (\$/kL)	2.1500	2.1500	2.1500	2.1500	2.1500
Fixed (20mm) (\$/year)	204.97	204.97	204.97	204.97	204.97
<b>Non-residential</b>					
Variable (\$/kL)	2.1500	2.1500	2.1500	2.1500	2.1500
Fixed (20mm) (\$/year)	204.97	204.97	204.97	204.97	204.97

Note: Numbers have been rounded down



**Table 2.9 Final decision – sewerage charges**  
\$ 2018-19

	2018-19	2019-20	2020-21	2021-22	2022-23
<b>Residential</b>					
Fixed (\$/year)	665.40	665.40	665.40	665.40	665.40
<b>Non-residential</b>					
Fixed (\$/year)	665.40	665.40	665.40	665.40	665.40

Note: Numbers have been rounded down

## **Adjusting prices**

In our draft decision we:

- proposed to approve East Gippsland Water's proposal to continue the existing uncertain and unforeseen events mechanism
- invited East Gippsland Water to submit price adjustment formulas that allowed prices to adjust to changes in the cost of debt.

In response to our draft decision, East Gippsland Water provided us with a proposed price adjustment formula for changes to cost of debt. East Gippsland Water's response also noted that we would establish a cost of debt adjustment formula that was consistent across the industry. Our approved cost of debt adjustment formula is set out in our determination for East Gippsland Water.

Our final decision approves East Gippsland Water's uncertain and unforeseen events mechanism and updated price adjustment mechanisms as they satisfy the requirements of our guidance.

## **New customer contributions**

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

Our draft decision proposed to accept East Gippsland Water's proposed zero charge for standard new customer contributions as it is in accordance with the commission's approved transition to a zero charge in our 2013 price determination. We also proposed to accept East Gippsland Water's proposed use of our new customer contribution pricing principles to calculate negotiated charges.

No other new considerations were presented in submissions received following the draft decision which caused us to change our views on new customer contributions.

For the reasons set out above, we consider it appropriate to maintain the views expressed in our draft decision. Our final decision accepts the position in our draft decision for the same reasons, and accepts East Gippsland Water's proposed zero charge for standard new customer contributions and its method of calculating negotiated charges.

East Gippsland Water should update and publish any development servicing plans and negotiation protocols to assist developers understand the underlying assumptions of its new customer contribution charges.<sup>51</sup>

## **Financial position**

In approving prices, we must have regard to the financial viability of the water industry.<sup>52</sup> We interpret the financial viability requirements under the *Essential Services Commission Act 2001* (Vic) and the Water Industry Regulatory Order (2014) to mean that the prices we approve should provide a level of certainty that each water corporation can generate sufficient cash flow to deliver on service commitments, including financing costs arising from investments to meet service expectations.

Our guidance set out key indicators of forecast financial performance. We have reviewed forecasts for these key indicators based on our final decision on East Gippsland Water's prices. We have assessed that under our final decision, East Gippsland Water will generate sufficient cash flow to deliver on service commitments, including financing costs arising from investments to meet service expectations.

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<sup>51</sup> Essential Services Commission 2013, *New Customer Contributions: Explanatory Note, December*, pp. 9-11.

<sup>52</sup> WIRO clause 8(b)(ii) and ESC Act s.8A(1)(b).



### 3. PREMO rating

PREMO is an incentive mechanism that links the return on equity to a water corporation's level of ambition in delivering value to its customers.

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

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

In Chapter 2, we noted our final decision is to accept East Gippsland Water's proposed return on equity of 4.5 per cent, based on the justification provided for the level of ambition in its price submission. In this chapter, we set out our final decision assessment of East Gippsland Water's proposed PREMO rating.

#### Our review of East Gippsland Water's PREMO self-rating

East Gippsland Water's proposed PREMO rating, and our draft and final decisions are summarised in Table 3.1. After considering submissions in response to our draft decision, our final decision confirms the ratings proposed in our draft decision.

**Table 3.1** PREMO Rating

	Overall PREMO rating	Risk	Engagement	Management	Outcomes
East Gippsland Water's rating	<b>Standard</b>	Advanced	Advanced	Advanced	Standard
Commission's draft decision rating	<b>Standard</b>	Advanced	Advanced	Standard	Standard
Commission's final decision rating	<b>Standard</b>	Advanced	Advanced	Standard	Standard

We agree with East Gippsland Water's proposed self-rating for the Risk, Engagement and Outcomes elements of PREMO, for the reasons set out in its price submission.

In terms of the Risk element of PREMO, East Gippsland Water accepted greater risk on behalf of its customers, proposing to change to a price cap form of price control, from a weighted average price cap.

East Gippsland Water has also demonstrated an 'Advanced' engagement program. It used a customer committee to guide its engagement approach, and provided evidence that engagement findings influenced its proposals. Feedback from members of the customer committee indicate the committee was provided with appropriate information, and an ability to influence East Gippsland Water's proposals (evidenced in the water corporation's proposals relating to GSLs – see page 8).

For the Outcomes element of PREMO, we note that East Gippsland Water will generally provide customers with the same level of service, informed by feedback from its engagement program. This is consistent with a 'Standard' rating for Outcomes.

Our final decision affirms our draft decision rating of 'Standard' for the Management element of PREMO, rather than the 'Advanced' rating proposed by East Gippsland Water.

In support of its Management rating, East Gippsland Water's price submission was clearly set out and provided sufficient justification for its proposals. However, we note that East Gippsland Water's efficiency improvement rate for controllable operating costs (1.15 per cent per annum) is one of the lowest proposed among the water corporations in our review.

Also, during our review a number of corrections had to be made to East Gippsland Water's financial model. While none were material in their own right, we consider the number of corrections does not support an 'Advanced' rating for the Management element of PREMO.

For these reasons our final decision for East Gippsland Water is to rate the Management element of PREMO as 'Standard'.

Overall however, we agree with East Gippsland Water's proposed overall PREMO self-rating of 'Standard'. This is reflected in the return on equity we have approved for East Gippsland Water at page 20.

## Appendix A – submissions received on draft decision

Name or organisation	Date received
Water Services Association Australia	16 May 2018
Consumer Action Law Centre	26 March 2018
Consumer Action Law Centre	13 March 2018
Rene Blin	14 February 2018
Environment Protection Authority Victoria	12 December 2018

## Appendix B – approved service standards

We have approved the following standards, and conditions of service and supply, and associated targets for East Gippsland Water.

### East Gippsland Water’s approved service standards

Service standard	2018-19	2019-20	2020-21	2021-22	2022-23
<b>Water</b>					
Number of customers experiencing more than 5 unplanned water supply interruptions in the year (number)	0	0	0	0	0
Average time taken to attend bursts and leaks (priority 1) (minutes)	18	18	18	18	18
Average time taken to attend bursts and leaks (priority 2) (minutes)	22	22	22	22	22
Average time taken to attend bursts and leaks (priority 3) (minutes)	71	71	71	71	71
Average duration of unplanned water supply interruptions (minutes)	75	75	75	75	75
Average duration of planned water supply interruptions (minutes)	139	139	139	139	139
<b>Sewerage</b>					
Customers receiving more than 3 sewer blockages in the year (number)	0	0	0	0	0
Average time to attend sewer spills and blockages (minutes)	32	32	32	32	32
Average time to rectify a sewer blockage (minutes)	80	80	80	80	80
Spills contained within 5 hours (per cent)	100	100	100	100	100

Note: Numbers have been rounded



## Appendix C – approved GSL scheme

We have approved the following service level obligations and corresponding amounts of payment for failure to attain the stated obligation as the guaranteed service level (GSL) scheme for East Gippsland Water.

In accordance with clause 13 of the Customer Service Code: Urban Water Businesses, East Gippsland Water must ensure that any payment is made to a customer as soon as practical after a customer becomes entitled to the GSL payment.

East Gippsland Water is not required to make a payment where the failure to meet the service level is due to the action or inaction of the customer or a third party. For the avoidance of doubt, third party does not include any person or firm acting on behalf of East Gippsland Water.

### East Gippsland Water's approved GSL scheme

Approved service level obligation	Approved payment (\$)
Sewage spill within a customer's house, caused by the business	1000
Planned water supply interruptions – failure to notify 48 hours in advance	65
Planned water supply interruptions – duration exceeds the period in the notice	65
Not restricting the water supply of, or taking legal action against, a residential customer prior to taking reasonable endeavours (as defined by the commission) to contact the customer and provide information about help that is available if the customer is experiencing difficulties paying	300
A 21 per cent reduction in greenhouse gas emissions by 2025, and a six monthly update on progress provided to the community	East Gippsland Water to provide a written public apology if any six monthly update is not provided.
Commitment to spend \$90,000 per year on native vegetation planting and habitat creation projects.	Unspent money will be safeguarded for use only on the program.

## Appendix D – rate of return

A submission from the Consumer Action Law Centre (CALC) recommended that we set the benchmark cost of debt at five per cent or around one per cent lower than the amount allowed in our draft decision (6.05 per cent per annum in nominal terms). It also recommended that we reduce each of the equity values in the PREMO matrix by one per cent. CALC submits that government owned water corporations carry less risk than private corporations, and as such, the allowed cost of debt and the return on equity should be lowered, compared with the rates allowed in our draft decision.<sup>53</sup> These recommendations are based on a report prepared by CME for CALC.<sup>54</sup>

Victoria's water corporations are subject to the competitive neutrality measures the Victorian government agreed to implement as part of the national competition policy agreement and related reforms.<sup>55</sup> This includes ensuring that borrowing costs reflect an estimate of a water corporation's standalone risk profile and credit rating. We note that:

- Victoria's water corporations do not access debt capital markets directly, but rather, their debt is managed by the state government treasury corporation, through the issuance of government bonds. While the treasury corporation may have access to lower debt funding costs due to government's higher credit rating, the water corporation's borrowing costs do not reflect this. Rather, the water corporations borrow from state treasuries at rates consistent with the risk inherent in the businesses as reflected in their stand-alone credit rating.
- The difference between the government's borrowing costs and the costs faced by water corporations represents consideration due to state taxpayers for accepting the business' credit risk. This is achieved via the Financial Accommodation Levy (FAL), which seeks to ensure the borrowing cost faced by each water corporation reflects the nature of their businesses, not the tax powers of government. If state-owned service providers accessed debt markets directly, then they would face debt financing interest rates that reflected their stand-alone credit ratings.

In keeping with these policy parameters, the approach we take to the cost of debt is to adopt a benchmark rate that applies to all water corporations. The benchmark rate reflects our estimate of the efficient financing costs for a privately owned business facing a similar degree of economic risk

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<sup>53</sup> Consumer Action Law Centre 2018, *Cost of debt*, op. cit.

<sup>54</sup> Consumer Action Law Centre 2018, *Cost of debt*, op cit., Appendix A.

<sup>55</sup> We note the Water Services Association of Australia supports application of competitive neutrality principles, see Water Services Association of Australia 2016, *Submission to the Essential Services Commission: A new model for pricing services in Victoria's water sector*, July, p. 11.

to a regulated water corporation. We consider this is consistent with the requirements of the WIRO.<sup>56</sup>

Adopting the approach recommended by CALC would mean the allowed rate for the cost of debt may be lower than the rate faced by a benchmark efficient water corporation. As well as being inconsistent with government policy that water corporations pay an estimate of a commercial equivalent borrowing rate, it would also be inconsistent with the WIRO's viability and efficiency objectives. Our approach is also similar to that adopted by other Australian economic regulators.

CALC's submission also recommended a one per cent reduction to each return on equity value in the PREMO matrix.<sup>57</sup> CME proposed the reduction mainly based on comparisons with the return allowed for UK water entities, and its view that government-owned water corporations carry less risk than comparable privately owned businesses.

We believe the most relevant comparisons for the return on equity are other economic regulators in Australia. We note the rate for the return on equity (and the overall regulatory rate of return, comprising the cost of debt and the return on equity) approved in our draft decision are within the range of rates estimated by other Australian-based regulators.<sup>58</sup>

Also, our current view is that the allowed return on equity should not be adjusted to reflect government ownership. In deriving the values for the return on equity in the PREMO matrix, we had regard to the return on equity we had allowed in the past, and the incentives for water corporations to provide high quality price submissions in the interests of their customers.

CME also argues for a reduction in return on equity to reflect the prevailing revenue cap form of price control. This reflects that a revenue cap provides a water corporation with greater revenue certainty than other forms of price control, such as a price cap. We note however, that only one urban water corporation in Victoria (Yarra Valley Water) has a revenue cap form of price control. As well, a revenue cap does not necessarily change the level of systematic risk faced by a water corporation. For example, it is possible that a water corporation operating under a revenue cap is more exposed to cost risks than corporation operating under a price cap.<sup>59</sup>

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<sup>56</sup> Including, in particular, the requirements that our decision have regard to: the promotion of efficiency in regulated industries and the financial viability of the regulated water industry (cl 8(b)(ii) WIRO); efficiency in the industry and incentives for long term investment (s 8A(1)(a) ESC Act); and consistency in regulation between States and on a national basis (s 8A(1)(f) ESC Act).

<sup>57</sup> Consumer Action Law Centre 2018, *Cost of debt*, op. cit.

<sup>58</sup> Essential Services Commission of South Australia 2016, *SA Water regulatory determination 2016*, Final Determination, June; Independent Pricing and Regulatory Tribunal 2017, *WACC biannual update*, August

<sup>59</sup> For example, increases in water demand can lead to increased costs for a water corporation, which would not be matched by an increase in revenue, under a revenue cap. By contrast, under a price cap increases in water demand would also lead to an increase in revenue.

While our final decision has not agreed with CALC’s recommendations, we will re-consider its arguments as part of any future review of the PREMO framework.