

East Gippsland Water final decision

2023 Water Price Review

23 June 2023

Acknowledgement

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

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

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

An appropriate citation for this paper is:

Essential Services Commission 2023, East Gippsland Water final decision: 2023 Water Price Review, 23 June

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Summary

We have made our final decision on East Gippsland Water's prices for the next 5 years

In March 2023, we released our draft decision on the price submission East Gippsland Water submitted to us in September 2022.¹ 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 forum in May 2023. In addition to a response by East Gippsland Water, we received two written submissions on our draft decision, which are available on our website (see Appendix A of this final decision for details).

After considering that feedback and East Gippsland Water's response, we have made a price determination for East Gippsland Water.² 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 5-year period from 1 July 2023 (2023-28). This final decision 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.

¹ Our draft decision for East Gippsland Water is available at www.esc.vic.gov.au/waterpricereview.

² Before the commencement of a regulatory period, clause 10 of the Water Industry Regulatory Order 2014 requires us to make a price determination which determines the maximum prices a water business 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, *East Gippsland Water Determination: 1 July 2023 – 30 June 2028*, 23 June 2023.

We have approved a revenue requirement of \$190.8 million over 5 years

Our final decision approves a revenue requirement of \$190.8 million over the 5-year period starting 1 July 2023 (see Chapter 4).³ This is \$3.0 million or 1.6 per cent higher than our draft decision, which mainly reflects our updates to the cost of debt.

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

Typical water and sewerage bills will rise from 1 July 2023

A summary of approved maximum prices for major services delivered by East Gippsland Water is set out in Section 5.3.2. Table A shows the estimated typical bills for different customer groups under our final decision, for 2022-23 (the current year) and 2023-24. For a typical residential owner occupier, estimated annual water and sewerage bills (including inflation) will rise from around \$1,238 currently to \$1,331 in 2023-24, an increase of around 7.5 per cent. For a typical residential tenant, bills (including inflation) will rise from around \$334 currently to \$359 in 2023-24, also an increase of around 7.5 per cent. The bill paid by each customer will vary depending on water use, prices for fixed and variable tariffs, and other charges.

After 2023-24, water and sewerage prices will generally increase by around 0.5 per cent, excluding inflation.

³ Along with forecast demand, the revenue requirement is an input to calculating the prices to be charged by a water business.

Table A Estimated typical annual water and sewerage bills

Customer group	Average consumption (kL p.a.)	2022-23 (current)	2023-24
		\$2022-23	\$2023-24
Residential – owner occupier	141	\$1,238	\$1,331
Residential – tenant	141	\$334	\$359
Non-residential (small)	75	\$1,081	\$1,163
Non-residential (medium)	517	\$3,271	\$3,517
Non-residential (large)	2,000	\$12,925	\$13,897

Note: The table shows the average bills for 2023-24 expressed in \$2023-24 terms (which means 7 per cent inflation has been included). Our draft decision included bill estimates based on our draft decision revenue requirement, expressed in \$2022-23 terms as the inflation figure was not available at this time. Our determination for East Gippsland Water sets prices in \$2023-24 terms, with provision for inflation to be added in each of the remaining years of the regulatory period based on the latest inflation data. Dollar amounts have been rounded.

East Gippsland Water plans to adapt to climate change and deliver other key customer priorities over the next 5 years

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

- Reliable services, done well
- Fair prices for all
- Improved environmental outcomes
- Prepare for population growth and a changing climate
- Contributing to community.⁴

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

⁴ East Gippsland Water, 2023 water price submission, September 2022, p. 33.

East Gippsland Water has considered the impacts of relatively high inflation for 2023-24

Our draft decision sought further information from East Gippsland Water on how it intends to address the impacts of relatively high inflation in 2023-24 on prices, customer bills, and expenditure. In its response to our draft decision, East Gippsland Water noted:

- it was passing on all inflation increases to customers to ensure the financial viability of the business in the long term
- it has made ample hardship provisions for customers in financial distress, with the business committing to an uplift in support for customers who are suffering financial hardship and struggling to pay their bills.

More information is available in East Gippsland Water's response to our draft decision.⁵

Under the prices proposed by East Gippsland Water, its revenue from tariffs will exceed its revenue requirement in 2023-24 by a relatively large amount (by around \$1.4 million) and will be below its revenue requirement in later years of the regulatory period.

This indicates that the business could have proposed to reduce prices in 2023-24 (and offset the financial impacts of this on the business by increasing prices later in the regulatory period) to help address the impacts of relatively high inflation on nominal prices and customer bills.

Some other businesses, including Yarra Valley Water, South East Water, GWMWater, Gippsland Water, Barwon Water and Central Highlands Water proposed prices of less than inflation in 2023-24, to help ameliorate the impacts of high inflation and impacts on nominal prices and bills.

In the lead up to our final decision, we asked East Gippsland Water to explain its reasons for the price path it had proposed. Specifically, we asked whether there was a reason it did not align its forecast revenue from tariffs with its revenue requirement early in the 2023–28 regulatory period, in the context of a 7 per cent inflation rate being added to customer prices and bills in 2023-24.

However, noting that East Gippsland Water has considered the issues we raised and argued that this reflects its understanding of customer preferences, we have decided not to impose a different price path in our final decision.

⁵ East Gippsland Water, *submission in response to the Essential Services Commission 'East Gippsland Water draft decision: 2023 water price review'*, 9 May 2023, p. 2.

Tariff structures will remain the same

Consistent with our draft decision, our final decision approves East Gippsland Water's proposed tariff structures, on the basis that they reflect a continuation of its current approach and otherwise consistent with our guidance. For water services, we have approved East Gippsland Water's proposal for a fixed service charge and a variable component that depends on water usage. For residential and non-residential sewerage services, we have approved East Gippsland Water's proposal for a fixed charge only.

Consistent with our draft decision, our final decision also approves East Gippsland Water's proposed price cap form of price control for its water and wastewater tariffs because, among other things, it is a continuation of its existing approach and otherwise consistent with our guidance. We have also approved a tariff basket form of price control for its major trade waste tariffs because we consider this will provide flexibility to East Gippsland Water to implement structural changes and rebalance tariffs, among other things. This means its maximum prices for water and wastewater services are fixed while maximum prices for major trade waste tariffs may see year-to-year movements within a constraint.

Under both forms of price control, maximum prices are subject to updates for inflation, and any other price adjustments we approve in our price determination. East Gippsland Water currently uses a price cap for its tariffs, including its major trade waste tariffs. For more detail on tariffs and the form of price control, see Chapter 5.

We have rated East Gippsland Water's price submission as 'Standard' under the PREMO framework

Consistent with our draft decision, our final decision is to rate East Gippsland Water's price submission as 'Standard' under the PREMO framework (Table B). This is the same as East Gippsland Water's self-rating. Factors in support of East Gippsland Water's PREMO rating include that it generally met expectations for delivery against outcome commitments in the current regulatory period, in a period where it responded to major challenges such as bushfires, very wet conditions in 2021 and the coronavirus pandemic. Further, there is evidence that the outcomes proposed by East Gippsland Water were informed by customer feedback on their priorities, such as future droughts, fires and more people living in the region.

See Section 1.4 for an explanation of the PREMO framework and Chapter 7 for more detail on our assessment of East Gippsland Water's price submission.



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

Table B **PREMO rating**

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

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

East Gippsland Water provided a submission to us proposing prices for a 5-year period starting 1 July 2023. Our task is to assess the price submission using the legal framework and make a price determination that takes effect from 1 July 2023. We make a price determination after issuing a draft decision and considering feedback from interested parties, including any response to the draft decision from the water business.

The price determination specifies the maximum prices a water business 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 our supporting 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 matters we must have regard to when making a price determination, and include matters set out in the WIRO, the WI Act and the ESC Act and clause 8 of the WIRO requires that we place particular emphasis on the promotion of efficiency related matters. In making a price determination, 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

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.

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

- 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 for our final decision for East Gippsland Water. Table 1.1 summarises the matters we must have regard to and groups them into themes.

In October 2021, we issued guidance to water businesses, including East Gippsland Water to inform their price submissions. The guidance set out how we would assess East Gippsland Water's submission against the matters we must consider under clause 11 of the WIRO. It also outlined our expectation that East Gippsland Water would comply with certain requirements and specified information that East Gippsland Water must provide to us when submitting its price submission.⁹

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 maximum proposed prices it can charge for the prescribed services it provides.¹⁰

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.¹¹



The power for water businesses to charge fees for services they provide is set out in the *Water Act 1989*.¹² These provisions in the Water Act also govern the processes for and manner in which water businesses may set and impose fees. Each water business must ensure that it complies with these legislative requirements.

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

⁹ Among these expectations are matters that progress our 'Getting to fair' strategy relating to the water industry. See Essential Services Commission, *Getting to fair: Breaking down barriers to essential services*, August 2021.

¹⁰ This is a requirement of the WIRO, clause 14(a).

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

¹² See Part 13, Division 5 and 6 of the Water Act 1989.

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, environmental 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 1994 (WI Act).

1.4 PREMO

PREMO stands for Performance, Risk, Engagement, Management, and Outcomes. 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 to take these into account in forming the proposals outlined in its price submission. This 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.¹³

¹³ In December 2022, we issued early draft decisions for Yarra Valley Water and Westernport Water.

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.¹⁴

¹⁴ Essential Services Commission, *2023 water price review: Guidance paper*, pp. 41–46.

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

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

- East Gippsland Water's price submission
- East Gippsland Water's presentation made directly to commissioners
- East Gippsland Water's responses to our queries and our draft decision
- our consultants' reports
- the views of participants in our public forum held on 1 May 2023¹⁵
- written submissions from interested parties (a list of submissions responding to our draft decision is provided in Appendix A).

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

Our guidance included matters water businesses must address in their price submissions. East Gippsland Water's price submission addressed each of these matters, and our initial assessment of those matters is set out in our draft decision.

We consulted on our draft decision, receiving submissions between 30 March 2023 and 9 April 2023 and holding an online public forum on 1 May 2023.

East Gippsland Water provided a response to our draft decision, including a revised financial model that reflected the updated cost of debt and inflation figures we provided to businesses in May 2023.¹⁶ In arriving at our final decision, we have considered East Gippsland Water's responses to our draft decision.

This paper sets out our final decision.

2.1 Final decision paper outline

This final decision paper is structured around the steps we have taken to arrive at our price determination. In summary, these steps were:

- Determine the regulatory period (Section 2.2).

¹⁵ A recording of this forum is available on our website.

¹⁶ All references to East Gippsland Water's price submission in this document refer to East Gippsland Water's original price submission that it provided to us in September 2022 rather than its response to our draft decision.

- Confirm the customer outcomes and service levels that East Gippsland Water has committed to over the regulatory period (Chapter 3).
- Establish East Gippsland Water's revenue requirement using a building block methodology (Chapter 4).
- Use demand forecasts and the form of price control to convert the revenue requirement to tariffs and prices (Chapter 5).

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

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

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

2.2 Regulatory period

Our final 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.¹⁷ 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.¹⁸

East Gippsland Water proposed, and our draft decision approved, a regulatory period of 5 years.

In a submission on our draft decisions, the Consumer Action Law Centre supported our proposed 5-year regulatory period. It noted that a 5-year period provided customers with predictability around billing and services and that having a uniform period across all businesses included in our current review meant it would be easier to generate public awareness and engagement.¹⁹

Accordingly, consistent with the reasons outlined in our guidance, and as proposed in our draft decision, our final decision is to set a regulatory period of 5 years.

¹⁷ This is a requirement of the WIRO, clause 9.

¹⁸ 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.

¹⁹ Consumer Action Law Centre, *Feedback on standard draft decisions: 2023 Water Price Review*, 5 May 2023, p. 4.

3. Customer outcomes

The customer outcomes East Gippsland Water plans to deliver over the regulatory period is 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 outlines our views on:

- East Gippsland Water’s engagement with its customers in preparing its price submission (Section 3.1)
- whether East Gippsland Water has delivered on the outcomes it committed to for the current regulatory period (2018–23) and the customer outcomes East Gippsland Water is committing to for the next regulatory period (Section 3.2)
- East Gippsland Water’s service standards for the regulatory period (Section 3.3)
- East Gippsland Water’s proposed guaranteed service level scheme for the regulatory period (Section 3.4).

3.1 Customer and community engagement

Our guidance required East Gippsland Water to engage with customers to inform its price submission. Our guidance also identified principles to guide East Gippsland Water’s engagement.²⁰

As outlined in our draft decision, we consider East Gippsland Water’s engagement with customers and community aligned with these principles in a number of ways. East Gippsland Water’s engagement:

- obtained the views of more than 900 community members between February 2021 and September 2022, and was informed by its ongoing engagement activities
- covered matters that had a material impact on prices, such as managing ageing assets and growth while maintaining service, and how best to respond to the challenges of climate change
- was inclusive of the experiences of First Nations people and of people experiencing vulnerability through the input of local community organisations (Gippsland Lakes Complete Health and Lakes Entrance Aboriginal Health Association, and Anglicare), targeted approaches to disability service providers, and through the life experiences provided by members of the deliberative forum.

²⁰ Essential Services Commission, *2023 water price review: Guidance paper*, p. 20. This guidance includes a focus on engagement by businesses with First Nations people and people experiencing vulnerability which are actions identified in our ‘Getting to fair’ strategy. See Essential Services Commission, *Getting to fair: Breaking down barriers to essential services*, August 2021.

Our draft decision outlined several ways in which East Gippsland Water demonstrated that its engagement influenced its proposals. These included:

- bringing forward capital works programs to enable more gradual price increases
- increasing targeted hardship support
- investing in additional water storage to improve climate resilience and support population growth.

Our preliminary view was to accept East Gippsland Water's 'Standard' self-rating for the Engagement element of PREMO on the basis it had designed and delivered an engagement program that was sensitive to the experiences of its customers and community and used methods well suited to the level of influence afforded to customers. Examples outlined in our draft decision included:

- the depth of East Gippsland Water's engagement on issues that had material impact on services and prices
- the early involvement of its Customer Committee in the planning of its price review process
- East Gippsland Water providing high quality instructions and information that was conducive to good decision making

We have considered all submissions received in response to our draft decision. Our final decision is the same as our draft decision, which is to accept East Gippsland Water's self-rating of 'Standard' for its price submission engagement.

See Chapter 7 for more detail on our PREMO assessment of East Gippsland Water's price submission.

3.2 Outcomes

East Gippsland Water's proposed set of outcomes indicates the value its customers can expect to receive during the next regulatory period. Actual performance against output measures and targets is monitored during the regulatory period to demonstrate whether customers are receiving the value they paid for. It also informs the rating for the 'Performance' element of PREMO at the next price review.

East Gippsland Water proposed to deliver the following outcomes over the regulatory period starting 1 July 2023:

- Reliable services, done well
- Fair prices for all
- Improved environmental outcomes
- Prepare for population growth and a changing climate
- Contributing to community

Customer outcomes

East Gippsland Water’s proposed measures and targets that it will use to report on the performance for each outcome are detailed in Appendix A of its price submission.

In our draft decision, we agreed with East Gippsland Water’s self-assessment that it has, overall, met its outcome commitments for the 2018–23 period to date, and that its reporting to customers during this period met our requirements.

We considered its proposed set of outcomes for 2023–28 demonstrated an overall improvement in customer value and was consistent with the requirements of a ‘Standard’ rating for the Outcomes element of PREMO. After considering all submissions received following our draft decision, we have not changed our views expressed in our draft decision on East Gippsland Water’s outcomes.²¹

In our draft decision, we noted that some of East Gippsland Water’s proposed outcome measures and targets were not presented in a manner consistent with our guidance requirements.

In response to our draft decision, East Gippsland Water amended its outcome measures and targets. We have worked with East Gippsland Water to ensure its final set of measures and targets meets the requirements set out in our guidance.

Following the release of this final decision, we will publish the 2023–28 outcomes reporting template for all water businesses participating in this price review, and we expect water businesses to publish them prominently on their own websites.

Our assessment of East Gippsland Water’s outcomes, measures and targets has informed our final decision rating of its price submission for the Outcomes element of PREMO, which is discussed further in Chapter 7.

3.3 Service standards related to service reliability and faults

East Gippsland Water provided a list of service standards relating to reliability and attending faults that it will include in its customer charter. Service standards are a common set of services applicable to all Victorian consumers as required by clause 18.2 of the Water Industry Standard – Urban Customer Service (Urban Water Industry Standard). Each water business must specify its own targets against each of these service standards. These service standards and corresponding target service levels are the minimum level of service customers can expect to receive.

Our draft decision summarised East Gippsland Water’s proposed service standards and the reasons that we considered that they comply with the requirements of the Urban Water Industry Standard.

²¹ A submission from the Consumer Action Law Centre commended all businesses for working closely with customers to develop their proposed outcomes set. Consumer Action Law Centre, *Feedback on standard draft decisions: 2023 water price review*, 5 May 2023.

After considering all submissions received following our draft decision, we have not changed our views expressed in our draft decision on East Gippsland Water's service standards.

Our final assessment is that the service standards relating to reliability and faults proposed by East Gippsland Water comply with the requirements of the Urban Water Industry Standard.

These service standards and East Gippsland Water's targets until 2028 are set out in Appendix C.

Service standards are also set out in the Urban Water Industry Standard. Accordingly, in early 2023-24, we will update the Urban Water Industry Standard to reflect targets set by the water business.

3.4 Guaranteed service levels

Our final decision is to adopt updated guaranteed service levels for East Gippsland Water, as set out in Appendix D.

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

East Gippsland Water's proposed guaranteed service levels are set out on pages 33, 34 and 82 of its price submission. Our draft decision summarised East Gippsland Water's proposed changes in its scheme from July 2023, including that East Gippsland Water proposed to replace the guaranteed service level relating to native vegetation grants with water efficiency rebates.

The water efficiency rebate is a program to encourage customers to claim rebates on water efficient products. This is a planned program rather than a commitment to a specified level of service with accountability through a rebate or payment to customers or the community. As such, in our draft decision we proposed to not include the water efficiency rebate commitment in the list of approved guaranteed service level payments in Schedule 2 of the Urban Water Industry Standard. East Gippsland Water has committed to report on the allocation of funds for the water efficiency rebates at least annually.²²

We proposed to accept the remainder of the proposed guaranteed service levels proposed by East Gippsland Water on the basis that they have been reviewed and determined by the independent customer committee as part of East Gippsland Water's engagement.

²² East Gippsland Water, 2023 water price submission, September 2022, p. 39.

In response to our draft decision, East Gippsland Water accepted the exclusion of the water efficiency rebate program from the guaranteed service levels in accordance with our draft decision.²³

After releasing our draft decision, we identified a further issue with East Gippsland Water's proposed guaranteed service levels. It proposed wording for the guaranteed service level relating to water restriction and legal action that did not comply with the requirements of the Urban Water Industry Standard. We have therefore made a change to East Gippsland Water's wording of the mandatory guaranteed service level relating to restriction and legal action, replacing the words 'reasonable efforts' (as proposed by East Gippsland Water), with 'reasonable endeavours' required in the Urban Water Industry Standard.²⁴

On the basis of the above, our final decision is to adopt the guaranteed service levels outlined in Appendix D.

Guaranteed service levels are approved in our water industry standards. Accordingly, in early 2023-24, we will update the Urban Water Industry Standard to reflect the guaranteed service levels set out in Appendix D.

²³ East Gippsland Water, *submission in response to the Essential Services Commission 'East Gippsland Water draft decision: 2023 water price review'*, 9 May 2023, p. 1.

²⁴ Clause 15.4 of the Urban Water Industry Standard specifies the requirements for reasonable endeavours.

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.²⁵ Along with forecast demand, it is an input to calculating prices.

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

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

Our final decision is to approve a revenue requirement of \$190.8 million.

East Gippsland Water proposed a revenue requirement of \$189.5 million over a 5-year period starting 1 July 2023. Our draft decision adopted a lower revenue requirement of \$187.9 million, mainly as a result of adjustments we proposed to its forecast operating expenditure. Our final decision approves a revenue requirement of \$190.8 million (Table 4.1), which reflects our assessment of each element of the revenue requirement, including forecast operating and capital expenditure.

²⁵ We met with officers of the Department of Energy, Environment and Climate Action, the Department of Health, and the Environment Protection Authority Victoria, to discuss their expectations of East Gippsland Water in the regulatory period from 1 July 2023. We had regard to their views in arriving at our final decision.

Table 4.1 Final decision on East Gippsland Water’s revenue requirement

\$ million 2022-23

	2023-24	2024-25	2025-26	2026-27	2027-28	Total
Operating expenditure	25.12	25.10	25.18	25.16	25.07	125.62
Return on assets	4.61	4.96	5.55	6.18	6.90	28.21
Regulatory depreciation	5.89	6.61	7.39	8.08	8.93	36.91
Non-prescribed revenue offset of revenue requirement	-0.06	-0.06	-0.06	-0.06	-0.06	-0.30
Tax allowance	-	-	0.07	0.14	0.19	0.40
Final decision – revenue requirement	35.56	36.62	38.13	39.49	41.04	190.84

Note: Numbers have been rounded.

Since our draft decision, we have updated our estimates for the cost of debt, licence fees, environmental contribution, and inflation to reflect the latest available information. We required East Gippsland Water to update its revenue requirement and prices to reflect updates to inflation and the cost of debt and we updated the licence fee and environmental contribution estimates.

In its response to our draft decision, East Gippsland Water updated its revenue requirement to reflect the updated inflation and cost of debt estimates, and also proposed updates to its operating expenditure to reflect new customer number growth rates based on its latest demand projections (see Section 4.1.1). East Gippsland Water also updated its forecast operating expenditure to reflect changes announced in the 2023-24 Victorian State Budget (see Section 4.1).

The main reason for the increase in our final decision revenue requirement compared to our draft decision is the updated estimate for the cost of debt, which reflects the rise in borrowing costs since East Gippsland Water prepared its price submission (Section 4.4.1).

The adjustments to East Gippsland Water’s revenue requirement that we have made in our draft and final decisions are set out in Table 4.2, with the reasons outlined in the following sections.

Table 4.2 Adjustments to revenue requirement – our draft and final decisions

\$ million 2022-23

	2023-24	2024-25	2025-26	2026-27	2027-28	Total
A. East Gippsland Water's proposed revenue requirement	35.95	36.75	37.92	38.87	40.05	189.55
B. Total adjustments proposed in our draft decision	-0.23	-0.28	-0.34	-0.40	-0.45	-1.69
Operating expenditure	-0.27	-0.33	-0.38	-0.44	-0.49	-1.91
Return on assets	0.02	0.02	0.02	0.01	0.01	0.08
Regulatory depreciation	0.02	0.02	0.02	0.02	0.02	0.12
Tax allowance	0.00	0.00	0.00	0.00	0.00	0.02
C. Draft decision – revenue requirement (C = A+B)	35.73	36.47	37.58	38.47	39.60	187.85
D. Total adjustments in our final decision	-0.17	0.14	0.55	1.02	1.44	2.98
Operating expenditure	0.11	0.14	0.14	0.13	0.05	0.57
Return on assets	-0.23	0.10	0.51	0.98	1.49	2.86
Regulatory depreciation	-0.00	-0.00	-0.00	-0.00	-0.00	-0.01
Tax allowance	-0.04	-0.10	-0.10	-0.09	-0.10	-0.43
E. Final decision – revenue requirement (E = C + D)	35.56	36.62	38.13	39.49	41.04	190.84

Note: Row A shows the total revenue requirement proposed by East Gippsland Water in its price submission. Row B shows the total difference between our draft decision and what East Gippsland Water proposed in its price submission. Row C shows the total revenue requirement we adopted in our draft decision. Row D shows the total difference between our final decision (row E) and our draft decision.

4.1 Operating expenditure

Our final decision is to adopt a forecast operating expenditure \$125.6 million for East Gippsland Water for the 2023–28 regulatory period.

Operating expenditure – comprising both controllable and non-controllable expenditure – is a component of the revenue requirement. Our draft decision proposed to adopt a forecast operating expenditure of \$125.1 million for the 5-year period, which was \$1.9 million lower than proposed by East Gippsland Water.

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

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

	2023-24	2024-25	2025-26	2026-27	2027-28	Total
Controllable operating expenditure	23.45	23.49	23.62	23.65	23.61	117.81
Non-controllable operating expenditure	1.67	1.61	1.56	1.51	1.46	7.81
Environmental contribution ^a	1.60	1.54	1.49	1.44	1.39	7.47
Licence fees – Essential Services Commission ^b	0.03	0.03	0.03	0.03	0.03	0.15
Licence fees – Department of Health ^b	0.01	0.01	0.01	0.01	0.01	0.06
Licence fees – Environment Protection Authority ^b	0.03	0.03	0.03	0.03	0.03	0.14
Final decision – operating expenditure	25.12	25.10	25.18	25.16	25.07	125.62

Notes: Numbers have been rounded. ^a Environmental contributions are funds collected from water businesses under the *Water Industry Act 1994*. ^b Licence fees are paid to cover costs incurred by the Department of Health, the Environment Protection Authority Victoria, and the Essential Services Commission in their regulatory activities related to the water business.

Table 4.4 sets out the adjustments we have made to controllable and non-controllable operating expenditure for our draft decision, and since our draft decision. Details of our assessment and the reasons for our final adjustments are included in Section 4.1.1 (controllable operating expenditure) and Section 4.1.2 (non-controllable operating expenditure).

The 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 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, meet its legislative and policy objectives, and to maintain services over the regulatory period.

Table 4.4 Our adjustments to East Gippsland Water’s operating expenditure for our draft and final decisions
\$ million 2022-23

	2023-24	2024-25	2025-26	2026-27	2027-28	Total
A. East Gippsland Water’s proposed total operating expenditure	25.28	25.28	25.42	25.46	25.51	126.96
A1 – Our draft decision adjustments to controllable operating costs	-0.27	-0.33	-0.38	-0.43	-0.49	-1.90
A2 – Our draft decision adjustments to non-controllable operating costs	-	-	-	-	-	-
B. Draft decision – total operating expenditure	25.01	24.96	25.04	25.03	25.02	125.06
C. Final adjustments to controllable operating costs	0.10	0.11	0.11	0.08	0.05	0.45
C1 – Updated growth costs	0.00	0.01	0.01	-0.02	-0.04	-0.03
C2 – 2023-24 State Budget updates	0.10	0.10	0.10	0.10	0.10	0.48
D. Final adjustments to non-controllable operating costs (D1 + D2 + D3 + D4)	0.00	0.04	0.03	0.05	-0.00	0.12
D1 – Environmental contribution	-0.00	0.03	0.03	0.05	-0.00	0.10
D2 – Licence fees – Essential Services Commission	0.01	0.01	0.01	0.00	0.00	0.03
D3 – Licence fees – Department of Health	-0.00	-0.00	-0.00	-0.00	-0.00	-0.00

Continued next page

Table 4.4 (continued)

	2023-24	2024-25	2025-26	2026-27	2027-28	Total
E. Final decision – total operating expenditure (E = B + C + D)	25.12	25.10	25.18	25.16	25.07	125.62

Note: See our draft decision for details of the adjustments we proposed in our draft decision (shown in rows A1 and A2). The adjustments shown in rows C and D (and disaggregated in rows D1 to D4) are the differences between our draft decision and our final decision and are outlined in Section 4.1.1 (controllable operating expenditure) and Section 4.1.2 (non-controllable operating expenditure) of this final decision. Numbers have been rounded.

4.1.1 Controllable operating expenditure

In relation to controllable operating expenditure, our preliminary findings (outlined in Section 4.1.1 of our draft decision) were that:

- We considered East Gippsland Water’s proposal reflects an efficient baseline cost to forecast annual operating expenditure.
- East Gippsland Water had proposed an average efficiency improvement rate of 0.75 per cent per year, which is lower than most other businesses in the current price review and is lower than its proposed average cost growth rate of 1.48 per cent per year.
- East Gippsland Water’s average cost growth rate is higher than forecast customer growth across the period, effectively delivering a net annual increase to its controllable annual baseline operating costs in each year of the regulatory period.

Our draft decision adopted an efficiency improvement rate of 1.0 per cent per year, instead of the 0.75 per cent proposed by East Gippsland Water, given that most other water businesses in the current review have identified an efficiency rate of at least 1.0 per cent per year.

Our draft decision also did not accept East Gippsland Water’s proposed cost adjustment variation above the baseline to accommodate salary increases to attract and retain staff, because we considered 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.

East Gippsland Water accepted our draft decision on its controllable operating expenditure for an average efficiency improvement rate of 1.0 per cent per year.

In a submission on our draft decisions, the Consumer Action Law Centre agreed with our draft decision to adopt a higher efficiency improvement rate and stated that meeting a rate of 1.0 per cent per year was a reasonable expectation for East Gippsland Water.²⁶

²⁶ Consumer Action Law Centre, *submission in response to the Essential Services Commission ‘East Gippsland Water draft decision: 2023 water price review’*, 5 May 2023, p. 2.

East Gippsland Water also updated its operating expenditure cost growth rate in response to the latest Victorian Government population and dwelling growth estimates resulting in small reductions to its residential customer growth and no change to non-residential growth rates.²⁷ We accept this adjustment because it reflects our requirement to consider the latest updated Victorian Government growth estimates. This update has resulted in a small reduction in controllable operating expenditure of \$0.03 million over the 5-year period.

Following release of the 2023-24 Victorian State Budget on 23 May, we wrote to water businesses to provide them with an opportunity to update their cost forecasts, should they seek to claim any additional costs and reflect these in customer prices.²⁸

East Gippsland Water responded with updated cost forecasts to reflect higher payments relating to payroll tax, land tax and WorkCover premiums. We have accepted these additional amounts as they are unavoidable costs that the business faces in delivering prescribed services to its customers.

After considering all submissions received in response to our draft decision, on the basis of the above, our final decision is to approve a forecast controllable operating expenditure of \$117.81 million (Table 4.3) for East Gippsland Water as it is consistent with our guidance.

4.1.2 Non-controllable operating expenditure

In relation to non-controllable operating expenditure, our preliminary findings (outlined in Section 4.1.2 of our draft decision) were that East Gippsland Water had followed the approach set out in our guidance paper to forecast its non-controllable operating costs in its price submission.

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.²⁹

For the environmental contribution, we have used the 2022-23 value provided by the Department of Energy, Environment and Climate Action and assumed that this will remain flat in nominal terms (decline in real terms) across the 2023–28 regulatory period.

We have assumed the licence fees for the Department of Health and the Environment Protection Authority Victoria remain flat in real terms across the period.³⁰

²⁷ East Gippsland Water, *submission in response to the Essential Services Commission 'East Gippsland Water draft decision: 2023 water price review'*, 9 May 2023, pp. 1-2.

²⁸ Victorian Government, *Budget papers '2023/24 State Budget papers'*, 23 May 2023.

²⁹ Non-controllable costs are those that cannot be directly or indirectly influenced by a water business's decisions.

³⁰ For the Safe Drinking Water Administration levy, we have used the 2021-22 value provided by the Department of Health and indexed it by the annual rate for fees in 2022-23 (1.75 per cent), as set out by the Department of Treasury

For our Essential Services Commission licence fee, we have taken our forecast fee estimate schedule, which is based on the expected work program across the 2023–28 regulatory period (which is in nominal dollars) and deflated it into 2022-23 dollars to express the fee in real terms.³¹

We have increased East Gippsland Water’s forecast non-controllable operating expenditure by \$0.12 million across the 2023–28 regulatory period, resulting from the following adjustments:

- \$0.02 million increase for licence fees after considering the latest information received from the relevant regulatory authorities
- \$0.10 million increase for the environmental contribution to account for the latest data on inflation.

Accordingly, after considering all submissions received in response to our draft decision and consistent with the reasoning in our guidance, our final decision is to adopt a revised non-controllable operating expenditure of \$7.81 million over the 5-year regulatory period.

4.2 Capital expenditure

Our final decision is to adopt a forecast capital expenditure of \$120.2 million.

Capital expenditure is an input to estimating the regulatory asset base, which is an input to the revenue requirement. Our draft decision proposed to adopt a forecast capital expenditure of \$120.2 million for the 5-year period, as proposed by East Gippsland Water.

The reasons for our draft decision were:

- East Gippsland Water demonstrated it has adopted a reasonable approach to developing its capital program, and that its capital expenditure forecasts are prudent and efficient.
- We considered the planned capital expenditure program is achievable, given East Gippsland Water’s past track record delivering its capital expenditure program while responding to significant unforeseen events including major floods and bushfires during the 2018–23 period.
- East Gippsland Water has demonstrated it has allocated funding and initiated design works to augment wastewater treatment facilities across both the 2023–28 and 2028–33 regulatory periods.
- We considered East Gippsland Water’s approach to forecasting its capital expenditure is consistent with the requirements of our guidance.

and Finance’s cost recovery guidelines (<https://www.dtf.vic.gov.au/financial-management-government/indexation-fees-and-penalties>). We have applied the same approach to the 2021-22 licence fee provided by the Environment Protection Authority Victoria.

³¹ These fees are yet to be determined by the Minister for Water.

We have considered all submissions in response to our draft decision. Our final decision is to adopt a forecast capital expenditure of \$120.2 million for the 5-year period (Table 4.6), as proposed in our draft decision and for the same reasons proposed in our draft decision. We consider this benchmark is consistent with our guidance and the principles in the Water Industry Regulatory Order (2014). Our final decisions on East Gippsland Water's forecast regulatory asset base (Table 4.6) and revenue requirement (Table 4.1) reflect this benchmark.

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

4.3 Regulatory asset base

A water business's regulatory asset base is the value of the business's assets for regulatory purposes.³² The regulatory asset base is used to estimate the return on assets (discussed in Section 4.4) and regulatory depreciation (discussed in Section 4.5). Both the return on assets and regulatory depreciation are components of the revenue requirement.

Our guidance required East Gippsland Water to propose:

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

³² These values were set initially for the water businesses by the Minister for Water and are adjusted on an ongoing basis to account for new investments, asset disposals, depreciation and inflation.

4.3.1 Closing regulatory asset base

Our final decision is to approve a closing regulatory asset base at 30 June 2022 of \$177.6 million.

We update the regulatory asset base to reflect actual gross capital expenditure, less government and customer contributions, and asset disposals for the period from 2017-18 to 2021-22.³³ This helps to ensure prices reflect the actual net expenditure of a water business.³⁴

Our draft decision adopted a closing regulatory asset base of \$177.6 million at 30 June 2022. This was slightly higher than proposed by East Gippsland Water due to an adjustment we made to its proposed government contributions to align with its approved regulatory accounts. In response to our draft decision, East Gippsland Water updated the closing regulatory asset base in its financial model to align with our draft decision and its approved regulatory accounts.

After considering all submissions received in response to our draft decision, our final decision is the same as our draft decision. Therefore, our final decision is to approve a closing regulatory asset base at 30 June 2022 of \$177.6 million (Table 4.5).

³³ See Section 4.2 for a discussion of East Gippsland Water's capital expenditure.

³⁴ 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.

Table 4.5 Final decision – closing regulatory asset base (RAB)

\$ million 2022-23

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

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

4.3.2 Forecast regulatory asset base

Our final decision is to adopt a forecast regulatory asset base as set out in Table 4.6.

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.

Our draft decision was to not accept East Gippsland Water's forecast regulatory asset base for the period from 1 July 2023, because we did not accept its proposed closing regulatory asset base due to an adjustment we made to its proposed government contributions to align with its approved regulatory accounts. For the purposes of calculating the revenue requirement in our draft decision, we adopted a forecast regulatory asset base that reflected our proposed adjustment to its closing regulatory asset base.

Table 4.6 sets out our final decision on East Gippsland Water's forecast regulatory asset base from 1 July 2023.³⁵

³⁵ 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)

Our final decision on East Gippsland Water’s forecast regulatory asset base reflects our final decisions on its closing regulatory asset base and the components of the forecast regulatory asset base, which are outlined in the following sections of this final decision paper:

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

Table 4.6 Final decision – forecast regulatory asset base (RAB)

\$ million 2022-23

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

Note: Numbers have been rounded.

4.3.2.1 Customer contributions

Our final decision adopts a forecast for customer contributions as set out in Table 4.6.

Revenue from customer contributions is deducted from gross capital expenditure so it is not included in the regulatory asset base.³⁶

Our draft decision proposed to not accept East Gippsland Water’s forecast for customer contributions. Our preliminary view was that East Gippsland Water’s forecast contributions were consistent with past outcomes and were calculated on a reasonable basis, but we noted our final

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.

³⁶ Revenue from new customer contributions reflects revenue earned from new connections made to the water business’s water, sewerage or recycled water networks.

decision was subject to our ongoing review of East Gippsland Water's new customer contributions. For the purposes of calculating the regulatory asset base and revenue requirement in our draft decision, we adopted East Gippsland Water's proposed customer contributions forecast.

As outlined in Section 5.4, our final decision is to approve East Gippsland Water's new customer contributions.

After considering all submissions received in response to our draft decision, and for the reasons set out above, our final decision adopts the benchmark revenue from customer contributions proposed by East Gippsland Water and as set out in Table 4.6.

4.4 Rate of return

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

4.4.1 Cost of debt

Our final decision is to accept the updated cost of debt figures used by East Gippsland Water to calculate its revenue requirement.

Our draft decision accepted 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 requirement. We also noted that our estimate of 3.75 per cent for the cost of debt in 2022-23 would be updated to reflect the latest available data.

In May 2023, we provided East Gippsland Water with an updated cost of debt value from 3.75 per cent to 6.76 per cent for 2022-23.³⁷ This reflects the rise in borrowing costs over the past 12 months. East Gippsland Water used this updated value to recalculate its revenue requirement.

For the above reasons, our final decision adopts the updated figures for the benchmark cost of debt as set out in Table 4.7. This increase in the cost of debt is the main contributor to the increase in our final decision revenue requirement compared to our draft decision.

³⁷ These updated figures were based on data from Treasury Corporation Victoria on the actual trailing average cost of debt for 2022-23.

Table 4.7 Final decision – 10-year 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%	6.76%

Note: Numbers have been rounded.

4.4.2 Return on equity

Our final decision is to adopt a return on equity of 4.1 per cent in real terms, which reflects East Gippsland Water’s PREMO rating.

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

Our guidance included a matrix proposing the return on equity we would adopt, based on the combination of the business’s self-rating and our rating.³⁸

East Gippsland Water rated its price submission as ‘Standard’. Based on this PREMO self-rating, East Gippsland Water proposed a real return on equity of 4.1 per cent per year. This reflects the maximum return rate allowed in our guidance for a price submission rated as ‘Standard’.³⁹

Our draft decision adopted East Gippsland Water’s proposed return on equity, which reflected our preliminary overall PREMO rating of its price submission.

No new considerations were presented by East Gippsland Water or in submissions received following our draft decision which caused us to change our overall PREMO rating of East Gippsland Water’s price submission.

Therefore, our final decision is to adopt East Gippsland Water’s proposed return on equity of 4.1 per cent per year, reflecting our final decision on the overall PREMO rating of its price submission (see Chapter 7).

³⁸ Essential Services Commission, *2023 water price review: Guidance paper*, pp. 42-43.

³⁹ Essential Services Commission, *2023 water price review: Guidance paper*, p. 42.

4.4.3 Long-term inflation forecast

A long-term inflation forecast is needed to convert the nominal cost of debt (outlined in Section 4.4.2 above) to real terms. A higher rate of inflation means a lower cost of debt in real terms, which would flow through to a lower revenue requirement and lower prices, all other things being equal. Conversely, a lower long-term inflation rate will flow through to increased prices, all other things being equal.

In addition to updating our estimate for the cost of debt, in May 2023 we also updated businesses on our long-term inflation forecast. We advised businesses that the long-term inflation rate we calculated was 3.5 per cent.⁴⁰ All businesses adopted this amount to calculate prices in their responses to our draft decision. We checked this estimate again for our final decision, based on the method below.

While we have estimated inflation based on the outcome of the two methods specified in our guidance – the ‘RBA geometric mean’ and the ‘bond breakeven’ methods – we have varied our approach given the relatively high near-term inflation environment. While our guidance indicated that our calculation of long-term inflation would cover a 10-year forecast period, we consider in the current high inflation environment, that this would lead to outcomes that underestimate inflation in the 2023–28 regulatory period, which would not be in the interests of customers. Accordingly, we have adopted an averaging period of 5 years. This is consistent with the time period adopted by other economic regulators, including the Australian Energy Regulator.

Estimates we have adopted for each year of the 2023–28 regulatory period under the ‘RBA geometric mean’ approach are set out in Appendix E. Using the ‘RBA geometric mean’ approach we estimate an inflation rate of 3.8 per cent.⁴¹

For the ‘bond breakeven’ approach, we estimate a 5-year average rate of 3.3 per cent, with the estimates adopted for each year of the 2023–28 regulatory period also set out in Appendix E.⁴²

The average outcome under the two approaches is 3.5 per cent, which we have adopted for our final decision.

However, to manage the risk that inflation falls well below our forecast, our price determinations include a provision that allows for a reconsideration of the inflation forecast adopted, if inflation falls

⁴⁰ The inflation rate adopted in our draft decision was 3 per cent.

⁴¹ We have decided to use a rate of 7 per cent for 2023-24, because it is consistent with the rate used to inflate 2023-24 prices in our price determination.

⁴² Similar to the ‘RBA geometric mean’ approach, we have adopted a rate of 7 per cent for 2023-24, because it is consistent with the rate used to inflate 2023-24 prices in our price determination.

below 2.5 per cent by 2026-27.⁴³ The updated inflation estimate, if needed, would be based on a 5-year averaging period.

4.5 Regulatory depreciation

Our final decision is to adopt the benchmarks for regulatory depreciation as set out in Table 4.6.

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

As indicated in our draft decision, East Gippsland Water's forecast regulatory depreciation was calculated using a straight-line depreciation profile, which is our preferred approach.⁴⁴ However, due to adjustments we proposed to its forecast regulatory asset base, our draft decision adopted a slightly higher forecast for regulatory depreciation than proposed by East Gippsland Water.

In response to our draft decision, East Gippsland Water provided an updated forecast regulatory depreciation that reflected its approved regulatory accounts and the adjustments we proposed to its closing and forecast regulatory asset bases (see Section 4.3).

We received no submissions from other stakeholders on this issue.

On that basis, our final decision is to adopt a forecast regulatory depreciation of \$36.9 million for East Gippsland Water for the 2023–28 regulatory period (Table 4.6 in Section 4.3.2).

4.6 Tax allowance

Our final decision is to adopt East Gippsland Water's forecast of \$0.4 million tax allowance for the 2023–28 regulatory period.

The tax allowance is a component of the revenue requirement. Our draft decision was not to accept East Gippsland Water's forecast tax allowance of \$0.82 million due to our proposed adjustments to its revenue requirement, which would alter its tax liability.

In its response to our draft decision, East Gippsland Water updated its estimates of forecast tax to reflect changes to its proposed revenue and costs. We consider East Gippsland Water's updated estimates were calculated in a manner consistent with our guidance.

⁴³ With inflation measured by the Australian Bureau of Statistics Consumer Price Index – all groups.

⁴⁴ Essential Services Commission, *2023 water price review: Guidance paper*, p. 39.

The revisions lower the forecasts for tax payments by East Gippsland Water by around \$0.4 million over the 5-year regulatory period from 1 July 2023, compared to our draft decision (Table 4.2).

After considering all submissions received in response to our draft decision, for the reasons set out above, our final decision adopts a forecast tax allowance of \$0.4 million for the 5-year regulatory period, as set out in Table 4.1.

5. Demand, tariffs and prices

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

5.1 Demand

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

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

In our draft decision, we accepted East Gippsland Water's proposed demand forecasts but required East Gippsland Water in its response to our draft decision to demonstrate how it has considered the updated Victorian Government population and dwelling growth estimates that had been made available to water businesses.

In response to our draft decision, East Gippsland Water slightly reduced its demand forecasts for residential customers to reflect the updated Victorian Government estimates as well as the latest local council projections for its service area.

We have reviewed East Gippsland Water's updated estimates and consider they were estimated consistently with the requirements of our guidance. Accordingly, our final decision is to approve East Gippsland Water's updated demand forecasts.

5.2 Form of price control

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

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

Among other things, we considered that a price cap provides customers with price certainty and allows East Gippsland Water to manage demand risk on behalf of its customers, which we consider is more efficient than customers managing that risk. For major trade waste tariffs, we considered a tariff basket provides flexibility for East Gippsland Water to reform the structure and level of its major trade waste tariffs during the regulatory period, to improve signals about the efficient costs of providing services to customers.

After considering all submissions received in response to our draft decision, for the reasons set out above, and consistent with our draft decision, our final decision is to approve East Gippsland Water's proposed price cap and tariff basket forms of price control.

5.3 Tariff structures and prices

Our draft decision accepted East Gippsland Water's proposed tariff structures but, like all our draft decisions in this review, did not approve prices for each tariff, because East Gippsland Water needed to update its proposed prices to reflect our updates to inflation and cost of debt estimates, and our draft decision on its revenue requirement including new customer contributions.

Our final decision on tariff structures and prices is set out below.

5.3.1 Tariff structures

Our final decision is to accept East Gippsland Water's proposed 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.⁴⁵ 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.

Our draft decision was to accept East Gippsland Water's proposal to retain its existing tariff structures and reform its major trade waste tariffs during the 2023–28 regulatory period following customer engagement. East Gippsland Water's existing tariff structures include:

- for residential and non-residential water services, a two-part tariff with a fixed service charge and a variable usage charge
- for residential and non-residential sewerage services, a fixed service charge only.⁴⁶

In our draft decision, we considered the two-part structure for water services will promote efficient use of the 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.⁴⁷ We also considered two-part tariff structures are easy to understand. In relation to sewerage services, we considered the proposed fixed charge is also easy to understand.

⁴⁵ Essential Services Commission, *2023 water price review: Guidance paper*, p. 51.

⁴⁶ The non-residential sewerage service charge is based on the equivalent tenement (EQT) methodology. One EQT is equivalent to the amount of wastewater collected, discharged and treated by an average residential customer.

⁴⁷ 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.

A submission from the Consumer Action Law Centre expressed support for water businesses' generally retaining the balance between fixed and variable charges in particular, given the disproportionate impact on tenants when more weight is assigned to variable charges.⁴⁸ We consider that East Gippsland Water's proposal retains such a balance.

No other new considerations were presented by East Gippsland Water, and we have not received any submissions from East Gippsland Water customers raising concerns about existing tariff structures.

For the reasons set out above and given East Gippsland Water's proposed tariff structures are a continuation of its current approach, our final decision is to approve East Gippsland Water's proposed tariffs structures.

East Gippsland Water advised in its price submission that it intends to reform its major trade waste tariffs during the regulatory period to better align with the cost of providing the service to customers. To facilitate this, East Gippsland Water proposed to change to a tariff basket form of price control for these tariffs. Our final decision has accepted this proposal (Section 5.2).

If East Gippsland Water needs to make an adjustment or amendment to its trade waste tariffs during the regulatory period to implement its proposed reforms, we will work with the business to identify the most appropriate mechanism specified in our price determination to do so.

5.3.2 Prices

Our final decision is to accept the revised prices proposed by East Gippsland Water.

In our draft decision, we noted that East Gippsland Water would need to propose updated prices to reflect our draft decision on its revenue requirement and our updates to inflation and cost of debt estimates.

Following our draft decision, East Gippsland Water proposed revised prices that reflect the updates to our inflation and cost of debt estimates. East Gippsland Water's revised prices also reflect changes to its revenue requirement as a result of its response to our draft decision and to changes announced in the Victorian State Budget (See Section 4.1). Under East Gippsland Water's revised prices, excluding inflation, prices will rise by 0.47 per cent each year over the 2023–28 regulatory period.

⁴⁸ Consumer Action Law Centre, *Feedback on standard draft decisions: 2023 water price review*, 5 May 2013, p.2.

After considering all submissions received following our draft decision, our final decision is to approve the prices East Gippsland Water proposed in response to our draft decision because they have been calculated in a manner consistent with our guidance.

Our price determination for East Gippsland Water sets out the maximum prices it may charge for the 5-year period from 1 July 2023 (or the manner in which its prices are to be calculated, determined, or otherwise regulated). Approved maximum prices for water and sewerage services applying to most residential and non-residential customers are set out in Tables 5.1 and 5.2. After 2023-24, water and sewerage prices will generally increase by around 0.5 per cent per year, excluding inflation.

Table 5.1 Final decision – water prices
\$ 2023-24

	2023-24	2024-25	2025-26	2026-27	2027-28
Residential and non-residential					
Variable (\$/kL)	2.5435	2.5554	2.5674	2.5794	2.5915
Fixed (\$/year)	242.49	243.63	244.77	245.91	247.07

Notes: These prices have been expressed in \$2023-24 terms, which means 7 per cent inflation has been factored into the prices for 2023-24. For the remaining years shown, inflation will be added each year based on the latest inflation data. The figures in other tables of this report are expressed in \$2022-23, which means inflation has not been accounted for in 2023-24 or the remaining years of the 2023–28 regulatory period. The fixed water charge refers to the 20mm water service fee.

Table 5.2 Final decision – sewerage prices
\$ 2023-24

	2023-24	2024-25	2025-26	2026-27	2027-28
Residential and non-residential					
Fixed (\$/year)	729.46	732.88	736.31	739.76	743.22

Notes: These prices have been expressed in \$2023-24 terms, which means 7 per cent inflation has been factored into the prices for 2023-24. For the remaining years shown, inflation will be added each year based on the latest inflation data. The figures in other tables of this report are expressed in \$2022-23, which means inflation has not been accounted for in 2023-24 or the remaining years of the 2023–28 regulatory period.

5.3.3 Addressing the interests of low income and vulnerable customers

In making our price determination, we must have regard to whether East Gippsland Water's prices take into account the interests of customers, including low income and vulnerable customers.⁴⁹

As outlined in our draft decision we considered that East Gippsland Water has done so in the following ways:

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

We received a submission from the Consumer Action Law Centre reiterating its strong support for East Gippsland Water's proposal to increase its hardship support.⁵⁰

We have considered all submissions in response to our draft decision, however, our views on how East Gippsland Water has addressed the interests of low income and vulnerable customers remain the same as expressed in our draft decision.

5.3.4 Other services

Our final decision approves East Gippsland Water's approach to calculating tariffs for recycled water, trade waste and miscellaneous services because they are consistent with the pricing principles referenced in our guidance which promote cost reflectivity of tariffs.

5.4 New customer contributions

Our final decision is to accept East Gippsland Water's proposed new customer contributions and its negotiated new customer contribution framework.

New customer contributions (or developer charges) are levied by water businesses when a new connection is made to its water, sewerage or recycled water networks. New customer contributions can be either standard or negotiated. Standard charges apply to new connections in areas where infrastructure requirements and growth rates are relatively well known and designated by the water business. The purpose of standard new customer contributions is to reduce the administrative

⁴⁹ Water Industry Regulatory Order 2014 clause 11(d)(iii).

⁵⁰ Consumer Action Law Centre, submission to the Essential Services Commission 'East Gippsland Water draft decision: 2023 water price review', 5 May 2023.

burden as well as improve the timeliness and predictability of costs faced by developers.⁵¹ Negotiated charges allow water businesses and developers to negotiate a site-specific arrangement where standard charges are not fair and reasonable or where a new connection is outside the areas eligible for standard charges.⁵²

Our draft decision proposed to not accept East Gippsland Water's proposal to continue to have no standard new customer contribution charges and to apply a negotiated new customer contribution charge when a development is out of sequence with East Gippsland Water's infrastructure projects.⁵³ The proposed standard zero new customer contribution was based on its 2018 new customer contributions model. We asked East Gippsland Water to provide updated customer contributions models for the 2023 price review, which is a requirement of our guidance.⁵⁴

Our draft decision proposed to accept East Gippsland Water's proposed negotiating framework as we considered it is consistent with the new customer contributions pricing principles outlined in our guidance.

In response to our draft decision, East Gippsland Water provided its 2023 new customer contributions models for water and sewer, including standard new customer contributions. We have verified the new customer contributions model, which shows that the forecast incremental revenue exceeds the incremental cost, and accordingly it supports the proposed zero standard new customer contribution charge for the 2023–28 regulatory period.

No other new considerations were presented in submissions received following our draft decision.

For the reasons set out above, our final decision is to approve East Gippsland Water's proposal to continue to have no standard new customer contribution charges and to apply a negotiated new customer contribution charge when a development is out of sequence with East Gippsland Water's infrastructure projects. We also approve East Gippsland Water's proposed negotiating framework as we considered it is consistent with the new customer contributions pricing principles outlined in our guidance.

If there is a dispute between a developer and a water business (whether in relation to a standard or negotiated new customer contributions), developers may use the dispute resolution offered by a water business as part of its new customer contribution negotiating framework. In addition, developers may follow the *Water Act 1989* process to object and seek internal review by the water

⁵¹ Essential Services Commission, *New customer contributions: explanatory note*, December 2013, p. 3.

⁵² Essential Services Commission, *New customer contributions: explanatory note*, December 2013, p. 3.

⁵³ In this case, East Gippsland Water may charge a developer a non-scheduled charge that will recover the most efficient costs associated with bringing forward the provision of the necessary shared assets.

⁵⁴ Essential Services Commission, 2023 water price review: Guidance paper, p. 58.

business, and to pursue unresolved matters through the Victorian Civil and Administrative Tribunal.⁵⁵

5.4.1 Review of the framework for new customer contributions

Our guideline for new customer contributions establishes our expectations for standard new customer contributions and bespoke negotiated new customer contributions. However, in light of issues we identified during our 2023 water price review, we believe that a review of the regulatory framework for new customer contributions is necessary. Our review will aim to identify and address key implementation issues for water businesses, establish consistency in setting new customer contributions across the sector, and define the purpose and content of the negotiating framework.

5.4.1.1 Current issues

Our experience reviewing the new customer contributions proposals of water businesses in the current price review has identified varied practices across businesses in terms of their approach and substantiation of proposed charges to meet our guidance and the objectives of the framework. This includes varied approaches to the inclusion of costs in new customer contributions, differentiated pricing, and use of negotiated new customer contributions.

A number of businesses in the current price review also based their new customer contributions on an average incremental cost methodology, rather than the net incremental cost approach adopted in the past. We want to explore the issues associated with having different underlying approaches and how this affects confidence and transparency in the way new customer contributions are arrived at.

Other issues we have identified in the current review – such as varied approaches to locational and incremental cost reflectivity – and the transparency of new customer contributions and the nature of engagement, may also be covered in the review.

5.4.1.2 Next steps

In 2023-24, we intend to initiate a review of the framework for new customer contributions by issuing a consultation paper. This paper will outline the proposed scope of the review and seek feedback from stakeholders. We encourage stakeholders to suggest any other important matters that they believe should be included in the review.

Throughout the review process, we will actively engage with industry and stakeholders to gather their input.

⁵⁵ *Water Act 1989*, section 271.

5.5 Adjusting prices

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

Our draft decision was to accept East Gippsland Water's proposed price adjustment mechanisms, which are a continuation of its current mechanisms.

After considering all submissions received in response to our draft decision, our final decision is to approve East Gippsland Water's proposed price adjustment mechanisms on the basis that they are a continuation of the current approach, and otherwise satisfy the requirements of our guidance.

6. Financial position

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

In approving prices, we must have regard to the financial viability of the water industry.⁵⁶ 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.

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 its service commitments, including financing costs arising from investments to meet service expectations.

⁵⁶ WIRO clause 8(b)(ii) and ESC Act s.8A(1)(b).

7. PREMO rating

PREMO is an incentive mechanism that links the return on equity used to calculate a water business's revenue requirement to that business's level of ambition expressed in its price submission. Our guidance required East Gippsland Water to self-assess the level of ambition of its price submission for each element of the PREMO mechanism and arrive at an overall self-rating.⁵⁷ We required East Gippsland Water to self-rate its price submission as either 'Leading', 'Advanced', 'Standard' or 'Basic', with 'Leading' being the most ambitious and 'Basic' the least.

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

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

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

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

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

Our PREMO assessment is set out in our draft decision.

No new considerations were presented by East Gippsland Water or in submissions received following our draft decision. For this reason, and the reasons set out in our draft decision, our final decision is to accept East Gippsland Water's proposed overall PREMO self-rating of 'Standard'.

This rating is reflected in the return on equity we have approved for East Gippsland Water (see Section 4.4.2).

⁵⁷ This is the first price review we have done where the rating has been based on all five elements of PREMO. In our 2018 price review, our PREMO assessment was against only four of the elements — Risk, Engagement, Management and Outcomes.

Table 7.1 **PREMO rating**

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

In summary, the following matters support East Gippsland Water's self-rating of its price submission as 'Standard':

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

Appendix A – Submissions received on draft decision

Name or organisation	Date received
Consumer Action Law Centre	5 May 2023
East Gippsland Water	9 May 2023
Registered Accommodation Association of Victoria	26 May 2023

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 final decision for East Gippsland Water.

The WIRO requires the Commission to place particular emphasis on the promotion of efficient use of prescribed services by customers, the promotion of efficiency in water businesses as well as efficiency in, and the financial viability of, the regulated water industry and the provision to regulated entities of incentives to pursue efficiency improvements.

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.⁵⁸ Our draft and final decisions provide further information on where we have considered our guidance, and East Gippsland Water’s compliance with our guidance, in making our price determination.⁵⁹

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

Economic efficiency and viability matters

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

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

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

- Our consideration of customer engagement (Section 3.1).
- Our assessment of the revenue requirement (Chapter 4).

⁵⁸ Essential Services Commission, *2023 water price review: Guidance paper*, 26 October 2021.

⁵⁹ Essential Services Commission, *East Gippsland Water draft decision: 2023 water price review*, 30 March 2023; Essential Services Commission, *East Gippsland Water Determination: 1 July 2023 – 30 June 2028*, 23 June 2023.

- Our assessment of efficient operating expenditure (Section 4.1) and capital expenditure (Section 4.2).
- Our assessment of tariffs (Section 5.3).

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 final decision has therefore had regard to the extent that East Gippsland Water has demonstrated its proposed outcomes reflect customer service priorities, and whether its tariffs and forecast costs reflect efficient levels of expenditure.

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

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

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

- A 10-year trailing average approach to estimating the benchmark cost of debt (see Section 4.4.1).
- A regulatory rate of return that we consider will enable East Gippsland Water to recover borrowing costs associated with its investment in services, and generate a return on assets.⁶⁰

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

⁶⁰ The regulatory rate of return is comprised of the cost of debt and the return on equity.

The following chapters and sections of our final 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).

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 final 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 final decision. This includes adopting operating and capital expenditure benchmarks that we consider will allow East Gippsland Water to deliver services that are covered by the prescribed services listed in the WIRO.

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

Our final decision provides for East Gippsland Water to generate a return on assets through:

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

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

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

- indicative bills paid by customers in other jurisdictions in Australia⁶¹
- operating and capital expenditure costs per connection throughout Australia⁶²
- tariff structures applied by water businesses throughout Australia⁶³
- the regulatory rate of return set by other regulators.⁶⁴

We are not aware of any international benchmarks that are relevant to our final 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 final decision involved consideration of this factor:

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

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

⁶¹ Bureau of Meteorology, *National performance report 2020-21; urban water utilities, part A*, February 2022.

⁶² Bureau of Meteorology, *National performance report 2020-21; urban water utilities, part A*.

⁶³ Includes Icon Water, Sydney Water, Hunter Water, Central Coast Council, Power and Water Corp, Urban Utilities, Unity Water, SA Water and TasWater.

⁶⁴ 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 final 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 assessment of financial viability (Chapter 6).

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 final 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 final decision involved consideration of this factor:

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

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

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

- feedback from customers during a water business’s engagement
- the structure of individual tariffs
- the proposed form of price control
- any changes to tariffs and how water businesses explain them to customers.

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

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

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

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

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

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

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

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

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

- Our consideration of customer engagement (Section 3.1)
- Our consideration of outcomes (Section 3.2)

Appendix B – Commission’s consideration of legal requirements

- 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 final decision proposes to approve a revenue requirement that will enable East Gippsland Water to deliver the outcomes valued by customers, and on its legal and regulatory obligations.

The following chapters and sections of our final 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 final decision proposes to approve a revenue requirement that will enable East Gippsland Water to deliver the outcomes valued by customers, and on its health, safety, environmental sustainability and social obligations.

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

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

Other matters

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

In relation to the above, East Gippsland Water does not face any competition in the delivery of its prescribed services within its region. Our final 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 final 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 2016.⁶⁵

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.⁶⁶

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

⁶⁵ Essential Services Commission 2016, *Water Pricing Framework and Approach, Implementing PREMO from 2018*, October, pp. 11–13.

⁶⁶ 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.⁶⁷

⁶⁷ Essential Services Commission, 2023 water price review: *Guidance paper*, p. 2.

Appendix C – Service standards

We have accepted the following standards, and conditions of service and supply, and associated targets for East Gippsland Water. Service standards are set out in our Water Industry Standard – Urban Customer Service (Urban Water Industry Standard). Accordingly, in early 2023-24, we will update the Urban Water Industry Standard to adopt these service standards and targets.

Water service standards

Service standard	2023-24	2024-25	2025-26	2026-27	2027-28
Minimum water pressure or flow rate a customer should receive (L/min)	20	20	20	20	20
Maximum number of unplanned water supply interruptions a customer should experience in any 12-month period	5	5	5	5	5
Average time taken to attend bursts and leaks (priority 1) (minutes)	35	35	35	35	35
Average time taken to attend bursts and leaks (priority 2) (minutes)	35	35	35	35	35
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)	145	145	145	145	145

Sewerage service standards

Service standard	2023-24	2024-25	2025-26	2026-27	2027-28
Maximum number of sewer blockages a customer should experience in any 12-month period	3	3	3	3	3
Average time to attend sewer spills and blockages (minutes)	35	35	35	35	35
Average time to rectify a sewer blockage (minutes)	80	80	80	80	80
Maximum time taken to contain a sewer spill (minutes)	300	300	300	300	300

Appendix D – Guaranteed service level scheme

We have adopted the following service level obligations and corresponding payment amounts for failure to attain the stated obligation as the guaranteed service level scheme for East Gippsland Water. Guaranteed service levels are approved in the Water Industry Standard – Urban Customer Service (Urban Water Industry Standard). Accordingly, in early 2023-24, we will update the Urban Water Industry Standard to reflect the guaranteed service levels set out below.

In accordance with clause 20(b) of the Urban Water Industry Standard, East Gippsland Water must ensure that any payment is made to a customer as soon as practicable after a customer becomes entitled to the guaranteed service level 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, a third party does not include any person or firm acting on behalf of East Gippsland Water.

East Gippsland Water’s guaranteed service level scheme

Service level obligation	Payment (\$)
In the event of a sewage spill within a customer’s house, which is caused by us, there will be a \$1,000 cash payment to the home-occupier affected.	\$1,000
Will notify customers of planned interruptions to their water supply at least 48 hours in advance. If the organisation fails to do this, a rebate of \$65 will be applied to the bills of affected customers.	\$65
If a planned water supply interruption exceeds the period specified in the notice, affected customers will have a \$65 rebate applied to their bill.	\$65
We will not restrict a residential customer’s water supply or take legal action against the customer before all reasonable endeavours have been made to contact them and provide information about help available if they are experiencing difficulties paying. If East Gippsland Water fails to do this, a rebate of \$300 will be applied to the customer’s bill.	\$300
We are striving for net zero greenhouse gas emissions by 2035 and will provide a six-monthly update on progress against our targets to the community. There will be a written public apology if this update is not provided.	East Gippsland Water to provide a written public apology if any six monthly update is not provided.

Note: These are nominal amounts, that is, the amount of payment will not be impacted by inflation.

Appendix E – Inputs to calculation of long-term inflation

Inflation – annual estimates (per cent)

	2023-24	2024-25	2025-26	2026-27	2027-28	Average
RBA geometric mean	7.0	4.1	3.1	2.5	2.5	3.8
Bond breakeven	7.0	2.3	2.3	2.3	2.3	3.3