


May 2023



Review of new customer contribution- related capital expenditure for South Gippsland Water

2023 Water Price Review

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Table of Contents

- 1 INTRODUCTION 4
 - 1.1 Purpose of this report 4
 - 1.2 Water industry regulatory framework..... 4
 - 1.3 Methodology and approach..... 5
- 2 SUMMARY OF BUSINESSES’ PROPOSALS 6
 - 2.1 Proposed new customer contributions..... 6
 - 2.2 Forecast capital expenditure..... 7
 - 2.1 Summary of our assessment..... 7
- 3 SOUTH GIPPSLAND WATER 8
 - 3.1 Proposed NCCs 8
 - 3.2 Capital expenditure included in new customer contributions 8
 - 3.3 Our assessment..... 9

1 INTRODUCTION

1.1 Purpose of this report

The Essential Services Commission (the Commission) is reviewing submissions from 14 Victorian water businesses setting out their proposed prices, revenue requirement and key service outcomes to apply to water and sewerage services commencing on 1 July 2023 through to 30 June 2028 (the PS5 regulatory period). Each of the Victorian water businesses submitted their proposals to the Commission for assessment on 30 September 2022.

FTI Consulting has been engaged to provide advice on whether the water business' capital expenditure included in the calculation of new customer contributions for Central Highlands Water, Coliban Water, Goulburn Valley Water, Lower Murray Water, South East Water, South Gippsland Water and Yarra Valley Water is reasonable. The commission has indicated that four water businesses have included historical capital expenditure (sunk costs) in their proposed new customer contributions¹, while three water businesses proposed significant increases in their new customer contributions² in the 2023-28 regulatory period compared to 2022-23.

This report sets out our independent expert view of the reasonableness of the capital expenditure included in the new customer contributions for South Gippsland Water. We have prepared a separate report for each water business.

1.2 Water industry regulatory framework

The water businesses' proposals are being assessed against a legal framework set out in the *Water Industry Regulatory Order 2014* (WIRO)³ and the Commission's PREMO framework for approving prices.⁴

The commission is required to assess each water corporations price submission in a manner consistent with the requirements of the regulatory framework, which places an emphasis on efficient delivery of services by water corporations. The assessment of the new customer contributions proposed by water corporation's plays an important role in achieving this objective.

¹ Lower Murray Water, South East Water, South Gippsland Water and Yarra Valley Water.

² Central Highlands Water, Coliban Water and Goulburn Valley Water.

³ The Water Industry Regulatory Order 2014 (WIRO) sits within the broader context of the *Water Industry Act 1994* (Vic) and the *Essential Services Commission Act 2001* (Vic).

⁴ Essential Services Commission 2016, Water Pricing Framework and Approach: Implementing PREMO from 2018, October.

1.3 Methodology and approach

Our methodology for assessing the capital expenditure included in proposed new customer contributions for the next regulatory period is consistent with guidance provided by the Commission.⁵ In summary, the scope of our review includes:

- whether the capital expenditure included in the new customer contributions relates to growth and the basis of the cost estimate is reasonable
- whether the methodology used is reasonable for apportioning capital expenditure that serves multiple purposes
- the relative merits of the proposed infrastructure and related capital expenditure in serving specific catchments versus a broader area
- the reasonableness of the incremental operating costs (and their relationship to growth)
- any historical capital expenditure included.

Our process has involved several steps:

- an initial review of PS5 price submissions, new customer contribution models, financial model templates and associated documentation provided by water businesses
- a high-level desktop review of the methodology used by each water corporation to assign capital expenditure, including sunk costs, to new customer contributions
- visits and/or online discussions with each of the water businesses on key issues related to their proposal
- further review and analysis of further information or explanations provided.

⁵ Essential Services Commission 2021, 2023 water price review: Guidance paper, 26 October, page 59.

2 SUMMARY OF BUSINESSES' PROPOSALS

2.1 Proposed new customer contributions

Water businesses are proposing the following new customer contributions for the forthcoming regulatory period (see Table 2.1). Most of the water businesses have proposed significant increases for new customer contributions in the forthcoming regulatory period, with Lower Murray Water and South Gippsland Water proposing more modest increases. Central Highlands Water, Coliban Water, South East Water and Yarra Valley Water are all proposing new customer contributions that are less than what has been calculated using their new customer contribution models.

Table 2.1: Proposed new customer contributions

Water business	Current NCC	Proposed NCC in year 1 of PS5	Proposed NCC in year 5 of PS5	Model calculated NCC
Central Highlands Water	Water: \$1,504 Sewer: \$0	Water: \$1,300 – 3,000 Sewer: \$1,300 – 3,000	Water: \$2,626 – 4,121 Sewer: \$2,626 – 4,121	Water: \$4,602 – 11,573 Sewer: \$5,287 – 7,210
Coliban Water	Water: \$1,790 Sewer: \$1,790 Recycled: \$895	Water: \$2,148 Sewer: \$2,148 Recycled: \$1,074	Water: \$3,144 Sewer: \$4,453 Recycled: \$1,572	Water: \$3,964 Sewer: \$4,841 Recycled: \$1,476
Goulburn Valley Water	Water: \$2,891 Sewer: \$0	Water: \$3,700 Sewer: \$1,700	Water: \$3,700 Sewer: \$1,700	Water: \$3,702 Sewer: \$1,707
Lower Murray Water	Water: \$2,076 – 4,152 Sewer: \$1,420 – 2,839	Water: \$2,482 – 4,963 Sewer: \$1,429 – 2,857	Water: \$2,482 – 4,963 Sewer: \$1,429 – 2,857	Water: \$4,963 Sewer: \$2,857
South East Water	Water: \$775 – 1,711 Sewer: \$775 – 1,224 Recycled: \$775 – 1,903	Water: \$813 Sewer: \$813 – 1,670 Recycled: \$813 – 2,595	Water: \$988 Sewer: \$988 – 2,030 Recycled: \$988 – 3,154	Water: (\$3,391.87) – (\$103.63) Sewer: (\$1,661.56) – 8,749.78 Recycled: \$6,416.65 – 17,472.93
South Gippsland Water	Water: \$2,518 Sewer: \$2,518	Water: \$2,971 Sewer: \$2,971	Water: \$2,971 Sewer: \$2,971	Water & Sewer: \$5,944
Yarra Valley Water	Water: \$775 – 2,776 Sewer: \$775 – 2,776 Recycled: \$775	Water: \$814 – 2,915 Sewer: \$814 – 2,915 Recycled: \$814	Water: \$989 – 3,543 Sewer: \$989 – 3,543 Recycled: \$814 – 989	Water: \$1969 – 11,815 Sewer: \$3,608 – 11,517 Recycled: \$5,927 – 16,535

2.2 Forecast capital expenditure

Water businesses have included a total of \$9.4 billion in capital expenditure in their new customer contribution models. Most of this spend is for assets that will exclusively service new customers, however, there is a substantial amount of capital expenditure that has multiple drivers and will service both new and existing customers. Water businesses have proposed to allocate the costs of these assets across both new and existing customers.

2.1 Summary of our assessment

In undertaking our assessment of capital expenditure, we reviewed the information provided by water businesses, including from pricing submissions, new customer contributions models and other information that had been provided to the commission during the price review. We then met with each of the businesses to gain a better understanding of their new customer contributions, and how these had been developed.

During these meetings we requested further information from water businesses that would demonstrate that the capital expenditure included in new customer contributions met the criteria as set out by the commission. Businesses were asked to provide documentation that outlined the methodology and approach used to derive new customer contributions, including how capital expenditure is incorporated into the calculation of charges.

The documentation provided by Central Highlands Water, Coliban Water, Goulburn Valley Water, Lower Murray Water, South East Water, South Gippsland Water and Yarra Valley Water was not sufficient to allow for a complete assessment of capital expenditure. It was apparent that no policy documents had been developed by these seven water businesses prior to submitting their pricing proposals to the commission. What was provided by these water businesses was mainly developed in response to our request for supporting information. None of these water businesses could articulate how it had implemented a pre-determined methodology.

In the absence of clearly articulated policy and methodology documentation, we have had to assess the capital expenditure based on a degree of confidence that it would be appropriate. We have rated this confidence level as either high; medium or low. It is important to note that the degree of confidence refers to our view that all the capital expenditure would be appropriate to include. Capital expenditure that is rated medium would likely result in some, and possibly all, the capital expenditure included in the calculation of new customer contributions, once additional documentation and analysis is provided. Capital expenditure that is rated low may still see some of that expenditure included.

In our review we have determined that we have a high degree of confidence that \$6.0 billion of capital expenditure should be included in new customer contributions, a medium degree of confidence in \$0.2 billion and a low degree of confidence in the remaining \$3.2 billion.

3 SOUTH GIPPSLAND WATER

3.1 Proposed NCCs

South Gippsland Water has proposed an increase of around 24 per cent for new customer contributions for water and sewer. Both charges will increase from their current rate of \$2,396 per lot to \$2,971 per lot in the first year of the regulatory period. New customer contributions will remain at those levels in real terms throughout PS5.

Table 3.1: Proposed new customer contributions

	Current NCC	Proposed NCC in year 1 of PS5	Proposed NCC in year 5 of PS5
Water	\$2,396	\$2,971	\$2,971
Sewer	\$2,396	\$2,971	\$2,971

3.2 Capital expenditure included in new customer contributions

3.2.1 Methodology and approach

South Gippsland Water provided no details of its methodology used to include capital expenditure in new customer contributions in its pricing submission. It provided some information after we met with staff.

South Gippsland Water has separated its capital expenditure into two categories. First, growth-driven projects which have been allocated 100 per cent to growth. This category includes water supply upgrades, water treatment plant upgrades, water network upgrades and wastewater treatment plant upgrades. Second, growth-driven projects with mixed drivers that have been allocated to growth and existing customers. This category includes sewer network projects and treatment plant projects with more than one driver.

South Gippsland Water provided no detailed project information in its NCC model. It provided a more detailed spreadsheet in response to an information request from the commission. However, it was unclear from this spreadsheet what had been included in new customer contributions. We sought further information from South Gippsland Water that summarised the capital expenditure by these drivers, which was provided and is summarised in table 3.2.

Table 3.2: Capital expenditure included in new customer contributions allocations

Category	Water	Sewer	Recycled	Total
Fully allocated to growth	170.7	225.7	-	396.3
Projects with mixed drivers	2.0	28.8	-	30.8
Grand total	172.7	254.4	-	427.2

3.2.2 Incremental operating costs

South Gippsland Water has included the average operating cost per customer in its new customer contributions model.

3.3 Our assessment

In assessing the capital expenditure included in the calculation of new customer contributions we have had regard to the guidance provided by the commission (as outlined in section 1.3). We have also established criteria for assessing how the capital expenditure is apportioned to new customer contributions, particularly where the assets have more than one driver (e.g. an upgrade to a treatment plant that is required to meet compliance requirements but will also cater for future growth in volumes of water treatment). The criteria we have used is as follows:

1. Whether the methodology and approach used to allocate the capital expenditure to new customer contributions is well explained and approved by senior management and the Board
2. Whether there is clear documentation of how the methodology and approach has been applied to establish new customer contributions for this pricing submission
3. Whether the allocator used to apportion capital expenditure is reasonable
4. Whether the allocator value is verifiable

In future assessments we would also consider whether the methodology and approach has been applied consistently from one period to the next, and if there were any changes that they were comprehensively explained.

The commission's guidance requires the capital costs included in new customer contributions should be incremental.⁶ This means those costs that are required only because of there being new customers. In a situation where there is more than one driver for capital expenditure, one method to estimate this incremental cost is to estimate what the cost would be with and without any new customers, with the difference between the two estimates being attributable to the new customers, and therefore being the incremental cost. We have assessed capital expenditure that is attributable to more than one driver against the principle of incremental cost.

⁶ Essential Services Commission 2021, 2023 water price review: Guidance paper, 26 October, page 59.

Table 3.2: Assessment of new customer contributions allocations

Category	Capital expenditure (\$m)	Methodology explained	Methodology applied & documented	Allocator	Allocator verifiable
Fully allocated to growth	396.3	Yes	No	Fully allocated	Yes
Projects with mixed drivers	30.8	Yes	No	Nominal	No

3.3.1 Fully allocated to growth

South Gippsland Water has included capital expenditure on water supply upgrades, water treatment plant upgrades, water network upgrades and wastewater treatment plant upgrades in this category. It has not provided any explanation as to why these assets should be fully attributable to new customers, noting that we would expect expenditure associated with treatment plants and water supply upgrades to be apportioned between new and existing customers using an incremental costs approach. It is also unclear what proportion of the \$396.3 million is attributable to treatment plants and water supply and network upgrades, although the project details provided suggest that it is not insignificant.

We would expect that some of the capital expenditure included in this category would be assets that only service new customers. However, we are unable to verify how much is included from the information provided. Given the lack of a fully documented methodology and approach, together with the uncertainty around the nature of the projects within this category, we have a low level of confidence that this capital expenditure is appropriate to include in the calculation of new customer contributions.

3.3.2 Projects with mixed drivers

South Gippsland Water has included capital expenditure on treatment plant upgrades and sewer projects, where growth is not the only driver in this category. South Gippsland Water has used either a 75-25; 50-50 or 25-75 split to allocate these costs to new customers. However, it has not provided any explanation as to whether or how it has had regard to incremental costs in allocating these costs.

Given the lack of a fully documented methodology and approach, together with no evidence of how South Gippsland Water has had regard to incremental costs for this asset category, we have a low level of confidence that this capital expenditure is appropriate to include in the calculation of new customer contributions.

3.3.3 Incremental operating costs

South Gippsland Water has included average operating costs in its calculation of new customer contributions. It has calculated the average operating costs of all new and existing customers across the forthcoming regulatory period and included this in its NCC model. South Gippsland Water has not

provided any information that supports the use of average costs and therefore we have a low level of confidence that this should be included in the determination of new customer contributions.

3.3.4 Summary of assessment

In summary we have a low level of confidence that all the \$427.2 million of capital expenditure should be included in the calculation of new customer contributions.

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