



Gippsland Water draft decision

2018 Water Price Review

28 March 2018



An appropriate citation for this paper is:

Essential Services Commission 2018, *Gippsland Water draft decision: 2018 Water Price Review*, 28 March

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Contents

Summary	iv
1. Our role and approach to water pricing	1
2. Our assessment of Gippsland Water's price submission	5
Regulatory period	6
Customer engagement	6
Outcomes	7
Guaranteed service levels	7
Revenue requirement	7
Operating expenditure	9
Regulatory asset base	16
– Closing regulatory asset base	17
– Forecast regulatory asset base	18
– Capital expenditure	19
– Revenue from customer contributions	22
Cost of debt	23
Return on equity – PREMO rating	24
Regulatory depreciation	24
Tax allowance	24
Demand	24
Form of price control	25
Tariff structures	25
– Price and bill levels	26
– Draft decision on tariff structures	27
Adjusting prices	27
New customer contributions	28
Financial position	28
3. PREMO rating	31
Our review of Gippsland Water's PREMO self-rating	31
4. We invite feedback on our draft decision	33
Attend a public forum	33
Provide written comments or submissions	33
Next steps	34

Summary

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

This draft decision sets out our preliminary views on Gippsland Water's price submission.^{1 2}

We invite interested parties to comment on our preliminary views in this draft decision before we make a final decision and issue a price determination in June 2018. Details on how to make a submission on our draft decision are provided in Chapter 4.

Gippsland Water will improve services in key areas

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

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

- improving the timeliness and quality of communication with customers
- providing greater transparency about response times to service interruptions
- improving the availability and reliability of drinking water.

Our draft decision proposes to approve a lower revenue requirement than proposed by Gippsland Water, reflecting our review of efficient costs

Our draft decision proposes to approve a revenue requirement of \$622.2 million for Gippsland Water over the five year period starting 1 July 2018, for the purpose of approving maximum prices.³ This is \$11.1 million or 1.7 per cent lower than proposed by Gippsland Water.

The main reasons for our proposed adjustments to the revenue requirement are the adjustments we have proposed to Gippsland Water's operating cost forecasts, and in particular, labour costs.

¹ Clause 16 of the Water Industry Regulatory Order 2014 requires us to issue a draft decision.

² Gippsland Water's price submission is available on our website at www.esc.vic.gov.au.

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

Gippsland Water proposed an increase in labour costs above inflation. Our view is that these increases should instead be managed through efficiency improvements, or funded via higher revenue generated from the customer growth forecast by the corporation. We have also adopted a lower forecast for Gippsland Water's electricity costs. The operating expenditure section (page 9) provides more information on our review of Gippsland Water's operating expenditure.

Our draft decision proposes relatively minor adjustments to Gippsland Water's capital expenditure forecast (see capital expenditure section from page 19 for more information).

Based on our draft decision, on average Gippsland Water's prices over 2018-19 to 2022-23 will be around 1.7 per cent lower than under its original proposal.⁴

Gippsland Water must respond to our draft decision and propose individual tariffs that reflect our initial views on the revenue requirement. Gippsland Water's response will determine the price and bill impact of our draft decision on individual tariffs and customer groups.

Tariff structures will remain the same

Our draft decision accepts Gippsland Water's proposed tariff structures, which are the same as its current tariff structures. For water services, Gippsland Water proposed a fixed service charge and a variable component that depends on water used. For residential sewerage services, Gippsland Water proposed a fixed service charge only. For non-residential sewerage services Gippsland Water proposed a fixed service charge and a variable usage component.

We propose to approve Gippsland Water's proposed 'price cap' form of price control. This means its maximum prices are fixed subject to updates for inflation and cost of debt, and any other price adjustments we approve in our price determination. Gippsland Water currently uses a price cap.

Gippsland Water's price submission is rated as 'Standard' under PREMO

Our draft decision is to accept Gippsland Water's PREMO self-rating of its price submission as 'Standard' (Table A).

In support of its PREMO self-ratings, we consider Gippsland Water's approach to engagement provided a reasonable opportunity for customers to provide feedback, and shape the business's proposals. It used a range of methods to get customer feedback, including online forums, community conversations, and pop-up information stalls in town centres. It also included steps to allow the business to re-test proposals with customers throughout the engagement process.

⁴ This is an indicative percentage change on prices based on the percentage change in draft decision revenue requirement compared to the proposed revenue requirement.

We note it has proposed broadly similar outcomes for service levels and prices, compared with previous regulatory periods. This is consistent with a ‘Standard’ price submission.

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

Table A **PREMO Rating**

	Overall PREMO rating	Risk	Engagement	Management	Outcomes
Gippsland Water’s rating	Standard	Standard	Standard	Standard	Standard
Commission’s rating	Standard	Standard	Standard	Standard	Standard

Among the 15 draft decisions we have released so far, Gippsland Water is one of five corporations for which we propose to approve a ‘Standard’ rating (Table B).

Table B **Draft decision on PREMO – overall rating**

Leading	Advanced	Standard	Basic
Goulburn Valley Water	Barwon Water	Coliban Water	Wannon Water
	Central Highlands Water	East Gippsland Water	
	City West Water	Gippsland Water	
	GWMWater	Lower Murray Water (urban)	
	North East Water	Westernport Water	
	South East Water		
	Southern Rural Water		
	Yarra Valley Water		

1. Our role and approach to water pricing

We are Victoria's independent economic regulator

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

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

Our review of the prices proposed by the water corporations covers the prescribed services listed in the WIRO.⁵ The prescribed services include retail water and sewerage services, and bulk water and sewerage services delivered by the water corporations.⁶

In September 2017, Gippsland Water provided a submission to us proposing prices for a five year period starting 1 July 2018. Our task is to assess the price submission against the legal framework that governs our role, and make a price determination that takes effect from 1 July 2018. The price determination will specify the maximum prices Gippsland Water 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 explains the reasons for our price determination.

We assess prices against the WIRO and other legal requirements

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

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

⁵ The review excludes Melbourne Water and Goulburn-Murray Water. In 2016 we approved prices for Melbourne Water to 30 June 2021 and for Goulburn-Murray Water to 30 June 2020.

⁶ The prescribed services are listed at clause 7(b) of the WIRO.

- the matters specified in our guidance⁷
- 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.

A separate document lists the specific objectives and the various matters the commission must have regard to when making a price determination and provides a guide to where the commission has done so in this draft decision.⁸

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

If we consider the price submission has adequate regard for the matters in clause 11 of the WIRO and complies with our guidance, we must approve Gippsland Water's proposed prices.⁹

If we consider the submission does not have adequate regard for the matters specified in clause 11 of the WIRO or comply with our guidance, we may specify maximum prices, or the manner in which prices are to be calculated, determined or otherwise regulated.¹⁰

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

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

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

In May 2016, we released a position paper setting out our proposed new pricing approach, and invited submissions.¹² We met with each water corporation and other interested parties to help

⁷ Essential Services Commission 2016, *2018 Water Price Review, Guidance paper*, November.

⁸ Essential Services Commission 2018, *Gippsland Water draft decision, 2018 Water Price Review – commission's consideration of legal requirements*, 28 March. This is located on our website at www.esc.vic.gov.au.

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

¹⁰ This is provided for under the WIRO, clause 14(b)(i).

¹¹ Essential Services Commission 2015, *Review of Water Pricing Approach, Consultation paper*, April.

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

inform their submissions. Submissions were supportive of the overall proposal, in particular the greater focus on customer engagement and value.

We finalised our new approach to water pricing in October 2016.¹³

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

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

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

PREMO

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

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

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

The 2018 water price review is the first time we've applied our PREMO incentive mechanism.

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

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

¹⁵ Essential Services Commission 2016, *Guidance Paper*, op. cit., pp. 8-9.

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

For the 2018 water price review, a water corporation's ambition in terms of delivering customer value is being assessed against four elements of PREMO – Risk, Engagement, Management and Outcomes.¹⁷

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

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

¹⁸ Essential Services Commission 2016, *Guidance paper*, op. cit., pp. 45–49.

2. Our assessment of Gippsland Water's price submission

We have made our draft decision on Gippsland Water's price submission after considering: Gippsland Water's price submission, its responses to our queries, and written submissions from interested parties (a list of submissions is provided in Appendix A).

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

Our guidance included a number of matters water corporations must address in their price submissions. Gippsland Water's price submission addressed each of these matters. Our preliminary assessment of these matters is provided in this chapter.

Gippsland Water must submit a response to our draft decision and provide an updated financial model by 8 May 2018 (via email to water@esc.vic.gov.au). The response will be published on our website. We also invite other interested parties to make a submission.

We intend to make a price determination for Gippsland Water in June 2018.

All financial values referred to in this chapter are in \$2017-18.

Regulatory period

Gippsland Water proposed a five year regulatory period. Our draft decision accepts Gippsland Water's proposal as it is consistent with our guidance. Our guidance proposed to approve a five year regulatory period, subject to any alternative and justified proposal.¹⁹

Customer engagement

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

The engagement by Gippsland Water:

- took place between January 2016 and August 2017
- used a range of methods including online forums, conversations with residential, non-residential customers and community groups, pop-up stalls in various towns, and social media posts
- sought views from its community consultative committee, community groups, local councils, industry associations, and residential and business customers
- covered topics such as prices and tariffs, water quality, environment and emission reductions, service levels, and its customer financial assistance program.

More detail on Gippsland Water's engagement is available in its price submission.²⁰

Evidence that Gippsland Water's engagement influenced its proposals includes:

- proposing to maintain current service levels, in response to feedback that customers did not want bills to rise in order to pay for service improvements
- investing in water supply infrastructure (such as a new pipe to supply Coongulla) to align with customers prioritising the availability of safe and clean drinking water
- proposing to trial metering and tariff options that could enable customers to have greater control over bills.

The influence of Gippsland Water's engagement on its proposals supports the objectives in our pricing framework relating to efficiency and the interests of consumers.²¹

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

²⁰ Gippsland Water's price submission is available on our website at www.esc.vic.gov.au.

²¹ See for example, WIRO clauses 8(b)(i), 8(b)(ii), 8(b)(iii), 11(d)(iii), and ESC Act Sections 8(1), 8A(1)(a).

Outcomes

Instead of specific outcomes, Gippsland Water proposed to deliver on five values that are intended to reflect customer expectations over the five year period starting 1 July 2018. Gippsland Water's customers want the corporation to:

- do your job well
- be easy to deal with
- be affordable and fair
- prepare and protect
- be involved.

Gippsland Water proposed measures it will use to report on progress against achieving on each value. These are set out at pages 19 to 23 of its price submission. To report on its performance Gippsland Water proposes to publish an annual report. The report and accompanying fact sheets will be available on its website, social media posts, media releases and targeted campaigns.

We will engage with Gippsland Water to finalise the measures and targets used to assess performance against each value, and how it will report this publicly. Performance against these measures will inform our assessment during future price reviews.

Guaranteed service levels

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

Gippsland Water's proposed GSLs are set out on pages 24 to 26 of its price submission. It proposes to change the rebate for its hardship GSL to allow for daily payments of \$300 if the business breaches the GSL (with total payments capped at \$900). It proposes to introduce four new GSLs including two that will be paid to a community compensation fund, recognising that it is the community which is affected, rather than individuals, if these two service levels are not met.

Gippsland Water's proposed GSLs were tested through its customer engagement. On this basis, we propose to accept Gippsland Water's proposed GSLs. Final GSLs will be subject to our consideration of any feedback following the release of our draft decision.

Revenue requirement

The revenue requirement is the forecast amount a water corporation needs to deliver on customer outcomes, government policy, and obligations monitored by technical regulators including

Environment Protection Authority Victoria and the Department of Health and Human Services. Along with forecast demand, it is an input to calculating prices.²²

Gippsland Water proposed a revenue requirement of \$633.3 million over a five year period starting 1 July 2018. Our draft decision proposes to reject the revenue requirement in Gippsland Water's submission and instead approve a revenue requirement of \$622.2 million, 1.7 per cent lower than proposed by Gippsland Water. This reflects our assessment of each element that comprises the revenue requirement, including forecast expenditure.

Our draft decision on the revenue requirement is set out at Table 2.1.

Table 2.1 Draft decision – revenue requirement
\$ million 2017-18

	2018-19	2019-20	2020-21	2021-22	2022-23	Total
Operating expenditure	78.2	77.5	75.3	75.5	76.0	382.5
Return on assets	27.0	28.0	29.1	30.0	30.5	144.5
Regulatory depreciation	17.4	18.2	19.0	19.8	20.8	95.2
Draft decision - revenue requirement	122.5	123.6	123.4	125.3	127.4	622.2

Note: Numbers have been rounded

The main adjustments we've proposed in our draft decision on the revenue requirement relate to our proposed adjustments to Gippsland Water's operating expenditure forecasts. Table 2.2 summarises proposed changes to the revenue requirement.

Our final decision will be based on the latest available information. Accordingly, as well as responding to our draft decision and providing an updated price schedule, Gippsland Water must update its revenue requirement and prices to reflect our April 2018 updates to estimates for the cost of debt and inflation.

There may be changes in laws or government policy before we make a price determination. If any such changes occur between the draft decision and the price determination, and impact on the

²² We met with officers of the Department of Environment, Land, Water and Planning, Department of Health and Human Services, and Environment Protection Authority Victoria, to discuss their expectations of Gippsland Water in the regulatory period from 1 July 2018. We had regard to their views in our draft decision.

revenue requirement, Gippsland Water should update its price submission and also provide us with an updated financial model. Any updates will be publicly available on our website.

Table 2.2 Adjustments to revenue requirement

\$ million 2017-18

	2018-19	2019-20	2020-21	2021-22	2022-23	Total
Proposed revenue requirement	123.2	124.7	125.9	128.4	131.0	633.3
Operating expenditure	-0.5	-0.8	-2.2	-2.8	-3.3	-9.6
Return on assets	-0.2	-0.2	-0.2	-0.2	-0.2	-0.9
Regulatory depreciation	-0.1	-0.1	-0.1	-0.1	-0.1	-0.6
Total adjustments	-0.7	-1.1	-2.5	-3.1	-3.7	-11.1
Draft decision revenue requirement	122.5	123.6	123.4	125.3	127.4	622.2

Note: Numbers have been rounded

Operating expenditure

Operating expenditure is an input to the revenue requirement. Gippsland Water’s price submission provides detail on its forecast operating expenditure from pages 28 to 36, with a cost breakdown shown in table 4.1 on page 29.

We assess both:

- controllable costs – those that can be directly or indirectly influenced by a water corporation’s decisions
- non-controllable costs – those that cannot be directly or indirectly influenced by a water corporation’s decisions.

For controllable operating expenditure, our assessment process first confirms an efficient baseline, based on the last year of actual costs prior to our price review (that is, 2016-17). We then consider the forecast costs relative to this baseline, including the proposed efficiency improvement rate and forecast growth, and any proposed cost changes relative to the baseline. We engaged Deloitte Access Economics to provide expert advice to inform our assessment of controllable operating

Our assessment

expenditure. Deloitte's report on its assessment of Gippsland Water's expenditure forecast is available on our website.²³

For non-controllable expenditure (including bulk water and sewerage services, government charges and licence fees) we confirm the proposed forecasts, with reference to the relevant regulatory body where appropriate.

Table 2.3 sets out our draft decision on Gippsland Water's forecast operating expenditure, for the purpose of establishing the revenue requirement (Table 2.1). Details of our assessment and reasons for our proposed adjustments to Gippsland Water's proposal follow, with a summary of our adjustments shown at Table 2.4.

We consider our proposed operating expenditure in this draft decision better reflects the expenditure that a prudent service provider would incur when acting efficiently to achieve the lowest cost in delivering the outcomes specified in Gippsland Water's price submission.

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

²³ Deloitte Access Economics 2018, *Gippsland Water – expenditure review for 2018 water price review*, February.

Table 2.3 Draft decision – operating expenditure

\$ million 2017-18

	2018-19	2019-20	2020-21	2021-22	2022-23	Total
Controllable costs	72.6	72.1	70.0	70.3	70.9	356.0
Non-controllable costs	5.5	5.4	5.3	5.2	5.1	26.5
Environmental contribution ^a	5.1	5.0	4.8	4.7	4.6	24.2
Licence fees – ESC ^b	0.071	0.071	0.071	0.071	0.107	0.392
Licence fees – DHHS ^b	0.034	0.034	0.034	0.034	0.034	0.169
Licence fees – EPA ^b	0.349	0.349	0.349	0.349	0.349	1.744
Draft decision – operating expenditure	78.2	77.5	75.3	75.5	76.0	382.5

^a The Environmental Contribution collects funds from water corporations under the WI Act

^b Licence fees are paid to cover costs incurred by Department of Health and Human Services, Environment Protection Authority Victoria, and the Essential Services Commission in their regulatory activities related to the water corporation
Note: Numbers have been rounded

Gippsland Water proposed a total forecast controllable operating expenditure of \$365.4 million over a five-year regulatory period. For the reasons set out below, we propose to reduce this by \$9.4 million to establish a benchmark controllable operating expenditure of \$356.0 million.

Corrections to its price submission:

- During our initial assessment of Gippsland Water's price submission and financial template, we identified a number of errors in its operating expenditure data which Gippsland Water subsequently corrected. The 2016-17 baseline year total operating expenditure was reduced by \$1.35 million to remove several non-regulatory cost items, and the non-controllable operating expenditure was increased by \$0.1 million due to an indexing error with the environmental contribution. However, in its resubmitted financial template, Gippsland Water reduced its proposed efficiency improvement rate from 1.2 per cent per year to 1.0 per cent per year, and also removed \$3.03 million of projected savings it had originally forecast against the growth adjusted baseline, effectively reversing most of its baseline reduction. The net effect of these changes was a \$0.24 million per year reduction in forecast controllable operating expenditure

Our assessment

(\$1.21 million total reduction). While we have accepted these figures for the purpose of making our draft decision, Gippsland Water must provide further information to explain why these corrections to the baseline year operating expenditure necessitated a reduction in forecast efficiency improvement rate, and the removal of the forecast operating expenditure savings.

Baseline controllable operating expenditure:

- The \$1.35 million correction to Gippsland Water's 2016-17 operating expenditure reduced the baseline controllable operating expenditure from \$70.19 million in the original submission to \$68.84 million. This new baseline value is 5.6 per cent below the benchmark of \$72.88 million allowed for 2016-17 in the previous price determination. Deloitte assessed the proposed 2016-17 baseline and recommended no further adjustment.²⁴ We accept Deloitte's assessment and Gippsland Water's revised figure, which demonstrates efficiency gains made during the 2013–18 period, and we consider this reflects an efficient baseline cost to forecast annual operating expenditure.

Efficiency improvement:

- Gippsland Water's proposed efficiency improvement rate on controllable operating costs is 1.0 per cent per annum. This is on par with its past performance (where it met our mandated 1 per cent efficiency rate), but it is the equal lowest rate proposed by water corporations in their price submissions. It is lower than Gippsland Water's forecast connection growth rate of 1.2 per cent per annum, giving an increasing annual baseline operating cost.

Proposed cost changes:

- Gippsland Water has sought additional operating expenditure of \$16.78 million (4.8 per cent) to its annual baseline cost for labour and electricity. It will manage any other forecast cost increases or decreases within its efficiency improvement rate and growth allowance.
- Deloitte reviewed forecast labour costs of \$10.59 million above the baseline, noting that Gippsland Water had the second highest labour increase of all water businesses:
 - Deloitte's assessment of wage increases above inflation is that these should be managed by the water corporation through productivity improvements or through the growth allowance applied to the baseline, as most other water corporations have proposed.
 - Gippsland Water assumed that all current vacancies would be filled in 2017-18. Deloitte's assessment considered that all businesses have vacancies at any point in time and that a 2 per cent vacancy rate is not unreasonable.

²⁴ Deloitte Access Economics, op. cit., p.15.

- For these two reasons, Deloitte recommended a reduction of \$5.32 million to the additional forecast labour costs.²⁵ We accept Deloitte’s recommendation as we are satisfied that the adjustments reflect efficient controllable expenditure for a prudent service provider.
- Deloitte also reviewed forecast electricity costs of \$6.19 million above the baseline and compared these with its latest forecasts for electricity prices. Deloitte recommended an indicative adjustment of \$2.87 million as it did not agree with Gippsland Water’s forecasted higher electricity prices continuing beyond 2019-20 through to 2022-23.²⁶ We accept Deloitte’s recommendation as we consider it reflects a more accurate forecast of efficient electricity costs during the 2018–23 regulatory period. However we do acknowledge that there is currently uncertainty in forecasting electricity prices and Gippsland Water’s electricity contract expires on 30 June 2018. We request that Gippsland Water proposes a revised electricity forecast based on its new contract prices in response to our draft decision.

We consider applying our proposed adjustment of \$9.41 million to Gippsland Water’s total proposed controllable operating expenditure forecast means that it better meets the requirements of the WIRO and the criteria for prudent and efficient expenditure outlined in our guidance.²⁷ The controllable operating expenditure per connection will decrease (in real terms) a little more than it did in Gippsland Water’s original proposal, and will be broadly on par with the industry average (see Figure 2.1).

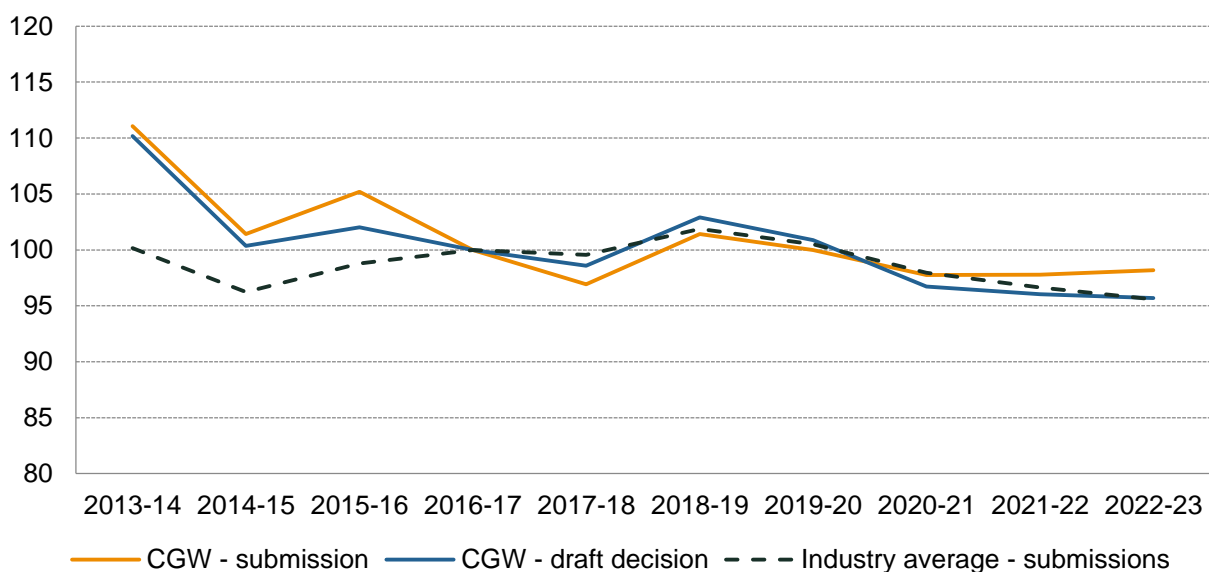
²⁵ Deloitte Access Economics, op. cit., pp.17–19 & p.24.

²⁶ Deloitte Access Economics, op. cit., pp.19–24.

²⁷ Essential Services Commission 2016, *Guidance paper*, op. cit., p. 31.

Figure 2.1 Controllable operating expenditure per water connection

Index: 2016-17=100



Submission – based on actual historical and forecast values provided by the water corporation in its price submission.
 Draft decision – includes any corrections or adjustments to historical and forecast values arising from our assessment.
 Industry average – drawn from the price submissions for all urban water corporations (excludes rural expenditure).

For non-controllable operating expenditure, we have adjusted Gippsland Water’s forecasts where required based on the latest information received from the relevant regulatory authorities on their licence fees and the environmental contribution. The values we have adopted for our draft decision are set out in Table 2.3 above.

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

We have assumed the licence fees for the Department of Health and Human Services, the Environment Protection Authority Victoria and the Essential Services Commission remain flat in real terms across the period, but with a 50 per cent increase for our commission fee in 2022-23 to align with our regulatory review cycle.²⁸

We have reduced Gippsland Water’s forecast non-controllable operating expenditure by \$0.178 million across the 2018–23 period, resulting from our adjustments to:

²⁸ The Department of Health and Human Services and the EPA Victoria provided their latest 2016-17 licence fees for making our draft decision. We have also based our forecast on our 2016-17 commission licence fee.

- decrease the Department of Health and Human Services licence fee from \$0.046 million to \$0.034 million per year (a total reduction of \$0.061 million)
- decrease our commission licence fee by \$0.11 million in 2018-19, and also by \$0.06 million per year in 2019-20 to 2022-23 (a total reduction of \$0.36 million)
- decrease the environment contribution by \$0.01 million in 2018-19 to \$5.06 million and then decline this across the period (a total reduction of \$0.122 million).

Overall, non-controllable operating expenditure will increase by \$0.41 million from 2017-18 to 2018-19, due to the increase in the environment contribution from \$4.66 million to \$5.06 million.

Prior to making our final decision, we will adjust Gippsland Water's forecast non-controllable operating expenditure for the latest inflation data.

Table 2.4 sets out our proposed adjustments to both controllable and non-controllable operating expenditure.

Table 2.4 Adjustments to operating expenditure

\$ million 2017-18

	2018-19	2019-20	2020-21	2021-22	2022-23	Total
Proposed total operating expenditure	78.6	78.3	77.5	78.3	79.4	392.1
Total corrections	-0.2	-0.2	-0.2	-0.2	-0.2	-1.2
Labour	-0.2	-0.6	-1.0	-1.5	-2.1	-5.3
Electricity	0.0	0.0	-0.9	-0.9	-1.0	-2.9
Total adjustments to controllable costs	-0.4	-0.8	-2.2	-2.7	-3.3	-9.4
Licence fees	-0.045	-0.004	-0.004	-0.004	0.001	-0.056
Environmental contributions	-0.009	-0.017	-0.025	-0.032	-0.040	-0.122
Total adjustments to non-controllable costs	-0.053	-0.021	-0.029	-0.036	-0.039	-0.178
Draft decision – total operating expenditure	78.2	77.5	75.3	75.5	76.0	382.5

Note: Numbers have been rounded

Regulatory asset base

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

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

Closing regulatory asset base

We update the regulatory asset base to reflect actual gross capital expenditure, less government and customer contributions, and asset disposals for the period to 30 June 2017. This helps to ensure prices reflect the actual net expenditure of a water corporation.²⁹

Gippsland Water's proposed closing asset base at 30 June 2017 is provided at page 77 of its price submission.³⁰

We compared Gippsland Water's actual net capital expenditure for 2012-13 to 2016-17 with the forecast used to approve maximum prices for the period from 1 July 2013. We undertake a prudence and efficiency review where a water corporation's net capital expenditure is more than 10 per cent above the forecast used to approve maximum prices for the period from 1 July 2013. We believe this approach is reasonable given capital expenditure can be relatively 'lumpy' in nature.

In its price submission, Gippsland Water assumed \$227.3 million net capital expenditure over the period from 2012-13 to 2016-17. We identified some minor adjustments to the estimates used by Gippsland Water, which reduced this to \$223.3 million. This figure is 3.8 per cent higher than the forecast used to approve maximum prices for the period from 1 July 2013. This is below the 10 per cent threshold identified above, so we have not undertaken a prudence and efficiency review of its past net capital expenditure.

Other than this correction for past net capital expenditure, Gippsland Water calculated its closing regulatory asset base in accordance with the requirements of our guidance. For these reasons, our draft decision proposes to approve a closing regulatory asset base for 30 June 2017 of \$648.1 million.

Table 2.5 sets out our draft decision on Gippsland Water's regulatory asset base at 30 June 2017.

²⁹ Net capital expenditure is calculated by deducting government and customer contributions from gross capital expenditure. Customer contributions reflects revenue earned from new connections made to the water corporation's water, sewerage or recycled water networks.

³⁰ This is set out at table 8.1 of its price submission (available at www.esc.vic.gov.au) – Gippsland Water has used the term "opening balance" for 2017-18 to describe its closing asset base as at 30 June 2017.

Table 2.5 Closing regulatory asset base
\$ million 2017-18

	2012-13	2013-14	2014-15	2015-16	2016-17
Opening RAB 1 July	500.6	545.4	577.5	612.9	631.2
Plus gross capital expenditure	62.4	57.8	54.7	39.7	34.1
Less government contributions	0.0	10.0	1.2	0.0	0.0
Less customer contributions	2.6	2.4	3.7	4.9	0.6
Less proceeds from disposals	0.9	0.5	0.6	1.5	0.3
Less regulatory depreciation	14.1	12.8	13.8	15.0	16.2
Closing RAB 30 June	545.4	577.5	612.9	631.2	648.1

Note: Numbers have been rounded

Forecast regulatory asset base

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

Table 2.6 sets out our draft decision on Gippsland Water's proposed forecast regulatory asset base from 1 July 2018.³¹ Our assessment of the components of the forecast regulatory asset base is set out below.

³¹ Our guidance required water corporations to provide an estimate of the components of its regulatory asset base for 2017-18. This is so we can assess the opening asset base for 1 July 2018. Our guidance noted that where the 2017-18 forecasts for net capital expenditure (gross capital expenditure less government and customer contributions) is lower than the forecast benchmark for that year in its 2013 price determination, the lower amount must be used (otherwise the 2013 determination forecast applies). The estimates for 2017-18 will be confirmed at the price review following the 2018 water price review.

Table 2.6 Forecast regulatory asset base
\$ million 2017-18

	2017-18	2018-19	2019-20	2020-21	2021-22	2022-23
Opening RAB 1 July	648.1	663.9	683.8	714.2	741.1	757.7
Plus gross capital expenditure	37.0	37.8	49.2	46.4	36.8	37.1
Less government contributions	0.0	0.0	0.0	0.0	0.0	0.0
Less customer contributions	3.6	0.1	0.0	0.0	0.1	4.9
Less proceeds from disposals	0.4	0.6	0.6	0.5	0.3	0.4
Less regulatory depreciation	17.2	17.4	18.2	19.0	19.8	20.8
Closing RAB 30 June	663.9	683.8	714.2	741.1	757.7	768.7

Note: Numbers have been rounded

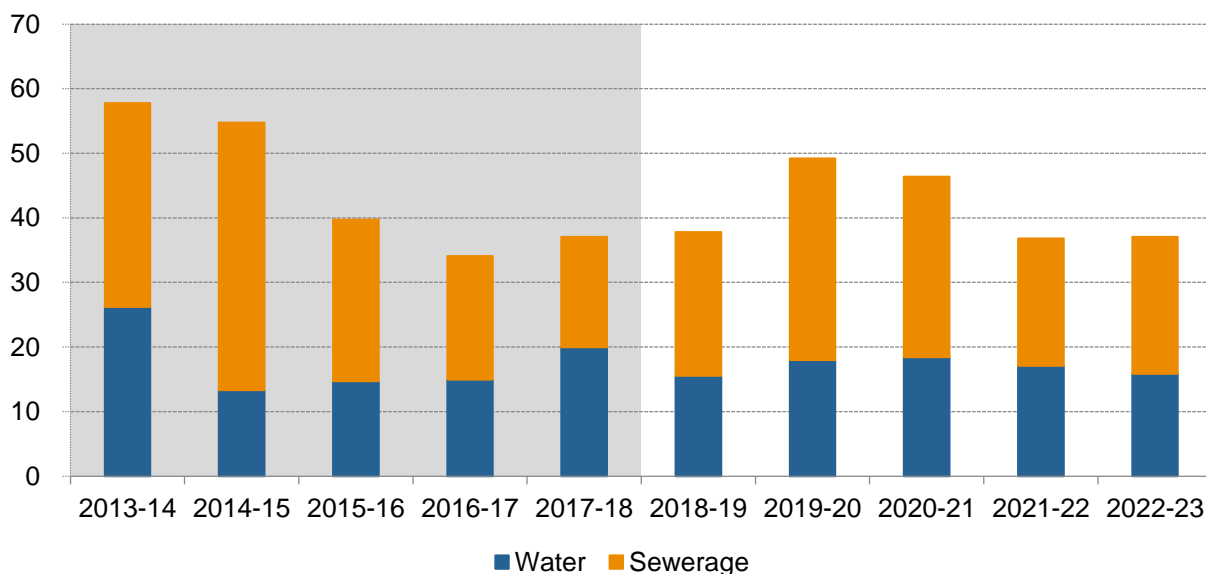
Capital expenditure

Capital expenditure is an input to estimating the regulatory asset base. Gippsland Water's forecast capital expenditure and supporting information is provided at pages 37 to 53 of its price submission. This is summarised in Figure 2.2, for the current 2013–18 period, and as proposed by the water corporation for the 2018–23 period.

We engaged Deloitte Access Economics to provide expert advice to inform our assessment of capital expenditure. Deloitte's report on its assessment of Gippsland Water's expenditure forecast is available on our website.³²

³² Deloitte Access Economics 2018, op. cit.

Figure 2.2 Gross capital expenditure by service category
\$ million 2017-18



Note: actuals for 2013-14 to 2016-17 and water corporation forecasts for 2017-18 to 2022-23

Gippsland Water proposed a total gross capital expenditure of \$208.8 million over the five-year regulatory period. For the reasons set out below, we propose to reduce this by \$1.6 million to establish a benchmark gross capital expenditure of \$207.3 million:

- Gippsland Water’s price submission provided forecasts for gross capital expenditure that are 7 per cent or \$16.1 million lower than the current regulatory period, with the reductions in spending across both water and sewerage services.
- Deloitte requested selected documents from Gippsland Water as a representative sample to demonstrate its asset management processes and justification for its capital expenditure program. Based on the sample of documents reviewed, Deloitte found that Gippsland Water has a reasonable approach for developing project scope, the timing of works and cost estimates. Deloitte noted that Gippsland Water utilises a traditional approach for its capital planning, with some greater attention for certain asset types.³³
 - Deloitte reviewed information for the Drouin wastewater treatment plant upgrade, the treated water basin liners and cover replacements program, the Coongulla water interconnect to

³³ Deloitte Access Economics, op. cit., p.26.

Heyfield project, the Moe and Churchill basin liner and covers, and the water and sewer main renewal programs.³⁴

- Deloitte’s review found the information for the Drouin wastewater treatment plant upgrade, the water renewals program and the Coongulla water interconnect to Heyfield project supported the prudence and efficiency of the proposed capital expenditure. We accept the reasoning for no recommended adjustments as the current costs reflect prudent and efficient expenditure.
 - For the sewer renewal program, Deloitte recommended a reduction of \$0.87 million as it did not consider Gippsland Water had sufficiently justified the need for the 16 per cent increase to maintain service levels. We accept Deloitte’s recommendation, as we do not have sufficient information to assess that the proposed expenditure is prudent and efficient, as required by our guidance.³⁵
 - For the treated water basin liners and cover replacements program, Deloitte recommended a reduction of \$0.66 million as it considered Gippsland Water should be able to make some efficiency gains through its procurement process. We accept Deloitte’s recommendation as it reflects more efficient expenditure.
- We consider the planned capital expenditure program is achievable, given Gippsland Water’s past track record delivering its capital expenditure program. Over the current 2013–18 regulatory period, Gippsland Water has delivered all three of its planned major projects.³⁶
 - Gippsland Water’s price submission did not identify how it would manage uncertainty in timing, scope and cost from capital works, although it did identify it had only included 50 per cent of its forecast shared assets costs for new developments, which excluded \$2.84 million from its capital expenditure forecast. Regarding uncertain expenditure, we note the following:
 - Gippsland Water will need to demonstrate the prudence and efficiency of any additional costs if they are indeed incurred during the 2018–23 period if seeking to include them in the regulatory asset base.
 - Variations in capital expenditure from forecast during the 2018–23 period will form a key part of our assessment of the Performance element of PREMO at the next price review.
 - We consider Gippsland Water’s approach to forecasting its capital expenditure is consistent with the requirements of our guidance.

³⁴ Deloitte Access Economics, op. cit., pp.26–32.

³⁵ Essential Services Commission 2016, *Guidance Paper*, op. cit., p. 35.

³⁶ Essential Services Commission 2018, Status of major projects supplement: Water performance report 2016-17, 1 March, p. 17.

Table 2.7 below sets out our proposed adjustments to Gippsland Water’s forecast to establish our draft decision benchmark for gross capital expenditure, consistent with our guidance and WIRO principles.³⁷ This benchmark is used to calculate the forecast regulatory asset base (Table 2.6) and the revenue requirement (Table 2.1).

Table 2.7 Draft decision – gross capital expenditure
\$ million 2017-18

	2018-19	2019-20	2020-21	2021-22	2022-23	Total
Proposed gross capital expenditure	38.1	49.4	46.8	37.1	37.4	208.8
– Treated water basin liners and covers replacement	-0.2	-0.1	-0.2	-0.1	-0.1	-0.7
– Sewer reticulation renewals program	-0.1	-0.1	-0.2	-0.2	-0.2	-0.9
Total adjustments to gross capital expenditure	-0.3	-0.2	-0.4	-0.3	-0.3	-1.6
Draft decision – gross capital expenditure	37.8	49.2	46.4	36.8	37.1	207.3

Note: Numbers have been rounded

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

Revenue from customer contributions

Revenue from customer contributions is deducted from gross capital expenditure so it is not included in the regulatory asset base.³⁸

³⁷ Essential Services Commission 2016, *Guidance Paper*, op. cit., p. 35: WIRO clause 8(b)

³⁸ Revenue from new customer contributions reflects revenue earned from new connections made to a water corporation’s water, sewerage or recycled water networks.

Gippsland Water has proposed:

- a significant decrease in forecast total customer contributions when compared to the current regulatory period
- a customer contribution arising from reimbursement of the stage 4 and 5 upgrade of the Saline Waste Outfall Pipeline by power station operators.

We assessed Gippsland Water's proposed contributions and consider it is reasonable, given relatively low growth in its area. We note we approved its transition to a zero charge for standard new customer contributions during the current regulatory period.

Our draft decision proposes to accept Gippsland Water's forecasts for customer contributions.

Cost of debt

Our guidance required Gippsland Water to use estimates of the cost of debt provided by the commission to estimate its revenue requirement. Gippsland Water used the cost of debt values we specified to calculate its revenue requirement. For this reason, our draft decision accepts the cost of debt proposed by Gippsland Water, as set out in Table 2.8.

Table 2.8 Trailing average cost of debt

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

* Estimated cost of debt – we will update the 2017-18 figure before the final decision and price determination.

Note: Numbers have been rounded

From 2016, we accepted a ten-year trailing average approach to estimating the benchmark cost of debt, changing from an on-the-day approach. The trailing average approach better aligns the actual cost of debt for an efficient business to the regulated benchmark, compared with an on-the-day approach.³⁹ We consider the ten year trailing average approach helps to minimise risk to water corporations and provides better incentives for long-term investment.

³⁹ For more detail on the trailing average and on the day approaches to the cost of debt, see Essential Services Commission 2016, *Water pricing framework*, op. cit., p.27.

Return on equity – PREMO rating

Gippsland Water rated its price submission as ‘Standard’. Based on its PREMO self-rating, Gippsland Water proposed a rate of return on equity of 4.5 per cent per annum. This reflects the maximum return rate allowed in our guidance for a price submission rated as ‘Standard’.⁴⁰

The return on equity is within the range of rates we have approved in past reviews for the water industry. We have also had regard to the return on equity allowed or estimated by regulators in other Australian jurisdictions recently for the water industry.⁴¹

Our draft decision proposes to accept Gippsland Water’s PREMO self-rating and proposed return on equity of 4.5 per cent per annum. Our assessment of Gippsland Water’s proposed PREMO rating is set out in Chapter 3.

Regulatory depreciation

Regulatory depreciation is an input to calculating the regulatory asset base. Gippsland Water’s forecast regulatory depreciation was calculated using a straight line depreciation profile.⁴² We noted in our guidance that we prefer this approach.⁴³

Our draft decision on regulatory depreciation differs from Gippsland Water’s proposal due to our proposed adjustments to capital expenditure. Our final decision will confirm the regulatory depreciation to be reflected in the forecast regulatory asset base.

Our draft decision on regulatory depreciation is shown in Table 2.6.

Tax allowance

The tax allowance is an input to the revenue requirement. Gippsland Water has proposed no allowance for tax in its revenue requirement. Our draft decision is to accept the forecast as it was calculated consistently with the method required by our guidance.⁴⁴

Demand

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

⁴⁰ Essential Services Commission 2016, *Guidance paper*, op. cit., p. 49.

⁴¹ Essential Services Commission of South Australia 2016, *SA Water regulatory determination 2016, Final determination*, June; Independent Pricing and Regulatory Tribunal 2017, *WACC biannual update*, August.

⁴² For the period from 2018-19 to 2022-23, Gippsland Water proposed a regulatory depreciation of \$95.8 million.

⁴³ Essential Services Commission 2016, *Guidance paper*, op. cit., p. 42.

⁴⁴ Essential Services Commission 2016, *Guidance paper*, op. cit., pp. 50-51.

Gippsland Water's demand forecasts are set out at pages 54 to 64 of its price submission, and are also included in its financial model. Our draft decision proposes to accept Gippsland Water's demand forecasts for the purpose of approving maximum prices as we consider they were estimated in a manner that is consistent with the requirements of our guidance. This includes basing demand forecasts on the latest *Victoria In Future* population growth forecasts issued by the Victorian Government.

Gippsland Water has notified us that it is considering updates to its demand forecasts, to reflect latest data in relation to water usage among its large customers. Gippsland Water may respond to our draft decision with updated forecasts.

Form of price control

Gippsland Water proposed a price cap form of price control. It currently uses a price cap.

Our draft decision is to accept Gippsland Water's proposed form of price control. A price cap will allow Gippsland Water to recover sufficient revenue to cover the forecast efficient costs of providing services. A price cap also provides customers with price certainty, and means a water corporation is managing demand risk on behalf of its customers. We consider demand risk is more efficiently managed by a water corporation, rather than its customers.⁴⁵

Tariff structures

Gippsland Water's proposed tariffs are set out at pages 65 to 73 of its price submission. Gippsland Water proposed an annual increase in prices of 0.5 per cent across most of its tariffs from 2018-19 to 2022-23.⁴⁶ Gippsland Water proposed no changes to its existing tariff structures, although it proposed to introduce a new water service charge for major customers on a 200mm connection.

Our draft decision revenue requirement is 1.7 per cent lower than Gippsland Water's proposed revenue requirement. On average this will result in a further reduction in prices from 2018-19 to 2022-23 by approximately the same amount, compared with Gippsland Water's original proposal.

Gippsland Water must respond to our draft decision with updated prices, which will reflect its response to our initial views on its revenue requirement. Because of this, our draft decision does not approve maximum prices for each tariff. We will provide final maximum prices in our final

⁴⁵ We note our determinations will allow water corporations flexibility to apply to change from a price cap to a weighted average price cap or tariff basket within a regulatory period.

⁴⁶ Note that annual price increases differ from Gippsland Water's price submission due to corrections identified during our review.

decision. However, our draft decision considers Gippsland Water's proposals relating to changes in tariff structures, and any submissions relating to the level of prices or bills.⁴⁷

As outlined in our guidance, we have provided the water corporations with a large degree of discretion to decide on individual tariff structures.⁴⁸ This recognises water corporations 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.

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

We consider the two-part structure proposed by Gippsland Water for its water service tariffs will promote efficient use of services. The two-part structure for water tariffs sends customers a signal about costs of their water use, and is an approach that is commonly applied in other states and territories.⁴⁹ We also consider two-part tariff structures are easy to understand.

For sewerage tariffs, we consider a fixed charge only for residential customers and a two-part tariff for non-residential tariffs sends customers signals about the efficient costs.⁵⁰

Gippsland Water proposed a new water service charge for major customers on a 200mm connection. Gippsland Water confirmed that the new tariff has been calculated in accordance with the pricing principles referenced in our guidance.

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

Price and bill levels

From 2014-15, Gippsland Water's residential customers receiving a bill with water usage charges received an annual rebate. The rebate reflects the outcomes of a government efficiency review, and ends after 2017-18. The removal of the rebate means the bill impact of price changes on customer groups may vary. In particular, for some customers such as relatively low water users

⁴⁷ Tariff structure refers to the way in which prices are grouped and the manner of charging, for example, water and sewerage charges, fixed and variable charges.

⁴⁸ Essential Services Commission 2016, *Guidance paper*, op. cit., p. 55.

⁴⁹ Includes the tariffs of Icon Water, Sydney Water, Hunter Water, Gosford City Council, Wyong Shire Council, Power and Water Corp, Urban Utilities, Unity Water, SA Water and TasWater.

⁵⁰ Our reasons are outlined in our 2013 draft decisions on price review 2012-13 to 2017-18.

(including some residential tenants), bills may rise as a result of the rebate being removed. Submission by Gerald Mallon, the Gippsland Resource Group Inc and the Consumer Action Law Centre highlighted the impact price changes may have on some customers, particularly those with low or fixed incomes.⁵¹

Gippsland Water has proposed to use its current support framework for customers experiencing payment difficulty to ease the impact of the rebate removal on customers, and assist those in financial hardship. Combined with our draft decisions to reduce Gippsland Water's revenue requirement, which will provide some bill relief, we consider these measures will help to mitigate the impact of the removal of the rebate after 2017-18.

Draft decision on tariff structures

For the reasons set out above, our draft decision accepts Gippsland Water's proposed tariff structures as set out at pages 65 and 73 of its price submission.

Prior to our final decision and price determination, Gippsland Water must submit updated prices to reflect our draft decision on the revenue requirement, and to reflect our updates to cost of debt and inflation estimates, which we will provide in late April 2018.

Adjusting prices

Gippsland Water's proposed price adjustment mechanisms are set out at page 86 of its price submission. It proposed to:

- continue with its existing uncertain and unforeseen events mechanism
- include risks in relation to power industry based revenues, and the impact of any economic slowdown on growth within its region as new uncertain and unforeseen events within the mechanism
- work with the commission on a price adjustment mechanism to account for movements in the cost of debt.

Our draft decision accepts Gippsland Water's proposal to continue the existing uncertain and unforeseen events mechanism. We noted in our guidance that we propose that the mechanism continue in its current form.

The existing uncertain and unforeseen events mechanism provides for cost pass-throughs if there is a material difference between forecast and actual revenue or demand. If there is a material

⁵¹ Gerald Mallon 2017, *Submission*, 7 November.; Gippsland Resource Group Inc 2017, *Price Review Gippsland Water*, 25 September.; Consumer Action Law Centre 2017, *Initial Feedback: 2018 Water Price Review*, 15 November.

difference between forecasts and actual demand or revenues arising from changes in the power industry, or an economic slowdown, this is covered by the existing uncertain and unforeseen events mechanism.⁵² So our draft decision proposes not to accept Gippsland Water's proposal to include these new additional events.

We invite Gippsland Water to submit proposed price adjustment formulas that allow prices to adjust to changes in the cost of debt.

New customer contributions

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

Gippsland Water's proposed charges for new customer contributions are set out at page 64 of its price submission. For standard new customer contributions, Gippsland Water proposed to continue to apply a zero charge. This is in accordance with the commission's approved transition to a zero charge in our 2013 price determination.

For negotiated customer contributions, Gippsland Water proposes to continue to calculate a charge in accordance with the requirements of our NCC principles.⁵³

We have reviewed Gippsland Water's proposed method of charging for new customer contributions and consider it consistent with the requirements of our guidance and the NCC pricing principles. For this reason, our draft decision proposes to accept Gippsland Water's proposed use of negotiation principles for new customer contributions.

Financial position

In approving prices, we must have regard to the financial viability of the water industry.⁵⁴ We interpret the financial viability requirements under the *Essential Services Commission Act 2001* (Vic) and the *Water Industry Regulatory Order (2014)* to mean that the prices we approve should provide a high level of certainty that each water corporation can generate sufficient cash flow to

⁵² We consider Gippsland Water has not provided a clearly articulated justification in its price submission for including these matters in the uncertain and unforeseen events mechanism, as required by our guidance. See: Essential Services Commission 2016, *Guidance paper*, op. cit., p. 60.

⁵³ Essential Services Commission 2016, *Guidance paper*, op. cit., p. 62.

⁵⁴ WIRO clause 8(b)(ii) and ESC Act s.8A(1)(b).

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

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

3. PREMO rating

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

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

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

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

Our review of Gippsland Water's PREMO self-rating

Gippsland Water's proposed PREMO rating, and our draft decision is summarised below.

Table 3.1 PREMO Rating

	Overall PREMO rating	Risk	Engagement	Management	Outcomes
Gippsland Water's rating	Standard	Standard	Standard	Standard	Standard
Commission's rating	Standard	Standard	Standard	Standard	Standard

We agree with Gippsland Water's proposed overall PREMO self-rating of 'Standard'. This is reflected in the return on equity we propose to approve for Gippsland Water at page 24. We also agree with Gippsland Water's proposed self-rating for each element of PREMO.

In support of Gippsland Water's PREMO self-ratings, we note:

- Gippsland Water provided a reasonable opportunity for customers to provide feedback, and shape the business's proposals. It used a range of methods to engage with customers, including online forums, community conversations, and pop-up information stalls in town

centres. It also included steps to allow the business to re-test proposals with customers throughout the engagement process. This supports Gippsland Water's self-rating for Engagement.

- The findings from customer engagement influenced Gippsland Water's proposed outcomes, including its focus on maintaining existing service levels and by introducing rebates to affected communities for guaranteed service levels that are not met. This is consistent with a 'Standard' rating for Outcomes.
- Gippsland Water's proposal will increase the revenue it has placed at risk for failing to deliver on its service targets (through increased rebates relating to guaranteed service levels, and the introduction of new guaranteed service levels). This provides greater accountability for the corporation to deliver on the service outcomes most valued by its customers, supporting its Risk rating.
- In the context of lower economic growth following the industrial closures in the La Trobe Valley, Gippsland Water's demand forecasts incorporate relatively optimistic assumptions about water demand from large customers (see page 55 of its price submission). Adopting optimistic demand forecasts means that the business is taking on greater risk, and reducing price increases for customers. This also supports its Risk rating.

In assessing whether to accept Gippsland Water's self-rating of 'Standard' for Management, we considered our proposed adjustments to its forecast expenditure, as well as the corporation's commitment to minimise its costs and prices. Gippsland Water proposed increases in controllable costs per connection that were above the average for all regional urban water corporations covered by our price review. This contributed to a proposed annual increase in prices of 0.5 per cent across most of Gippsland Water's tariffs.

However, in support of Gippsland Water's Management self-rating, we note the relatively small adjustments proposed in our draft decision on its forecast expenditure, and in particular, for capital expenditure. This provides assurance that the business's approach to expenditure forecasting is based on sound methodologies. On balance, our draft decision accepts Gippsland Water's 'Standard' self-rating for Management.

4. We invite feedback on our draft decision

We invite feedback from stakeholders on our draft decision before we make a final decision and price determination. Our final decision and price determination will be made in June 2018.

Stakeholders may comment on any aspect of our draft decision, including the information we have relied upon in our assessment (such as Gippsland Water's price submission). Feedback may also cover:

- additional matters or issues we should consider before making our final decision
- whether our draft decision on Gippsland Water's price submission has adequate regard to the matters in clause 11 of the WIRO and our guidance.

How to provide feedback:

Attend a public forum

We will hold a public forum in April or May 2018. Forums provide an opportunity for interested parties to discuss key features of our draft decisions. We will publish details of public forums at www.esc.vic.gov.au/waterpricereview.

Provide written comments or submissions

Written comments or submissions in response to this draft decision will be due in early May 2018.

We require submissions by this date so we have time to fully consider submissions for our final decision. Comments or submissions received after this date may not be afforded the same weight as submissions received by the due date.

We would prefer to receive comments and submissions via our website at www.esc.vic.gov.au/waterpricereview.

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

2018 Water Price Review
Essential Services Commission
Level 37, 2 Lonsdale Street
Melbourne VIC 3000

We usually make all comments and submissions publicly available in the interests of transparency. If you wish part or all of your submission to be private, please discuss with commission staff.

We invite feedback

If you cannot access documents related to our price review, please contact us to make alternative arrangements (phone (03) 9032 1300).

Next steps

Indicative dates are provided below. To keep up-to-date, visit our website at www.esc.vic.gov.au/waterpricereview.

- April or May 2018 – public forum.
- 8 May 2018 – closing date for submissions on our draft decision.
- June 2018 – release date for final decision and price determination.

APPENDIX A – submissions received

Name or organisation	Date received
Environment Protection Authority Victoria	12 December 2017
Consumer Action Law Centre	15 November 2017
Mr G Mallon	7 November 2017
Gippsland Resource Group Inc	28 September 2017