Gippsland Water final decision

2018 Water Price Review

19 June 2018

An appropriate citation for this paper is:

Essential Services Commission 2018, Gippsland Water final decision: 2018 Water Price Review, 19 June

Contents

Summary

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

In March 2017, we released our draft decision on Gippsland Water's price submission.[1] The draft decision set out our preliminary views on Gippsland Water's proposals, and invited interested parties to make further submissions. We also held a public meeting in April 2018. In addition to a response from Gippsland Water, we received nine written submissions on our draft decision, which are available on our website. A list of these submissions is included in Appendix A to this final decision.

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

Where our final decision on a particular aspect is unchanged from our draft decision, we have not detailed the supporting reasons in our final decision. Rather, we have noted that our final decision accepts 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] Clause 16 of the Water Industry Regulatory Order 2014 requires us to issue a draft decision. Gippsland Water's price submission and our draft decision are 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 corporation may charge, or the manner in which its prices are to be calculated, determined or otherwise regulated during the regulatory period. See Essential Services Commission 2018, *Gippsland Water Determination: 1 July 2018 – 30 June 2023*, June.

Our final decision has updated the revenue to be collected by Gippsland Water

Our final decision approves a revenue requirement of $621.5 million over the five year period starting 1 July 2018.[3] This is $0.7 million or 0.1 per cent lower than our draft decision, and mainly reflects our updates to the cost of debt (as anticipated in our draft decision).

A summary of approved maximum prices for major services delivered by Gippsland Water is set out on page 26. The estimated typical bills for residential customers under Gippsland Water's proposal and our final decision are provided in Table A. In 2018-19 the estimated annual bill for an owner occupier will rise by around $20 and for a tenant by around $6 (in constant price $2018-19 terms). Bills will generally remain steady over the following four years to 2022-23.

Table A Estimated typical water and sewerage bills
$ 2018-19

Customer group	Average consumption (kL p.a.)	2017-18 annual bill	2018-19 annual bill	2022-23 annual bill
Residential (Owner occupier)	168	$1,314[a]	$1,334	$1,334
Residential (Tenant)	168	$338[a]	$344	$344

[a] Following a rebate ($36 for owner occupier and $10 for tenants) paid to customers from a government efficiency review

Note: Numbers have been rounded

Gippsland Water will improve services

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

Some of the ways 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.

[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 the Environment Protection Authority Victoria and the Department of Health and Human Services. Along with forecast demand, it is an input to calculating the prices to be charged by a water corporation.

Tariff structures are the same

Our final decision approves Gippsland Water's proposed tariff structures, which reflect a continuation of its current approach. For water services, we have approved Gippsland Water's proposal for a fixed service charge and a variable component that depends on water use. For residential sewerage services we have approved Gippsland Water's proposal for a fixed service charge only. For non-residential sewerage services we have approved Gippsland Water's proposal for a fixed service charge and a variable usage component.

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

For more detail on the form of price control and tariffs, see pages 24 to 26.

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

Consistent with our draft decision, our final decision accepts Gippsland Water's PREMO self-rating of its price submission as 'Standard'. In support of its PREMO rating, we note Gippsland Water's approach to engagement provided a reasonable opportunity for customers to provide feedback and shape the corporation's proposals. It used a range of methods to get customer feedback, including online forums, community conversations, and pop-up information stalls. It also allowed for time to re-test proposals with customers throughout the engagement process.

Figures A and B summarise our final decision on PREMO. More detail on our assessment of Gippsland Water's PREMO rating is provided in Chapter 3. Gippsland Water is one of four corporations for which we propose to approve a 'Standard' PREMO price submission rating.

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

Figure A PREMO Rating – Gippsland Water

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

Figure B   Final decision on PREMO – overall rating

Leading	Advanced	Standard	Basic	Not rated
Goulburn Valley Water	Barwon Water Central Highlands Water City West Water Coliban Water GWMWater North East Water South East Water Southern Rural Water Yarra Valley Water	East Gippsland Water Gippsland Water Lower Murray Water (urban) Westernport Water	Wannon Water	South Gippsland Water Western Water *

* We have not assessed Western Water under PREMO, as prior to lodging its price submission it notified us of its intention to target a short-term pricing outcome rather than the overall value for money outcome expected under PREMO. Western Water adopted this approach to provide time for it to undertake a review to inform longer-term prices.

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.[4] The prescribed services include retail water and sewerage services, and bulk water and sewerage services delivered by the water corporations.[5]

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

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

We assess prices against the WIRO and other legal requirements

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

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

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[4] 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.

[5] The prescribed services are listed at clause 7(b) of the WIRO.

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

Our consideration of legal requirements document lists the specific objectives and the various matters the commission must have regard to when making a price determination and provides a guide to where we have done so for our final decision for Gippsland Water.[7]

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.[8]

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.[9]

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

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[6] Essential Services Commission 2016, *2018 Water Price Review: Guidance paper*, November.

[7] Essential Services Commission 2018, *Gippsland Water final decision, 2018 Water Price Review – commission's consideration of legal requirements*, 19 June. This is available at www.esc.vic.gov.au/waterpricereview.

[8] This is a requirement of the WIRO, clause 14(b).

[9] This is provided for under the WIRO, clause 14(b)(i).

[10] See Part 13, Division 5 of the *Water Act 1989* (Vic).

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

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

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

We finalised our new approach to water pricing in October 2016.[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.

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

[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.

The 2018 water price review is the first time we've applied our PREMO incentive mechanism. A water corporation's ambition in terms of delivering customer value is being assessed against four elements of PREMO – Risk, Engagement, Management and Outcomes.[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] The PREMO process is described in: Essential Services Commission 2016, *Guidance paper*, op. cit., pp. 44–49.

2. Our assessment of Gippsland Water's price submission

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

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 content 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, with our preliminary assessment set out in our draft decision. Our final decision is set out below.

Regulatory period

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

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

Our final decision is to approve the five year regulatory period proposed by Gippsland Water. This is the same period we have approved for all but three water corporations in our current price review.

Customer engagement

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

[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] Consumer Action Law Centre 2018, *Submission on standard draft decisions: 2018 Water Price Review*, 8 May, p. 10.

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.[21]

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.[22]

CALC suggested we could play a greater role to promote best practice customer engagement and identify areas for improvement.[23] We note that following our price review, we will continue to work with water corporations to promote best practice customer engagement.

Outcomes

Over the five year period starting 1 July 2018, Gippsland Water has committed to:

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

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[21] Gippsland Water's price submission is available on our website at www.esc.vic.gov.au. See pages 10 to 17.

[22] 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).

[23] Consumer Action Law Centre, op. cit., p. 4.

Some of the specific 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.

Gippsland Water's proposed measures and targets for reporting against these outcomes are set out on pages 19 to 23 of its price submission. Gippsland Water has committed to reporting to customers annually against these measures. Performance information will be available on its website, social media posts, media releases and targeted campaigns.

In early 2018-19, we will engage with Gippsland Water to finalise the set of measures, targets, and how it will report on its achievement against outcomes to customers. Its performance will inform our assessment during future price reviews as part of the Performance element of PREMO

CALC commented on the need for additional funding for regional water corporations to strengthen existing hardship programs or adopt new practices to assist vulnerable customers.[24] CALC cited our 2013 price review where we provided an additional allowance for metropolitan water corporations to expend existing hardship programs or introduce new hardship programs.

We have not adopted CALC's recommendation in our final decision. We note that the additional allowance in our 2013 price review was provided in recognition of the large one-off price increases approved for the metropolitan corporations during the 2013 review.[25] Further, water corporations already allocate funds to programs aimed to deliver payment options and hardship support required by our customer service codes. In its price submission, Gippsland Water commented that findings from its engagement showed customers supported Gippsland Water's current approach to hardship support for vulnerable customers.

Service Standards

Gippsland Water has also provided a list of service standards relating to reliability and attending faults that it will include in its customer charter. These service standards and Gippsland Water's targets until 2023 are set out in Appendix B.

CALC has noted a range of ambitions by water corporations when it comes to proposed service standards and that water corporations should be encouraged to 'improve service standards over

[24] Consumer Action Law Centre, op. cit., p. 3.

[25] The increase in prices approved in 2013 for metropolitan Melbourne was around 20 to 25 per cent. We note for most water corporations in our 2018 price review, generally prices are remaining relatively steady, or falling.

time'.[26] We note that Gippsland Water has proposed targets for reliability and attending faults in line with past targets and performance.

We accept there are arguments for maintaining or decreasing service levels over time particularly where engagement identifies customers are satisfied with the existing level of service or do not support increasing expenditure to deliver improvements. We note that Gippsland Water's proposed reliability and water quality targets were informed by engagement, an approach which aligns with our expectation that corporations consider customer preferences when forming service targets.

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

Guaranteed service levels

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

Gippsland Water's proposed GSLs are set out on pages 24 to 26 of its price submission. It has proposed to expand the payment difficulty GSL, and introduce new GSLs, including GSLs where rebates are paid to a community fund.

In our draft decision we provided an overview of Gippsland Water's proposed GSLs. CALC supported GSL payments increasing over time.[27] We note Gippsland Water has proposed to maintain the payment amount for its two existing GSLs.

We note Gippsland Water's approach to its GSL scheme was developed through its community engagement to reflect the aspects of service delivery most important to customers. Informed by its engagement, Gippsland Water has also expanded its GSL program, increasing the accountability on the business to deliver on customer service targets. For these reasons, our final decision approves Gippsland Water's proposed GSLs.

Gippsland Water's GSLs are set out in Appendix C to this final decision.

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

[26] Consumer Action Law Centre, op. cit., p. 6.

[27] ibid., p. 1.

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.[28] Along with forecast demand, it is an input to calculating prices.

Our draft decision proposed to approve a revenue requirement of $622.2 million over a five year period starting 1 July 2018. Our final decision approves a slightly lower revenue requirement of $621.5 million. This reflects our final decision on each element of the revenue requirement, as set out in Table 2.1.

The reduction for our final decision is mainly due to updates we made to Gippsland Water's cost of debt lowering the forecast amount for return on assets. Adjustments to the revenue requirement since our draft decision are set out at Table 2.2, with the reasons set out in the following sections.

Table 2.1 Final decision – Revenue requirement
$ million 2017-18

	2018-19	2019-20	2020-21	2021-22	2022-23	Total
Operating expenditure	77.5	76.8	75.8	76.1	76.6	382.8
Return on assets	26.8	27.8	28.9	29.8	30.3	143.5
Regulatory depreciation	17.4	18.2	19.0	19.8	20.8	95.2
Tax allowance	0.0	0.0	0.0	0.0	0.0	0.0
Revenue requirement	**121.6**	**122.8**	**123.8**	**125.7**	**127.7**	**621.5**

Note: Numbers have been rounded

[28] 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 and final decisions.

Table 2.2 Adjustments to draft decision revenue requirement
$ million 2017-18

	2018-19	2019-20	2020-21	2021-22	2022-23	Total
Draft decision – revenue requirement	**122.5**	**123.6**	**123.4**	**125.3**	**127.4**	**622.2**
Operating expenditure	-0.7	-0.7	0.6	0.5	0.5	0.3
Return on assets	-0.2	-0.2	-0.2	-0.2	-0.2	-1.0
Regulatory depreciation	0.001	0.004	0.01	0.01	0.01	0.03
Total adjustments	**-0.9**	**-0.9**	**0.4**	**0.3**	**0.4**	**-0.7**
Final decision – revenue requirement	**121.6**	**122.8**	**123.8**	**125.7**	**127.7**	**621.5**

Note: Numbers have been rounded

Operating expenditure

Operating expenditure is an input to the revenue requirement. Our draft decision proposed to adopt a $356.0 million benchmark for Gippsland Water's forecast controllable operating costs for the 2018–23 period. This was $9.4 million lower than proposed by Gippsland Water, and we set out our reasoning for this adjustment in our draft decision (pages 9 to 16). In summary, we found:

- Evidence indicating its baseline controllable operating expenditure reflects an efficient benchmark.[29] This was after a correction which reduced it by $1.35 million to remove several non-regulatory cost items that had been included in error.
- An average efficiency improvement rate of 1.0 per cent per year, which is on par with our mandated rate for the 2013–18 period, but is the equal lowest rate proposed by water corporations on their price submissions for 2018–23. It is also lower than Gippsland Water's forecast customer connection growth rate of 1.2 per cent per year, giving an increasing annual baseline operating cost.
- Gippsland Water sought additional expenditure of $16.8 million above the growth-adjusted baseline for labour ($10.6 million) and electricity ($6.2 million). We allowed $5.3 million for filling a number of staff vacancies in the baseline year (up to a two per cent vacancy rate) but removed the forecast amount for wage increases above inflation, which we consider should be

[29] Controllable costs are those that can be directly or indirectly influenced by a water corporation's decisions.

managed within the growth-adjusted baseline allowance. We also removed $2.9 million from the electricity cost forecast, but requested Gippsland Water provides a revised forecast for our final decision.

We also asked Gippsland Water to provide further information to explain why the corrections to the baseline year operating expenditure necessitated a reduction in the forecast efficiency improvement rate, and the removal of the forecast operating expenditure savings.

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 and external bulk charges data.[30]

Gippsland Water's response to our draft decision:

- accepted the labour vacancy rate of two per cent, but sought to retain the wage increases above inflation for the current enterprise agreement which expires in 2019
- reduced labour costs to reflect the reduction in payroll tax rate for regional employers announced in the 2018 State Budget
- provided an updated electricity forecast based on its new contract
- accepted the adjustments to the non-controllable operating expenditure
- provided an explanation on the baseline year adjustments
- requested an additional $0.63 million across the period for costs associated with a major customer following a recent contract renegotiation.

Gippsland Water accepted our position that a two per cent staff vacancy rate was reasonable, and the adjustment we made in our draft decision. It also accepted that wage increases above inflation not be included as additional expenditure for future enterprise agreements, but requested these costs be allowed for the existing agreement.[31] We note that Gippsland Water does not propose to further increase FTEs across the period. Gippsland Water's controllable operating expenditure, including the wages component, increases by 1.2 per cent per year through the customer connection growth allowance. We consider this growth allowance will cover the difference between inflation and the 3.0 per cent wage increase provided by the current enterprise agreement, given

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[30] Non-controllable costs are those that cannot be directly or indirectly influenced by a water corporation's decisions.

[31] Our pricing approach does not necessarily allow for the direct pass through of costs incurred (or forecast to be incurred) by a water corporation. This approach is commonly adopted by economic regulators, and is consistent with efficiency objectives in the WIRO. For example, in the Australian Energy Regulator's 2015 decision for the SA Power Networks (SAPN) 2015-20 regulatory period, it rejected SAPN's proposed annual wage increase because it considered them above the efficient market rate. SAPN's proposal had reflected its future actual wage costs, arising from an enterprise agreement it had entered into with its employees. The AER's approach in relation to labour costs was affirmed as reasonable by both the Tribunal and the Full Federal Court.

there will be no actual growth in FTEs. Therefore, our final decision on labour costs remains unchanged from our draft decision.

The 2018-19 Victorian budget cut the payroll tax rate from 3.65 per cent to 2.425 per cent for regional corporations from 1 July 2018. As a result, Gippsland Water has advised a reduction of $1.66 million across the 2018–23 period. This is consistent with our draft decision requirement to be provided with updated forecasts if there is a change in legislation or government policy, and we have reduced the forecast accordingly.

Gippsland Water's response proposed additional electricity costs of $4.94 million above its baseline across 2018–23, based on its latest energy contract until 30 June 2021 and then assumed small price increases until 30 June 2023.[32] This is lower than its price submission forecast of $6.2 million above the baseline, but higher than our draft decision indicative forecast of $3.32 million. We consider the updated electricity forecast is reasonable and reflects efficient operating expenditure, and we accept the $1.62 million increase above our draft decision for our final decision.

We note CALC's submission to our draft decision supported our approach of adjusting forecast electricity costs and limiting wage increases in operating expenditure above the baseline.[33]

Gippsland Water explained the changes it made to its original submission after we identified the correction required to remove non-regulatory costs from the baseline year operating expenditure total. Gippsland Water derived its forecast controllable operating cost for each year of the 2018–23 period, and effectively "back-solved" the efficiency calculations to produce the desired forecast figures. This included an efficiency rate of 1.2 per cent per year, and also a balancing amount to lower the calculated forecast relative to the baseline year in the financial model to match its derived forecast. When the baseline year was reduced to remove the non-regulatory costs, Gippsland Water no longer needed to lower the new baseline figure by as much to achieve its derived forecasts (which did not include the same non-regulatory items as the baseline year). It therefore reduced the efficiency rate to 1.0 per cent, and removed the negative balancing amount which it identified on page 35 of its price submission as 'a range of cost savings…when compared to the 2016-17 baseline'. While the revised model does not appear to offer as much in the way of cost savings as the original submission, we are now satisfied that the figures in the corrected model are consistent with what Gippsland Water would have provided in the first instance, were its model error-free and the baseline not artificially high.

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[32] We requested our expenditure consultant, Deloitte Access Economics, to review the updated electricity price forecasts and compare against the information received for our draft decision. Deloitte did not recommend any adjustments for our final decision.

[33] Consumer Action Law Centre, op. cit.

In response to our draft decision, Gippsland Water marginally revised its efficiency improvement from 0.98 per cent to 1.00 per cent to achieve its derived forecast controllable operating cost. We accept the resulting reduction of $0.36 million across the 2018–23 period for our final decision.

In its response, Gippsland Water advised it recently renegotiated its contract with a major customer, which resulted in increased annual operating costs of $0.13 million to cover legal and sampling costs associated with the new contract. However, the additional revenue from this customer will exceed $0.9 million per year, well in excess of the new costs. Accordingly, we have increased the operating expenditure forecast by $0.63 million across the 2018–23 period because these costs will be recovered from the customer.

No other new considerations were presented in submissions received following the draft decision that caused us to change our views on controllable operating expenditure.

Accordingly for our final decision, we have accepted an increase of $2.25 million and a reduction of $2.02 million, a net increase of $0.22 million above our draft decision for 2018–23.

For non-controllable operating expenditure, we have revised our draft decision forecasts where required based on the latest March 2018 inflation and external bulk charges information. We have revised our forecast environmental contribution from our draft decision, and made no changes to forecast licence fees or external bulk charges.[34]

Based on the latest inflation data, we have revised the forecast 2018-19 environmental contribution from $5.06 million to $5.08 million, which results in a total increase of $0.09 million across the 2018–23 period.

Accordingly, we have increased our draft decision forecast for Gippsland Water’s non-controllable operating expenditure by $0.09 million to $26.61 million across the 2018–23 period.

Table 2.3 sets out our adjustments from our draft decision for controllable and non-controllable operating expenditure. Table 2.4 sets out the benchmark operating expenditure we have adopted for our final decision.

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

Table 2.3 Adjustments to draft decision operating expenditure
$ million 2017-18

	2018-19	2019-20	2020-21	2021-22	2022-23	Total
Draft decision – total operating expenditure	**78.2**	**77.5**	**75.3**	**75.5**	**76.0**	**382.5**
Cost efficiency revision	-0.06	-0.07	-0.07	-0.08	-0.09	-0.36
Payroll tax cut	-0.32	-0.33	-0.33	-0.34	-0.34	-1.66
Electricity	-0.44	-0.41	0.82	0.81	0.84	1.62
Legal costs	0.08	0.08	0.08	0.08	0.08	0.38
Sampling & testing costs	0.05	0.05	0.05	0.05	0.05	0.25
Total adjustments to controllable costs	**-0.70**	**-0.68**	**0.55**	**0.52**	**0.53**	**0.22**
Environmental contribution	0.02	0.02	0.02	0.02	0.02	0.09
Total adjustments to non-controllable costs	**0.02**	**0.02**	**0.02**	**0.02**	**0.02**	**0.09**
Final decision – total operating expenditure	**77.5**	**76.8**	**75.8**	**76.1**	**76.6**	**382.8**

Note: Numbers have been rounded

We have adopted the benchmark for operating expenditure set out in Table 2.4 for the purpose of making our final decision on Gippsland Water's revenue requirement (Table 2.1). We consider our final decision for Gippsland Water's forecast operating expenditure is consistent with the requirements of the Water Industry Regulatory Order 2014 (WIRO) and the criteria for prudent and efficient expenditure outlined in our guidance.[35]

[35] Essential Services Commission 2016, *Guidance paper*, op. cit., p. 31.

Table 2.4 Final decision – operating expenditure
$ million 2017-18

	2018-19	2019-20	2020-21	2021-22	2022-23	Total
Controllable costs	**71.9**	**71.4**	**70.5**	**70.9**	**71.5**	**356.2**
Non-controllable costs	**5.5**	**5.4**	**5.3**	**5.2**	**5.1**	**26.6**
Bulk services[a]	0.0	0.0	0.0	0.0	0.0	0.0
Environmental contribution[b]	5.1	5.0	4.9	4.7	4.6	24.3
Licence fees – ESC[c]	0.071	0.071	0.071	0.071	0.107	0.392
Licence fees – DHHS[c]	0.034	0.034	0.034	0.034	0.034	0.169
Licence fees – EPA[c]	0.349	0.349	0.349	0.349	0.349	1.744
Other	0.0	0.0	0.0	0.0	0.0	0.0
Final decision – total operating expenditure	**77.5**	**76.8**	**75.8**	**76.1**	**76.6**	**382.8**

[a] Bulk services covers the supply of bulk water and sewerage services

[b] The Environmental Contribution collects funds from water corporations under the *Water Industry Act 1994* (Vic)

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

Note: Numbers have been rounded

The benchmark operating expenditure that we have adopted for 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 and to provide services over the regulatory period.

Regulatory asset base

The regulatory asset base is used to estimate the return on assets and regulatory depreciation in the revenue requirement. Our guidance required 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 capital expenditure, government and customer contributions, and asset disposals for the period to 30 June 2017. This helps to ensure prices reflect the actual expenditure of a water corporation.

For our draft decision, we compared Gippsland Water's net capital expenditure for 2012-13 to 2016-17 with the forecast used to approve maximum prices for the period from 1 July 2013.[36] We undertake a prudency 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 'lumpy'.

Gippsland Water's net capital expenditure was 3.8 per cent higher than the forecast used to approve maximum prices for the period from 1 July 2013, below the 10 per cent threshold discussed above. Gippsland Water also calculated its closing asset base in accordance with our guidance. For these reasons, our draft decision proposed to approve a closing regulatory asset base for 30 June 2017 of $648.1 million.

No new considerations were raised in submissions on our draft decision that affected our assessment of the closing regulatory asset base.

For the reasons set out above, our final decision approves a closing regulatory asset base at 30 June 2017 of $648.1 million. The calculations are provided at Table 2.5.

[36] Net capital expenditure is calculated by deducting government and customer contributions from gross capital expenditure.

Table 2.5 Final decision – 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 final decision on Gippsland Water's forecast regulatory asset base from 1 July 2018.[37] The following sections outline our assessment of each component of the forecast regulatory asset base.

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

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

	2017-18	2018-19	2019-20	2020-21	2021-22	2022-23
Opening RAB 1 July	648.1	663.9	683.9	714.5	741.6	758.3
Plus gross capital expenditure	37.0	38.0	49.3	46.6	36.9	37.2
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**	**683.9**	**714.5**	**741.6**	**758.3**	**769.3**

Note: Numbers have been rounded

Capital expenditure

Capital expenditure is an input to estimating the regulatory asset base. In our draft decision (pages 19 to 22), we proposed a gross capital expenditure forecast of $207.3 million for Gippsland Water for the 2018–23 period. The reasons for this were:

- Gippsland Water's price submission and business cases provided evidence that its approach for developing project scope, timing of works and costs was reasonable.
- We removed $1.6 million from its forecast gross capital expenditure as Gippsland Water did not sufficiently justify the efficiency of its proposed costs for two capital programs.
- We considered the planned capital expenditure program is achievable, given Gippsland Water's past track record delivering its capital expenditure program.
- Gippsland Water has an appropriate approach for managing expenditure associated with uncertain projects.
- We considered Gippsland Water's approach to forecasting its capital expenditure is consistent with the requirements of our guidance.

Gippsland Water's response to our draft decision proposed to reinstate all gross capital expenditure as per its price submission, specifically:

- $0.87 million for its sewer reticulation renewals program

- $0.66 million for its treated water basin liners and covers program.

Gippsland Water outlined its CCTV sewer inspection program and the basis for its planned fifteen year sewer reticulation renewals program. It plans to replace around $8.6 million of sewer reticulation pipes over 2018–23, but it has only included $6.4 million in its price submission.[38] For our draft decision, we noted performance data suggested that the current level of sewer renewals appeared sufficient to maintain service levels and recommended a reduction to align the program expenditure level with the 2013–18 period. Over the three years to 2016-17, the rates of sewer blockages and spills reported have been relatively flat, with an increase in spills from the prior two years but blockages remaining consistent over the full five years.[39] We consider that Gippsland Water's response has not justified why it should increase its renewals program given its current program is delivering consistent performance trends. Our final decision remains unchanged from our draft decision on gross capital expenditure.

Gippsland Water did not agree that it could achieve efficiency savings through its procurement process for its treated water basin liners and covers program. It explained how its tender packaging is designed to take into account lessons learned, and the requirement for significant scoping and pre-works before new items can be installed limits its ability to tender all basins together. Gippsland Water also advised its recent experience in 2017-18 has identified some unexpected costs above those it proposed in its price submission. Overall, Gippsland Water considered its total program value should not be reduced by five per cent. We accept Gippsland Water's response, as we consider that it has sufficiently justified the prudency and efficiency of its project costs. Our final decision adopts the $0.66 million increase to gross capital expenditure for our draft decision.[40]

No other new considerations were presented in submissions received following the draft decision that caused us to change our views on gross capital expenditure.

Accordingly, we have adopted Gippsland Water's proposed increase to the gross capital expenditure benchmark proposed in our draft decision for our final decision (Table 2.7). We consider this benchmark is consistent with our guidance and WIRO principles, and is used to

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[38] We requested our expenditure consultant, Deloitte Access Economics, to review North East Water's response and compare against the information received for our draft decision. Deloitte did not recommend any adjustments for our final decision.

[39] Essential Services Commission 2018, *Water performance report 2016-17: performance of Victorian urban water and sewerage businesses*, 1 March.

[40] We note there was a rounding error between our draft decision paper and the associated financial model. Only $0.65 million was removed from the financial model and factored into pricing for our draft decision, therefore we have reinstated the same $0.65 million for the model accompanying this final decision.

calculate our final decision on Gippsland Water's forecast regulatory asset base (Table 2.6) and its revenue requirement (Table 2.1).[41]

Table 2.7 Adjustments to draft decision capital expenditure

$ million 2017-18

	2018-19	2019-20	2020-21	2021-22	2022-23	Total
Draft decision – capital expenditure	**37.8**	**49.2**	**46.4**	**36.8**	**37.1**	**207.3**
Treated Water Basin Liners and Covers Replacement	0.17	0.12	0.19	0.07	0.10	0.65
Final decision – capital expenditure	**38.0**	**49.3**	**46.6**	**36.9**	**37.2**	**207.9**

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. 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.

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

Customer contributions

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

Our draft decision considered Gippsland Water's forecast revenue from customer contributions was reasonable, having regard to past trends and its growth forecasts. We proposed to accept Gippsland Water's forecast. No other new considerations were presented in submissions received following the draft decision which caused us to change our views on revenue from customer contributions.

[41] Essential Services Commission 2016, *Guidance Paper*, op. cit., p. 35; WIRO clause 8(b).

For the reasons set out above, our final decision confirms our draft decision. The benchmark revenue from customer contributions adopted for our final decision is set out at Table 2.6.

Cost of debt

In our draft decision we proposed to approve the cost of debt proposed by Gippsland Water as it used the cost of debt values we specified in our guidance to calculate its revenue requirement. We also noted that we will update the value of the estimated cost of debt for 2017-18 with our calculation of the actual cost, applying the method outlined in our guidance.[42]

CALC recommends that we set the benchmark cost of debt at five per cent or around one per cent lower than the amount allowed in our draft decision (6.05 per cent per annum in nominal terms).[43] CALC submits that government owned water corporations carry less risk than private corporations and as such, the allowed cost of debt and the return on equity should be lowered compared with the rates allowed in our draft decision. These recommendations are based on a report prepared by CME for CALC.[44]

A submission by the Water Services Association of Australia (WSAA) addressed CALC's submission.[45] Among other things, WSAA's submission noted that competitive neutrality principles have been embedded in government policy, including in Victoria via the Financial Accommodation Levy. As a result, water corporations face a cost of debt that reflects the commercial cost of debt.

In keeping with government policy, the approach we take to the cost of debt is to adopt a benchmark rate that applies to all water corporations. The benchmark reflects our estimate of the efficient financing costs for a privately owned business facing a similar degree of economic risk to a regulated water corporation. We consider this is consistent with the requirements of the WIRO.[46]

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

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

Our final decision adopts the benchmark cost of debt as set out in Table 2.8.

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[42] We received data on the actual trailing average cost of debt for 2017-18 from Treasury Corporation Victoria in April 2018 and we updated the 2017-18 estimates for our final decision.

[43] Consumer Action Law Centre, op. cit. p. 8.

[44] ibid.

[45] Water Services Association of Australia 2018, *Submission,* May.

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

Table 2.8 Final decision – Trailing average cost of debt

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

Note: Numbers have been rounded

Return on equity – PREMO rating

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'.[47]

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

Consumer Action Law Centre (CALC) recommended a one per cent reduction to each return on equity value in the PREMO matrix.[48] CALC's recommendation is based on the findings of a report prepared by CME. The main reason CME proposed the reduction is due to comparisons with returns allowed for UK water entities, and that government owned water corporations carry less risk than private corporations.

The most relevant comparisons for the return on equity are other economic regulators in Australia. The rate for the return on equity (and the regulatory rate of return, comprising the cost of debt and the return on equity) approved in our draft decision are similar to rates recently estimated by other Australian-based regulators of the water sector.[49] We also consider the allowed return on equity should not be adjusted to reflect government ownership, as the exposure of a water corporation to market risk will not be materially affected by government ownership.

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

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

[47] Essential Services Commission 2016, *Guidance paper*, op. cit., p. 49.

[48] Consumer Action Law Centre, op. cit., p. 8.

[49] Essential Services Commission of South Australia 2016, *SA Water regulatory determination 2016*, Final Determination, June; Independent Pricing and Regulatory Tribunal 2017, *WACC biannual update*, February.

also had regard to the return on equity allowed or estimated by regulators in other Australian jurisdictions recently for the water industry.[50]

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

Regulatory depreciation

Regulatory depreciation is an input to calculating the regulatory asset base. Our draft decision proposed to accept Gippsland Water's forecast regulatory depreciation, as it was calculated in a manner consistent with the requirements of our guidance.[51]

Our final decision on regulatory depreciation is slightly higher than our draft decision due to final decision adjustments to forecast capital expenditure, as set out in Table 2.6.

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

For the reasons set out above, our final decision adopts the forecasts for regulatory depreciation set out in Table 2.1.

Tax allowance

The tax allowance is an input into the revenue requirement. Our draft decision accepted Gippsland Water's forecasts for zero tax in its revenue requirement, as it was calculated consistently with the method required by our guidance.[52] No other new considerations were presented in submissions received following the draft decision which caused us to change our views on the tax allowance.

For the reasons set out above, our final decision adopts Gippsland Water's tax forecasts, as set out in Table 2.1.

Demand

In our draft decision, we proposed to accept Gippsland Water's demand forecasts as we considered they were estimated in a manner consistent with the requirements of our guidance.

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[50] Essential Services Commission of South Australia, op. cit.; Independent Pricing and Regulatory Tribunal 2017, *WACC biannual update*, August.

[51] Essential Services Commission 2016, *Guidance paper*, op. cit., p. 42.

[52] ibid., pp. 50-51.

In response to our draft decision Gippsland Water updated its demand forecasts to reflect latest data in relation to water usage among its large customers. Gippsland Water's revised demand forecast is slightly lower than the draft decision forecast (the difference is less than one per cent).

We assessed Gippsland Water's revised forecasts and consider they were estimated in a manner consistent with the requirements of our guidance.

For these reasons, our final decision confirms our draft decision. Gippsland Water's price determination includes the benchmark demand forecasts adopted for our final decision.

Form of price control

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

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

For the reasons set out above, our final decision confirms our draft decision. Our final decision approves Gippsland Water's proposed price cap form of price control.[53]

Tariff structures and prices

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

- For residential and non-residential water services, a two-part tariff structure with a fixed service charge and a variable component that depends on water use.
- For residential sewerage services, a fixed service charge only.
- For non-residential sewerage services, a two-part tariff structure with a fixed service charge and a variable usage component.

We considered the two-part structure for water services will promote efficient use. It also provides customers a signal about their water use costs, and is an approach that is commonly applied in other states and territories.[54] We also considered two-part tariff structures are easy to understand.

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

[54] 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.

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

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

Our draft decision also accepted Gippsland Water's proposed 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.

A number of submissions raised concerns about the proportion of fixed and variable charges, and affordability.[55] Affordability was also raised as an issue at the April 2018 public forum we held in Moe on our draft decision for Gippsland Water.[56]

During the development of its price submission, Gippsland Water engaged with customers on the share of fixed and variable charges in bills. Many customers preferred to increase variable charges relative to fixed, to support water conservation objectives. While it did not propose to modify tariff structures or tariff mix at this time, Gippsland Water has committed to learn more about customer preferences and provide for greater flexibility in the future, including through tariff trials.

On affordability, we consider our final decision approves tariffs that reflect prudent and efficient expenditure. We note that Gippsland Water has proposed maintaining its level of support for customers having difficulty paying their water bill.

We consider Gippsland Water's proposal takes into account customers' interests, including low income and vulnerable customers. For the reasons set out above, our final decision approves Gippsland Water's proposed tariffs.

Our price determination for Gippsland Water sets out the maximum prices it may charge for the five year period from 1 July 2018 (or the manner in which its prices are to be calculated, determined, or otherwise regulated for each tariff). Approved maximum prices for water and

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[55] Sylvia Leibrecht 2018, *Submission*, 4 May; Consumer Action Law Centre, op. cit., pp. 2-3; Anonymous 2018, *Submission*, 30 April; Anonymous 2018, *Submission*, 1 May; Anonymous 2018, *Submission*, 3 May; Anonymous 2018, *Submission*, 7 May.

[56] A submission from the Gippsland Resource Group noted concern that Gippsland Water had over-charged customers in the 2013-18 period. We have previously investigated these claims and found Gippsland Water had charged in accordance with its price determination. See report available on our website.

sewerage services applying to most residential and non-residential customers are set out in Tables 2.9 and 2.10 (in $2018–19). [57]

Table 2.9 Final decision – water prices

$ 2018-19

	2018-19	2019-20	2020-21	2021-22	2022-23
Residential					
Variable ($/kL)	2.0472	2.0472	2.0472	2.0472	2.0472
Fixed ($/year)	177.04	177.04	177.04	177.04	177.04
Non-residential					
Variable ($/kL)	2.0472	2.0472	2.0472	2.0472	2.0472
Fixed ($/year)	177.04	177.04	177.04	177.04	177.04

Note: Numbers have been rounded

Table 2.10 Final decision – sewerage charges

$ 2018-19

	2018-19	2019-20	2020-21	2021-22	2022-23
Residential					
Fixed ($/year)	813.34	813.34	813.34	813.34	813.34
Non-residential					
Variable ($/kL)	3.8749	3.8749	3.8749	3.8749	3.8749
Fixed ($/year)	813.34	813.34	813.34	813.34	813.34

Note: Numbers have been rounded

[57] On 23 May 2018 (after our consultation period had closed on our draft decision for Gippsland Water), we received a submission from Kingspan Environmental and Urban Water Cycle Solutions under our consultation process for Western Water's draft decision. We have considered the views raised in the submission for our final decision and price determination for Gippsland Water. Our response to the submission is set out in our final decision paper for Western Water.

Adjusting prices

In our draft decision we:

- accepted Gippsland Water's proposal to continue its existing uncertain and unforeseen events mechanism, but did not accept Gippsland Water's proposal to include risks in relation to power industry based revenues, and the impact of any economic slowdown on growth within its region as specific matters listed under the mechanism
- invited Gippsland Water to submit price adjustment formulas that allowed prices to adjust to changes in the cost of debt.

In its response to our draft decision, Gippsland Water accepted our draft decision to not include risks in relation to power industry based revenues, and the impact of any economic slowdown on growth as specific matters listed under its uncertain and unforseen events mechanism. It also noted it would accept an adjustment formula for the cost of debt developed by the commission.

Our final decision approves a continuation of Gippsland Water's existing uncertain and unforseen events mechanism. Its price determination also includes an adjustment formula that allows prices to adjust to changes in the cost of debt, which we consider is consistent with the requirements of our guidance (as it will allow for the pass through of efficient costs).

New customer contributions

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

Our draft decision proposed to accept Gippsland Water's proposal to continue applying a zero charge for standard new customer contributions, as it is in accordance with the commission's approved transition to a zero charge in our 2013 price determination.

For negotiated new customer contributions, we proposed to accept Gippsland Water's proposal to continue to calculate charges in accordance with the requirements of our new customer contribution pricing principles.

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

For the reasons set out above, we consider it appropriate to maintain the views expressed in our draft decision. Our final decision accepts the position in our draft decision for the same reasons, and accepts Gippsland Water's proposed new customer contribution charges, including its method of calculating negotiated contribution charges, as they are consistent with the requirements of our guidance.[58]

Our price determination for Gippsland Water sets out the approved new customer contribution charges for the five year period from 1 July 2018 (or the manner in which its prices are to be calculated, determined, or otherwise regulated).

Gippsland Water should update and publish any development servicing plans and negotiation protocols to assist developers understand the underlying assumptions of its new customer contribution charges.[59]

Financial position

In approving prices, we must have regard to the financial viability of the water industry.[60] We interpret the financial viability requirements under the *Essential Services Commission Act 2001* (Vic) and the WIRO to mean that the prices we approve should provide a level of certainty that each water corporation can generate sufficient cash flow to deliver on service commitments, including financing costs arising from investments to meet service expectations.

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

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[58] Essential Services Commission 2016, *Guidance paper,* op. cit., pp. 62-63.

[59] Essential Services Commission 2013, *New Customer Contributions: Explanatory Note,* December, pp. 9-11.

[60] WIRO clause 8(b)(ii) and ESC Act section 8A(1)(b).

3. PREMO rating

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

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

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

In Chapter 2, we noted our final decision is to accept Gippsland Water's proposed return on equity of 4.5 per cent, based on our PREMO review.

Our review of Gippsland Water's PREMO rating

Gippsland Water's proposed PREMO rating, and our draft and final decision are summarised below (Table 3.1).

Table 3.1 PREMO Rating

	Overall PREMO rating	Risk	Engagement	Management	Outcomes
Gippsland Water's rating	**Standard**	Standard	Standard	Standard	Standard
Commission's draft decision rating	**Standard**	Standard	Standard	Standard	Standard
Commission's final decision rating	**Standard**	Standard	Standard	Standard	Standard

Consistent with our draft decision, our final decision approves a rating of 'Standard' for Gippsland Water's price submission. In support of Gippsland Water's PREMO ratings, we note:

- Gippsland Water provided a reasonable opportunity for customers to provide feedback, and shape the corporation's proposals. It used a range of methods to engage, 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, supporting its Engagement rating.

- 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. These factors supported Gippsland Water's Outcomes rating.
- Gippsland Water 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.

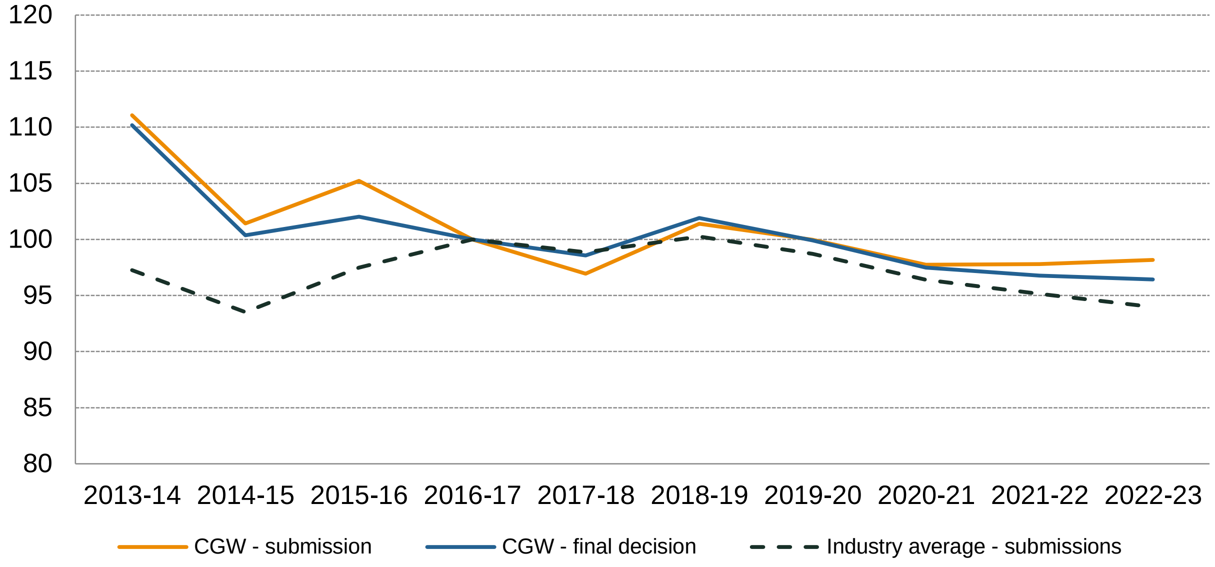
Compared to other water corporations Gippsland Water proposed a relatively low efficiency improvement rate for controllable operating expenditure (Figure 3.1). Gippsland Water's price submission incorporated forecast increases in controllable costs per connection that were above the average for all regional urban water corporations covered by our price review.

On balance however, our final decision has accepted Gippsland Water's proposed rating of 'Standard' for Management. This reflects the consideration we gave to the relatively small adjustments we have made to forecast expenditure, and in particular, for capital expenditure. This provides assurance that Gippsland Water's approach to expenditure forecasting is based on sound methodologies.

Our final decision to approve a PREMO rating of 'Standard' is reflected in the return on equity we have approved at page 23.

Figure 3.1 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. Final 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).

Appendix A – submissions received on draft decision

Name or organisation	Date received
Gippsland Resource Group	24 May 2018
Kingspan Environmental and Urban Water Cycle Solutions	23 May 2018
Water Services Association of Australia	15 May 2018
Consumer Action Law Centre	8 May 2018
Anonymous	7 May 2018
Sylvia Leibrecht	4 May 2018
Anonymous	3 May 2018
Anonymous	1 May 2018
Anonymous	30 April 2018

Appendix B – approved service standards

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

Gippsland Water's approved service standards

Service Standard	2018-19	2019-20	2020-21	2021-22	2022-23
Water					
Number of customers experiencing more than 5 unplanned water supply interruptions in the year (number)	0	0	0	0	0
Average time taken to attend bursts and leaks (priority 1) (minutes)	35	35	35	35	35
Average time taken to attend bursts and leaks (priority 2) (minutes)	90	90	90	90	90
Average time taken to attend bursts and leaks (priority 3) (minutes)	1500	1500	1500	1500	1500
Average duration of unplanned water supply interruptions (minutes)	90	90	90	90	90
Average duration of planned water supply interruptions (minutes)	168	168	168	168	168
Sewerage					
Customers receiving more than 3 sewer blockages in the year (number)	0	0	0	0	0
Average time to attend sewer spills and blockages (minutes)	40	40	40	40	40
Average time to rectify a sewer blockage (minutes)	95	95	95	95	95
Spills contained within 5 hours (per cent)	98	98	98	98	98

Note: Numbers have been rounded

Appendix C – approved GSL schemes

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

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

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

Gippsland Water's approved GSL scheme

Approved service level obligation	Approved payment ($)
A sewer spill within a house, caused by failure of Gippsland Water's system, contained within one hour of notification	500
Hardship GSL – if a customer in genuine hardship is restricted for non-payment Gippsland Water will pay $300 per day to a maximum of $900 until the service is restored	300 - 900
If we are required to issue a 'boil water' alert, we will contribute $5,000 to a fund administered by our Community Consultative Committee.	5,000
If a planned interruption goes longer than advised then each affected customer will be compensated by a $50 credit to their next water bill.	50
If a customer is affected by a planned interruption and was not provided a minimum of five days notification, we will credit that customer $50 on their next water bill.	50
If we receive a sanction from a regulator for harm to the environment we will contribute $5,000 to a fund administered by our Community Consultative Committee.	5,000
We commit to investing a minimum of $30,000 per year in programs that support the wellbeing of our communities.	30,000

Appendix D – rate of return

A submission from the Consumer Action Law Centre (CALC) recommended that we set the benchmark cost of debt at five per cent or around one per cent lower than the amount allowed in our draft decision (6.05 per cent per annum in nominal terms). It also recommended that we reduce each of the equity values in the PREMO matrix by one per cent. CALC submits that government owned water corporations carry less risk than private corporations, and as such, the allowed cost of debt and the return on equity should be lowered, compared with the rates allowed in our draft decision.[61] These recommendations are based on a report prepared by CME for CALC.[62]

Victoria's water corporations are subject to the competitive neutrality measures the Victorian government agreed to implement as part of the national competition policy agreement and related reforms.[63] This includes ensuring that borrowing costs reflect an estimate of a water corporation's standalone risk profile and credit rating. We note that:

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

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

[61] Consumer Action Law Centre, op. cit.

[62] ibid., Appendix A.

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

to a regulated water corporation. We consider this is consistent with the requirements of the Water Industry Regulatory Order 2014 (WIRO).[64]

Adopting the approach recommended by CALC would mean the allowed rate for the cost of debt may be lower than the rate faced by a benchmark efficient water corporation. As well as being inconsistent with government policy that water corporations pay an estimate of a commercial equivalent borrowing rate, it would also be inconsistent with the Water Industry Regulatory Order (2014)'s viability and efficiency objectives. Our approach is also similar to that adopted by other Australian economic regulators.

CALC's submission also recommended a one per cent reduction to each return on equity value in the PREMO matrix.[65] CME proposed the reduction mainly based on comparisons with the return allowed for UK water entities, and its view that government-owned water corporations carry less risk than comparable privately owned businesses.

We believe the most relevant comparisons for the return on equity are other economic regulators in Australia. We note the rate for the return on equity (and the overall regulatory rate of return, comprising the cost of debt and the return on equity) approved in our draft decision are within the range of rates estimated by other Australian-based regulators.[66]

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

CME also argues for a reduction in return on equity to reflect the prevailing revenue cap form of price control. This reflects that a revenue cap provides a water corporation with greater revenue certainty than other forms of price control, such as a price cap. We note however, that only one urban water corporation in Victoria (Yarra Valley Water) has a revenue cap form of price control. As well, a revenue cap does not necessarily change the level of systematic risk faced by a water

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

[65] Consumer Action Law Centre, op. cit.

[66] Essential Services Commission of South Australia, op. cit.; Independent Pricing and Regulatory Tribunal 2017, August, op. cit.

corporation. For example, it is possible that a water corporation operating under a revenue cap is more exposed to cost risks than corporation operating under a price cap.[67]

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

[67] For example, increases in water demand can lead to increased costs for a water corporation, which would not be matched by an increase in revenue, under a revenue cap. By contrast, under a price cap increases in water demand would also lead to an increase in revenue.