



# South East Water draft decision

2023 Water Price Review

30 March 2023



## Acknowledgement

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

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

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

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# Summary

## **Our draft decision considers South East Water’s proposed prices for a 5-year period starting 1 July 2023**

This draft decision sets out our preliminary views on South East Water’s price submission.<sup>1</sup> Our draft decision should be read together with South East Water’s price submission.



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 2023. For details of how to provide feedback, see our dedicated Engage Victoria page: <https://engage.vic.gov.au/water-price-review-2023>.

## **South East Water has committed to delivering a number of key outcomes for its customers**

South East Water has committed to delivering the following outcomes for customers:

- ‘Get the basics right, always’
- ‘Warn me, inform me’
- ‘Fair and affordable for all’
- ‘Make my experience better’
- ‘Support my community, protect our environment’.<sup>2</sup>

Recognising the impacts of climate change and growth in its region, South East Water will invest in its infrastructure to help ensure quality and reliable services, support customers to use water wisely, and invest in alternative water supplies. It will also invest in its emergency response planning and achieving net zero emissions by 2030.

South East Water will also focus on streamlining customer processes and providing customers with information when they need it; in part supported by its decision to further rollout digital meters. As part of its commitment to minimising its impact on the environment and supporting its community, South East Water has committed to continuing to learn from Traditional Owners in its service region, and one of its priorities is to engage with them in water and land planning and management.

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<sup>1</sup> Clause 16 of the Water Industry Regulatory Order 2014 requires the Essential Services Commission to issue a draft decision; South East Water’s price submission is available on our website at [www.esc.vic.gov.au](http://www.esc.vic.gov.au).

<sup>2</sup> South East Water, 2023–28 water price submission, 30 September 2022, pp. 19-20.

South East Water has also proposed improving many of its service targets which along with its proposal to deliver real price reductions from 1 July 2023, indicates improved value to its customers.

## **Our draft decision on the revenue requirement will allow South East Water to deliver on its obligations and customer priorities**

Our draft decision adopts a revenue requirement that will allow South East Water to deliver on its customer service commitments, government policy, statements of obligations, and obligations monitored by the Environment Protection Authority Victoria and the Department of Health.

South East Water proposed a revenue requirement of \$4,633 million over a 5-year period starting 1 July 2023.<sup>3</sup> Our draft decision adopts a revenue requirement of \$4,631.5 million, which reflects our preliminary assessment of each element of the revenue requirement, including forecast operating and capital expenditure.

Our draft decision incorporates some proposed changes to the treatment of operating and capital expenditure, compared to South East Water's price submission.

After lodging its price submission, South East Water's 2021-22 regulatory accounts process identified that its price submission incorrectly classified several operating expenditure items as capital expenditure. This included corporate or overhead items such as insurance. We have corrected for this in our draft decision (Section 4.1.1).

During our review, South East Water identified other changes to its policy for the treatment of costs as either operating or capital in nature for pricing purposes.

To help ensure that customer prices reflect the appropriate allocation of costs, in its response to our draft decision South East Water must explain its approach to the treatment of expenditure as operating or capital, identifying any changes in approach that impacted its estimated costs or forecasts from the start of the 2018–23 regulatory period. As well as informing the starting point for base year (2021-22) operating costs, this will inform our final decision on the capital expenditure amounts used to calculate South East Water's closing regulatory asset base at 30 June 2022.

Our draft decision also proposes some relatively minor adjustments to South East Water's operating and capital expenditure forecasts that it must take into account in its response to our draft decision.

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

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

### **South East Water’s proposal means customer bills will fall in real terms**

Based on South East Water’s price submission, before inflation the typical annual water and sewerage bill for a residential owner-occupier who uses both water and sewerage services will fall from \$967 currently, to \$908 in 2023-24 and remain steady to 2027-28 (Table A). Bills for household tenants (before inflation) will fall from \$516 in 2022-23 to \$483 in 2023-24 and then remain steady. Estimated annual water and sewerage bills for non-residential customers are also shown below. These estimates exclude inflation (they are in 2022-23 terms).

South East Water’s proposed price path reduces prices from 1 July 2023, to help address affordability for customers given the impact of expected high inflation on 2023-24 customer bills.

Estimated bills are likely to change following our draft decision, to reflect our updates for inflation and the cost of debt. There are also some areas for further exploration that may also impact South East Water’s revenue requirement and prices approved in our final decision and determination, which could impact estimated customer bills.

**Table A** Estimated typical water and sewerage bills (\$2022-23)

	Average consumption (kL p.a.)	2022-23 (current)	2023-24	2027-28
Residential – owner occupier	150	\$969	\$908	\$908
Residential – tenant	150	\$515	\$483	\$483
Non-residential (small)	150	\$1,281	\$1,207	\$1,207
Non-residential (medium)	1000	\$5,597	\$5,270	\$5,270
Non-residential (large)	10,000	\$51,254	\$48,289	\$48,289

### **Tariff structures will generally remain the same, but South East Water will simplify charges for residential customers**

For residential customers receiving both water and sewerage services, South East Water proposed to combine its residential sewage disposal charge and its residential variable water charge. This was justified by South East Water based on support from customers (including their preference for simpler tariffs), and because the change will help to ensure customers respond to price signals. Our preliminary position is that we agree with its justification and our draft decision approves this proposed change.

Our draft decision is to approve other water and sewerage tariff structures proposed by South East Water because they remain unchanged and are generally supported by customers.

## Our draft decision rates South East Water’s price submission as ‘Advanced’ under the PREMO framework

Our draft decision is to rate South East Water’s price submission as ‘Advanced’ under the PREMO framework (Table B). This is the same as the business’s self-rating of its price submission, and the same as the PREMO rating it received at its previous price review in 2018.

Key factors supporting this PREMO rating include:

- South East Water generally met its outcome commitments in the current regulatory period, and recorded relatively strong outcomes in our survey of customer sentiment
- strong endorsement from South East Water’s customer panel members on the alignment between the panel’s recommendations and the business’s proposals
- South East Water proposed the highest efficiency improvement rate for controllable operating expenditure over the next regulatory period (2 per cent) of any business in the current price review, contributing to real price reductions over the 2023–28 regulatory period
- South East Water’s proposal to reduce prices in real terms from 1 July 2023 (and then generally remaining flat) to help manage the impacts of expected high inflation on customer bills
- a number of outcome targets proposed by South East Water suggest an improvement in customer service which along with the real price reductions proposed by South East Water indicate customers will receive improved value over the 2023–28 regulatory period.

See Section 1.4 and Chapter 7 for an explanation of the PREMO framework.



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

**Table B**      **PREMO rating**

	Overall PREMO rating	Performance	Risk	Engagement	Management	Outcomes
South East Water’s self-rating	Advanced	Advanced	Advanced	Advanced	Standard	Advanced
Commission’s rating	Advanced	Advanced	Advanced	Advanced	Standard	Advanced

Among the 9 draft decisions we have released so far, South East Water is one of 5 corporations for which we propose to approve an ‘Advanced’ rating (Table C).

**Table C** Draft decision on PREMO — overall rating

Leading	Advanced	Standard	Basic
	Barwon Water Gippsland Water GWMWater South East Water Yarra Valley Water	East Gippsland Water Lower Murray Water South Gippsland Water Westernport Water	

## 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. We expect to release our final decision and price determination in June 2023.

Stakeholders may comment on any aspect of our draft decision, including:

- the information we have relied upon in our assessment (such as South East Water’s price submission)
- additional matters or issues we should consider before making our final decision
- whether our draft decision on South East Water’s price submission has adequate regard to the matters in clause 11 of the Water Industry Regulatory Order 2014 and our guidance.

Table D lists specific issues we are seeking feedback on to inform our final decision and price determination for South East Water.

**Table D** Specific topics we are particularly interested in stakeholder feedback on

Topic	Specific issue	Draft report reference
Guaranteed service levels	South East Water’s proposed guaranteed service levels, including its proposal for a new guaranteed service level and rebate focused on water quality.	Section 3.4
New customer contributions	South East Water’s proposed standard new customer contributions.	Section 5.4



## How to provide feedback and stay up to date

You can stay up to date with our review via the dedicated Engage Victoria website:

<https://engage.vic.gov.au/water-price-review-2023>

You can provide feedback by:

- taking part in a public forum
- providing written comments or submissions.

### Taking part in a public forum

We plan to hold a public forum on 2 May 2023. Forums provide an opportunity for interested parties to discuss key features of our draft decisions. Details of our public forums will be published on the Engage Victoria website.

### Provide written comments or submissions

Written comments or submissions in response to this draft decision will be due by 9 May 2023.

We require submissions by this date so that 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 the dedicated [Engage Victoria website](#).

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

2023 Water Price Review  
Essential Services Commission  
Level 8, 570 Bourke Street  
Melbourne VIC 3000

### Submission and privacy statement

We encourage transparency in our review processes. It is our policy to publish all submissions to the 2023 water price review on the Essential Services Commission website unless the submitter has requested confidentiality. When we publish a submission, we will also include some details about the submitter (your name, not your address) unless the submitter has requested anonymity (does not want to be identified).

You can request confidentiality in relation to your submission. Requesting this may affect the weight we can give to your submission. You may also request anonymity.

## Next steps

Activity	Indicative date
Public forum	2 May 2023
Closing date for submissions on our draft decision	9 May 2023
Release date for our final decision and price determination	June 2023

# 1. Our role and approach to water pricing

## 1.1 We are Victoria's independent economic regulator

Our role in the water industry is based on the Water Industry Regulatory Order 2014 (WIRO), which is made under the *Water Industry Act 1994* (WI Act) and sits within the broader context of the *Essential Services Commission Act 2001* (ESC Act). Our role under the WIRO includes regulating the prices and monitoring service standards of the 18 water corporations operating in Victoria.

## 1.2 We are reviewing the proposed prices of 14 water businesses

Our review is of the prices that the 14 water corporations propose to charge customers for prescribed services from 1 July 2023.<sup>4</sup> The prescribed services include retail water and sewerage services, and bulk water and sewerage services delivered by the water corporations.<sup>5</sup>

South East Water provided a submission to us proposing prices for a 5-year period starting 1 July 2023. Our task is to assess the price submission using the legal framework and make a price determination that takes effect from 1 July 2023. The price determination will specify the maximum prices South East Water may charge for prescribed services, or the manner in which prices are to be calculated, determined or otherwise regulated. We will also issue a final decision that explains the reasons for our price determination.

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

Clause 11 of the WIRO specifies the mandatory 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

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<sup>4</sup> The review excludes Melbourne Water, Goulburn-Murray Water, North East Water and Greater Western Water. In 2021 we approved prices for Melbourne Water to 30 June 2026 and in 2020 we approved prices for Goulburn-Murray Water to 30 June 2024. In 2018, we approved prices for North East Water to 30 June 2026. We have approved an extension to the regulatory period for Greater Western Water to 30 June 2024.

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

- the matters set out in section 33(3) of the ESC Act, which include the return on assets, relevant benchmarking and any other matters that the ESC considers relevant
- the matters specified in our guidance<sup>6</sup>
- the principle that prices should be easily understood by customers and provide signals about the efficient costs of providing services, while avoiding price shocks where possible
- the principle that prices should take into account the interests of customers of the regulated entity, including low income and vulnerable customers.

Appendix B lists the specific objectives and the various matters we must have regard to when making a price determination and provides a guide to where we have done so in this draft decision. Table 1.1 summarises the matters we must have regard to and groups them into themes.

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

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 South East Water's proposed prices.<sup>7</sup>

If we consider the submission does not have adequate regard for the matters specified in clause 11 of the WIRO or does not comply with our guidance, we may specify maximum prices, or the manner in which prices are to be calculated, determined or otherwise regulated.<sup>8</sup>

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<sup>6</sup> Essential Services Commission, *2023 water price review: Guidance paper*, 26 October 2021.

<sup>7</sup> This is a requirement of the WIRO, clause 14(b).

<sup>8</sup> This is provided for under the WIRO, clause 14(b)(i).

**Table 1.1 Matters businesses and the commission must have regard to**

Economic efficiency and viability matters	Industry/business specific matters	Customer matters
<ul style="list-style-type: none"> <li>• promotion of efficient use of prescribed services by customers [cl 8(b)(i), WIRO]</li> <li>• promotion of efficiency in regulated entities as well as efficiency in, and the financial viability of, the regulated water industry [cl 8(b)(ii), WIRO]</li> <li>• provision to regulated entities of incentives to pursue efficiency improvements [cl 8(b)(iii), WIRO]</li> <li>• efficiency in the industry and incentives for long term investment [s. 8A(1)(a), ESC Act]</li> <li>• efficient costs of producing or supplying regulated goods or services and of complying with relevant legislation and relevant health, safety, environmental and social legislation applying to the regulated industry [s. 33(3)(b), ESC Act]</li> <li>• financial viability of the industry [s. 8A(b)(1), ESC Act]</li> </ul>	<ul style="list-style-type: none"> <li>• particular circumstances of the regulated industry and the prescribed goods and services for which the determination is being made [s. 33(3)(a), ESC Act]</li> <li>• return on assets in the regulated industry [s. 33(3)(c), ESC Act]</li> <li>• ensure that regulatory decision making and regulatory processes have regard to any differences between the operating environments of regulated entities [s. 4C(b), WI Act]</li> </ul>	<ul style="list-style-type: none"> <li>• in performing its functions and exercising its powers, the objective of the Commission is to promote the long term interests of Victorian consumers [s. 8(1), ESC Act] without derogating from that objective. The Commission must in seeking to achieve the objective have regard to the price, quality and reliability of essential services [s. 8(2), ESC Act]</li> <li>• enable customers or potential customers of the regulated entity to easily understand the prices charged by the regulated entity for prescribed services or the manner in which such prices are calculated, determined or otherwise regulated [cl 11(d)(i), WIRO]</li> <li>• provide signals about the efficient costs of providing prescribed services to customers (either collectively or to an individual customer or class of customers) while avoiding price shocks where possible [cl 11(d)(ii), WIRO]</li> <li>• take into account the interests of customers of the regulated entity, including low income and vulnerable customers [cl 11(d)(iii), WIRO]</li> </ul>

Continued next page

Table 1.1 (continued)

Benchmarking	Health, safety and social obligations	Other
<ul style="list-style-type: none"> <li>any relevant interstate and international benchmarks for prices, costs and return on assets in comparable industries [s. 33(3)(d), ESC Act]</li> </ul>	<ul style="list-style-type: none"> <li>the relevant health, safety, environmental and social legislation applying to the industry [s 8A(1)(d), ESC Act]</li> <li>to ensure that regulatory decision making has regard to the health, safety, environmental sustainability (including water conservation) and social obligations of regulated entities [s. 4C(c), WI Act]</li> </ul>	<ul style="list-style-type: none"> <li>the degree of, and scope for, competition within the industry, including countervailing market power and information asymmetries [s. 8A(1)(c), ESC Act]</li> <li>consistency in regulation between States and on a national basis [s. 8A(1)(f), ESC Act]</li> <li>the benefits and costs of regulation (including externalities and the gains from competition and efficiency) for—(i) consumers and users of products or services (including low income and vulnerable consumers) (ii) regulated entities [s. 8A(1)(e), ESC Act]</li> <li>wherever possible, to ensure that the costs of regulation do not exceed the benefits [s. 4C(a), WI Act]</li> </ul>

**Note:** References in the table are to the Water Industry Regulatory Order 2014 (WIRO), the Essential Services Commission Act 2001 (ESC Act), and the Water Industry Act 1995 (WI Act).

## 1.4 PREMO

PREMO stands for **P**erformance, **R**isk, **E**ngagement, **M**anagement, and **O**utcomes. Each element of PREMO is summarised in Box 1.1.

### Box 1.1 PREMO

Water businesses must demonstrate their level of ambition in delivering value for money for customers in their price submissions across the five PREMO elements:

- Performance — have the performance outcomes to which the business committed in the previous regulatory period been met or exceeded?
- Risk — has the business sought to allocate risk to the party best positioned to manage that risk? To what extent has the business accepted risk on behalf of its customers?
- Engagement — how effective was the business’s customer engagement to inform its price submission?
- Management — is there a strong focus on efficiency? Are controllable costs increasing, staying the same, or decreasing? Is the price submission succinct and free of material errors?
- Outcomes — do proposed service outcomes represent an improvement, the status quo, or a reduction of service standards?

First introduced at our 2018 water price review, the purpose of PREMO is to provide incentives for water corporations to deliver outcomes most valued by customers. PREMO includes reputation incentives, via the rating of price submissions as Leading (the highest available rating), Advanced, Standard or Basic, depending on the level of ambition expressed by a water business in its price submission. Financial incentives are provided by linking the return on equity to the PREMO rating.

A key priority under PREMO is to provide incentives for a water business to engage with customers to understand their priorities and concerns and take these into account in forming its proposals, as outlined in its price submission. These should be evidenced in price submissions by linking the outcomes proposed with findings from a business’s engagement.

Our guidance specifies the way in which we expect water corporations to assess themselves by reference to the PREMO elements.

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 framework rewards stronger customer value propositions in price submissions, and an early draft decision is available for price submissions we can assess in a short timeframe.<sup>9</sup>

For the 2023 water price review, a water corporation's ambition in terms of delivering customer value is being assessed against all five elements of PREMO — Performance, Risk, Engagement, Management and Outcomes. This is the first water price review where we are assessing the Performance element of the PREMO framework. The Performance element assesses businesses against their Outcomes and proposals from the previous price review (for our 2023 review, this means proposals at the 2018 water price review). We did not assess the Performance element in 2018 because it was the first time that we had applied the PREMO framework and so we did not have a set of approved Outcomes to inform our assessment.

Taking into account all five elements of PREMO, a water business must self-assess and propose a rating for its price submission as 'Leading', 'Advanced', 'Standard' or 'Basic'. Its proposed return on equity will then reflect its proposed PREMO rating. A 'Leading' submission has the highest return on equity, and a 'Basic' submission the lowest. We assess the self-rating and also assess the price submission more broadly, including the water corporation's justification for the proposed PREMO rating, and form our own view of the appropriate rating. This process determines the PREMO rating adopted and the return on equity reflected in the revenue requirement.<sup>10</sup>

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<sup>9</sup> In December 2022, we issued early draft decisions for Yarra Valley Water and Westernport Water.

<sup>10</sup> Essential Services Commission, *2023 water price review: Guidance paper*, pp. 41–46.



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

We have made our draft decision on South East Water's price submission after considering:

- South East Water's price submission
- South East Water's responses to our queries
- our consultants' reports
- written submissions from interested parties (a list of submissions is provided in Appendix A).

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

Our guidance included matters water corporations must address in their price submissions. South East Water's price submission addressed each of these matters. Our preliminary assessment of these matters is provided in this draft decision.

We found South East Water's price submission generally presented clear and comprehensive information to support its proposals. South East Water also provided evidence that its engagement sought to capture the main priorities and concerns of customers, and that it has taken this feedback into account (see Section 3.1 on customer engagement).

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



South East Water must submit a response to our draft decision and provide an updated financial model by 9 May 2023 (via email to [water@esc.vic.gov.au](mailto: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 South East Water in June 2023.

### 2.1 Draft decision paper outline

This decision paper is structured around the steps we take to arrive at our price determination. In summary, these steps are:

- Determine the regulatory period (Section 2.2).
- Confirm the customer outcomes and service levels that South East Water has committed to over the regulatory period (Chapter 3).

Our assessment of South East Water's price submission

- Establish South East Water’s revenue requirement using a building block methodology (Chapter 4).
- Use demand forecasts and the form of price control to convert the revenue requirement to tariffs and prices (Chapter 5).

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

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

## 2.2 Regulatory period

Our draft decision is to approve a regulatory period of 5 years from 1 July 2023.

We are required to set the term of the regulatory period over which a water business’s price determination will apply.<sup>11</sup> Our guidance proposed that we set a 5-year regulatory period, but also noted we were open to justified alternatives proposed in a price submission.<sup>12</sup>

South East Water proposed a regulatory period of 5 years. Accordingly, consistent with the reasons outlined in our guidance, our draft decision proposes to set a regulatory period of 5 years.

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<sup>11</sup> This is a requirement of the WIRO, clause 9.

<sup>12</sup> For detail on the reasons for using 5 years as the default regulatory period, see: Essential Services Commission, *2023 water price review: Guidance paper*, p. 18.

## 3. Customer outcomes

The customer outcomes South East Water plans to deliver over the regulatory period are a key component of its price submission – confirming its commitments to customers, underpinning its revenue requirement, and feeding in to its PREMO assessment.

This chapter:

- examines South East Water’s engagement with its customers in preparing its price submission
- reviews whether South East Water has delivered on the outcomes it committed to for the current regulatory period (2018–23) and examines the customer outcomes South East Water is committing to for the next regulatory period
- outlines South East Water’s proposed service standards
- outlines South East Water’s proposed guaranteed service levels.

### 3.1 Customer engagement

Our guidance required South East Water to engage with customers to inform its price submission. Our guidance also identified principles to guide South East Water’s engagement.<sup>13</sup>

We consider South East Water’s engagement aligned with these principles in a number of ways. South East Water:

- engaged early and sought customer insight on the design of its engagement program, which ran between December 2020 and May 2022
- engaged over 8,500 customers and stakeholders using a wide range of engagement methods such as surveys, interviews, focus groups, willingness to pay studies, workshops, a 34-member deliberative community panel, and its Customer and Community Advisory Council (which has been meeting since 2018 to represent the views of customers)
- used engagement methods suitable to the issues and context it was seeking to engage on, including discussions to learn the values and concerns of different customer groups including customers experiencing vulnerability, newly financially vulnerable customers, culturally and linguistically diverse customers, tenants and small business owners
- tailored its engagement methods to the terms proposed by its First Nations customers and considered specific feedback from these customers at the community panel where recommendations to the business were made

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<sup>13</sup> Essential Services Commission, *2023 water price review: Guidance paper*, p. 20.

- engaged on matters that influence services and prices, such as service disruptions and sewer spills, digital meters, affordability, integrated water management, water conservation education, environment and climate change.

More detail on South East Water’s engagement is available in its price submission.<sup>14</sup>

Actions proposed to be taken by South East Water provides evidence that its engagement influenced its proposals. For example, in its price submission, South East Water proposed:

- a price decrease in real terms, in response to a community panel recommendation following feedback from surveys and focus groups that affordability and assistance for customers experiencing vulnerability should be considered and supported<sup>15</sup>
- investment to further develop and deliver its water literacy strategy to build community water knowledge and reduce water bills through behaviour change, in response to feedback that customers valued improved water security awareness<sup>16</sup>
- a digital metering program for the installation of new digital meters to all its customer base to assist in the identification of problems at an earlier stage leading to fewer disruptions and water savings, in response to a recommendation with strong support from the community panel and results from the willingness to pay analysis<sup>17</sup>
- investment in capacity building to improve engagement Traditional Owners on land and water decision making, in response to feedback South East Water work more collaboratively with Traditional Owners on water and land planning and management.
- the design and construction of a biofactory to assist capacity flow limitations and to support emission reductions, in response to customer and panel feedback on ensuring reliable and innovative services<sup>18</sup>
- two new guaranteed service levels paid directly to affected customers for water spills inside a customer’s house and for failure to notify any planned water supply interruption, developed in collaboration with its customer panel.<sup>19</sup>

The influence of South East Water’s engagement on its proposals supports the objectives in our pricing framework relating to efficiency and the interests of consumers.

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<sup>14</sup> South East Water’s price submission is available on our website at [www.esc.vic.gov.au](http://www.esc.vic.gov.au).

<sup>15</sup> South East Water, 2023–28 Price Submission, September 2022, p. 28.

<sup>16</sup> South East Water, 2023–28 Price Submission, September 2022, p. 30 and p. 38.

<sup>17</sup> South East Water, 2023–28 Price Submission, September 2022, p. 30.

<sup>18</sup> South East Water, 2023–28 Price Submission, September 2022, p. 80.

<sup>19</sup> South East Water, 2023–28 Price Submission, September 2022, p. 43.

Overall, our preliminary view is that South East Water has designed and delivered a robust and thorough engagement program and achieved strong customer and stakeholder influence on its proposals.

South East Water provided its customers a fair opportunity to participate, with its engagement representative of its customer base. It provided for dedicated focus groups for customers with a disability or high medical needs, and customers experiencing vulnerability.

Its engagement approach with First Nations customers and customers experiencing vulnerability was sensitive and appropriate, consistent with the expectations we set out in our guidance. It allowed for these groups and all customers who participated in the early stages of engagement to self-determine the level of involvement and participation in the price submission.

Our preliminary view is that we consider that South East Water designed methods and materials that were well suited to the issues it engaged on.

South East Water convened a 6-day community panel to form recommendations from insights from earlier research studies. We received a positive submission from the Consumer Action Law Centre regarding the quality of the guidance South East Water provided to community panel members to support them in this task.<sup>20</sup> We agree with this feedback and consider that information and materials developed by South East Water were of a high quality, including dedicated training to ensure panel members understood the information provided to them.

South East Water's engagement was influential on its price submission. Its engagement was informed and stewarded by South East Water's Customer and Community Advisory Council, a representative council of its customer base and local community established in 2018. This group played an active role in the early planning of South East Water's engagement, and helped ensure feedback on customer priorities was addressed in South East Water's price submission.

We also received feedback from customer panel members who commented favourably on the alignment between their recommendations and the proposals in the submission.

Based on the above, our preliminary view is that we agree with South East Water's self-rating of 'Advanced' for its price submission engagement.

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

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<sup>20</sup> Consumer Action Law Centre, Initial Feedback: 2023–28 Water Price Review, 1 December 2022, p. 7.

## 3.2 Outcomes

### 3.2.1 Performance against outcome commitments 2018–23

As part of our 2018 water price review, South East Water established ‘outcomes’ it would deliver customers over the following 5 years. These outcomes were reflected in the prices we approved for the period 1 July 2018 to 30 June 2023. Progress against these outcome commitments can indicate whether customers got what they paid for.

A business’s price submission should account for its actual performance against its outcome commitments for the current period, from 1 July 2018 to 30 June 2023.<sup>21</sup>

We consider South East Water accounted for its annual performance for each measure in its price submission. Table 3.1 lists South East Water’s outcome commitments and includes its annual performance results as reported in its price submission and the period-to-date rating published in our 2021-22 Outcomes report.<sup>22</sup> The information in this table informs our assessment under the Performance element of PREMO, which is discussed in Chapter 7.

**Table 3.1 Business self-assessment of performance against Outcome commitments**

Outcome	2018-19	2019-20	2020-21	2021-22	Period to date <sup>a</sup>
Get the basics right, always	Green	Green	Green	Green	Green
Warn me, inform me	Green	Green	Green	Green	Green
Fair and affordable for all	Green	Amber	Green	Green	Green
Make my experience better	Green	Green	Amber	Amber	Amber
Support my community, protect my environment	Green	Green	Amber	Amber	Amber

**Note:** Green = achieved target; Amber = close to achieving target; Red = failed to meet target. <sup>a</sup> This is South East Water’s self-assessment of its performance across the first 4 years of the current regulatory period. South East Water’s performance against Outcome commitments in the final year of the current regulatory period (2022-23) will be published in our 2022-23 Outcomes Report.

Source: South East Water, 2023 water price submission, September 2022, p. XX; Essential Services Commission, South East Water’s outcomes performance 2021-22, October 2022.

<sup>21</sup> Essential Services Commission, 2023 water price review: Guidance paper, 26 October 2021, p. 23.

<sup>22</sup> South East Water provided a period-to-date rating for the purpose of compiling our 2021-22 Outcomes report.

Over the first 4 years of the current regulatory period, South East Water either achieved, exceeded (or was within its tolerance band) for 66 of its 72 measures.<sup>23</sup>

Of the 10 major projects proposed for the 2018–23 regulatory period, 4 were completed on time and 2 are delayed, with the remaining 4 projects delayed or deferred to 2023–28.<sup>24</sup> South East Water noted that several factors contributed to the variations in its actual capital expenditure program in the current regulatory period. Refer to Section 4.2 ‘Capital Expenditure’ for more information on its actual capital expenditure.<sup>25</sup>

As part of our annual outcomes reporting, South East Water provided clear explanations where it had underperformed. In our annual outcomes review process, we also considered South East Water’s self-assessments of its performance against outcomes were reasonable. South East Water reports its performance quarterly to its customers via its website and annually to us via our outcome reporting process.<sup>26</sup>

Based on the above factors, our draft decision is that we agree with South East Water’s self-assessment that it has, overall, met its outcome commitments for the period to date.

### 3.2.2 Outcome commitments for 2023–28

South East Water engaged with its customers to refine its outcomes for the period from 1 July 2023 to 30 June 2028. It has established five customer outcomes it proposes to deliver:

- ‘Get the basics right, always’
- ‘Warn me, inform me’
- ‘Fair and affordable for all’
- ‘Make my experience better’
- ‘Support my community, protect our environment’.<sup>27</sup>

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<sup>23</sup> For more detail on the tolerance bands South East Water has established, see South East Water, 2023 water price submission, Appendix 3 Performance self-assessment framework, September 2022, p. 176–179. For information on South East Water’s assessment of its performance, see South East Water, 2023 water price submission, September 2022, p. 19.

<sup>24</sup> Essential Services Commission, *Status of Major Projects Supplement: Outcomes report 2021-22*, 18 October 2022, pp. 51–53. South East Water’s major projects status is reported by the business as part of our annual outcomes reporting process, as part of its commitment to communicate the delivery of its major projects to its customers. The business’s comments are not audited by the commission.

<sup>25</sup> South East Water, 2023 water price submission, September 2022, Appendix 2: *Major projects (2018–23) summary report*, p. 154–175.

<sup>26</sup> South East Water, 2023 water price submission, September 2022, p. 19.

<sup>27</sup> South East Water, 2023 water price submission, September 2022, p. 36–42.

Among the key initiatives to deliver on its commitments are maintaining reliable services, catering for expected growth, scaling up its digital metering, and modernising its business systems to improve its efficiency and responsiveness to customers. This includes putting systems in place to make it easier for customers to pay bills or move house and for it to give customers information when they need it. In addition, it will embed climate resilience into the way it designs and operates its assets.

### 3.2.3 Our assessment of measures and targets

South East Water proposed a set of 16 measures and targets that it will use to report on performance across the 5 outcomes. These are set out on pages 36 to 42 of its price submission. Performance against these measures will inform our assessment during future price reviews.

We have assessed South East Water's proposed measures against the criteria set out in our guidance which states that proposed output measures for each outcome must:

- be relevant to, or be a reasonable proxy for, the delivery of the outcome they represent
- be measurable
- be clearly defined and unambiguous
- be easy for customers to understand
- have performance targets listed for each year of the regulatory period.<sup>28</sup>

Evidence provided by South East Water demonstrates that its measures and targets were developed in consultation with its customers, and that they are supported by its customers.<sup>29</sup>

Generally, we consider South East Water's intentions are clear, and its measures and targets will provide a sound basis to track performance and delivery against each outcome. There are some matters we will follow up with South East Water in order to improve the clarity of targets.

We will provide South East Water with our standard Outcomes Reporting Template, identifying these matters, to complete and submit with its response to this draft decision. We will work with the business to ensure the final set of measures addresses the above matters and complies with our guidance requirements.

South East Water's proposed targets for its outcome measures suggest an overall improvement in customer value.

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<sup>28</sup> Essential Services Commission, 2023 water price review: Guidance paper, 26 October 2021, p. 23.

<sup>29</sup> As part of its price submission customer engagement, customers told South East Water that its existing outcomes should remain and endorsed its associated measures, targets and preferred proposals. South East Water, 2023 water price submission, September 2022, p. 24–33.



South East Water has committed to reporting its performance on its website every 6 months, and annually via our outcome reporting process. It has also committed to providing a 6-monthly update to its Customer and Community Advisory Council.<sup>30</sup>

A submission mentioned the lack of input from Traditional Owners on the outcomes proposed by South East Water.<sup>31</sup>

South East Water has committed to improving its engagement with Traditional Owners in water and land planning management and our draft decision incorporates South East Water's proposal for funding to improve its engagement with Traditional Owners through improved cultural competency for its staff and to support the capacity of Traditional Owner groups to collaborate in these areas of planning.

We have observed improvements from water businesses in terms of engagement with Traditional Owners and aboriginal communities. And we expect that this will be an ongoing area of focus by South East Water and other water businesses.

On the basis that South East Water's proposal suggests an overall improvement in customer value and that its proposed outcomes appear to be supported by its customers, our draft decision is to accept South East Water's self-assessment of 'Advanced' for the Outcomes element of PREMO, which is discussed further in Chapter 7.

### **3.3 Service standards relating to service reliability and faults**

Service standards are a common set of services applicable to all Victorian consumers required under clause 18.2 of the *Water Industry Standard – Urban Customer Service* (Water Industry Standard). Each water business must specify its own service levels against each of these service standards. Rather than performance measures, these service standards and corresponding service levels are the minimum level of service customers can expect to receive.

South East Water's service standards relating to reliability and faults can be found on page 2 of its proposed service standards 2023–28 document.<sup>32</sup>

The service standards proposed by South East Water are the same as those for the current 2018–23 regulatory period (with some wording changes required by the updated Water Industry Standard). The service levels proposed are also the same as for the current regulatory period.

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<sup>30</sup> South East Water, 2023 water price submission, September 2022, p. 42.

<sup>31</sup> Rahimi, Ali, submission to the Essential Services Commission on South East Water's 2023 price submission, 11 October 2022.

<sup>32</sup> South East Water, Proposed service standards 2023–28, February 2023, p. 2.

South East Water has also provided the minimum flow rate as required by the Water Industry Standard.

On this basis, our preliminary assessment is that the service standards relating to reliability and faults proposed by South East Water comply with the requirements of the Water Industry Standard.

Service standards are approved in our Water Industry Standard. Accordingly, in early 2023-24, we will update the Water Industry Standard to reflect approved Service Standards.

### 3.4 Guaranteed service levels

Our draft decision is to accept South East Water's proposed guaranteed service levels.

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

South East Water's proposed guaranteed service levels are set out on pages 43 to 45 of its price submission and in additional information submitted on 1 December 2022.<sup>33</sup> It has proposed to retain seven of its eight existing service levels. Based on its engagement, it will introduce two new guaranteed service levels paid directly to affected customers:

- A payment of \$1,500 if a water spill inside a customer's house is caused by South East Water in recognition of the significant damage and inconvenience that this can cause. This guaranteed service level was the result of engagement with customers directly affected by this type of event.
- A payment of \$60 for failure to provide a minimum of 48 hours' notice to a customer of any planned water supply interruption impacting their property following feedback from customers that advanced notice of works was important.

Additionally, it has proposed a new guaranteed service level for water quality events. When water quality advisories are issued it proposes a community rebate of:

- \$5,000 for small, localised events impacting less than 50 customers
- \$10,000 for each affected postcode for advisories that affect more than 50 customers.

The proposal for the new community rebate has been developed in consultation with Yarra Valley Water, Greater Western Water and Melbourne Water with the aim of achieving consistency for customers affected by system wide events that could impact different parts of Melbourne.

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<sup>33</sup> South East Water, Additional information on 2023 water price submission: Water quality GSL, 1 December 2022

South East Water's proposes allocating the rebate amounts through its existing community grants program, prioritising community groups affected by the water quality event, or which provide customer support to when water quality events occur.

South East Water has also enhanced two of its existing guaranteed service levels:

- For the guaranteed service level relating to unplanned interruptions (a \$60 payment per disruption after the first five disruptions), it will count the interruptions across both water and sewer assets whereas previously these were counted separately. It will also retain the existing guaranteed service level relating to sewerage service interruptions to ensure no customer is worse off combining the measures.
- For the guaranteed service level relating to sewer spills within the house, it will double the payment from \$1,500 to \$3,000. It will also remove the time threshold of one hour for clean-up, meaning payment will be made regardless of how quickly the spill is cleaned up.

To better incentivise compliance with the guaranteed service levels, South East Water has not included costs associated with the proposed guaranteed service level scheme in its proposed revenue requirement. As a result, where South East Water does not meet the required level of service, it will absorb the cost.

Our draft decision is to accept South East Water's proposed guaranteed service levels on the basis that they have been agreed with customers during its engagement. Final guaranteed service levels and rebates will be subject to our consideration of any feedback following the release of our draft decision.

Guaranteed service levels are approved in our water industry standards. Accordingly, in early 2023-24, we will update the standards to reflect the guaranteed service levels published in our final decision.

## 4. Revenue requirement

The revenue requirement is the forecast amount a water corporation needs to deliver on customer outcomes, government policy, statements of obligations, and obligations monitored by technical regulators including the Environment Protection Authority Victoria and the Department of Health.<sup>34</sup> Along with forecast demand, it is an input to calculating prices.

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

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

Our draft decision adopts a revenue requirement of \$4,631.5 million, compared to the \$4,633 million proposed by South East Water.

South East Water proposed a revenue requirement of \$4,633 million over a 5-year period starting 1 July 2023. Our draft decision adopts a revenue requirement of \$4,631.5 million.<sup>35</sup>

Our draft decision incorporates some proposed changes to the treatment of operating and capital expenditure, compared to South East Water's price submission.

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<sup>34</sup> We met with officers of the Department of Energy, Environment and Climate Action, the Department of Health, and the Environment Protection Authority Victoria, to discuss their expectations of South East Water in the regulatory period from 1 July 2023. We had regard to their views in arriving at our draft decision.

<sup>35</sup> The revenue requirement is the forecast amount a water corporation needs to deliver on customer outcomes, government policy, and obligations monitored by technical regulators including the Environment Protection Authority Victoria and the Department of Health. Along with forecast demand, it is an input to calculating the prices to be charged by a water business.

After lodging its price submission, our review of South East Water's 2021-22 regulatory accounts identified that its price submission incorrectly classified several operating expenditure items as capital expenditure. This included corporate or overhead items such as insurance. We have corrected for this in our draft decision (Section 4.1.1).

During our review, South East Water identified and advised us of other changes to its policy for the treatment of costs as either operating or capital in nature for pricing purposes.

To help ensure that customer prices reflect the appropriate allocation of costs, in its response to our draft decision South East Water must explain its approach to the treatment of expenditure as operating or capital, identifying any changes in approach that impacted its estimated costs or forecasts from the start of the 2018–23 regulatory period. As well as informing the starting point for base year (2021-22) operating costs, this will inform our final decision on the capital expenditure amounts used to calculate South East Water's closing regulatory asset base at 30 June 2022.

Our draft decision also proposes some relatively minor adjustments to South East Water's operating and capital expenditure forecasts that it must take into account in its response to our draft decision. South East Water must respond to our draft decision and propose individual tariffs that reflect our initial views on the revenue requirement. South East Water's response will determine the price and bill impact of our draft decision on individual tariffs and customer groups.

Our proposed adjustments are summarised in Table 4.1. Table 4.2 sets out the revenue requirement and component benchmarks adopted for our draft decision.

**Table 4.1 Our proposed adjustments to South East Water's proposed revenue requirement**  
\$ million 2022-23

	2023-24	2024-25	2025-26	2026-27	2027-28	Total
<b>A. South East Water's proposed revenue requirement</b>	<b>944.2</b>	<b>923.4</b>	<b>921.6</b>	<b>917.5</b>	<b>926.3</b>	<b>4,633.0</b>
B. Operating expenditure <sup>a</sup>	3.9	3.9	3.9	3.8	3.8	19.4
C. Return on assets	-2.0	-1.9	-1.9	-1.9	-1.9	-9.6
D. Regulatory depreciation	-2.2	-2.0	-1.8	-1.9	-2.0	-10.0
E. Tax allowance	-0.4	-0.3	-0.2	-0.2	-0.2	-1.3
<b>F. Draft decision – revenue requirement (A+B+C+D+E)</b>	<b>943.6</b>	<b>923.1</b>	<b>921.5</b>	<b>917.3</b>	<b>926.0</b>	<b>4,631.5</b>

**Note:** Numbers have been rounded. Our proposed adjustments are the differences between our draft decision and what South East Water proposed in its price submission. Row A shows the total revenue requirement proposed by South East Water in its price submission. We have arrived at our draft decision (row F) by proposing the relevant adjustments to the components of the revenue requirement shown in rows B to E. <sup>a</sup> These adjustments relate to South East Water's approved regulatory accounts (see Section 4.1) and our review of South East Water's proposed cost adjustments (see Section 4.1.1.3). Our draft decision on South East Water's operating expenditure is subject to our consideration of further information on the changes in South East Water's capitalisation policy.

**Table 4.2 Draft decision on South East Water's revenue requirement**  
\$ million 2022-23

	2023-24	2024-25	2025-26	2026-27	2027-28	Total
Operating expenditure	701.2	696.4	699.6	686.1	681.1	3,464.4
Return on assets	106.1	103.1	104.0	105.1	107.0	525.4
Regulatory depreciation	119.0	109.4	105.0	110.8	121.6	565.8
Adjustments from last period	0.0	0.0	0.0	0.0	0.0	0.0
Tax allowance	17.2	14.3	12.9	15.3	16.2	76.0
<b>Draft decision – revenue requirement</b>	<b>943.6</b>	<b>923.1</b>	<b>921.5</b>	<b>917.3</b>	<b>926.0</b>	<b>4,631.5</b>

**Note:** Numbers have been rounded.

Our final decision on South East Water's revenue requirement will be based on the latest available information. Accordingly, as well as responding to our draft decision and providing an updated price schedule, South East Water must update its revenue requirement and prices to reflect our updates to estimates for the cost of debt and inflation, which we will advise in April 2023.

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 that impact on its forecast costs and the revenue requirement, South East Water should update its price submission and provide us with an updated financial model. It also should notify us of any material changes that impact its forecast costs, revenue requirement or prices (including demand). Any updates to its submission or pricing model will be made publicly available on our website.

## 4.1 Operating expenditure

Our draft decision is to adopt a forecast for operating expenditure of \$3,464.4 million, which is higher than the \$3,445 million proposed by South East Water.

Operating expenditure is a component of the revenue requirement. South East Water's price submission provides detail on its forecast operating expenditure from pages 94 to 106.

We assess both:

- controllable operating expenditure – comprising all costs that can be directly or indirectly influenced by a water corporation's decisions
- non-controllable operating expenditure – comprising all costs that cannot be directly or indirectly influenced by a water corporation's decisions.

We engaged FTI Consulting to provide expert advice to inform our assessment of controllable operating expenditure. FTI Consulting's report on its assessment of South East Water's expenditure forecast is available on our website.<sup>36</sup>

Table 4.3 sets out our draft decision on South East Water's forecast operating expenditure, for the purpose of establishing the revenue requirement outlined in Table 4.2.

As noted above, our process for approving South East Water's 2021-22 regulatory accounts identified that it had incorrectly classified several operating expenditure items as capital expenditure in its price submission. Correcting for this results in a net increase of \$4.35 million to South East Water's 2021-22 baseline controllable operating expenditure, with a resulting increase of \$21.05 million in forecast controllable operating expenditure for the 2023–28 regulatory period, which is reflected in Table 4.3.

As described in Section 4.1.1.1 below, our draft decision proposes to adopt the controllable operating expenditure benchmarks set out in Table 4.3.

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<sup>36</sup> FTI Consulting, *South East Water – Expenditure Review for 2023 water price review*, February 2023.

**Table 4.3 Draft decision – operating expenditure**

\$ million 2022-23

	2023-24	2024-25	2025-26	2026-27	2027-28	Total
<b>Controllable operating expenditure</b>	<b>163.69</b>	<b>163.29</b>	<b>163.99</b>	<b>162.48</b>	<b>161.51</b>	<b>814.96</b>
<b>Non-controllable operating expenditure</b>	<b>537.52</b>	<b>533.11</b>	<b>535.60</b>	<b>523.59</b>	<b>519.59</b>	<b>2,649.42</b>
Bulk services <sup>a</sup>	494.56	491.40	494.88	483.74	480.87	2,445.45
Environmental contribution <sup>b</sup>	42.19	40.97	39.77	38.61	37.49	199.03
Licence fees – Essential Services Commission <sup>c</sup>	0.41	0.38	0.58	0.87	0.87	3.12
Licence fees – Department of Health <sup>c</sup>	0.07	0.07	0.07	0.07	0.07	0.35
Licence fees – Environmental Protection Authority <sup>c</sup>	0.29	0.29	0.29	0.29	0.29	1.46
<b>Draft decision – operating expenditure</b>	<b>701.22</b>	<b>696.40</b>	<b>699.59</b>	<b>686.07</b>	<b>681.11</b>	<b>3,464.38</b>

**Notes:** Numbers have been rounded. <sup>a</sup> Bulk services covers the supply of bulk water and sewerage services.

<sup>b</sup> Environmental contributions are funds collected from water businesses under the *Water Industry Act 1994*. <sup>c</sup> Licence fees are paid to cover costs incurred by the Department of Health, the Environment Protection Authority Victoria, and the Essential Services Commission in their regulatory activities related to the water business.

Table 4.4 summarises how our draft decision on South East Water's operating expenditure (row D) and its two components differ from the operating expenditure proposed by South East Water in its price submission (row A). Rows B and C of the table summarise our proposed adjustments to South East Water's proposed controllable and non-controllable operating expenditure.

Details of our assessment and reasons for our proposed adjustments to South East Water's proposal are included in Section 4.1.1 (controllable operating expenditure) and Section 4.1.2 (non-controllable operating expenditure).

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



**Table 4.4 Our proposed adjustments to South East Water’s proposed operating expenditure**  
\$ million 2022-23

	2023-24	2024-25	2025-26	2026-27	2027-28	Total
<b>A. South East Water’s proposed total operating expenditure</b>	<b>697.27</b>	<b>692.50</b>	<b>695.74</b>	<b>682.23</b>	<b>677.28</b>	<b>3,445.02</b>
<b>B. Our total proposed adjustments to controllable operating costs (B1 + B2)</b>	<b>3.95</b>	<b>3.90</b>	<b>3.86</b>	<b>3.84</b>	<b>3.82</b>	<b>19.37</b>
B1 – Reconciliation and reclassification of capital expenditure to baseline operating expenditure	4.28	4.24	4.19	4.18	4.16	21.05
B2 – Water literacy	-0.34	-0.34	-0.34	-0.34	-0.34	-1.68
<b>C. Our total proposed adjustments to non-controllable operating costs</b>	<b>0.00</b>	<b>0.00</b>	<b>0.00</b>	<b>0.00</b>	<b>0.00</b>	<b>0.00</b>
<b>D. Draft decision – total operating expenditure (D = A + B + C)</b>	<b>701.22</b>	<b>696.40</b>	<b>699.59</b>	<b>686.07</b>	<b>681.11</b>	<b>3,464.38</b>

**Notes:** Our proposed adjustments are the differences between our draft decision and what South East Water proposed in its price submission. Row A shows the total operating expenditure proposed by South East Water in its price submission. We have arrived at our draft decision (row D) by proposing the relevant adjustments to controllable operating costs shown in row B (and itemised in rows B1 and B2). Numbers have been rounded.

#### 4.1.1 Controllable operating expenditure

South East Water proposed a total forecast controllable operating expenditure of \$795.6 million over a 5-year regulatory period. For the reasons set out below, we propose to adopt a forecast operating expenditure of \$815.0 million for the 2023–28 regulatory period, which is \$19.4 million higher than proposed by South East Water.

South East Water’s forecast controllable operating expenditure for the period from 1 July 2023 is estimated through a series of steps:

1. Establish a controllable operating expenditure baseline – the baseline comprises the efficient recurring costs from the last full year of data (2021-22) after non-controllable expenditure, one-off items are removed or normally occurring items are added in.
2. Apply a growth rate for operating expenditure for the regulatory period – assumed by South East Water to be ranging between 0.60 per cent and 1.61 per cent each year (an average of 1.13 per cent per year).

3. Apply an annual cost efficiency improvement rate – assumed by South East Water to be 2.0 per cent per year.
4. Make adjustments for additional costs or cost saving expected in future years.

#### **4.1.1.1 Baseline controllable operating expenditure**

South East Water proposed a controllable operating expenditure baseline of \$144.4 million, after removing \$2.5 million in non-recurring operating expenditure that occurred in 2021-22. South East Water's proposed baseline is \$3.8 million (or 3 per cent) higher than the benchmark figure of \$140.6 million of controllable operating expenditure for 2021-22 used for our 2018 price determination.

However, with the adjustment described above to reflect the changes following the approval of South East Water's 2021-22 regulatory accounts, the controllable operating expenditure baseline increases to \$148.8 million which is \$8.2 million (or 6 per cent) higher than the 2018 determination benchmark figure.

Our expenditure consultant requested substantiation of South East Water's increase in expenditure compared to its baseline year operating expenditure benchmark set in the 2018 price review.<sup>37</sup> South East Water explained the increase was mainly due to reclassification of operating and capital expenditure due to a review of its capitalisation policy and a review of its corporate overhead charge-out policy. These reviews resulted in expenditure of \$5.5 million and \$6.1 million respectively that had previously been capitalised now being treated as operating expenditure. South East Water stated that if its 2018 benchmark allowance was adjusted to take into account these reclassifications, its baseline spend of \$148.8 million would be below \$3.5 million (or 2.6 per cent) below such an adjusted benchmark allowance.

In response to our draft decision, we require South East Water to provide a more detailed explanation on the changes to its capitalisation policy and how these associated expenditure items have been classified previously for pricing purposes – specifically whether they were already included in the operating expenditure baseline, and therefore the benchmark figure for 2021-22, from the 2018 price determination. South East Water's response will also inform our final decision on South East Water's closing regulatory asset base (see Section 4.3.1).

While noting the commission's intention to clarify the allocation of these costs, our expenditure consultant verified they were recurring and found South East Water's substantiation of them to be reasonable. On this basis, it recommended no adjustments to South East Water's proposed baseline increase, subject to the commission's further consideration of South East Water's capitalisation policy.

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<sup>37</sup> FTI Consulting, *South East Water – Expenditure Review for 2023 water price review*, February 2023, pp. 23–24.

We reviewed South East Water's proposal and the advice from our expenditure consultant. While we understand the explanation provided by South East Water accounts for the rise in its baseline year operating expenditure, we are not satisfied it has adequately described the nature and timing of these shifts in capitalisation policy, and how they correlate with the baseline and 2021-22 benchmarks established at the 2018 price review.

Accordingly, we have not been able to confirm that the baseline of \$148.8 million (after reconciling with the regulatory accounts) reflects an efficient baseline cost to forecast annual operating expenditure. However, we have adopted the adjusted figure of \$148.8 million for the purposes of establishing South East Water's revenue requirement for our draft decision (Table 4.2).

#### **4.1.1.2 Efficiency improvement and growth rate**

South East Water proposed an average efficiency improvement rate on its controllable operating costs of 2.0 per cent per annum. This is the highest rate when compared with other businesses in the current price review.

South East Water expects this efficiency rate to be achieved through several measures such as a revised maintenance model, its digital utility program, and more efficient contracting arrangements, which is anticipated to deliver an overall reduction in controllable expenditure of \$22.5 million over the next regulatory period.

As the efficiency improvement rate (2.0 per cent per annum) is higher than South East Water's proposed average cost growth rate (an average of 1.13 per cent per annum) for the next regulatory period, this will effectively deliver a net annual decrease to its controllable baseline operating costs in each year of the regulatory period.

#### **4.1.1.3 Cost adjustments**

South East Water has proposed additional forecast operating expenditure above the annual baseline. This included amounts for upgraded water recycled treatment plants, improvements to water quality and changes to its maintenance model. In total, these costs represent an additional \$96.0 million over the 5-year regulatory period, or an average of \$19.2 million per annum.

Our expenditure consultant assessed each forecast variation against criteria for prudent and efficient operating expenditure and was mostly satisfied each item was appropriately costed and supported by internal documentation, which included evidence of its prudence and efficiency. It therefore considered that South East Water's proposed additions were mostly reasonable and recommended only one change to the additional operating expenditure items proposed by South East Water.

For South East Water's proposed \$1.68 million step change for water literacy, our expenditure consultant noted that this was supported by South East Water's community panel during the

engagement process for its price submission and was intended to support the development and execution of South East Water's water literacy strategy and build community water knowledge.

While the reasoning for this initiative was clearly outlined, our consultant was not satisfied the information provided by South East Water clearly explained how this strategy would be delivered. Our consultant has therefore recommended an adjustment to South East Water's controllable operating expenditure to remove the \$1.68 million step change that relates to water literacy.

In addition to the views of our consultant, we consider there is flexibility for businesses to change the focus of programs and strategies over time, within its revenue requirement. As well, the likelihood of a relatively high inflation figure to be added to 2023–24 real prices (compared to the long run forecast of 3 per cent adopted in our pricing model) should provide South East Water with scope to undertake activities such as these.

Based on this and considering the views of our expenditure consultant, our draft decision proposes to remove the \$1.68 million step change for water literacy.

We have considered the advice from our expenditure consultant, and South East Water's proposal. But for the step change for water literacy, our draft decision accepts South East Water's other proposed step changes as we consider they have justified the prudence and efficiency of them.

Further, there is evidence that South East Water has significantly tested its controllable expenditure requirements, resulting in a forecast overall decline (excluding inflation) in controllable operating expenditure per customer connection across the 2023–28 regulatory period.

#### **4.1.2 Non-controllable operating expenditure**

Our process for establishing non-controllable operating expenditure involves:

- obtaining the most recent information from the relevant regulatory authorities on their licence fees and the environmental contribution
- adjusting the forecasts proposed by South East Water where required.

The values we have adopted for our draft decision are set out above in Table 4.3.

South East Water has proposed \$2,649.4 million in non-controllable operating expenditure over the 2023–28 regulatory period. This is a decrease of \$310.9 million compared to the 2018–23 regulatory period, driven by a \$285.6 million decrease in external bulk charges, and a decrease of \$25.2 million due to forecast decreases in the real value of the environmental contribution.

Our guidance paper sets out our approach for businesses to forecast their non-controllable operating costs. We consider businesses should forecast licence fees for the Department of Health, the Environment Protection Authority Victoria and the Essential Services Commission to remain flat in real terms, and for the environmental contribution to remain flat in nominal terms

(decline in real terms) across the 2023–28 regulatory period. South East Water has followed this approach in its price submission. We will review these figures prior to our final decision.

For the purpose of calculating the revenue requirement for our draft decision, we have accepted South East Water’s proposed non-controllable operating expenditure. We have verified that South East Water’s forecast bulk charges are consistent with Melbourne Water’s 2021 price determination and prior to making our final decision, we will update the forecast licence fee and environmental contribution values with the relevant regulatory bodies and adjust where necessary for the latest inflation and external bulk charges data.

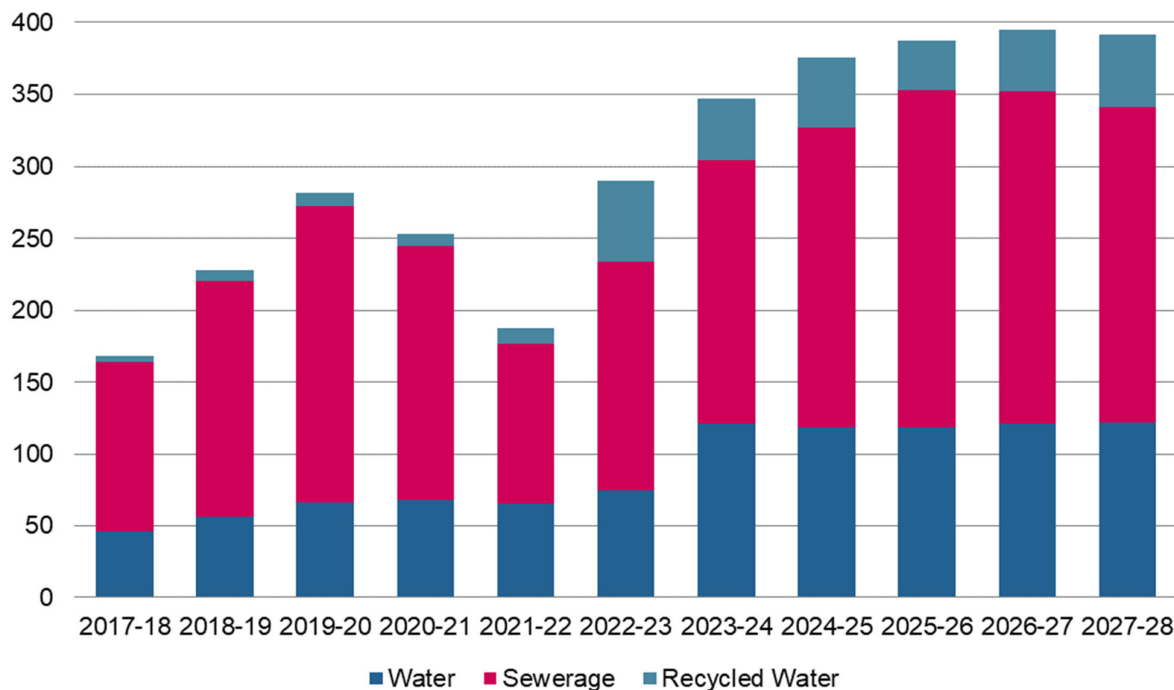
## 4.2 Capital expenditure

Our draft decision is to adopt a forecast capital expenditure of \$1,897.6 million between 2023-24 and 2027-28, which is less than the \$1.92 billion proposed by South East Water.

Capital expenditure is an input to estimating the regulatory asset base, which is an input to the revenue requirement. South East Water’s forecast capital expenditure and supporting information is provided at pages 68 to 93 of its price submission.

Figure 4.1 shows South East Water’s actual gross capital expenditure for 2017-18 and the first 4 years of the current regulatory period (2018-19 to 2021-22) and forecast gross capital expenditure from 2022-23 to 2027-28. The first 5 years of actual expenditure shown in Figure 4.1 (2017-18 to 2021-22) are relevant to the calculation of the closing regulatory asset base discussed in Section 4.3.1.

**Figure 4.2 Gross capital expenditure by service category**  
\$ million 2022-23



**Note:** This graph shows actual figures for 2017-18 to 2021-22, and South East Water's forecasts for 2022-23 to 2027-28.

We engaged FTI Consulting to provide expert advice to inform our assessment of capital expenditure. FTI Consulting's report on its assessment of South East Water's expenditure forecast is available on our website.<sup>38</sup>

#### 4.2.1 Actual capital expenditure

The PREMO framework involves reviewing a business's actual performance over the current regulatory period, against its proposals and commitments made to its customers in its previous price submission. This includes a comparison of its actual capital expenditure against the approved expenditure forecasts for the current regulatory period.

Our review of South East Water's annual regulatory accounts identified some necessary changes to the capital expenditure it proposed in its price submission. This resulted in a \$1.9 million decrease in actual capital expenditure in 2021-22, and removal of \$4.7 million in forecast capital expenditure each year from 2022-23 to 2027-28 (Table 4.5 and discussed below in Section 4.2.2). We propose to accept this change for the purpose of our draft decision regarding capital

<sup>38</sup> FTI Consulting, *South East Water: Review of expenditure forecasts - 2023 Water Price Review*, February 2023.

expenditure because it is consistent with the audited regulatory accounts (see Section 4.3.1). Our assessment below reflects these revised figures.

**Table 4.5 Our proposed adjustments to South East Water’s proposed prescribed capital expenditure**  
\$ million 2022-23

	2017-18	2018-19	2019-20	2020-21	2021-22	2022-23	Total
<b>South East Water’s proposed prescribed capital expenditure</b>	<b>168.65</b>	<b>227.81</b>	<b>281.93</b>	<b>253.55</b>	<b>189.93</b>	<b>295.13</b>	<b>1416.99</b>
Our proposed adjustments – regulatory accounting reconciliation	0.00	0.00	0.00	0.00	-1.93	-4.70	-6.64
<b>Draft decision – total prescribed capital expenditure</b>	<b>168.65</b>	<b>227.81</b>	<b>281.93</b>	<b>253.55</b>	<b>188.00</b>	<b>290.42<sup>a</sup></b>	<b>1410.36</b>

Note: Actual total prescribed capital expenditure from 2017-18 to 2021-22, forecast in 2022-23. <sup>a</sup> This forecast figure for South East Water’s 2022-23 capital expenditure is higher than the figure of \$219.6 million in Table 4.8 because our draft decision on the closing regulatory asset base does not accept the inclusion of the proposed higher figure in the forecast regulatory asset base (see Section 4.3.2).

South East Water will incur \$1,119.9 million in gross capital expenditure over the period from 2017-18 to 2021-22, 7.9 per cent below the benchmarks adopted at the 2018 water price review. In net terms, its capital expenditure was \$924.6 million, around 8.2 per cent lower than the benchmarks adopted at the 2018 water price review.

For 2022-23, gross capital expenditure is forecast to be \$290.4 million, \$70.8 million higher than the benchmark adopted at the 2018 price review (with net capital expenditure of \$245.2 million, \$63.1 million higher than the benchmark). South East Water identified that the higher forecast for 2022-23 is a result of re-profiling of prescribed capital expenditure it did not undertake in earlier years of the current period, mostly related to delayed land purchases.<sup>39</sup>

<sup>39</sup> South East Water has proposed to include the additional expenditure above the 2018 price determination benchmark in its 2022-23 capital expenditure for the purpose of calculating its revenue requirement. However, this is inconsistent with our guidance (see Section 4.3.1 for our draft decision on South East Water’s forecast regulatory asset base).

South East Water's major capital projects summary report included in its price submission noted that as at September 2022, of the 10 major projects proposed for the 2018–23 regulatory period, 4 were completed, 2 are delayed and expected to be completed in 2022–23, with the following 4 projects delayed or deferred to 2023–28:

- Hanna Street sewerage capacity improvements are delayed to allow for investigation works and a change in scope to accommodate increased forecast growth and expected to be completed in 2023–24.
- Pakenham East sewer servicing is delayed and expected to be completed in 2023–24 due to delayed approval of the Pakenham East Precinct Structure Plan about 2 years later than anticipated.
- Elster Creek sewer catchment capacity improvement works are deferred due to revision of the scope for a lower-cost alternative and are now rescheduled to be completed in 2023–24 with some works deferred beyond 2023–28 resulting in reduced project costs.
- Clayton East and West sewer catchment capacity improvement works are deferred and rescheduled for completion in 2026–27 due to a change in scope following options assessment.
- Given the delay or deferral of a number of projects in the current period, South East Water's price submission explained several factors contributing to the variations in its actual capital expenditure in the current regulatory period relative to the 2018 price determination benchmarks:
  - coronavirus pandemic-related impacts, including slower than anticipated growth and supply chain issues, unfavourable site conditions and delays in obtaining relevant approvals, have led to project delays
  - increased sewer compliance and renewals expenditure to reactively manage higher than expected sewer asset failures and spills caused by climate variations
  - increased project costs due to revised scope of works.

We consider South East Water's approach to managing its capital program in response to changing priorities and changes in the operating environment that are outside its control through project reprioritisation, rescoping and reallocation of funds is appropriate.

#### **4.2.2 Forecast Capital Expenditure**

South East Water proposed a total forecast capital expenditure of \$1,921.1 million over the 2023–28 regulatory period. As discussed in Sections 4.1.1 and 4.2.1, our audit and approval of South East Water's 2021–22 regulatory accounts identified various operating expenditure items that had been inappropriately included in its price submission as capital expenditure. We propose to adopt the revised figures because this is consistent with the requirements of our regulatory accounting principles. This reallocation reduces South East Water's gross capital expenditure by



\$4.7 million each year of the next regulatory period, or by \$23.5 million over the 5-year period (Table 4.6).

**Table 4.6 Draft decision adjustments – total prescribed capital expenditure**  
\$ million 2022-23

	2023-24	2024-25	2025-26	2026-27	2027-28	Total
<b>South East Water's proposed total prescribed capital expenditure</b>	<b>351.96</b>	<b>380.20</b>	<b>392.38</b>	<b>399.87</b>	<b>396.65</b>	<b>1,921.07</b>
Adjustments – capitalisation of operating expenditure reversal	-4.70	-4.70	-4.70	-4.70	-4.70	-23.52
<b>Draft decision – total prescribed capital expenditure</b>	<b>347.26</b>	<b>375.50</b>	<b>387.67</b>	<b>395.17</b>	<b>391.95</b>	<b>1,897.55</b>

For the reasons set out below, our draft decision is to adopt the revised forecast capital expenditure of \$1,897.6 million proposed by South East Water for the purpose of calculating its revenue requirement:

- South East Water's price submission provided evidence that its forecasts for capital expenditure are prudent and efficient. Its total proposed capital expenditure is \$655.8 million (52.8 per cent) higher than actual capital expenditure in the current 2018–23 period. This is due to continued expenditure on renewals (\$622.3 million, or 32.8 per cent of the total capital program), growth-related expenditure to meet customer growth (\$541.4 million, 28.5 per cent of total capital expenditure) and increased expenditure to ensure compliance with environmental protection regulations and safety regulations (improvements and compliance expenditure accounts for \$522.9 million, or 27.6 per cent of the total program). South East Water has also proposed \$203.5 million (10.7 per cent of the total forecast capital program) over the next regulatory period to roll out digital water meters following a trial project in the current period. South East Water indicated in its price submission that increasing unit costs for inputs into construction due to supply chain issues, labour shortages and fuel costs are a further driver of the increase in its forecast capital program compared to its actual spend in the current period.
- Our expenditure consultant requested selected documents from South East 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, its workshop with the business and South East Water's responses to questions, our consultant found that South

East Water has a robust approach for developing project scope, the timing of works and cost estimates.<sup>40</sup>

- South East Water has forecast \$580.6 million on its top 10 major projects in the next regulatory period. Our expenditure consultant reviewed each major project and requested further information on the Digital Metering project (\$203.5 million), Hanna Street Capacity Upgrade – Stage 2 (\$69.4 million), Mt Martha Water Recycling Plant Augmentation (\$54.1 million), South East Regional Biofactory (\$29.8 million) and the Westernport Irrigation Scheme – Stage 1 (\$51.8 million).<sup>41</sup> Our consultant found the additional information reviewed was sufficiently detailed, appropriately costed and provided strong justification for each of the projects and the related expenditure. Our consultant recommended no adjustments to South East Water’s forecast capital expenditure for its top 10 major projects.<sup>42</sup> We agree with our consultant’s view because we consider that, for the purposes of our draft decision, the prudence and efficiency of the expenditure has been justified, consistent with our guidance.
- Our consultant also reviewed 23 programs allocated across both water and sewerage and a number of drivers including growth, improvement and compliance, renewals and land purchases. The sum of related expenditure reviewed by our consultant accounts for 44.5 per cent of the overall forecast capital program. Our consultant found that the program plans, strategies and supporting information it reviewed provided strong justification for the programs, and that each of the programs reviewed are well prioritised.<sup>43</sup>
- Given the size of South East Water’s forecast capital program, including the large digital metering rollout project, we consider South East Water’s capacity to deliver the program in the regulatory period is highly relevant to its capital expenditure proposal. In its price submission, South East Water pointed toward its delivery of its current capital program, including its performance against the benchmarks approved for the 2018–23 regulatory period in its 2018 price determination. South East Water’s price submission also noted its new integrated capital delivery model, which involves procuring expert partners to increase its delivery capability, and will be responsible for delivering 40 per cent of its forecast capital program. Our expenditure consultant also reviewed South East Water’s delivery capability and considered the business was making good progress in implementing its new capital delivery model, which has appropriate ongoing board and executive focus. Given the above, our preliminary view is that the planned capital expenditure program, while materially larger than the capital expenditure program delivered during the current regulatory period, is likely to be achievable.

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<sup>40</sup> FTI Consulting, *South East Water: Review of expenditure forecasts – 2023 water price review*, February 2023, pp. 40–43.

<sup>41</sup> The Digital Metering project is further discussed in Section 4.2.2.1.

<sup>42</sup> FTI Consulting, *South East Water: Review of expenditure forecasts – 2023 water price review*, February 2023, p. 50.

<sup>43</sup> FTI Consulting, *South East Water: Review of expenditure forecasts – 2023 water price review*, February 2023, p. 49.

- South East Water has not specifically identified any project costs it has excluded from its price submission where there is uncertainty in timing, cost, scope and benefits of capital expenditure. For any additional capital expenditure in the 2023–2028 regulatory period that South East Water proposes to include in the regulatory asset base at the end of the regulatory period, it should note the following:
  - South East Water will need to demonstrate the prudence and efficiency of these costs if they are indeed incurred during the 2023–28 regulatory period if seeking to include them in the regulatory asset base for the 2028–33 price review.
  - Deviations from forecasted capital expenditure during the 2023–28 regulatory period will form a key part of our assessment of the Performance element of PREMO at the next price review.

We have reviewed South East Water’s proposals and advice from FTI Consulting and our preliminary view is that South East Water’s approach to forecasting its capital expenditure is consistent with the requirements of our guidance and the principles in the Water Industry Regulatory Order 2014.<sup>44</sup>

Our draft decision is therefore to accept total gross capital expenditure of \$1,897.55 million over the 5-year period, which is consistent with updated forecasts provided by South East Water following approval of its 2021-22 regulatory accounts. The benchmark we propose to adopt is set out in Table 4.6.

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

#### **4.2.2.1 Digital metering – New Connections and Exchanges Project**

South East Water’s \$203.5 million digital metering project accounts for 10.7 per cent of its total capital expenditure forecast. This project involves the installation of digital water meters across the business’s customer base over a 6-year period beginning in 2023-24, and follows a trial project South East Water conducted in the current regulatory period. Our 2018 price review decision

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<sup>44</sup> Essential Services Commission, *2023 water price review: Guidance paper*, pp. 32–37.

required South East Water to define and meet success criteria for its trial before a broader roll out is undertaken, and that a positive net present value should be attained through any future roll out.

South East Water explained in its price submission that it delivered the trial and met its success criteria for the project. The business also stated the behavioural analysis it conducted on the data collected from its trial identified reductions in customer water usage that would translate to reductions in bulk water demand.<sup>45</sup> The analysis was either conducted or reviewed by BehaviourWorks Australia (Monash University), the University of Melbourne and Jacobs. South East Water surpassed the original scope of the trial project and began a 'build and scale' phase of the project, installing 50,000 digital meters in the current period, ahead of the 2023 price review.<sup>46</sup>

South East Water has identified it expects its digital metering rollout will defer major network augmentations over a planning horizon that extends beyond 30 years, delivering benefits across the area serviced by metropolitan retailers by reducing water demand and maintenance and renewals costs, and providing better information to inform network expansion requirements in future periods.<sup>47</sup>

South East Water has also committed to absorb any cost overruns in its digital metering rollout.<sup>48</sup>

This is a commitment that we will scrutinise closely in future price reviews. We expect South East Water will manage all risks associated with this rollout, including costs and customer bill impacts.

Given the cost, size and scope of the proposal, our expenditure consultant conducted a detailed review of the project to establish its prudence and efficiency. Our consultant reviewed the business's price submission, the project business case, and additional supporting information related to the project. Our consultant noted that the project benefits and potential water savings identified in the price submission and project business case are informed by the trial project undertaken in the current regulatory period, and the significant econometric and behavioural analysis conducted on the trial.<sup>49</sup>

Our consultant also identified the project's business case estimated a net present value of \$67 million over a lifespan of 30 years, but that the increased capital expenditure compared to a mechanical meter replacement program (approximately \$130 million) and associated operating expenditure required to deliver the digital meter rollout would have a material impact on customer

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<sup>45</sup> South East Water, 2023 water price submission, September 2022, p. 119.

<sup>46</sup> South East Water, 2023 water price submission, September 2022, p. 78.

<sup>47</sup> South East Water, 2023 water price submission, September 2022, p. 54.

<sup>48</sup> South East Water, 2023 water price submission, September 2022, p. 13.

<sup>49</sup> FTI Consulting, *South East Water: Review of expenditure forecasts – 2023 water price review*, February 2023, p. 47.

bills in the next regulatory period (\$14.60 on an average customer bill).<sup>50</sup> Our consultant noted that South East Water tested this impact with customers through a willingness to pay assessment.

Given the information it reviewed, our expenditure consultant did not recommend any adjustments to the digital metering project, and noted the proposed approach is well targeted, based on sound risk assessment approaches and includes appropriate cost allowances.

We have reviewed the advice from FTI Consulting and the information provided by South East Water and our draft decision is to accept South East Water's proposed expenditure in relation to the digital metering project. However, in response to our draft decision, South East Water must provide further information regarding how it proposes to manage the immediate price impacts of its digital metering proposal on its customers in the next regulatory period, given the extended timeframe over which it anticipates the benefits will be realised.

### **4.3 Regulatory asset base**

A water corporation's regulatory asset base is the value of the corporation's assets for regulatory purposes.<sup>51</sup> The regulatory asset base is used to estimate the return on assets (discussed in Section 4.4), and regulatory depreciation (discussed in Section 4.5). Both the return on assets and regulatory depreciation are components of the revenue requirement.

Our guidance required South East Water to propose:

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

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<sup>50</sup> FTI Consulting, *South East Water: Review of expenditure forecasts – 2023 water price review*, February 2023, p. 48.

<sup>51</sup> These values were set initially for the water corporations by the Minister for Water and are adjusted on an ongoing basis to account for new investments, asset disposals, depreciation and inflation.

### 4.3.1 Closing regulatory asset base

Our draft decision is to adopt a closing regulatory asset base of \$4,001.1 million at 30 June 2022, which is lower than the \$4,003.0 million proposed by South East Water.

We update the regulatory asset base to reflect actual gross capital expenditure, less government and customer contributions, and asset disposals for the period from 2017-18 to 2021-22.<sup>52</sup> This helps to ensure prices reflect the actual net expenditure of a water corporation.<sup>53</sup>

South East Water's proposed closing asset base at 30 June 2022 is provided at page 109 of its price submission.<sup>54</sup>

As noted in Section 4.2.1, our review and approval of South East Water's regulatory accounts for 2021-22 identified some necessary corrections to its past capital expenditure (Section 4.2.1). These corrections reduced net capital expenditure over the period from 2017-18 to 2021-22 from the \$926.6 million proposed by South East Water in its price submission, to \$924.6 million. Our draft decision adopts a closing regulatory asset base of \$4,001.1 million at 30 June 2022, which reflects the corrections and is consistent with the approved regulatory accounts (Table 4.7).

We compared South East Water's net capital expenditure for 2017-18 to 2021-22 with the forecast used to approve maximum prices for the period from 1 July 2018. Typically, if a water corporation's net capital expenditure was more than 10 per cent above the forecast, we consider the business's justification for the additional expenditure before including it in the closing regulatory asset base. We consider this approach is reasonable given capital expenditure can be 'lumpy' in nature.

South East Water's net capital expenditure over the period from 2017-18 to 2021-22 was \$924.6 million. This is \$82.6 million or 8.2 per cent lower than the forecast used to approve maximum prices for the period from 1 July 2018. This is well below the 10 per cent threshold noted above so our draft decision proposes to reflect the \$924.6 million in the closing regulatory asset base.

Table 4.7 sets out our draft decision on South East Water's closing regulatory asset base at 30 June 2022.

As noted in Section 4.1.1.1, our draft decision requires South East Water to verify how costs that were identified during its 2021-22 regulatory accounts approval process as being incorrectly

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<sup>52</sup> See Section 4.2 for a discussion of South East Water's capital expenditure.

<sup>53</sup> Net capital expenditure is calculated by deducting government and customer contributions from gross capital expenditure. Customer contributions reflect revenue earned from new connections made to the water corporation's water, sewerage or recycled water networks.

<sup>54</sup> Available at [www.esc.vic.gov.au](http://www.esc.vic.gov.au).

treated as capital costs in its price submission, have been reflected in its prices from the commencement of the 2018–23 regulatory period. This is to inform the amount to be determined for its closing regulatory asset base at 30 June 2022.

**Table 4.7 Draft decision – closing regulatory asset base (RAB)**  
\$ million 2022-23

	2017-18	2018-19	2019-20	2020-21	2021-22
<b>Opening RAB 1 July</b>	<b>3,688.8</b>	<b>3,722.2</b>	<b>3,748.3</b>	<b>3,877.0</b>	<b>3,969.8</b>
Plus gross capital expenditure	168.6	227.8	281.9	253.5	188.0
Less government contributions	0.0	0.0	0.0	0.0	0.0
Less customer contributions	48.4	45.0	35.9	33.6	32.5
Less proceeds from disposals	2.3	90.7	42.2	42.6	30.6
Less regulatory depreciation	84.5	66.1	75.1	84.6	93.6
<b>Closing RAB 30 June</b>	<b>3,722.2</b>	<b>3,748.3</b>	<b>3,877.0</b>	<b>3,969.8</b>	<b>4,001.1</b>

Note: Numbers have been rounded.

#### 4.3.2 Forecast regulatory asset base

Our draft decision is to not accept South East Water’s proposed forecast regulatory asset base.

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

Based on our proposed adjustments to South East Water’s closing regulatory asset base (Section 4.3.1), forecast capital expenditure (Section 4.2.2) and our draft decision to not accept South East Water’s proposed standard new customer contributions (Section 5.4), our draft decision is to not accept South East Water’s proposed forecast regulatory asset base.

Table 4.8 sets out our draft decision on the forecast regulatory asset base reflecting our preliminary views on South East Water’s closing regulatory asset base and forecast capital expenditure, noting that the forecast customer contributions (and regulatory depreciation) may change, subject to South East Water’s response to our draft decision on its new customer contributions. As outlined in Section 4.3.2.1, in response to our draft decision, South East Water

must provide updated justification and estimates for its forecast customer contributions and regulatory depreciation.

Our guidance specifies that the amount reflected for 2022-23 in the forecast regulatory asset base is to be calculated based on the forecast for gross capital expenditure adopted in the 2018 price determination less any contributions (net capital expenditure).<sup>55</sup>

This is intended to provide an incentive for businesses not to defer capital expenditure, noting they recover financing costs on projects included in capital expenditure benchmarks in earlier years.

As noted in Section 4.2.1, South East Water has proposed to roll in a higher amount than specified in our guidance, mainly due to re-profiling of prescribed capital expenditure it did not undertake in earlier years of the current period.

Our preliminary view is that South East Water has not justified additional amounts for inclusion in its forecast regulatory asset base for 2022-23 that cause us to take a different approach to our guidance. On that basis, our draft decision is to not accept South East Water's proposed additional capital expenditure amounts for 2022-23, and instead adopt the benchmark used in South East Water's 2018 price determination for the purpose of calculating the forecast regulatory asset base.

Our assessments of the other components of the forecast regulatory asset base are outlined in different sections of this draft decision paper as follows:

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

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<sup>55</sup> Our guidance required water businesses to provide an estimate of the components of their regulatory asset base for 2022-23. This was so we could assess the opening asset base for 1 July 2023. Our guidance noted that where the 2022-23 forecast for net capital expenditure (gross capital expenditure less government and customer contributions) is lower than the forecast benchmark for that year in its 2018 price determination, the lower amount must be used. Otherwise, the benchmark figure used for the 2018 price review is reflected in the regulatory asset base. The estimates for 2022-23 will be confirmed at the price review following the 2023 water price review. Essential Services Commission, *2023 water price review: Guidance paper*, p. 38.



**Table 4.8 Draft decision – forecast regulatory asset base (RAB)**  
\$ million 2022-23

	2022-23	2023-24	2024-25	2025-26	2026-27	2027-28
<b>Opening RAB 1 July</b>	<b>4,001.1</b>	<b>4,071.7</b>	<b>4,252.3</b>	<b>4,481.8</b>	<b>4,726.1</b>	<b>4,962.7</b>
Plus gross capital expenditure	219.6	347.3	375.5	387.7	395.2	391.9
Less government contributions	12.3	12.5	0.0	0.0	0.0	0.0
<i>Less customer contributions<sup>a</sup></i>	33.0	33.2	34.7	36.5	45.9	48.0
Less proceeds from disposals	1.9	1.9	1.9	1.9	1.9	1.9
<i>Less regulatory depreciation<sup>b</sup></i>	101.8	119.0	109.4	105.0	110.8	121.6
<b>Closing RAB 30 June</b>	<b>4,071.7</b>	<b>4,252.3</b>	<b>4,481.8</b>	<b>4,726.1</b>	<b>4,962.7</b>	<b>5,183.1</b>

**Note:** Numbers have been rounded. <sup>a</sup> Forecast customer contributions are subject to South Gippsland Water's response to our draft decision on its new customer contributions, and our consideration of its response. These forecasts are indicative only (see Section 4.3.2.1). <sup>b</sup> Regulatory depreciation is calculated based on the opening regulatory asset base of the given year. Therefore, regulatory depreciation forecasts are indicative only and may change in response to any changes to the indicative customer contributions forecasts shown.

#### 4.3.2.1 Customer contributions

Our draft decision is to not accept South East Water's forecasts for revenue from customer contributions.

Revenue from customer contributions is deducted from gross capital expenditure so it is not included in the regulatory asset base.<sup>56</sup>

Our draft decision is to not accept South East Water's forecasts for customer contributions as our draft decision has not approved its proposed new customer contributions (Section 5.4). New customer contributions are a key input to revenue from customer contributions.

For the purposes of calculating the regulatory asset base and revenue requirement in our draft decision, we have used South East Water's proposed customer contributions forecast.

<sup>56</sup> Revenue from new customer contributions reflects revenue earned from new connections made to the water corporation's water, sewerage or recycled water networks.

However, South East Water must update and justify its customer contribution forecasts in response to our draft decision.

## 4.4 Rate of return

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

### 4.4.1 Cost of debt

Our draft decision is to accept the cost of debt proposed by South East Water.

Our guidance required South East Water to use estimates of the cost of debt provided by the commission to estimate its revenue requirement.

South East Water used the cost of debt values we specified to calculate its revenue requirement. For this reason, as set out in Table 4.9, our draft decision is to accept the cost of debt proposed by South East Water, noting that the cost of debt estimates will be updated following the release of the Australian Bureau of Statistics March Quarter 2023 consumer price index.

**Table 4.9** Draft decision – cost of debt

	2013-14	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20	2020-21	2021-22	2022-23
Cost of debt (nominal)	7.05%	5.36%	5.27%	4.91%	4.53%	4.61%	3.31%	3.05%	3.75%	3.75% <sup>a</sup>

**Note:** Numbers have been rounded. <sup>a</sup> Estimated cost of debt – we will update the 2022 23 figure before the final decision and price determination.

### 4.4.2 Return on equity

Our draft decision is to adopt South East Water’s proposed return on equity of 4.1 per cent.

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

Our guidance included a matrix proposing the return on equity we would adopt, based on the combination of the corporation's self-rating and our rating.<sup>57</sup> We reviewed the return on equity values in the matrix in mid-2022 given the change in market conditions that has occurred since we published our guidance in October 2021. We consider that the values in our matrix reflect the medium-term real rates of return.<sup>58</sup>

South East Water rated its price submission as 'Advanced'. The maximum return on equity allowed in our guidance for a price submission rated as 'Advanced' is 4.5 per cent.<sup>59</sup> However, South East Water proposed to adopt a lower return on equity of 4.1 per cent, equivalent to the maximum return on equity for a price submission rated as 'Standard'. South East Water explained its proposal to adopt the lower return on equity was to manage price impacts for its customers and maintain affordable services, while ensuring it can deliver outcomes and undertake necessary investments.

As outlined in Chapter 7, our draft decision is to agree with South East Water's self-rating of its price submission as 'Advanced', allowing a return on equity of up to 4.5 per cent. However, our draft decision is to adopt the return on equity of 4.1 per cent proposed by South East Water, because this is below the maximum amount that South East Water could propose. Our PREMO assessment of South East Water's price submission is set out in Chapter 7.

## 4.5 Regulatory depreciation

Our draft decision is to not accept South East Water's forecast regulatory depreciation.

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

South East Water's forecast regulatory depreciation was calculated using a straight-line depreciation profile.<sup>60</sup> We noted in our guidance that we prefer this approach.<sup>61</sup> South East Water's

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<sup>57</sup> Essential Services Commission, *2023 water price review: Guidance paper*, pp. 42–43.

<sup>58</sup> We will continue to monitor market conditions and may amend the return on equity matrix values to reflect any changes to the medium-term outlook prior to releasing our final decision. We have had regard to the return on equity adopted by interstate regulators in the following publications: Independent Pricing and Regulatory Tribunal NSW, *Final Report - Review of WaterNSW's rural bulk water prices*, 9 September 2021; Independent Pricing and Regulatory Tribunal NSW, *Final Report - Review of prices for Sydney Water*, June 2020; Essential Services Commission of South Australia, *SA Water's water and sewerage retail services: 1 July 2020 - 30 June 2024*, Price Determination, 1 July 2020; Queensland Competition Authority, *Final report - Seqwater bulk water price review 2022–26*, March 2022; Queensland Competition Authority (QCA), *Final report - Rural irrigation price review 2020–24, Part A: Overview*, January 2020; Office of the Tasmanian Economic Regulator, *Final report - Investigation into TasWater's prices and services for the period 1 July 2022 to 30 June 2026*, May 2022.

<sup>59</sup> Essential Services Commission, *2023 water price review: Guidance paper*, p. 42.

<sup>60</sup> For the period from 2022-23 to 2027-28, South East Water proposed a regulatory depreciation of \$677.5 million.

<sup>61</sup> Essential Services Commission, *2023 water price review: Guidance paper*, p. 39.

price submission calculated regulatory depreciation consistently with the requirements of our guidance. However, because our draft decision is to not accept South East Water's forecast regulatory asset base, our draft decision proposes to not accept South East Water's forecast regulatory depreciation.

For the purposes of this draft decision we have adopted the regulatory depreciation as shown in Table 4.6 in Section 4.3.2. In response to our draft decision South East Water must update its forecast regulatory depreciation.

## **4.6 Tax allowance**

Our draft decision is to adopt a tax allowance of \$76.0 million for the 2023–28 regulatory period.

The tax allowance is a component of the revenue requirement. South East Water has proposed a tax allowance of \$77.3 million in its revenue requirement for the 2023–28 regulatory period. Our draft decision is to not accept the forecast as our draft decision has adopted a different revenue requirement to South East Water's proposal, reflecting proposed adjustments to its forecast costs and revenue (Table 4.2).

## 5. Demand, tariffs and prices

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

### 5.1 Demand

Our draft decision is to accept South East Water's demand forecasts.

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

South East Water's demand forecasts are set out at pages 114 to 127 of its price submission and are also included in its financial model.

Our draft decision is to accept South East Water's demand forecasts for the purpose of approving maximum prices, because they were developed consistently with the requirements of our guidance.

Since lodgement of its price submission, updated Victorian Government population and dwelling growth estimates have been made available to water businesses.

In its response to our draft decision, South East Water must demonstrate how it has considered these updated estimates and if required, identify and justify any changes to its demand forecasts (any updates must also be included in its pricing model submitted in response to our draft decision).

### 5.2 Form of price control

Our draft decision is to accept South East Water's proposed tariff basket form of price control for core water, sewerage and trade waste charges, including limiting price increases for individual tariffs to 3 per cent per annum (excluding inflation).

Our draft decision is to accept South East Water's proposed price cap form of price control for miscellaneous charges.

Our guidance indicated we would have particular regard to whether a corporation proposed to continue its existing form of price control or introduce a new form of price control.<sup>62</sup>

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<sup>62</sup> Essential Services Commission, *2023 water price review: Guidance paper*, p. 50.

South East Water's proposed form of price control is set out on pages 143 to 145 of its price submission. South East Water proposed to retain a tariff basket form of price control for core water, sewerage and trade waste charges, including limiting price increases for individual tariffs to 3 per cent per annum (in real terms). It also proposed to retain a price cap form of price control for miscellaneous charges.

Our draft decision is to accept South East Water's proposed tariff basket form of price control for its core water, sewerage and trade waste charges because:

- it is a continuation of its current approach, which we have previously approved
- it provides sufficient revenue to cover the forecast efficient costs of providing services and for South East Water to deliver on any health, safety and environmental obligations
- it provides flexibility to the business to rebalance prices without over (or under) collecting revenue
- it provides price stability to customers by limiting price increases under its tariff basket constraint and a 3 per cent per annum (in real terms) limit on price increases
- it is otherwise consistent with the requirements of our guidance.

Our draft decision is to accept South East Water's proposed price cap form of price control for its miscellaneous charges because it is a continuation of its current approach, which we have previously approved, and it places demand risk on South East Water rather than its customers.

### 5.3 Tariff structures and prices

Our draft decision is to accept South East Water's proposed tariff structures.

South East Water's proposed tariffs are set out at pages 130 to 145 of its price submission.

Our draft decision does not approve prices for each tariff. Prices will need to be updated by South East Water to reflect our draft decision on the revenue requirement and our updates to inflation and cost of debt estimates prior to our final decision. Our draft decision considers proposals related to tariff structures, the price path proposed, and any submissions on the level of prices or bills.

#### 5.3.1 Tariff structures

As outlined in our guidance, we have provided the water corporations with a large degree of discretion to decide on individual tariff structures.<sup>63</sup> 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.

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<sup>63</sup> Essential Services Commission, *2023 water price review: Guidance paper*, p. 51.

South East Water proposed to largely maintain its existing tariff structures.

For residential customers receiving water services only, South East Water proposed that these customers continue to pay a fixed charge and a charge that varies with water use.

For residential customers receiving both water and sewerage services, South East Water proposed to combine the residential sewage disposal charge and its residential variable water tariff. This means these customers would pay a fixed charge and a charge that varies with water use. However, the variable charge would be higher compared to water only customers as it incorporates the costs of disposing sewage. This change was justified by South East Water because it is easier for customers to understand.

The Consumer Action Law Centre provided a submission to us supporting South East Water's proposal to decrease its prices in 2023-24 and remove its sewage disposal tariffs.<sup>64</sup>

Another submission considered South East Water's existing tariffs do not allow customers to influence their bill by changing their behaviour and saving water.<sup>65</sup>

Our draft decision is to accept South East Water's proposal to combine the residential sewage disposal charge and its residential variable water tariff (for residential customers with a water and sewerage service) because South East Water's customers support this approach, and we consider that this structure is easier for customers to understand.<sup>66</sup>

Our draft decision is to also accept other water and sewerage tariff structures proposed by South East Water because they remain unchanged and are generally supported by its customers.

Our preliminary view is that the two-part tariff structure proposed by South East Water for both its water services will promote the efficient use of services. It also sends customers a signal about the costs of their water use and is an approach that is commonly applied in other states and territories.<sup>67</sup> We also consider two-part tariff structures are easy to understand.

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<sup>64</sup> Consumer Action Law Centre, Initial Feedback: 2023–28 Water Price Review, Essential Services Commission, 30 November 2022.

<sup>65</sup> Anonymous, submission to the Essential Services Commission on South East Water's 2023 price submission, 10 October 2022.

<sup>66</sup> Our guidance indicated that we consider that variable sewerage tariffs for residential customers of the metropolitan water businesses were difficult for customers to understand (Essential Services Commission, 2023 water price review: Guidance paper, p. 54).

<sup>67</sup> Includes the tariffs of Icon Water, Sydney Water, Hunter Water, Central Coast Council, Power and Water Corp, Urban Utilities, Unity Water, SA Water and TasWater.

For sewerage services, we consider South East Water's proposed charge for residential customers is easy for customers to understand (consistent with its engagement findings). A two-part tariff for non-residential customers sends customers signals about efficient costs.<sup>68</sup>

For recycled water, South East Water proposed to continue with only a variable usage charge.

### 5.3.2 Prices

The prices proposed by South East Water for water and sewerage services are set out in chapter 10 of its price submission (from page 129).

Under South East Water's proposal, generally prices (excluding inflation) will be lower. For both residential and non-residential customers, water and sewerage bills are proposed (before inflation) to fall by around 6 per cent in 2023-24 and then remain steady to 2027-28.

One stakeholder submission considered the variation in prices between South East Water and another retailer was material despite having the same level of capital investment.<sup>69</sup> Our views on South East Water's proposed capital expenditure are set out in Section 4.2 and we acknowledge that different water retailers have different cost drivers, hence prices among retailers for similar services will vary.

In May 2023, we intend to determine prices for South East Water in \$2023-24 terms. This means we will add the annual change in the March Quarter 2023 consumer price index (published by the Australian Bureau of Statistics) to its 2023-24 prices, which will also flow through to customer bills.

South East Water's prices will also be affected by our draft decision on the revenue requirement, which is outlined in Chapter 4. In response to our draft decision, South East Water will need to propose updated prices that reflect our draft decision and any updates to its revenue requirement.

### 5.3.3 Addressing the interests of low income and vulnerable customers

In making our price determination, we must have regard to whether South East Water's prices take into account the interests of customers, including low income and vulnerable customers.<sup>70</sup>

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<sup>68</sup> Our reasons are outlined in our 2013 draft decisions on price review 2013-14 to 2017-18.

<sup>69</sup> Rahimi, Ali, submission to the Essential Services Commission on South East Water's 2023 price submission, 11 October 2022.

<sup>70</sup> Water Industry Regulatory Order 2014 clause 11(d)(iii).



There is evidence that South East Water has sought to address the interests of low income and vulnerable customers because South East Water proposed:

- real price reductions across all core water and sewerage services for the first year of the regulatory period (helping to manage the impacts of relatively high inflation on customers' bills) then maintaining the price levels for the remaining years
- tariffs that reflect efficient costs for delivering services
- tariff reform that was informed by an extensive customer engagement program
- a continuation of assistance for customers experiencing difficulty in paying bills
- increased investment in engagement with Traditional Owners who can be amongst the most vulnerable members of the community, to support their capacity to collaborate in land and water decision making.

### 5.3.4 Unique services

South East Water has confirmed that its proposed tariffs for trade waste and miscellaneous services are calculated in accordance with the pricing principles referenced in our guidance.

In response to our queries, South East Water noted a miscellaneous tariff was missing from its pricing model.<sup>71</sup> In response to our draft decision, South East Water must update its pricing model to include the missing tariff.

## 5.4 New customer contributions

Our draft decision is to not accept South East Water's proposed new customer contributions.

Our draft decision is to accept South East Water's proposed negotiated new customer contributions framework.

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.

South East Water's proposed new customer contributions are set out at pages 135 to 138 of its price submission. South East Water proposed the following:

- An increase of 5 per cent per annum in real terms for new customer contributions in the Casey and Cardinia growth areas.

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<sup>71</sup> South East Water, Response to request for information, 10 February 2023.

- The removal of the new customer contributions for lot sizes 300m<sup>2</sup> or less that are located in the Casey and Cardinia regions, on the basis that the relationship between lot size and the cost to connect has diminished.
- The introduction of new customer contributions for the Fishermans Bend precinct, which will also increase in real terms by 5 per cent per annum. Around 30 per cent of the incremental cost associated with the Fishermans Bend precinct area is proposed to be recovered through new customer contributions with the remaining 70 per cent to be recovered from the broader community.

Changes in modelled costs since 2018 reflect updated capital expenditure and revenue estimates, an allocation of renewals and compliance capital expenditure to new customers, and the inclusion of a portion of historical or sunk costs going back to 2013-14.

We have reviewed South East Water’s proposed standard new customer contributions and compared them to the charges calculated in its new customer contributions pricing model. We do not consider South East Water’s proposed customer contributions are cost reflective.<sup>72</sup>

Table 5.1 compares South East Water’s proposed new customer contributions with its calculated charge for 2023-24.

**Table 5.1 South East Water’s proposed new customer contributions – combined water, sewerage and recycled water (per lot)**  
\$ 2022-23

	Calculated charge	Proposed new customer contribution
<b>Growth area</b>		
Casey	\$7,370	\$3,925
Cardinia	\$10,195	\$5,078
Other areas	\$6,520	\$2,349
Fishermans Bend (integrated water contribution)	\$5,570	\$2,441

<sup>72</sup> We estimate that using the charges South East Water proposed for the 2023–28 regulatory period, it could take up to 41 years for the charges to achieve cost-reflectivity. This estimate relies on the combined water, sewerage and recycled water new customer contributions and forecast annual inflation of 2.5 per cent and a price path of 5 per cent (as proposed for the 2023–28 regulatory period).

South East Water proposed new customer contributions that are below the net incremental cost necessary to align them with its calculated new customer contributions for each growth area. That is, South East Water's proposed new customer contributions will under-recover its forecast costs of providing the service.

South East Water indicated that during its engagement, it received feedback from the Urban Development Institute of Australia that its new customer contributions should remain consistent with the current level.

The submission we received from the Consumer Action Law Centre noted its hope that the commission will more closely scrutinise those price submissions that do not address decreasing cross subsidies, and said that it wants to see all users, particularly builders and developers, paying the full costs of their water use.<sup>73</sup>

South East Water has not provided us with an explanation of its proposed transition plan to achieve cost reflective pricing.

The inclusion of sunk costs impacts the time to transition to cost reflectivity, which based on our calculations, could take between 15 to 40 years if the transition path continued as proposed by South East Water (and based on its modelled new customer contributions).<sup>74</sup>

We observe that compared to the prices established at the 2018 price review, South East Water's 2023 price submission proposal increases the gap between South East Water's proposed new customer contributions and the estimated costs of the service. It appears that its proposal to include sunk capital expenditure is a key driver of this increase.

Accordingly, prior to our final decision we will undertake a further assessment of the reasonableness of South East Water's proposed inclusion of sunk costs, including for renewals, in its proposed new customer contributions, and whether they comply with our guidance.<sup>75</sup>

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<sup>73</sup> Consumer Action Law Centre, Initial Feedback: 2023-28 Water Price Review, 30 November 2022, p. 5.

<sup>74</sup> If sunk costs were not included in the calculation of South East Water's cost reflective level of new customer contributions, it may not take an estimated 14 years to transition to the cost reflective charge. Transitioning to the lower cost reflective charge (which excludes sunk costs) from the proposed charge may take less time and be more acceptable to customers and developers. This is because water and sewerage customers would be required to cross-subsidise the lower than cost reflective new customer contribution for a shorter length of time.

<sup>75</sup> The inclusion of sunk capital expenditure is not a requirement of our existing net cash flow framework to calculate new customer contributions. We note that very few businesses since 2013, when we commenced using our net cash flow framework, have included sunk costs in their calculation of new customer contributions. Our 2013 explanatory note regarding new customer contributions explained that these costs should only be included where they were built in anticipation of connections growth and needed to be justified as such. We stated: 'Incremental cost can include an allocation of costs of assets that the business had prudently built in expectation of future growth. If such costs are included, they should be explicitly revealed.' Essential Services Commission, New Customer Contributions Explanatory Note, December 2013, p. 5.

On the basis of information available to us we are not currently satisfied that the proposal is justified given the relatively large differential between South East Water's proposed standard new customer contributions and its modelled price and our lack of clarity about its transition towards achieving full cost reflective pricing. We require further review of South East Water's proposed new customer contributions to determine compliance with our guidance prior to our final decision.

Based on the above, our draft decision is to not accept South East Water's proposed new customer contributions.

In response to our draft decision, South East Water must do the following:

- Explain its transition plan towards achieving full cost reflectivity for each growth area including the timeframes of this plan and provide reasons for adopting this transition plan.
- Set out how it proposes to fund any shortfall in revenue from new customer contributions, compared to the estimated costs of providing the service. The commission considers that the broader customer base should not contribute to shortfalls in revenue arising from a proposal to set new customer contributions below estimated costs.

We are seeking feedback from developers and customers regarding the proposed new customer contributions.

South East Water has provided its negotiating framework for negotiated new customer contribution contracts. This framework is in accordance with the requirements of our new customer contribution pricing principles.<sup>76</sup> For this reason, our draft decision is to accept South East Water's proposed framework for negotiated new customer contributions.

## 5.5 Adjusting prices

Our draft decision is to accept South East Water's proposed price adjustment mechanisms.

South East Water's proposed price adjustment mechanisms are set out at page 145 of its price submission. It proposed to continue with the current annual price adjustments which allows for pass through of several specific costs including:

- annual desalination water order and changes to security charge
- annual change to Melbourne Water's fixed and variable bulk water and sewerage prices including changes to its cost of debt<sup>77</sup>

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<sup>76</sup> Essential Services Commission, 2023 water price review: Guidance paper, p. 59.

<sup>77</sup> In response to a request for information, South East Water confirmed that it sought to pass-through the annual change to Melbourne Water's fixed and variable bulk charges, 25 Jan 2023.

- annual cost of debt adjustment to reflect benchmark efficient cost of debt under a 10-year trailing average approach.

South East Water also proposed a continuation of its existing uncertain and unforeseen events adjustment mechanism.

Our preliminary assessment is that South East Water's proposed price adjustment mechanisms satisfy the requirements of our guidance and the Water Industry Regulatory Order 2014. Further, they are a continuation of South East Water's current arrangements. Therefore, our draft decision accepts South East Water's proposed price adjustment mechanisms.

## 6. Financial position

We have reviewed key indicators of South East Water's financial performance and our preliminary view is that South East Water will generate sufficient cash flow to deliver on its service commitments.

In approving prices, we must have regard to the financial viability of the water industry.<sup>78</sup> We interpret the financial viability requirements under the *Essential Services Commission Act 2001* and the Water Industry Regulatory Order (2014) to mean that the prices we approve should provide a high level of certainty that each water corporation can generate sufficient cash flow to deliver on its service commitments, including financing costs arising from investments to meet service expectations.

South East Water's price submission and the supporting financial model provided estimates for key indicators of financial performance. These estimates were based on South East Water's assumptions about its revenue and expenditure. We have reviewed the key indicators of financial performance and our preliminary view is that we consider South East Water will generate sufficient cash flow to deliver on its service commitments, including financing costs arising from investments to meet service expectations.

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<sup>78</sup> WIRO clause 8(b)(ii) and ESC Act s.8A(1)(b).

## 7. PREMO rating

PREMO is an incentive mechanism that links the return on equity used to calculate a water corporation’s revenue requirement to that corporation’s level of ambition expressed in its price submission. Our guidance required South East Water to self-assess the level of ambition of its price submission for each element of the PREMO mechanism and arrive at an overall self-rating.<sup>79</sup> We required South East Water to self-rate its price submission as either ‘Leading’, ‘Advanced’, ‘Standard’ or ‘Basic’, with ‘Leading’ being the most ambitious and ‘Basic’ the least.

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

We also assessed and rated South East Water’s price submission.

### 7.1 Our PREMO assessment of South East Water’s price submission

Our draft decision is to rate South East Water’s price submission as ‘Advanced’ under PREMO, which is the same as South East Water’s self-rating.

South East Water’s self-rating for each of the PREMO elements and its overall self-rating are shown in Table 7.1. This table also includes our proposed ratings following our assessment of South East Water’s price submission.

**Table 7.1** PREMO rating

	Overall PREMO rating	Performance	Risk	Engagement	Management	Outcomes
South East Water’s self-rating	Advanced	Advanced	Advanced	Advanced	Standard	Advanced
Commission’s rating	Advanced	Advanced	Advanced	Advanced	Standard	Advanced

<sup>79</sup> This is the first price review we have done where the rating has been based on all five elements of PREMO. In our 2018 price review, our PREMO assessment was against only four of the elements — Risk, Engagement, Management and Outcomes.

Our preliminary view is that we agree with South East Water’s proposed overall PREMO self-rating of ‘Advanced’. We have formed this view after reviewing South East Water’s proposed self-rating for each of the five PREMO elements, with a summary of our assessment provided below.

### 7.1.1 Performance

For the 2023 price review, a business’s rating for the Performance element of PREMO is based on a combination of its overall PREMO rating at its most recent price review, and its level of performance based on achievement of outcomes (related to service targets and performance against expenditure benchmarks set at the previous price review) and customer sentiment.<sup>80</sup>

As noted in Section 3.2, our preliminary view is that we agree with South East Water’s self-assessment that it has, overall, met its outcome commitments for the period to date. As part of our annual outcome reporting, South East Water provided clear explanations where it had underperformed, and consistently provided well written and well-presented reports.

In terms of customer perceptions South East Water generally performed strongly in the commission’s survey of customer sentiment – covering measures of overall satisfaction, value for money, trust, and reputation in the community. In our most recent survey (to January 2023), it ranked in the top 3 on all measures, and was ranked highest among all water businesses for overall customer satisfaction.<sup>81</sup>

In 2021-22 (the last available year of audited results), South East Water’s controllable operating expenditure was moderately higher than the benchmark established at the 2018 water price review (after removing one off items). As noted in Section 4.2.1, in net terms, capital expenditure over the period 2017-18 to 2021-22 is lower than the benchmarks established at the 2018 water price review. For 2022-23, net capital expenditure is forecast to be higher than the benchmark. South East Water identified that the higher forecast for 2022-23 is a result of re-profiling of prescribed capital expenditure it did not undertake in earlier years of the current period, mostly related to delayed land purchases.

As noted in Section 4.2.1, 4 of its major projects for the current regulatory period have been completed, with 2 delayed and expected to be completed in 2022-23, and the remaining 4 projects delayed or deferred to 2023–28. We consider South East Water has appropriately justified changes to its major project delivery schedule, noting this included delivery of unplanned

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<sup>80</sup> As set out in Essential Services Commission 2021, *2023 Water Price Review: Guidance Paper*, pp. 74-75. Guiding questions are set out on page 45.

<sup>81</sup> The commission’s customer perception survey results are available on our website. See <https://www.esc.vic.gov.au/water/sector-performance-and-reporting/how-customers-rate-their-water-business#tabs-container2>.



compliance and renewals expenditure to manage higher than expected sewer asset failures and spills caused by climate variations.

Our draft decision is to accept South East Water's self-rating of 'Advanced' for the Performance element of PREMO, on the basis that we consider it met expectations for delivery against outcome commitments, and achieved an overall rating of 'Advanced' for PREMO in 2018.

### 7.1.2 Risk

The Risk element of PREMO is assessed against guiding questions focused on the appropriate allocation of risk (so that customers don't pay more than they need to), and the business's proposed guaranteed service level scheme (including that it provides incentives for the business to deliver valued services efficiently).<sup>82</sup>

In support of its self-rating of 'Advanced' for the Risk element of PREMO, South East Water's price submission provided an overview of its approach to risk management, a summary of key risks and how these will be managed or allocated.

Key factors supporting South East Water's Risk self-rating include:

- absorbing any costs associated with its guaranteed service level scheme
- committing to absorb any expenditure overruns with its digital metering program
- maintaining a price cap form of price control for the majority of services, which means the business is accepting demand risk on behalf of its customers
- embedding efficiency savings into operating cost and capital cost forecasts, and committing to absorb escalation rate increases for capital projects where these exceed forecasts
- compliance with ISO 55000 and seeking accreditation by the end of the current 2018–23 regulatory period
- testing its guaranteed service level scheme with customers, and including a new guaranteed service level focused on service interruptions, as well as doubling the payment amount for not meeting its guaranteed service level for sewer spills within homes.

Considering the above, our draft decision is to accept South East Water's self-rating of 'Advanced' for the Risk element of PREMO.

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<sup>82</sup> Essential Services Commission 2021, *2023 Water Price Review: Guidance Paper*, p. 45.

### 7.1.3 Engagement

The Engagement element of PREMO is assessed against guiding questions such as the form, timing, and nature of matters engaged on by the water business, and the influence of engagement on proposals. We also consider the extent to which a business has undertaken inclusive engagement, including with First Nations peoples and those experiencing vulnerability.<sup>83</sup>

Our draft decision is to accept South East Water's self-rating of 'Advanced' for the Engagement element of PREMO on the basis of the overall quality of its engagement program and the level of influence it afforded to its customers.

For example, South East Water provided high quality training and support to its deliberative customer panel members to assist their consideration of feedback from the broader community in making recommendations to the business. Further, members of the customer panel strongly endorsed the alignment between their recommendations and the business's proposals.

South East Water enabled a high degree of influence for its First Nations customers who were involved at the early planning stages of the price submission, self-determining the nature and extent of their involvement in the development of the price submission. South East Water's Customer and Community Advisory Council was also involved in the early planning stages and had oversight of the engagement process.

### 7.1.4 Management

The Management element of PREMO is assessed against guiding questions that cover matters such as the efficiency of proposed expenditure and prices, the quality of the business's submission and supporting information to justify proposals, and evidence that there is senior-level ownership and commitment to the proposals contained in the submission.<sup>84</sup>

In support of its self-rating of 'Standard' for the Management element of PREMO, as noted in Section 4.1.1, South East Water proposed the highest efficiency improvement rates for controllable operating expenditure over the next regulatory period (2 per cent). It has also proposed an expenditure growth rate that is below its expected customer growth rate, effectively adding to its efficiency improvement rate. Informed by advice from FTI Consulting, we have also tested South East Water's assumptions for forecast operating and capital expenditure, and our preliminary view is that they generally reflect efficient expenditure.

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<sup>83</sup> Essential Services Commission 2021, *2023 Water Price Review: Guidance Paper*, p. 45.

<sup>84</sup> Essential Services Commission 2021, *2023 Water Price Review: Guidance Paper*, p. 45.

We consider South East Water did not meet the requirements of our guidance in terms of its proposed treatment of items such as insurance costs and facilities management as capital in nature (See Section 4.1.1). Our draft decision treats the expenditure as operating expenditure.

Generally however, we consider that South East Water's price submission was of a high quality and clearly set out its proposals and supporting justification. The supporting financial model submitted by South East Water was also generally free from error. Its board also attested to the quality of the submission, and its price submission set out in detail the internal processes used to support sound governance and accountability for its price submission process.<sup>85</sup>

Taking into account the matters above, our draft decision is to accept South East Water's self-rating of 'Standard' for the Management element of PREMO.

### 7.1.5 Outcomes

The Outcomes element of PREMO is assessed against guiding questions focused on:

- the alignment of proposed outcomes with customer priorities and expenditure forecasts
- whether the proposed outcomes are measurable
- the processes established to measure performance and report to customers.<sup>86</sup>

As noted in Section 3.2, our preliminary view is that South East Water has provided evidence that demonstrates its outcome measures and targets were developed in consultation with its customers, and that they are supported by customers. Our preliminary review found that South East Water's Customer and Community Advisory Council played a key role in helping to ensure customer priorities were addressed in South East Water's price submission.

Generally, we consider South East Water's intentions are clear, and its measures and targets will provide a sound basis to track performance and delivery against each outcome. South East Water has committed to reporting its performance on its website every 6 months, and annually via our outcome reporting process. It has also committed to providing a 6-monthly update to its Customer and Community Advisory Council, providing for additional accountability.

As noted in Section 3.2.3, a number of outcome targets suggest an improvement in customer service. This, along with the real price reductions proposed by South East Water indicate customers will receive improved value over the 2023–28 regulatory period.

On the basis of the above, our draft decision is to accept South East Water's self-rating of 'Advanced' for the Outcomes element of PREMO.

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<sup>85</sup> South East Water, 2023–28 Price Submission, September 2022, p. 5-57

<sup>86</sup> Essential Services Commission 2021, *2023 Water Price Review: Guidance Paper*, p. 45.

# Appendix A — Submissions received

Name or organisation	Date received
Anonymous	7 October 2022
Ali Rahimi	10 November 2022
Greenswaps	20 November 2022
Consumer Action Law Centre	30 November 2022
Concerned Waterways Alliance	1 December 2022
Concerned Waterways Alliance	21 December 2022

## Appendix B — Commission’s consideration of legal requirements

Clause 11 of the Water Industry Regulatory Order 2014 (WIRO) specifies the mandatory factors we must have regard to when making a price determination. The WIRO covers matters that are included in the *Water Industry Act 1994* (WI Act) and the *Essential Services Commission Act 2001* (ESC Act).

Below, we describe how we apply the mandatory factors and where we have done so in our draft decision for South East Water.

In addition to the mandatory factors set out below, clause 11 of the WIRO requires the commission to have regard to the matters specified in the commission’s guidance.<sup>87</sup> We have had regard to the matters specified in our guidance in reaching our preliminary view. Our draft decision provides further information on where we have considered our guidance, and South East Water’s compliance with our guidance, in reaching our preliminary view.

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

### **Economic efficiency and viability matters**

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

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

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

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

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<sup>87</sup> Essential Services Commission, *2023 water price review: Guidance paper*, 26 October 2021.

**WIRO clause 8(b)(ii) requires us to have regard to the ‘promotion of efficiency in regulated entities as well as efficiency in, and financial viability of, the regulated water industry’.**

We consider that the delivery of outcomes which reflect customer service priorities at an efficient cost promotes efficiency in regulated entities and the water industry. Our draft decision has therefore had regard to the extent that South East Water has demonstrated its proposed outcomes reflect customer service priorities, and whether its tariffs and forecast costs reflect efficient levels of expenditure.

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

- Our consideration of customer engagement (Section 3.1).
- Our assessment of the revenue requirement (Chapter 4).
- Our assessment of efficient operating expenditure (Section 4.1) and capital expenditure (Section 4.2).
- Our assessment of tariffs (Section 5.3).
- Our assessment of financial viability (Chapter 6).

**WIRO clause 8(b)(iii) requires us to have regard to the ‘provision to regulated entities of incentives to pursue efficiency improvements’.**

We consider that the delivery of outcomes which reflect customer service priorities at an efficient cost provides regulated entities incentives to pursue efficiency improvements. The following chapters and sections of our draft decision involved consideration of this factor:

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

Additionally, our pricing approach allows a water corporation to retain the benefits of any cost efficiencies it generates until the end of its regulatory period. In other words, a water corporation has an incentive to outperform the operating and capital expenditure benchmarks we accept for the purpose of estimating its revenue requirement and prices. This is consistent with providing incentives for water corporations to pursue efficiency improvements.

**ESC Act section 8A(1)(a) requires us to have regard to ‘efficiency in the industry and incentives for long term investment’.**

We consider that adopting forecasts of efficient expenditure that reflect the service priorities of the customers of each water corporation promotes efficiency in the water industry.

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

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

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

- A 10-year trailing average approach to estimating the benchmark cost of debt (see Section 4.4.1).
- A regulatory rate of return that we consider will enable South East Water to recover borrowing costs associated with its investment in services, and generate a return on assets.<sup>88</sup>

**ESC Act section 8A(1)(b) requires us to have regard to the ‘financial viability of the industry’.**

We consider that the financial viability of the industry is secured by approving prices that provide a high degree of certainty that each water corporation can maintain an investment grade credit rating. Further, prices should enable each corporation to generate cash flow to service financing costs arising from investments to meet service expectations.

We have had regard to this matter in Chapter 6.

**ESC Act section 33(3)(b) requires us to have regard to the ‘efficient costs of producing or supplying regulated goods or services and of complying with relevant legislation and relevant health, safety, environmental and social legislation applying to the regulated industry’.**

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

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

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

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<sup>88</sup> The regulatory rate of return is comprised of the cost of debt and the return on equity.

- Our assessment of tariffs (Section 5.3).

## **Industry specific matters**

**ESC Act section 33(3)(a) requires us to have regard to the ‘particular circumstances of the regulated industry and the prescribed goods and services for which the determination is being made’.**

Our pricing approach allows each water corporation to propose outcomes, tariff structures and expenditure that reflect its particular circumstances. We consider that taking into account the particular circumstances of each water corporation is consistent with taking into account the particular circumstances of the water industry.

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

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

We have had regard to the prescribed services listed in the WIRO in making our draft decision. This includes adopting operating and capital expenditure benchmarks that we consider will allow South East Water to deliver services that are covered by the prescribed services listed in the WIRO.

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

Our draft decision provides for South East Water to generate a return on assets through:

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



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

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

- indicative bills paid by customers in other jurisdictions in Australia<sup>89</sup>
- operating and capital expenditure costs per connection throughout Australia<sup>90</sup>
- tariff structures applied by water corporations throughout Australia<sup>91</sup>
- the regulatory rate of return set by other regulators.<sup>92</sup>

We are not aware of any international benchmarks that are relevant to our draft decision.

**WI Act section 4C(b) requires us to ‘ensure that regulatory decision making and regulatory processes have regard to any differences between the operating environments of regulated entities’.**

Our pricing approach allows each water corporation to propose outcomes, a revenue requirement, expenditure and tariffs that reflect its particular circumstances and operating environment.

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

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

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

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<sup>89</sup> Bureau of Meteorology, *National performance report 2020-21; urban water utilities, part A*, February 2022.

<sup>90</sup> Bureau of Meteorology, *National performance report 2020-21; urban water utilities, part A*.

<sup>91</sup> Includes Icon Water, Sydney Water, Hunter Water, Central Coast Council, Power and Water Corp, Urban Utilities, Unity Water, SA Water and TasWater.

<sup>92</sup> Independent Pricing and Regulatory Tribunal NSW, *Final Report - Review of WaterNSW’s rural bulk water prices*, 9 September 2021; Independent Pricing and Regulatory Tribunal NSW, *Final Report - Review of prices for Sydney Water*, June 2020; Essential Services Commission of South Australia, *SA Water’s water and sewerage retail services: 1 July 2020 - 30 June 2024*, Price Determination, 1 July 2020; Queensland Competition Authority, *Final report - Seqwater bulk water price review 2022–26*, March 2022; Queensland Competition Authority (QCA), *Final report - Rural irrigation price review 2020–24, Part A: Overview*, January 2020; Office of the Tasmanian Economic Regulator, *Final report - Investigation into TasWater’s prices and services for the period 1 July 2022 to 30 June 2026*, May 2022.

## Customer matters

**ESC Act section 8(1) requires us to have regard to the fact that the ‘objective of the Commission is to promote the long term interests of Victorian consumers’.**

We consider that promoting efficiency in delivering outcomes that align to service priorities of customers is consistent with promoting the long-term interests of Victorian consumers.

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

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

**ESC Act Section 8(2) requires us to ‘have regard to the price, quality and reliability of essential services’ in seeking to achieve the objective in section 8(1) of the ESC Act.**

We consider that promoting efficiency in delivering outcomes that align to service priorities of customers, and allowing businesses to meet regulatory and policy obligations is consistent with this objective.

In terms of prices, the following chapters and sections of our draft decision involved consideration of this factor:

- Our consideration of the revenue requirement (Chapter 4).
- Our assessment of efficient operating expenditure (Section 4.1) and capital expenditure (Section 4.2).
- Our consideration of demand (Section 5.1).
- Our consideration of tariffs (Section 5.3).

In terms of the quality and reliability of services, the following sections of our draft decision involved consideration of this factor:

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

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

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

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

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

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

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

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

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

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

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

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

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

- Our consideration of customer engagement (Section 3.1).

Commission’s consideration of legal requirements

- Our consideration of outcomes (Section 3.2).
- Our consideration of guaranteed service levels (Section 3.4).
- Our consideration of tariff structures and prices (Chapter 5).

## **Health, safety, environmental and social obligations**

**ESC Act Section 8A(1)(d) requires us to have regard to ‘the relevant health, safety, environmental and social legislation applying to the industry’.**

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

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

- Our assessment of the revenue requirement (Chapter 4).
- Our assessment of efficient operating expenditure (Section 4.1) and capital expenditure (Section 4.2).
- Our assessment of the form of price control (Section 5.2).

**WI Act section 4C(c) requires us to ‘ensure that regulatory decision making has regard to the health, safety, environmental sustainability (including water conservation) and social obligations of regulated entities’.**

Our draft decision proposes to approve a revenue requirement that will enable South East Water to deliver the outcomes valued by customers, and on its health, safety, environmental sustainability and social obligations.

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

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

## **Other matters**

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

In relation to the above, South East Water does not face any competition in the delivery of its prescribed services within its region. Our draft decision takes this into account through our consideration of forecast efficient costs, and considering the service priorities of customers as revealed through a business’s customer engagement.

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

- Our assessment of engagement (Section 3.1)
- Our assessment of outcomes (Section 3.2)
- Our assessment of efficient operating expenditure (Section 4.1) and capital expenditure (Section 4.2).

We consider that our pricing approach helps to address market power and information asymmetries relating to the water corporations. Our PREMO water pricing approach provides incentives for a water corporation to provide its “best offer” to customers in its price submission. This is described in further detail in a report we released in 2016.<sup>93</sup>

**ESC Act section 8A(1)(e) requires us to have regard to the ‘benefits and costs of regulation (including externalities and gains from competition and efficiency) for: (i) consumers and users of products or services (including low income and vulnerable consumers); and (ii) regulated entities’.**

We have had regard to benefits and costs of regulation by:

- Implementing a price review process so that water corporations may receive streamlined price reviews if they submit a high quality price submission. This reduces the costs of regulation for water corporations and the commission.
- Focusing our assessments of price submissions on the materiality of proposals to customer interests (including low income and vulnerable services), including in terms of price, bill and service impacts.
- Designing our guidance so we minimise the compliance costs for water corporations. Our guidance noted that much of the information required in price submissions should be readily available to water corporations as it would be relevant for other purposes such as corporate planning and project prioritisation and justification.<sup>94</sup>

**ESC Act section 8A(1)(f) requires us to have regard to ‘consistency in regulation between States and on a national basis’.**

Similar to other state and national regulators, our economic regulatory approach:

- uses the building block method to estimate a water corporation’s revenue requirement
- allows water corporations to implement various forms of price control, including price caps and revenue caps

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<sup>93</sup> Essential Services Commission 2016, Water Pricing Framework and Approach, Implementing PREMO from 2018, October, pp. 11–13.

<sup>94</sup> Essential Services Commission, 2023 water price review: Guidance paper, p. 2.

- allows for consultation with key stakeholders during a price review, including through the release of a draft decision.

**WI Act section 4C(a) requires us to ‘ensure that the costs of regulation do not exceed the benefits’.**

We have sought to ensure that the costs of regulation do not exceed the benefits by:

- Implementing a price review process so that water corporations may receive streamlined price reviews if they submit a high quality price submission. This reduces the costs of regulation for water corporations and the commission.
- Focusing our assessments of price submissions on the materiality of proposals to customer interests (including low income and vulnerable services), including in terms of price, bill and service impacts.
- Designing our guidance so we minimise the compliance costs for water corporations. Our guidance noted that much of the information required in price submissions should be readily available to water corporations as it would be relevant for other purposes such as corporate planning and project prioritisation and justification.<sup>95</sup>
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<sup>95</sup> Essential Services Commission, 2023 water price review: *Guidance paper*, p. 2.