



Barwon 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 Barwon Water’s proposed prices for a 5-year period starting 1 July 2023

This draft decision sets out our preliminary views on Barwon Water’s price submission.¹ Our draft decision should be read together with Barwon 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>.

Barwon Water has committed to improving services in key areas

Barwon Water plans to deliver the following outcomes for customers:

- Safe, secure, sustainable water
- Innovative, reliable services
- Healthier environment
- Trust, affordability and value.²

Among key initiatives to deliver on its commitments, through its capital works program Barwon Water will increase the resilience of its infrastructure to deal with challenges including climate change and population growth. It will also increase direct financial support for customers experiencing vulnerability and those affected by family violence. Building on its engagement, Barwon Water will take a caring-for-country approach to its land and waterways in partnership with Traditional Owners, other agencies and community members and continue its support for Traditional Owner self-determination.

These outcomes will be delivered by Barwon Water alongside falling (real) prices, indicating improved value for customers.

¹ Clause 16 of the Water Industry Regulatory Order 2014 requires the Essential Services Commission to issue a draft decision; Barwon Water’s price submission is available on our website at www.esc.vic.gov.au.

² Barwon Water, 2023 water price submission, September 2022, pp. 62-63.

Our draft decision approves a lower revenue requirement than proposed by Barwon Water

Our draft decision approves a revenue requirement that will allow Barwon 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.

Our draft decision is to approve a revenue requirement of \$1,137.9 million for Barwon Water over the 5-year period starting 1 July 2023 (Chapter 4).³ This reflects our view of efficient costs. Our draft decision amount is 0.3 per cent lower than the \$1,141.3 million proposed by Barwon Water, mainly reflecting our draft decision adjustments to its forecast operating expenditure. This means (excluding inflation) Barwon Water's prices over 2023-24 to 2027-28 will be 0.3 per cent lower on average than estimated in its price submission.⁴

Estimated annual water and sewerage bills based on Barwon Water's price submission are provided in Table A. They indicate a decrease in customer bills before inflation, with bills for household owner occupiers and non-residential customers falling by around 6.8 per cent over the period from 2022-23 to 2027-28. The price path proposed by Barwon Water smooths real price reductions over the 2023–28 regulatory period. Tenant bills will increase in real terms, reflecting the progressive removal of an existing rebate applied by Barwon Water.

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

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

	Average consumption (kL p.a.)	2022-23 (current)	2023-24	2027-28
Residential – owner occupier	160	\$1,076	\$1,061	\$1,003
Residential – tenant	160	\$314	\$309	\$332
Non-residential (small)	300	\$1,723	\$1,699	\$1,606
Non-residential (medium)	3,000	\$12,827	\$12,649	\$11,960
Non-residential (large)	50,000	\$206,130	\$203,265	\$192,198

³ The revenue requirement is the forecast amount a water business 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.

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

Tariff structures will generally remain the same

Barwon Water generally proposed to maintain its existing tariff structures, with some changes to recycled water tariffs. For residential and non-residential water services, it proposed a two-part tariff with a fixed service charge and a variable usage component that depends on water use. For residential sewerage services, Barwon Water proposed a fixed service charge only. For non-residential sewerage services, Barwon Water proposed a two-part tariff with a fixed service charge and a variable usage component.

Our draft decision is to accept Barwon Water's proposed tariff structures. This reflects our preliminary view that for its water and sewerage services, the proposed tariff structures are generally a continuation of Barwon Water's current approach and are generally supported by customers. Further, we have assessed Barwon Water's proposed changes to its recycled water tariff structures and consider they comply with our guidance. Specifically, the tariff structures ensure a sustainable revenue stream and are simple to understand.

Our draft decision is to accept Barwon Water's proposed price cap form of price control (Section 5.2), for reasons including that it is the same as its current approach which we have previously approved. This means Barwon Water's maximum prices are fixed subject to updates for inflation and cost of debt, and any other price adjustments we approve in our price determination.

Our draft decision rates Barwon Water's price submission as 'Advanced' under the PREMO framework

Our draft decision is to rate Barwon 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.

Key factors supporting this PREMO rating include:

- Barwon Water has generally met (or is on track to meet) its outcome commitments in the current regulatory period.
- Barwon Water has demonstrated accountability for not meeting some of its targets under the performance incentive mechanism it adopted at the 2018 water price review.
- Barwon Water's engagement provided its customers with a high level of influence on its proposals, including through its 2-year deliberative process undertaken to develop its long-term strategy 'Water for our future', the recommendations from which were incorporated into proposed outcomes.
- Barwon Water proposed one of the highest efficiency improvement rates for controllable operating expenditure over the next regulatory period (2 per cent), contributing to price reductions (excluding inflation).

- While the financial model Barwon Water provided with its price submission needed some corrections to reflect its approved regulatory accounts, we found its submission generally was well presented and of a high standard.
- Most targets indicate Barwon Water will deliver improved service outcomes in the 2023–28 period, which along with a proposed reduction in (real) prices, indicates that customer value will be improved.

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
Barwon Water’s self-rating	Advanced	Standard	Advanced	Leading	Advanced	Advanced
Commission’s rating	Advanced	Standard	Advanced	Leading	Advanced	Advanced

Among the 9 draft decisions we have released so far, Barwon Water is one of 5 businesses 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 Barwon Water’s price submission)
- additional matters or issues we should consider before making our final decision
- whether our draft decision on Barwon 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 Barwon Water.

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

Topic	Specific issue	Draft report reference
New customer contributions	Barwon Water’s proposed increases to greenfield and infill contributions in 2023-24 and its proposed reinstatement of new customer contributions for sewerage connections.	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 28 April 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	28 April 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 businesses operating in Victoria.

1.2 We are reviewing the proposed prices of 14 water businesses

Our review is of the prices that the 14 water businesses propose to charge customers for prescribed services from 1 July 2023.⁵ The prescribed services include retail water and sewerage services, and bulk water and sewerage services delivered by the water businesses.⁶

Barwon 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 Barwon 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

⁵ 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.

⁶ 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 guidance⁷
- the principle that prices should be easily understood by customers and provide signals about the efficient costs of providing services, while avoiding price shocks where possible
- the principle that prices should take into account the interests of customers of the regulated entity, including low income and vulnerable customers.

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 Barwon Water to inform its price submission. The guidance set out how we would assess Barwon Water's submission against the matters we must consider under clause 11 of the WIRO. It also outlined our expectation that Barwon Water would comply with certain requirements and specified information that Barwon 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 Barwon Water's proposed prices.⁸

If we consider the submission does not have adequate regard for the matters specified in clause 11 of the WIRO or 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.⁹

⁷ Essential Services Commission, *2023 water price review: Guidance paper*, 26 October 2021.

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

⁹ 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"> • promotion of efficient use of prescribed services by customers [cl 8(b)(i), WIRO] • promotion of efficiency in regulated entities as well as efficiency in, and the financial viability of, the regulated water industry [cl 8(b)(ii), WIRO] • provision to regulated entities of incentives to pursue efficiency improvements [cl 8(b)(iii), WIRO] • efficiency in the industry and incentives for long term investment [s. 8A(1)(a), ESC Act] • efficient costs of producing or supplying regulated goods or services and of complying with relevant legislation and relevant health, safety, environmental and social legislation applying to the regulated industry [s. 33(3)(b), ESC Act] • financial viability of the industry [s. 8A(b)(1), ESC Act] 	<ul style="list-style-type: none"> • particular circumstances of the regulated industry and the prescribed goods and services for which the determination is being made [s. 33(3)(a), ESC Act] • return on assets in the regulated industry [s. 33(3)(c), ESC Act] • ensure that regulatory decision making and regulatory processes have regard to any differences between the operating environments of regulated entities [s. 4C(b), WI Act] 	<ul style="list-style-type: none"> • in performing its functions and exercising its powers, the objective of the Commission is to promote the long term interests of Victorian consumers [s. 8(1), ESC Act] without derogating from that objective. The Commission must in seeking to achieve the objective have regard to the price, quality and reliability of essential services [s. 8(2), ESC Act] • enable customers or potential customers of the regulated entity to easily understand the prices charged by the regulated entity for prescribed services or the manner in which such prices are calculated, determined or otherwise regulated [cl 11(d)(i), WIRO] • provide signals about the efficient costs of providing prescribed services to customers (either collectively or to an individual customer or class of customers) while avoiding price shocks where possible [cl 11(d)(ii), WIRO] • take into account the interests of customers of the regulated entity, including low income and vulnerable customers [cl 11(d)(iii), WIRO]

Continued next page

Table 1.1 (continued)

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

Note: References in the table are to the Water Industry Regulatory Order 2014 (WIRO), the Essential Services Commission Act 2001 (ESC Act), and the Water Industry Act 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 businesses to deliver outcomes most valued by customers. PREMO includes reputation incentives, via the rating of price submissions as Leading (the highest available rating), Advanced, Standard or Basic, depending on the level of ambition expressed by a water business in its price submission. Financial incentives are provided by linking the return on equity to the PREMO rating.

A key priority under PREMO is to provide incentives for a water business to engage with customers to understand their priorities and concerns and 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 businesses to assess themselves by reference to the PREMO elements.

Our PREMO framework rewards stronger customer value propositions in price submissions, and an early draft decision is available for price submissions we can assess in a short timeframe.¹⁰

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

Taking into account all five elements of PREMO, a water business must self-assess and propose a rating for its price submission as 'Leading', 'Advanced', 'Standard' or 'Basic'. Its proposed return on equity will then reflect its proposed PREMO rating. A 'Leading' submission has the highest return on equity, and a 'Basic' submission the lowest. We assess the self-rating and also assess the price submission more broadly, including the water business's justification for the proposed PREMO rating, and form our own view of the appropriate rating. This process determines the PREMO rating adopted and the return on equity reflected in the revenue requirement.¹¹

¹⁰ In December 2022, we issued early draft decisions for Yarra Valley Water and Westernport Water.

¹¹ Essential Services Commission, *2023 water price review: Guidance paper*, pp. 41–46.

2. Our assessment of Barwon Water's price submission

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

- Barwon Water's price submission
- Barwon 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 Barwon Water's price submission are available on our website (to the extent the material is not confidential).

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

We found Barwon Water's price submission generally presented clear and comprehensive information to support its proposals. Barwon 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.



Barwon 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). 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 Barwon 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 Barwon Water has committed to over the regulatory period (Chapter 3).

Our assessment of Barwon Water's price submission

- Establish Barwon 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 Barwon Water’s financial position, which we have also had regard to.

Chapter 7 outlines our assessment of Barwon 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.¹² 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.¹³

Barwon 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.

¹² This is a requirement of the WIRO, clause 9.

¹³ 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 Barwon 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 Barwon Water’s engagement with its customers in preparing its price submission
- reviews whether Barwon Water has delivered on the outcomes it committed to for the current regulatory period (2018–23) and examines the customer outcomes Barwon Water is committing to for the next regulatory period
- outlines Barwon Water’s service standards
- outlines Barwon Water’s proposed guaranteed service levels.

3.1 Customer engagement

Our guidance required Barwon Water to engage with customers to inform its price submission. Our guidance also identified principles to guide Barwon Water’s engagement.¹⁴

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

Barwon Water’s engagement on its price submission:

- commenced early, informed by ongoing engagement activities since 2017, with targeted engagement taking place between May 2021 and September 2022.
- used a wide range of engagement methods to support effective participation, including surveys, workshops, focus groups, community markets, a willingness to pay study, regional forums, webinars, fact sheets and three different deliberative processes.
- supported participation from across its geographical area, including 336,000 instances of engagement with its community, which included through e-newsletters as well as multiple opportunities for deeper engagement via its Customer Advisory Committee, regional forum and its ‘Water for our Future’ community panel.
- was inclusive of First Nations customers as well as customers at risk of vulnerability, and built on its established partnerships with Traditional Owners and customer support agencies.
- used methods were well suited to the breadth of issues it engaged on, which included the challenges and opportunities in the region, the change in community expectations for customer

¹⁴ Essential Services Commission, *2023 water price review: Guidance paper*, p. 20.

support, a growing region with ageing infrastructure, climate change, proposed investments and how to measure the business's performance.

More detail on Barwon Water's engagement is available in its price submission.¹⁵

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

- boosting financial assistance through its customer support program for customers experiencing vulnerability and those impacted by family violence, in response to strong customer feedback to care for those who need support
- installing digital meters in areas that will benefit most from water efficiency measures – in response to customers' strong interest in more efficient use of water in Barwon Water's systems and by the community (currently planned for Apollo Bay, Lorne and high leakage areas in Geelong)
- developing new public open space as an environmental and cultural asset at Porronggitj Karrong and rehabilitating Bellarine Basin, in response to what it has learned of Aboriginal Values and land management through its partnerships with Traditional Owners and its support for Traditional Owner self-determination
- upgrading the quality of recycled water where there is willingness to pay a higher price for the service in order to expand the productive use of recycled water.¹⁶

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

Overall, our preliminary view is that Barwon Water has designed and delivered a high-quality engagement program and achieved strong customer and stakeholder influence on the proposals in its submission.

Barwon Water's engagement builds on the well-developed engagement program it undertook for its 2018 price submission as well as extensive customer deliberation for its 2018 Customer Support Strategy, its 2-year 'Water for our Future' Community Panel, and 4-year Regional Forum. Insights gathered from these programs informed the targeted engagement on its price submission and ensured the quality of the customer input at each stage of the process.

We consider that Barwon Water's engagement achieved a high level of participation across its diverse customer base as seen in the high level of customer contact it was able to achieve, and the

¹⁵ Barwon Water's price submission is available on our website at www.esc.vic.gov.au.

¹⁶ For example, on the Bellarine Peninsula, users of recycled water are willing to pay a higher price for this service to support improved agricultural production.

number of participants across its deliberative processes. These engagement activities were all inputs into Barwon Water's price submission and informed its pricing proposals.

The increase in the response rate and the strong support for Barwon Water's proposals in the June 2022 check-in survey prior to lodgement of its price submission indicates the confidence that engagement participants had in its proposals.

A submission from the Consumer Action Law Centre commented favourably on the quality of Barwon Water's engagement, noting the training and discussion with committee and panel members to support their deliberations, and the depth of Barwon Water's engagement and ongoing collaboration with First Nations people.¹⁷

We also consider that Barwon Water's engagement was sensitive and inclusive, particularly for First Nations people and people experiencing vulnerability, and note the meaningful engagement with First Nations people as a result of its formal partnership with Wadawurrung Traditional Owners Aboriginal Corporation that it has established for their involvement in Barwon Water's strategic projects.

On the basis of the above, our preliminary view is that we agree with Barwon Water's self-rating of 'Leading' for its price submission engagement. See Chapter 7 for more detail on our PREMO assessment of Barwon Water's price submission.

3.2 Outcomes

3.2.1 Performance against outcome commitments 2018–23

As part of our 2018 water price review, Barwon 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 2023.¹⁸

We consider Barwon Water accounted for its annual performance for each measure in its price submission. Table 3.1 lists Barwon Water's outcome commitments and includes its annual performance results as reported in its price submission and the period-to-date rating published in

¹⁷ Consumer Action Law Centre, Initial Feedback: 2023–28 Water Price Review, 30 November 2022, p. 7.

¹⁸ Essential Services Commission, 2023 water price review: Guidance paper, 26 October 2021, p. 23.

our 2021-22 Outcomes report.¹⁹ 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 ^a
A reliable, secure water future for our region	Green	Amber	Amber	Amber	Amber
Timely, innovative services for our customers	Green	Green	Green	Green	Green
A healthier environmental for all	Green	Amber	Green	Amber	Amber
Deeper knowledge and partnerships with our community	Green	Green	Green	Green	Green
Affordability for all of our customers	Green	Green	Green	Green	Green

Note: Green = achieved target; Amber = close to achieving target; Red = failed to meet target. ^a This is Barwon Water’s self-assessment of its performance across the first 4 years of the current regulatory period. Barwon 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: Barwon Water, 2023 water price submission, September 2022, p. XX; Essential Services Commission, Barwon Water’s outcomes performance 2021-22, October 2022.

Barwon Water considers it has achieved or exceeded its targets for 114 of its 132 measures reported over the first 4 years of the current regulatory period. Of these 132 performance measures, 13 (10 per cent) have been rated as amber ‘close to achieving target’ and 5 (4 per cent) as red ‘failed to meet target’ in the period to date. It considers it has performed well, despite challenges due to the coronavirus pandemic, threats to water security, and higher than forecast regional growth.²⁰

Barwon Water was close to achieving its ‘a reliable, secure water future for our region’ outcome for the period to date. Barwon Water’s outcomes reporting revealed that it had failed to meet targets in some years for volume of recycled water allocated for productive use. Additionally, in some years of the period to date, it failed to meet its targets of zero non-compliance incidents for its Environmental Protection Authority licence conditions measure, and *Safe Drinking Water Act 2003* (water sampling and audit) measure. In its outcomes report, Barwon Water noted that investigative action and corrections were implemented to prevent recurrence of breaches of compliance.²¹

¹⁹ Barwon Water provided a period-to-date rating for the purpose of compiling our 2021-22 Outcomes report.

²⁰ Barwon Water, 2023 water price submission, September 2022, figure 2.1 *challenges and opportunities over 2018–23 regulatory period*, p. 13.

²¹ Essential Services Commission, Barwon Water’s outcomes performance 2021-22, October 2022

Barwon Water's 2018 price submission proposed a performance incentive mechanism, whereby it would incur a financial penalty for underperformance against some of its network performance and customer service-related performance measures. The cumulative value of these underperformance penalties is to be deducted from the calculated revenue requirement for the following regulatory period, to produce a corresponding price reduction for customers. Barwon Water put at risk up to \$2.3 million (\$2017-18) in total each year (or a total amount of \$11.5 million (over the 5-year regulatory period). The dollar amount it put at risk equated to the difference in its revenue requirement under an 'Advanced' PREMO rating compared to a 'Standard' PREMO rating. It used a sliding scale to determine the performance incentive amount against its actual performance for each measure to which its performance incentive mechanism applies. To acknowledge its underperformance over the first 4 years of the current period, it has determined a total penalty of \$0.18 million (\$2017-18) to be returned to customers. This level of accountability for not meeting expectations in some areas demonstrates Barwon Water's commitment to providing value to its customers.

In the current regulatory period, Barwon Water published its annual performance results on the 'About us' section of its website. It also engaged its Customer Advisory Committee in July 2022 to review Barwon Water's performance against the outcome commitments it set in its 2018 price submission, which partly informed its outcomes self-assessment.²²

Based on the matters outlined above, our draft decision is that we agree with Barwon 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

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

- Safe, secure, sustainable water
- Innovative, reliable services
- Healthier environment
- Trust, affordability and value.

Among key initiatives to deliver on its commitments, Barwon Water will invest to increase the resilience of its infrastructure to deal with challenges including climate change and population growth. It will also increase direct financial support for customers struggling with their circumstances, including customers experiencing vulnerability and those affected by family violence.

²² Essential Services Commission, Barwon Water's outcomes performance 2021-22, October 2022

Building on its engagement it will apply a caring-for-country approach to its land and waterways in partnership with Traditional Owners, other agencies and community members and continue its support for Traditional Owner self-determination.

3.2.3 Our assessment of measures and targets

Barwon Water proposed a set of 44 measures and targets that it will use to report on performance across the 4 outcomes. These are set out on pages 48 to 51 of its price submission. Performance against these measures will inform our assessment during future price reviews.

We have assessed Barwon 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.²³

Evidence provided by Barwon Water demonstrates that these measures and targets were developed in consultation with its customers, and that they are supported by its customers.²⁴ A submission from People for a Living Moorabool supports Barwon Water's 'healthier environment' outcome, particularly its measures for investment in catchment and waterway health and water entitlement returned to the Moorabool River.²⁵ Another submission commented favourably on its proposed outcomes, and considers the outcomes show a commitment to the community.

Generally, we consider Barwon Water's intentions are clear, and its measures and targets will provide a sound basis to track performance and delivery against each outcome. We have identified a number of matters that Barwon Water will need to address in its response to our draft decision to improve clarity and accountability of the targets.

To facilitate this, we will provide Barwon Water with our standard Outcomes Reporting Template, identifying the issues we have found, to complete and submit with its response to this draft decision.

²³ Essential Services Commission, 2023 water price review: Guidance paper, 26 October 2021, p. 23.

²⁴ Barwon Water engaged EY Sweeney to research customer views on its proposals prior to submitting its pricing proposal to us. This research titled *Draft 2023 Price Submission Check-in research – Final Quantitative Report, September 2022* was supplied to us to assist with our review. In it, customers rate (among other things) their comfort with the various measures and targets underpinning Barwon Water's five proposed outcomes.

²⁵ People for a Living Moorabool, Initial Feedback: 2023–28 Water Price Review, 1 December 2022.

Barwon Water’s proposed targets for its outcome measures suggest an overall improvement in customer value.

Barwon Water will continue its performance incentive mechanism in the 2023–28 regulatory period with some changes. It has proposed modifying the set of performance measures to which the mechanism applies to better reflect customer priorities, by including one measure from each of the four outcomes and including reimbursement triggers for each. Barwon Water’s proposal means up to \$15.6 million could be returned to customers if it does not meet its commitments.

Barwon Water has committed to reporting annually to its customers on how it has performed against its outcome commitments. It will continue to communicate performance by publishing on its website its annual customer scorecard, which is assessed by its Customer and Environmental Advisory committees. Additionally, it will implement a robust communications and engagement strategy to provide further insights on performance and capture more feedback from customers and key stakeholders.²⁶

Our draft decision is to accept Barwon Water’s self-assessment of ‘Advanced’ for the Outcome element of PREMO, which is discussed further in Chapter 7.

3.3 Service Standards related 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.

Barwon Water’s service standards relating to reliability and faults can be found on page 2 of its Supporting Paper 1: Service Standards and GSLs.²⁷

The service standards proposed by Barwon Water are the same as its service standards for the current regulatory period (with some wording changes to align with the updated Water Industry Standard). The service levels proposed are the same or in some cases an improvement on service levels for the current regulatory period. Barwon Water has also specified minimum flow rates as required by the Water Industry Standard.

Our preliminary assessment is that the service standards relating to reliability and faults proposed by Barwon Water comply with the requirements of the Water Industry Standard.

²⁶ Barwon Water, 2023 water price submission, September 2022, p. 52.

²⁷ Barwon Water, Supporting Paper 1: Service Standards and GSLs, February 2023, p.2.

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 Barwon Water's proposed guaranteed service levels.

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

Barwon Water's proposed guaranteed service levels are set out on pages 53 and 54 of its price submission.

Based on feedback received from customers via surveys and the Customer Advisory Committee, Barwon Water proposes to retain its existing four guaranteed services, which focus on hardship, water supply reliability and sewerage service reliability. These are supported by customers because they provide incentives to Barwon Water to deliver good outcomes in relation to services that are most important to customers. Barwon Water will also continue to annually adjust its guaranteed service level payments to reflect movements in the Consumer Price Index to ensure they do not decline in real terms.²⁸

Barwon Water has proposed to introduce a new guaranteed service in relation to sewage spills, based on customer feedback on the impact of spills inside premises and the sentiment that customers would prefer these events not to occur. Under this new guaranteed service, a customer would receive a rebate of \$1,000 if there was a sewage spill inside their premises that was caused by Barwon Water or a failure in its systems.²⁹

Our draft decision is to accept Barwon Water's proposed guaranteed service levels on the basis that they have been developed 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.

²⁸ Barwon Water, 2023 water price submission, September 2022, p. 54

²⁹ This figure is in nominal terms, that is, it will not increase further with inflation.

4. Revenue requirement

The revenue requirement is the forecast amount a water business needs to deliver on customer outcomes, government policy, statements of obligations, and obligations monitored by technical regulators including the Environment Protection Authority Victoria and the Department of Health.³⁰ 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 Barwon 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 Barwon 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 is to adopt a revenue requirement of \$1,137.9 million, 0.3 per cent lower than proposed by Barwon Water.

Barwon Water proposed a revenue requirement of \$1,141.3 million over a 5-year period starting 1 July 2023, as set out on page 81 of its price submission. Our draft decision adopts a revenue requirement of \$1,137.9 million (Table 4.1), 0.3 per cent lower than proposed by Barwon Water, mainly reflecting our proposed adjustments to forecast operating expenditure.

³⁰ 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 Barwon Water in the regulatory period from 1 July 2023. We had regard to their views in arriving at our draft decision.

Table 4.1 Draft decision on Barwon Water’s revenue requirement
\$ million 2022-23

	2023-24	2024-25	2025-26	2026-27	2027-28	Total
Operating expenditure	136.9	133.2	132.5	132.4	131.4	666.4
Return on assets	42.9	41.1	40.5	39.8	39.6	203.9
Regulatory depreciation	46.4	49.7	53.5	57.0	59.0	265.5
Adjustments from last period	0.0	0.0	0.0	0.0	0.0	0.0
Non-prescribed revenue offset of revenue requirement ^a	-0.9	-0.3	-0.3	-0.5	-0.6	-2.6
Tax allowance	0.0	0.0	0.0	0.0	4.8	4.8
Draft decision – revenue requirement	225.3	223.6	226.1	228.7	234.1	1,137.9

Note: Numbers have been rounded. ^a This includes revenue from Barwon Assets Solutions, Performance Incentive Mechanism customer reimbursement and revenue from miscellaneous non-prescribed services.

Table 4.2 summarises how our draft decision on Barwon Water’s revenue requirement (row F) differs to the revenue requirement proposed by Barwon Water in its price submission (row A). Where our draft decision differs from Barwon Water’s price submission in relation to a component of the revenue requirement, the adjustment we propose is shown in rows B to E of Table 4.2. The main adjustments relate to Barwon Water’s controllable and non-controllable operating expenditure, and return on assets and regulatory depreciation (reflecting adjustments to gross capital expenditure and customer contributions).

Our final decision on Barwon 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, Barwon 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.

Table 4.2 Our proposed adjustments to Barwon Water’s proposed revenue requirement
\$ million 2022-23

	2023-24	2024-25	2025-26	2026-27	2027-28	Total
A. Barwon Water’s proposed revenue requirement	221.6	224.2	228.1	231.0	236.3	1,141.3
B. Operating expenditure	3.5	-0.8	-2.2	-2.5	-2.4	-4.3
C. Return on assets	0.1	0.1	0.1	0.1	0.1	0.4
D. Regulatory depreciation	0.1	0.1	0.1	0.1	0.1	0.5
E. Tax liability	0.0	0.0	0.0	0.0	0.1	0.1
F. Draft decision – revenue requirement (A+B+C+D + E)	225.3	223.6	226.1	228.7	234.1	1,137.9

Notes: Our proposed adjustments are the differences between our draft decision and what Barwon Water proposed in its price submission. Row A shows the total revenue requirement proposed by Barwon 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. Numbers have been rounded.

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, Barwon 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 operating expenditure benchmark of \$666.4 million, which is \$4.3 million lower than proposed by Barwon Water.

Operating expenditure is a component of the revenue requirement. Barwon Water’s price submission provides detail on its forecast operating expenditure from pages 58 to 65.

We assess both:

- controllable operating expenditure – comprising all costs that can be directly or indirectly influenced by a water business’s decisions
- non-controllable operating expenditure – comprising all costs that cannot be directly or indirectly influenced by a water business’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 Barwon Water’s expenditure forecast is available on our website.³¹

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

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

	2023-24	2024-25	2025-26	2026-27	2027-28	Total
Controllable operating expenditure	120.61	117.12	116.59	116.89	116.13	587.34
Non-controllable operating expenditure	16.26	16.06	15.93	15.52	15.27	79.03
Bulk services ^a	6.46	6.53	6.67	6.51	6.51	32.69
Environmental contribution ^b	9.32	9.05	8.78	8.53	8.28	43.96
Licence fees – Essential Services Commission ^c	0.18	0.18	0.18	0.18	0.18	0.90
Licence fees – Department of Health ^c	0.21	0.21	0.21	0.21	0.21	1.07
Licence fees – Environmental Protection Authority ^c	0.08	0.08	0.08	0.08	0.08	0.41
Draft decision – operating expenditure	136.87	133.17	132.52	132.41	131.40	666.37

Notes: Numbers have been rounded. ^a Bulk services covers the supply of bulk water and sewerage services.

^b Environmental contributions are funds collected from water businesses under the *Water Industry Act 1994*. ^c 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 Barwon Water’s operating expenditure (row D) and its two components differ from the operating expenditure proposed by Barwon Water in its price submission (row A). Rows B and C of the table summarise our proposed adjustments to Barwon Water’s proposed controllable and non-controllable operating expenditure.

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

³¹ FTI Consulting, *Barwon Water – Expenditure Review for 2023 water price review*, February 2023.

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

The operating expenditure that we propose to adopt for Barwon Water does not represent the amount that Barwon 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 Barwon Water's proposed operating expenditure
\$ million 2022-23

	2023-24	2024-25	2025-26	2026-27	2027-28	Total
A. Barwon Water's proposed total operating expenditure	133.38	133.94	134.67	134.86	133.82	670.67
B. Our total proposed adjustments to controllable operating costs (B1 + B2)	3.18	-1.09	-2.55	-2.62	-2.52	-5.61
B1 – Total baseline adjustments	-3.50	-3.51	-3.51	-3.51	-3.52	-17.55
B1.1 – More expensive water sources turned on – Melbourne to Geelong Pipeline	-0.40	-0.40	-0.40	-0.40	-0.40	-2.00
B1.2 – Additional monitoring at Anglesea Borefield	-0.30	-0.30	-0.30	-0.30	-0.30	-1.50
B1.3 – Imminent safety issues at the Ovoid Sewer Aqueduct	-0.50	-0.50	-0.50	-0.50	-0.50	-2.50
B1.4 – East Barwon River willow tree removal	-2.30	-2.31	-2.31	-2.31	-2.32	-11.55

Continued next page

Table 4.4 (continued)

	2023-24	2024-25	2025-26	2026-27	2027-28	Total
B2 – Total step change adjustments	6.68	2.42	0.96	0.89	1.00	11.94
B2.1 – Contribution to readiness investigations for future major water supply	0.00	0.00	-0.66	-0.65	-0.55	-1.87
B2.2 – Additional resource for future major water supply	0.17	0.17	0.17	0.17	0.17	0.85
B2.3 – Additional monitoring at Anglesea borefield	0.23	0.23	0.35	0.45	0.46	1.72
B2.4 – Imminent safety issue at the Ovoid Sewer Aqueduct	2.15	0.00	0.00	0.00	0.00	2.15
B2.5 – East Barwon River willow tree removal	4.13	2.02	1.10	0.92	0.92	9.09
C. Our total proposed adjustments to non-controllable operating costs (C1)	0.31	0.33	0.40	0.18	0.10	1.32
C1 – Updated External Water Bulk Charges (Melbourne Water)	0.31	0.33	0.40	0.18	0.10	1.32
D. Draft decision – total operating expenditure (D = A + B + C)	136.87	133.17	132.52	132.41	131.40	666.37

Notes: Our proposed adjustments are the differences between our draft decision and what Barwon Water proposed in its price submission. Row A shows the total operating expenditure proposed by Barwon Water in its price submission. We have arrived at our draft decision (row D) by proposing the relevant adjustments to controllable operating costs and non-controllable operating costs shown in rows B and C (and itemised in rows B1.1 to B2.5 and row C1). Numbers have been rounded.

4.1.1 Controllable operating expenditure

Barwon Water proposed a total forecast controllable operating expenditure of \$592.96 million over a 5-year regulatory period. For the reasons set out below, we propose to adopt a forecast operating expenditure of \$587.34 million for the 2023–28 regulatory period, which is \$5.62 million lower than proposed by Barwon Water.

Barwon 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 Barwon Water to be an average of 2.1 per cent per year across the next regulatory period.
3. Apply an annual cost efficiency improvement rate – assumed by Barwon 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

Barwon Water has proposed a controllable operating expenditure baseline of \$115.0 million, after removing \$6.41 million in non-recurring operating expenditure that occurred in 2021-22. Barwon Water's proposed baseline is \$16.4 million (or 17 per cent) higher than the benchmark figure of \$98.65 million of controllable operating expenditure for 2021-22 used for our 2018 price determination.

Under the commission's framework, a business bears the risk of operating expenditure above the benchmark figure (in other words, the expenditure above the benchmark is not reflected in customer prices in a regulatory period). However, a key step in our review is to ensure that a business's proposed expenditure in the 2021-22 year reflects only ongoing prudent and efficient costs, as this is used as the baseline to estimate future operating costs.

Our expenditure consultant requested substantiation of Barwon Water's proposed increase to its baseline year operating expenditure benchmark.³² Barwon Water explained the increase was due to a number of factors including expenditure related to responding to threats to water security, catering for greater community expectations around safety and the environment, and internal innovation and transformation to improve customer value.

Our expenditure consultant investigated Barwon Water's proposed baseline which was 17 per cent higher than the benchmark figure in the 2018 price determination.

Our expenditure consultant found that Barwon Water had included several items in its proposed baseline that were not recurring costs across the regulatory period. Accordingly, our consultant recommended adjusting Barwon Water's proposed baseline to remove the following items, and

³² FTI Consulting, *Barwon Water – Expenditure Review for 2023 water price review*, February 2023, pp. 23-35.

reallocate them as a cost adjustment step change with appropriate allocations for each year of the next regulatory period:

- \$0.3 million for additional monitoring at the Anglesea Borefield
- \$0.5 million to address imminent safety issues at the Ovoid Sewer Aqueduct and maintenance for heritage assets
- \$2.3 million for catchment and river health initiatives including East Barwon River willow tree removal.

Additionally, our consultant recommended removing from the baseline the \$0.4 million for more expensive water sourced through the Melbourne to Geelong Pipeline, noting it was unclear how this expenditure item differed from the non-controllable operating expenditure charges for access to water from the Melbourne to Geelong Pipeline.

Our consultant found Barwon Water's substantiation of the remainder of these costs to be reasonable and that they were of a recurring nature, and it recommended no further adjustments to Barwon Water's proposed baseline increase. We reviewed Barwon Water's proposal and the advice from our expenditure consultant.

Based on the above, and our own review of Barwon Water's proposal, we consider Barwon Water's proposal, adjusted in accordance with our consultant's recommendations above, reflects an efficient baseline cost to forecast annual operating expenditure for the purpose of our draft decision.

4.1.1.2 Efficiency improvement and growth rate

Barwon Water proposed an average efficiency improvement rate on its controllable operating costs of 2 per cent per annum. This is the second highest when compared to other businesses in the current price review. Barwon Water proposes to deliver these efficiencies through a continuation of its successful internal efficiency program, Customer Affordability Pipeline, to realise \$5.8 million of savings.

The efficiency improvement rate is marginally lower than Barwon Water's proposed average cost growth rate of 2.1 per cent per annum over the next regulatory period, effectively delivering a small net increase to its controllable annual baseline operating costs in each year of the regulatory period. While the efficiency improvement rate is offset by strong growth forecasts when compared to other areas of Victoria, Barwon Water's overall operating expenditure still compares favourably to other Victorian water businesses, with its combined operating cost per property one of the lowest in the state.³³

³³ Bureau of Meteorology, *National performance report 2020-21; urban water utilities, part A*, February 2022.

4.1.1.3 Cost adjustments

Barwon Water has proposed additional forecast operating expenditure above the annual baseline, including:

- \$1.6 million for the implementation of Barham Catchment priority actions
- \$1.9 million to contribute to readiness investigations for future major water supply augmentation
- \$3.1 million to invest in smart networks including digital metering and platform
- \$5.3 million in cyber security uplift to improve cyber awareness and the ability to respond to a cyber-security event
- \$0.9 million for Upper Barwon River Health initiatives under a shared arrangement with Corangamite Catchment Management Authority for the Living Barwon initiatives
- \$0.7 million for the Stretch Reconciliation Action Plan including strengthening the relationship with the Eastern Maar
- \$0.8 million to prepare and implement the decommissioning plan for the Barwon Downs borefield
- \$0.8 million increase for the hardship program to provide hardship assistance to customers

The above costs represent an additional \$15.2 million over the regulatory period, or an average of \$3.0 million per annum.

Our expenditure consultant reviewed each of the proposed forecast variations above the baseline and requested further information from Barwon Water, including a further breakdown by individual cost item where required, along with documentation that supported the prudence and efficiency of each cost item.

Our consultant assessed each forecast variation against criteria for prudent and efficient operating expenditure and was satisfied most items were appropriately costed and supported by internal documentation, which included evidence of its prudence and efficiency. However, our consultant requested further information to support the following items:

- \$1.9 million to contribute to readiness investigations for future major water supply
- \$3.1 million to invest in smart networks
- \$5.3 million for cyber security uplift.

Our consultant was not satisfied with how the \$1.9 million to contribute to readiness investigations had been costed and how Barwon Water developed its estimate for its expected share of the cost across all the augmentation partners. The estimate was developed on a series of high-level assumptions, which our expenditure consultant was unable to properly assess for prudence and efficiency and consequently recommended the removal of this expenditure item.

However, our consultant did recognise the need for Barwon Water to conduct initial investigations for future water supply. Subsequently, Barwon Water proposed to our consultant an amount of

\$0.85 million for an additional resource to lead the work until there is more certainty on the readiness investigations for all augmentation partners, in lieu of the \$1.9 million, which our consultant considered a reasonable allowance for this work.

Our consultant was satisfied that the \$3.1 million for investment in smart networks was informed by pilot projects, trials and business cases while also being supported by customers that wanted more insight and control over their water use and earlier leak detection.

Our consultant was also satisfied that the \$5.3 million for cyber security uplift was supported by an overarching digital strategy combined with a detailed program of work, and it was required to comply with new or increased regulatory obligations. As such, our consultant recommended accepting these expenditure items.

Our consultant considered Barwon Water's proposed additions as a whole and was satisfied that these additions were mostly reasonable and only recommended removing one of the proposed expenditure items, the \$1.9 million to contribute to readiness investigations while allowing for \$0.85 million for an additional resource to perform initial work instead.

As identified in Section 4.1.1.1 (baseline controllable operating expenditure), our expenditure consultant also identified that Barwon Water had incorrectly included some non-recurring spending in the 2021-22 baseline and recommended its removal from the baseline. However, as the spending was prudent and efficient and was also justified as necessary to meet legislative or regulatory obligations, customer support, and alignment with Victorian Government policy, our expenditure consultant recommended the addition of the following as a cost adjustment step change:

- \$1.72 million for additional monitoring at the Anglesea Borefield
- \$2.15 million to address imminent safety issues at the Ovoid Sewer Aqueduct and maintenance for heritage assets
- \$9.09 million for catchment and river health initiatives including East Barwon River willow tree removal.

We have considered the advice from our consultant, and Barwon Water's proposal. We consider Barwon Water's approach to forecasting its operating expenditure is mostly consistent with the requirements of our guidance. Our preliminary position is that we are satisfied that its proposed forecast represents efficient controllable operating expenditure for the next regulatory period after the following adjustments to the step changes:

- removal of \$1.9 million to contribute to readiness investigations for future major water supply
- addition of \$0.85 million for an additional resource to perform initial future major water supply investigations

- addition of \$13.0 million to account for additional monitoring at the Anglesea Borefield; imminent safety issues at the Ovoid Sewer Aqueduct and maintenance for heritage assets; and catchment and river health initiatives which were classified as non-recurring costs and taken out of the baseline.

There is evidence that Barwon 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 contribution³⁴
- adjusting the forecasts proposed by Barwon Water where required.

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

Barwon Water has proposed \$77.7 million in non-controllable operating expenditure over the 2023–28 regulatory period. This is an increase of \$27.2 million compared to the 2018–23 regulatory period, driven by a \$31.4 million increase in new external bulk charges, balanced against a decrease of \$4.3 million due to forecast decreases in the real value of the environmental contribution. The large increase in bulk charges is consistent with our decision in 2018 to allow Barwon Water to capitalise its new Melbourne Water headworks charges to avoid a price shock in the 2018–23 regulatory period, with an expectation these charges would revert to operating expenditure from 2023.

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. Barwon Water has followed this approach in its price submission.

Since lodging its price submission with us, we identified that Barwon Water’s proposed bulk water charges paid to Melbourne Water were not consistent with our latest annual tariff approval for Melbourne Water in 2022. Barwon Water subsequently submitted a revised financial model with updated figures which has increased the total non-controllable operating expenditure by a further

³⁴ Environmental contributions are funds collected from water businesses under the *Water Industry Act 1994*.

\$1.3 million over the next regulatory period to a total of \$79.0 million in non-controllable operating expenditure.

We have verified that Barwon Water's revised forecast bulk charges are consistent with Melbourne Water's 2021 price determination.

Accordingly, consistent with the reasoning in our guidance paper, our draft decision is to adopt a total of \$79.0 million in non-controllable operating expenditure over the 5-year regulatory period, which is the same as Barwon Water's revised proposal.

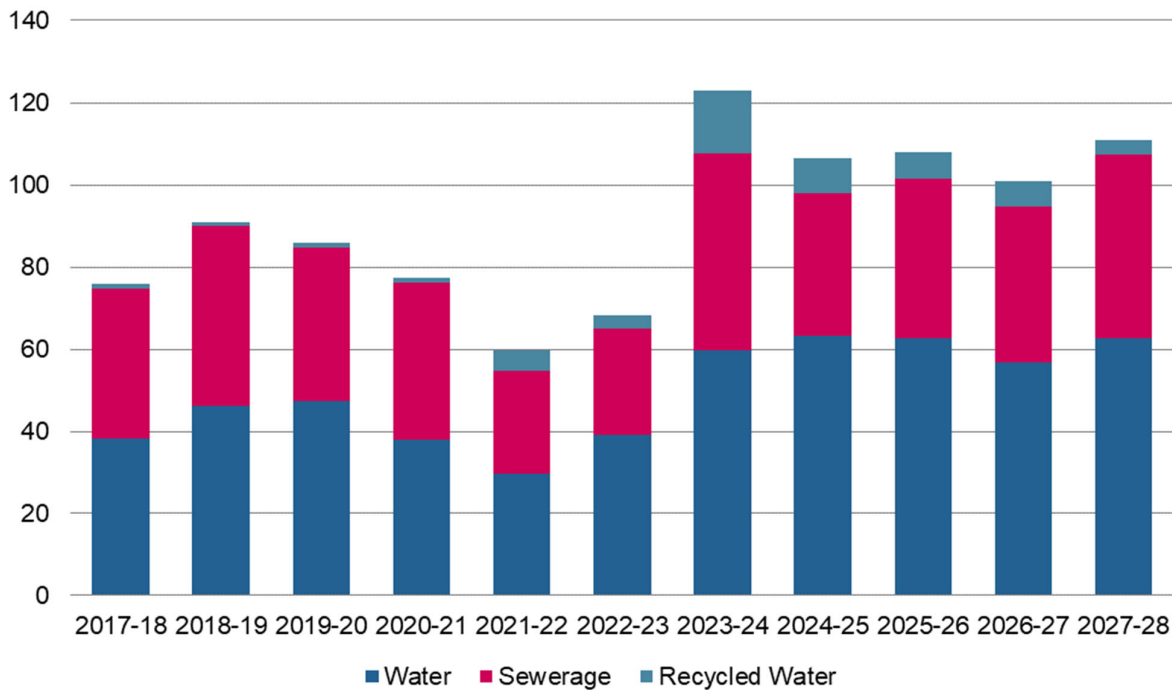
Prior to making our final decision, we will update the forecast licence fee and environmental contribution values with the relevant regulatory bodies and adjust where necessary for the latest inflation and external bulk charges data.

4.2 Capital expenditure

Our draft decision is to accept Barwon Water's proposed forecast capital expenditure of \$549.4 million between 2023-24 and 2027-28.

Capital expenditure is an input to estimating the regulatory asset base, which is an input to the revenue requirement. Barwon Water's forecast capital expenditure and supporting information is provided at pages 66 to 76 of its price submission. Figure 4.1 shows Barwon 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) is relevant to the calculation of the closing regulatory asset base discussed in Section 4.3.1.

Figure 4.1 Gross capital expenditure by service category
\$ million 2022-23



Note: This graph shows actual figures for 2017-18 to 2021-22, and Barwon 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 Barwon Water’s expenditure forecast is available on our website.³⁵

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.

Since lodging its price submission with us, Barwon Water’s annual regulatory accounts audit identified some necessary changes to the reported capital expenditure (Table 4.5). This results in a \$4.7 million increase in actual capital expenditure in 2021-22. We propose to accept this change because it is consistent with Barwon Water’s approved regulatory accounts (see Section 4.3.1). Our assessment below reflects these revised figures.

³⁵ FTI Consulting, *Barwon Water: Review of expenditure forecasts - 2023 Water Price Review*, February 2023.

Table 4.5 Our proposed adjustments to Barwon Water’s proposed total prescribed capital expenditure

\$ million 2022-23

	2017-18	2018-19	2019-20	2020-21	2021-22	2022-23	Total
Barwon Water’s proposed total prescribed capital expenditure	76.02	91.10	86.09	77.38	55.12	68.45	454.16
Our adjustments – regulatory accounting reconciliation	0.00	0.00	0.00	0.00	4.73	0.00	4.73
Draft decision – Total prescribed capital expenditure	76.02	91.10	86.09	77.38	59.85	68.45	458.89

Note: Actual total prescribed capital expenditure from 2017-18 to 2021-22, forecast in 2022-23.

Over the period from 2017-18 to 2021-22, Barwon Water incurred capital expenditure in net terms of \$315.4 million, \$17.3 million or 5.2 per cent below the benchmarks adopted at the 2018 price review. For 2022-23 Barwon Water’s gross capital expenditure will exceed the benchmark adopted at the 2018 review. However, it has proposed that the expenditure reflected in prices matches the benchmark adopted at the 2018 price review, consistent with the approach in our guidance.³⁶

Barwon Water’s price submission also provided a summary of its major capital projects and their status, consistent with the project timelines noted in its major capital projects report as at the end of June 2022.³⁷ As at September 2022, Barwon Water reported that of the two projects that were carried over from the 2013–18 regulatory period – the Black Rock water reclamation plant hydraulic capacity upgrade was completed, while the Torquay West high level feeder main has been deferred to 2023–28.

Of the top 10 major projects proposed for the 2018–23 regulatory period, 3 have been completed and 4 are delayed, but remain in progress (with one project expected to be completed in 2022-23). Barwon Water delayed these 4 projects in response to events during the regulatory period, including the need to reprioritise projects to deliver higher need projects in the period and changes in government legislation. The delays range from 12 to 24 months. It has also deferred 2 major

³⁶ The 2018 determination figure is used for the purposes of calculating the regulatory asset base. The updated gross capital expenditure forecast for 2022-23 is \$117.1 million as noted in Barwon Water’s written submission.

³⁷ Essential Services Commission, *Status of Major Projects Supplement: Outcomes report 2021–22*, 18 October 2022, pp. 3–5. Barwon Water’s major projects are 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.

projects following the development of lower-cost solutions to meet the project objectives and another in response to a change in government policy.

We consider Barwon Water's approach to delivering its major projects is reflective of appropriate management of its capital program in response to changing priorities and requirements, noting we expect Barwon Water will continue reporting on the delivery of these projects to its customers until they are delivered.

4.2.2 Forecast Capital Expenditure

For the reasons set out below, our draft decision is to accept the forecast capital expenditure of \$549.4 million proposed by Barwon Water for the purpose of calculating its revenue requirement:

- Barwon Water's price submission provided evidence that its forecasts for capital expenditure are prudent and efficient. Its total proposed capital expenditure is \$166.5 million (43.5 per cent) higher than actual capital expenditure in the current 2018–23 period.³⁸ This is due to proposed increases in expenditure to meet high rates of growth (\$108.2 million total, or 19.7 per cent of its capital program) and increased expenditure on renewals (\$248.2 million total, or 45.2 per cent of its capital program) to maintain ageing infrastructure. Barwon Water has forecast \$106.6 million (19.4 per cent of its capital program) to deliver its top 10 major projects over the next regulatory period and \$233 million (42.4 per cent) to deliver 17 major programs. A further \$170.5 million (31 per cent) is allocated to smaller programs and projects.
- Our expenditure consultant requested selected documents from Barwon Water as a representative sample to demonstrate its asset management processes and justification for its top 10 major projects and the remainder of its capital expenditure program. Based on the sample of documents reviewed and Barwon Water's responses to questions, our consultant found that Barwon Water has a robust approach for developing project scope, the timing of works and cost estimates.³⁹
- Of the top 10 major projects proposed by Barwon Water, our expenditure consultant reviewed information on the Pettavel Basin augmentation (\$17.5 million over the regulatory period), the Recycled Water on the Bellarine (stage 3) project (\$13.6 million) and the Colac Birregurra Pipeline (\$10.1 million over the regulatory period). Our consultant considered the business cases and supporting information for each project were sufficiently detailed, appropriately

³⁸ In its submission, Barwon Water provided an updated forecast of \$117.1 million of capital expenditure for 2022-23, but has sought only to include the benchmark amount of \$68.5 million in the regulatory asset base, in line with the benchmark that was approved in its 2018 price determination. When considering the updated forecast for 2022-23, Barwon Water is forecast to increase its capital expenditure program by \$117.9 million (or 27.3 per cent). Barwon Water will seek to roll in any additional expenditure that occurs in this year at the end of the next regulatory period.

³⁹ FTI Consulting, *Barwon Water: Review of expenditure forecasts - 2023 Water Price Review, February 2023*, pp. 57-59.

costed and provided a high level of confidence the proposed expenditure was prudent and efficient.

- Our consultant also reviewed a number of the underlying asset renewal plans, strategies and supporting documentation for a sample of Barwon Water's major programs. Our consultant found this information provided evidence these programs have been developed and prioritised appropriately.
- Our preliminary view is that the planned capital expenditure program is achievable given Barwon Water's past track record in delivering its capital expenditure program. Over the current 2018–23 regulatory period, Barwon Water has delivered three of its major projects, and is expected to deliver four delayed major projects within 12 to 24 months of their original expected completion dates due to project reprioritisation. Three remaining projects were deferred where efficiencies were found to deliver project objectives at lower costs, or land acquisition was unable to be realised due to changes in government policy.⁴⁰ Barwon Water's submission also noted its past delivery of large capital programs, referencing its 2008–13 capital program (\$946 million). Our expenditure consultant also found that Barwon Water has prepared to deliver a larger capital program, noting it has implemented a number of initiatives to enhance its delivery arrangements and governance processes.⁴¹
- Barwon Water has excluded approximately \$111.7 million of project costs from its price submission where there is uncertainty in timing, cost, scope and benefits of capital expenditure, under its 'customer pays later' proposal. This equates to about 20.3 per cent of the forecast capital expenditure. Barwon Water also excluded a further \$50 million in capital expenditure where it has identified projects that can be reduced in scope or deferred. Barwon Water has accepted the risk that it can maintain required service levels without this additional expenditure. This approach is consistent with our guidance for managing uncertain expenditure. Our draft decision is to accept Barwon Water's proposal for addressing uncertainty, noting the following:
 - Barwon Water will need to demonstrate the prudence and efficiency of these costs if they are 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 received a number of submissions from stakeholders regarding a capital project proposed by Barwon Water to upgrade wastewater treatment and sewerage services in the town of Forrest.

⁴⁰ Essential Services Commission, *Status of Major Projects Supplement: Outcomes report 2021-22*, 18 October 2022, pp. 3–6.

⁴¹ FTI Consulting, *Barwon Water: Review of expenditure forecasts - 2023 Water Price Review, February 2023*, pp. 55-57.

Some stakeholders supported the project, and some raised concerns with Barwon Water's proposed solution.⁴²

Barwon Water has proposed capital expenditure of \$1.9 million in the next regulatory period to undertake design works relating to this project, but expects to begin construction later in the period, with expenditure to be recouped in the 2028–33 regulatory period under its 'customer pays later' proposal. Barwon Water has stated it undertook a substantive engagement process with customers on how to best meet the need for this work, and Barwon Water considers its proposed approach received a majority of customer support. We expect Barwon Water to continue engaging with its customers on this project across the period as it undertakes design works and moves towards a construction phase.

Overall, our expenditure consultant considered Barwon Water's forecasts were well developed and that its forecast capital expenditure program is prudent, efficient and deliverable. Our consultant recommended no adjustments to Barwon Water's forecast capital expenditure for the next regulatory period based on the information sighted, the significant amount of capital expenditure Barwon Water has excluded from its proposed capital program under its 'customer pays later' proposal, and that any adjustment made to expenditure at the end of the period to account for variations in timing would not materially impact customer prices.⁴³ Our preliminary position is that 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.

We have reviewed Barwon Water's proposals and advice from FTI Consulting. Our preliminary position is that we agree with our consultant's assessment and consider Barwon 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 2014.⁴⁴

Our draft decision for gross capital expenditure is therefore to accept Barwon Water's proposed benchmark. The benchmark we propose to adopt is set out in Table 4.6.

⁴² Nasser Kotb, submission to the Essential Services Commission on Barwon Water's 2023 price submission, 3 November 2022; Michelle Davidson, submission to the Essential Services Commission on Barwon Water's 2023 price submission, 3 November 2022; Forrest District Community Group, submission to the Essential Services Commission on Barwon Water's 2023 price submission, 14 November 2022; Kingsley Davidson, submission to the Essential Services Commission on Barwon Water's 2023 price submission, 24 November 2022; Matthew Bradshaw, submission to the Essential Services Commission on Barwon Water's 2023 price submission, 28 November 2022; Byron Pakula, submission to the Essential Services Commission on Barwon Water's 2023 price submission, 1 December 2022.

⁴³ FTI Consulting, *Barwon Water: Review of expenditure forecasts - 2023 Water Price Review, February 2023*, pp. 54, 57-58.

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

The benchmark that we propose to adopt for Barwon Water does not represent the amount that Barwon 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 Barwon Water's revenue requirement, we are not requiring the business to remove that project. Barwon Water determines how to best manage the allocation of its revenue and priority of its expenditure within a regulatory period.

4.3 Regulatory asset base

A water business's regulatory asset base is the value of the business's assets for regulatory purposes.⁴⁵ 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 Barwon 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.

4.3.1 Closing regulatory asset base

Our draft decision is to adopt a closing regulatory asset base of \$1,548.6 million at 30 June 2022, which is higher than the \$1,545.4 million proposed by Barwon 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 2021-22.⁴⁶ This helps to ensure prices reflect the actual net expenditure of a water business.⁴⁷

⁴⁵ These values were set initially for the water businesses by the Minister for Water and are adjusted on an ongoing basis to account for new investments, asset disposals, depreciation and inflation.

⁴⁶ See Section 4.2 for a discussion of Barwon Water's capital expenditure.

⁴⁷ Net capital expenditure is calculated by deducting government and customer contributions from gross capital expenditure. Customer contributions reflect revenue earned from new connections made to the water business's water, sewerage or recycled water networks.

Barwon Water's proposed closing asset base at 30 June 2022 is provided at page 78 of its price submission.⁴⁸

Reflecting corrections arising from Barwon Water's approved regulatory accounts for 2021-22, for Barwon Water's 2021-22 capital expenditure, customer contributions and asset disposals, our draft decision adopts a closing regulatory asset base of \$1,548.6 million at 30 June 2022. This is slightly higher than the amount Barwon Water proposed in its price submission (\$1,545.4 million).

We compared Barwon Water's actual 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 business'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.

As noted in Section 4.2.1, Barwon Water's net capital expenditure over the period from 2017-18 to 2021-22 was 5.2 per cent lower than the forecast used to approve maximum prices for the period from 1 July 2018. This amount is well below the 10 per cent threshold noted above, so we propose to accept the amount of \$315.4 million for inclusion in Barwon Water's regulatory asset base at 30 June 2022.

Table 4.6 sets out our draft decision on Barwon Water's closing regulatory asset base at 30 June 2022.

⁴⁸ Available at www.esc.vic.gov.au.

Table 4.6 Draft decision – closing regulatory asset base (RAB)
\$ million 2022-23

	2017-18	2018-19	2019-20	2020-21	2021-22
Opening RAB 1 July	1,524.8	1,533.9	1,569.5	1,581.5	1,571.8
Plus gross capital expenditure	76.0	91.1	86.1	77.4	59.8
Less government contributions	0.0	0.0	0.0	0.0	3.5
Less customer contributions	19.1	12.3	15.7	12.4	11.9
Less proceeds from disposals	8.4	0.9	13.3	26.9	18.0
Less regulatory depreciation	39.3	42.2	45.1	47.7	49.6
Closing RAB 30 June	1,533.9	1,569.5	1,581.5	1,571.8	1,548.6

Note: Numbers have been rounded.

4.3.2 Forecast regulatory asset base

Our draft decision is to not accept Barwon Water’s proposed forecast regulatory asset base, reflecting our preliminary views on its closing 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 Barwon Water’s closing regulatory asset base noted above in Section 4.3.1, our draft decision is to not accept Barwon Water’s forecast regulatory asset base for the period 2023-24 to 2027-28

Table 4.7 sets out our draft decision on Barwon Water’s forecast regulatory asset base from 1 July 2023.⁴⁹ Our assessments of the components of the forecast regulatory asset base are outlined in different sections of this draft decision paper as follows:

- Section 4.2 (capital expenditure)

⁴⁹ Our guidance required water businesses to provide an estimate of the components of their regulatory asset base for 2022-23. This was so we could assess the opening asset base for 1 July 2023. Our guidance noted that where the 2022–23 forecasts for net capital expenditure (gross capital expenditure less government and customer contributions) is lower than the forecast benchmark for that year in its 2018 price determination, the lower amount must be used. The estimates for 2022 23 will be confirmed at the price review following the 2023 water price review. Essential Services Commission, *2023 water price review: Guidance paper*, p. 38.

- Section 4.3.2.1 (customer contributions)
- Section 4.5 (regulatory depreciation).

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

	2022-23	2023-24	2024-25	2025-26	2026-27	2027-28
Opening RAB 1 July	1,548.6	1,553.7	1,612.6	1,652.3	1,693.0	1,723.2
Plus gross capital expenditure	68.5	122.9	106.6	108.0	101.1	110.8
Less government contributions	0.5	3.4	2.9	0.0	0.0	0.0
Less customer contributions	10.9	13.3	13.4	13.6	13.6	13.5
Less proceeds from disposals	2.9	0.9	1.0	0.2	0.2	0.2
Less regulatory depreciation	49.1	46.4	49.7	53.5	57.0	59.0
Closing RAB 30 June	1,553.7	1,612.6	1,652.3	1,693.0	1,723.2	1,761.4

Note: Numbers have been rounded

4.3.2.1 Customer contributions

Our draft decision is to accept Barwon Water's forecast for customer contributions.

Revenue from customer contributions is deducted from gross capital expenditure so it is not included in the regulatory asset base.⁵⁰

We compared Barwon Water's forecast for customer contributions with past outcomes. Our preliminary view is that Barwon Water's forecast contributions were calculated on a reasonable basis. Accordingly, our draft decision is to accept Barwon Water's forecast.

⁵⁰ Revenue from new customer contributions reflects revenue earned from new connections made to the water business's water, sewerage or recycled water networks.

4.4 Rate of return

In establishing the return on assets component of Barwon Water's revenue requirement, we have applied a rate of return to Barwon 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 Barwon Water.

Our guidance required Barwon Water to use estimates of the cost of debt provided by the commission to estimate its revenue requirement. Barwon Water used the cost of debt values we specified to calculate its revenue requirement. For this reason, as set out in Table 4.8, our draft decision is to accept the cost of debt proposed by Barwon 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 4.8 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% ^a

Note: Numbers have been rounded. ^a 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 a return on equity of 4.5 per cent, which reflects Barwon Water's PREMO self-rating.

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

Our guidance included a matrix proposing the return on equity we would adopt, based on the combination of the business's self-rating and our rating.⁵¹ 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.⁵²

Barwon Water rated its price submission as 'Advanced'. Based on this PREMO self-rating, Barwon Water proposed a return on equity of 4.5 per cent per annum. This reflects the maximum return rate allowed in our guidance for a price submission rated as 'Advanced'.⁵³

As outlined in Chapter 7, our draft decision is to agree with Barwon Water's PREMO self-rating and adopt its proposed return on equity.

4.5 Regulatory depreciation

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

Regulatory depreciation is a component of Barwon Water's revenue requirement and is also an input to calculating the regulatory asset base. Barwon Water's forecast regulatory depreciation was calculated using a straight-line depreciation profile.⁵⁴ We noted in our guidance that we prefer this approach.⁵⁵ However, our draft decision is to not accept Barwon Water's forecast for regulatory depreciation, noting our draft decision on its forecast regulatory asset base (Section 4.2.2).

Our draft decision on regulatory depreciation is shown in Table 4.7 in Section 4.3.2. This reflects an updated estimate for depreciation reflecting our draft decision on Barwon Water's forecast regulatory asset base, using the asset lives proposed by Barwon Water.

⁵¹ Essential Services Commission, *2023 water price review: Guidance paper*, pp. 42–43.

⁵² 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.

⁵³ Essential Services Commission, *2023 water price review: Guidance paper*, p. 42.

⁵⁴ For the period from 2022-23 to 2027-28, Barwon Water proposed a regulatory depreciation of \$314.7 million.

⁵⁵ Essential Services Commission, *2023 water price review: Guidance paper*, p. 39.

4.6 Tax allowance

Our draft decision is to not accept Barwon Water's proposed tax allowance.

The tax allowance is a component of the revenue requirement. Barwon Water has proposed a tax allowance of \$4.7 million in its revenue requirement for the 2023–28 regulatory period. As we have adopted a lower revenue requirement compared to Barwon Water's proposed revenue requirement, our draft decision is to not accept the proposed forecast tax allowance.

Our draft decision adopts an adjusted tax allowance of \$4.8 million. This amount reflects a slightly higher net revenue due to our proposed adjustments to Barwon Water's revenues and costs for 2023–28. Barwon Water's response to our draft decision must justify and provide an updated estimate for its tax forecasts, based on our draft decision.

5. Demand, tariffs and prices

Once Barwon 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 Barwon Water's demand forecasts.

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

Barwon Water's demand forecasts are set out at pages 82 to 88 of its price submission and are also included in its financial model.

Our draft decision is to accept Barwon 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, Barwon 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 Barwon Water's proposed price cap form of price control.

Our guidance indicated we would have particular regard to whether a business proposed to continue its existing form of price control or introduce a new form of price control.⁵⁶

Barwon Water proposed a price cap form of price control as set out on pages 89 to 90 of its price submission. This is the same as its current approach. Under the price cap form of price control, maximum prices for each prescribed service for the 2023–28 regulatory period are determined at the start of the regulatory period. Adjustments to account for movements in inflation (measured by the consumer price index published by the Australian Bureau of Statistics), return on assets and any approved pass-through mechanisms will be made during the regulatory period.

⁵⁶ Essential Services Commission, *2023 water price review: Guidance paper*, p. 50.

Our draft decision is to accept Barwon Water’s proposed form of price control because:

- it is the same as its current approach, which we have previously approved
- it provides sufficient revenue to cover the forecast efficient costs of providing services and for Barwon Water to deliver on any health, safety and environmental obligations
- it is easy to verify that proposed prices comply with the determination requirements
- it provides Barwon Water’s customers with price certainty
- it is easy to explain to customers
- demand risk is more efficiently managed by Barwon Water than by its customers
- it was otherwise consistent with the requirements of our guidance.

5.3 Tariff structures and prices

Our draft decision is to accept Barwon Water’s proposed tariff structures.

Barwon Water’s proposed tariffs are set out at pages 89 to 93 of its price submission.

Our draft decision does not approve prices for each tariff because as noted above, prices will need to be updated by Barwon Water to reflect 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 businesses with a large degree of discretion to decide on individual tariff structures.⁵⁷ This recognises water businesses are often best placed to consider the interests of customers in designing tariffs, and that existing tariff structures have been developed over time to deal with a variety of local circumstances.

Barwon Water generally proposed to maintain its existing tariff structures, with some changes to recycled water tariffs. For residential and non-residential water services, it proposed a two-part tariff with a fixed service charge and a variable usage component that depends on water use. For residential sewerage services, Barwon Water proposed a fixed service charge only. For non-residential sewerage services, Barwon Water proposed a two-part tariff with a fixed service charge and a variable usage component.

Our draft decision is to accept Barwon Water’s proposed tariff structures, on the basis that they are generally a continuation of Barwon Water’s current approach and otherwise meet the criteria in our guidance and are generally supported by its customers.

⁵⁷ Essential Services Commission, *2023 water price review: Guidance paper*, p. 51.

Our preliminary view is that the two-part tariff structure proposed by Barwon Water for 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.⁵⁸ We also consider two-part tariff structures are easy to understand.

For sewerage services, we consider Barwon Water's proposed fixed charge for residential customers is easy to understand. A two-part tariff for non-residential customers sends these customers signals about efficient costs.⁵⁹

For recycled water services, Barwon Water proposed the following changes:

- a new tariff for Class B recycled water from the Portarlinton Water Reclamation Plant
- transitioning to uniform tariffs to deliver Class C recycled water to customers from several smaller water reclamation plants
- charging the recycled water class C at Bannockburn Water Reclamation Plant a single, common price. For most customers, this change will either lower their prices or keep them the same. But, for some customers, their prices will go up from \$97 to \$109.

Barwon Water noted in its price submission that the proposed changes to tariffs are cost reflective and are consistent with the pricing principles in our guidance.

5.3.2 Prices

The prices proposed by Barwon Water for water and sewerage services are set out on pages 89 to 91 of its price submission.

Under Barwon Water's proposal, average residential water and sewerage prices are expected to decrease by 1.4 per cent each year, excluding inflation. Non-residential customers will see a similar decrease in prices before inflation.

However, tenants can expect a slight increase in their bills over the next 5 years (excluding inflation) due to the gradual removal of an efficiency rebate from their bills by 2027-28. Barwon Water's decision to remove this rebate was made with the support of stakeholders during its consultation period and is estimated to result in an increase of about \$6 per annum more than inflation for tenant water and sewerage bills.

We reviewed Barwon Water's engagement program and our preliminary position is that we are satisfied that Barwon Water has tested the proposed price path with customers. We have received several submissions from Barwon Water's stakeholders in support of its proposed prices. The

⁵⁸ 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.

⁵⁹ Our reasons are outlined in our 2013 draft decisions on price review 2013-14 to 2017-18.

submission indicates that submitters consider prices are fair and they are supportive of tariff structure, but expressed preferences for inclining block tariff and setting minimum charges for covering basic households needs.⁶⁰ A submission by the Concerned Waterways Alliance noted it does not understand why inclining block tariffs are not adopted by all water businesses.⁶¹ We note that changes to these structures can impact customers in different ways – for example, they can impact on affordability for larger households. The Consumer Action Law Centre noted Barwon Water’s decreasing price path.⁶²

In May 2023, we intend to determine prices for Barwon 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.

Based on recent inflation outcomes and market expectations, the annual outcome for the March Quarter 2023 consumer price index is likely to be relatively high. We are seeking further information from Barwon Water in its response to our draft decision on how it intends to address the impacts of relatively high inflation on its proposed prices and customer bills for 2023-24.

As part of its response, Barwon Water must demonstrate how it has considered the impacts of inflation on its forecast expenditure in 2023-24, and whether they are reasonable taking into account that some of its key costs (such as labour) are unlikely to increase in line with near term inflation.

Barwon 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, Barwon 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 Barwon Water’s prices take into account the interests of customers, including low income and vulnerable customers.⁶³

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

- its tariffs reflect efficient costs for delivering services

⁶⁰ Anonymous, submission to the Essential Services Commission on Barwon Water’s 2023 price submission, 10 October 2022.

⁶¹ Concerned Waterways Alliance, submission to the Essential Services Commission Water Price Review 2023, 1 December 2022.

⁶² Consumer Action Law Centre, Initial Feedback: 2023-28 Water Price Review, Essential Services Commission, 30 November 2022.

⁶³ Water Industry Regulatory Order 2014 clause 11(d)(iii).

- its tariffs were informed by an extensive customer engagement program, including with customer support agencies who represent customers experiencing vulnerability
- it proposed increasing the financial assistance available to customers through its customer support programs, including for renters who experience difficulty paying bills as the Transitional Rebate Adjustment is removed
- it proposed increasing access to customer support through upgrades to its contact centre and investment in staff training.

5.3.4 Unique services

Following a review of its trade waste charges, Barwon Water proposed in its price submission to maintain the current variable charges. However, it proposed changes to its trade waste quality charges to better reflect the costs of managing the strength of the waste. These proposed changes will result in a reduction in trade waste charges for the majority of its customers. However, customers with a higher chemical oxygen demand or phosphorous load will experience a bill increase, estimated at no more than 2 per cent (excluding inflation).

Barwon 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.

5.4 New customer contributions

Our draft decision is to accept Barwon Water's proposed standard and negotiated new customer contributions.

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

Barwon Water's proposed standard and negotiated new customer contributions are set out at pages 93 and 94 of its price submission.

Barwon Water proposed increases in the standard water supply charge of 9.9 per cent for greenfield contributions and 9 per cent for infill contributions in 2023-24, with no further increases in real terms for the last 4 years of the regulatory period.⁶⁴ Barwon Water indicated the proposed

⁶⁴ A development is considered infill if it can be serviced by existing infrastructure and does not trigger the need for a capacity upgrade.

increases were primarily driven by rising expenditure to service demand growth in the region and we consider the expenditure to be prudent and efficient.⁶⁵

For the 2023–28 regulatory period, Barwon Water proposed to reinstate standard new customer contributions for sewerage connections, which had been removed for the 2018–23 regulatory period due to reduced capital expenditure forecasts in sewerage assets. The proposed reinstatement of standard new customer contributions reflects that Barwon Water now forecasts growth in new sewerage connections and an increase in capital expenditure in sewerage services.⁶⁶

Barwon Water also proposed to continue applying area-specific water and sewerage charges for the Fyansford growth area, by contracts established under its negotiated new customer contributions framework. It proposed to keep these charges unchanged in real terms during the 2023–28 regulatory period.

We have reviewed Barwon Water’s proposed standard new customer contributions and consider they are consistent with the new customer contribution pricing principles outlined in our guidance.⁶⁷ For this reason, our draft decision is to accept Barwon Water’s proposed standard new customer contributions.

Barwon Water noted it engaged with developers about its proposed new customer contributions, including through an online forum during April and May 2022. Barwon Water provided evidence that developers generally understood the drivers of the increase in standard new customer contributions and the need to balance expenditure with the timing of growth investments. However, we invite developers and customers to provide any further comments on Barwon Water’s proposal and our draft decision.

We consider Barwon Water’s proposed negotiated new customer contribution contracts comply with the requirements of our new customer contribution pricing principles.⁶⁸ Therefore, our draft decision is to accept Barwon Water’s proposed negotiated new customer contribution framework.

⁶⁵ Barwon Water, 2023 water price review submission, 30 September, p. 95. We reviewed Barwon Water’s proposed expenditure forecast and found it prudent and efficient. Our draft decision can be found in Section 4.2.

⁶⁶ Barwon Water, 2023 water price review: Supporting Paper 7 - NCC tariff structure and prices, 30 September 2022.

⁶⁷ Essential Services Commission, *2023 water price review: Guidance paper*, p. 58.

⁶⁸ Essential Services Commission, *2023 water price review: Guidance paper*, p. 58.

5.5 Adjusting prices

Our draft decision is to accept Barwon Water's proposed approach to uncertain and unforeseen events.

Our draft decision is to not accept Barwon Water's proposed approach to Melbourne Water's bulk water tariffs applying from 2025-26.

Barwon Water's proposed price adjustment mechanisms are set out at page 90 of its price submission. It proposed to maintain the current mechanism for adjusting prices in response to uncertain and unforeseen events.

Barwon Water has not proposed to add other price adjustment mechanisms. This means that Barwon Water has proposed to accept the potential risks of increases in the Environmental Contribution (due for review in 2023-24).

Further, it proposes no adjustment mechanism to reflect the bulk water headworks and transfer charges as a result of Melbourne Water's 2025-26 price review. The goal of this proposal is to keep prices as low as possible and simplify the adjustment mechanisms.⁶⁹

For consistency across businesses, our draft decision proposes to maintain the current adjustment mechanisms that allow prices to change in response to changes in Melbourne Water's bulk water charges. We note that Barwon Water may choose not to pass changes in costs through to its customers if they result in higher customer prices.

⁶⁹ Barwon Water, 2023 water price review submission, 30 September, p. 90. This refers to Barwon Water's general proposal for its form of price control.

6. Financial position

We have reviewed key indicators of Barwon Water's financial performance and our preliminary view is that Barwon 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.⁷⁰ We interpret the financial viability requirements under the *Essential Services Commission Act 2001* and the Water Industry Regulatory Order (2014) to mean that the prices we approve should provide a high level of certainty that each water business can generate sufficient cash flow to deliver on its service commitments, including financing costs arising from investments to meet service expectations.

Barwon Water's price submission and the supporting financial model provided estimates for key indicators of financial performance. These estimates were based on Barwon 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 Barwon Water will generate sufficient cash flow to deliver on its service commitments, including financing costs arising from investments to meet service expectations.

⁷⁰ WIRO clause 8(b)(ii) and ESC Act s.8A(1)(b).

7. PREMO rating

PREMO is an incentive mechanism that links the return on equity used to calculate a water business's revenue requirement to that business's level of ambition expressed in its price submission. Our guidance required Barwon 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.⁷¹ We required Barwon 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 Barwon 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 Barwon Water's price submission. As outlined in our guidance, the combination of Barwon Water's self-rating and our rating has determined the return on equity we have adopted to calculate Barwon Water's revenue requirement in our draft decision.

7.1 Our PREMO assessment of Barwon Water's price submission

Our draft decision is to rate Barwon Water's price submission as 'Advanced' under PREMO, which is the same as Barwon Water's self-rating.

Barwon 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 Barwon Water's price submission.

Table 7.1 PREMO rating

	Overall PREMO rating	Performance	Risk	Engagement	Management	Outcomes
Barwon Water's self-rating	Advanced	Standard	Advanced	Leading	Advanced	Advanced
Commission's rating	Advanced	Standard	Advanced	Leading	Advanced	Advanced

⁷¹ 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 Barwon Water's proposed overall PREMO self-rating of 'Advanced'. This is reflected in the return on equity we propose to approve for Barwon Water (see Section 4.4.2). We have formed this view after reviewing Barwon 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, 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.⁷²

As noted in Section 3.2, we agree with Barwon Water's self-assessment that it has, overall, met its outcome commitments for the period to date. It has also demonstrated accountability for not meeting some of its targets, under the performance incentive mechanism adopted at the 2018 price review. This level of accountability for underperformance demonstrates Barwon Water's commitment to providing value to its customers.

In terms of customer perceptions Barwon Water's results on the commission's survey of customer sentiment – covering measures of overall satisfaction, value for money, trust, and reputation in the community – generally improved over the regulatory period compared to other businesses. In our most recent survey (covering the period to January 2023) Barwon Water received the highest customer scores of any business for all measures except overall satisfaction (where it ranked second).⁷³

Barwon Water's controllable operating costs during the current regulatory period are forecast to be higher than the benchmark established at the 2018 price review.

In 2021-22 (the last available year of audited results), its expenditure was \$115.0 million compared to a benchmark of \$98.7 million. As noted in Section 4.1.1, the higher than benchmark outcome reflects a number of different drivers, including costs related to innovation and transformation programs, water supply and security, and responding to greater community expectations in relation to community safety and the environment.

Barwon Water's capital expenditure for the period 2017-18 to 2021-22 is lower than the benchmark adopted at the 2018 review (in gross and net terms). Capital expenditure for 2022-23 will be higher than the benchmark used for our 2018 price determination. However, consistent with our guidance

⁷² 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.

⁷³ 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>.

Barwon Water has adopted the lower 2018 benchmark figure in its proposal. Our preliminary view is that Barwon Water's proposed expenditure for the 2023–28 regulatory period reflects prudent and efficient expenditure (Section 4.2).

In terms of major projects, of the 10 proposed for the 2018–23 regulatory period, 3 were completed, 4 are delayed but in progress (with 1 project expected to be completed in 2018–23) and the remaining 3 are deferred to the 2023–28 period or beyond. Barwon Water has transparently explained the reasons for delays and deferrals to its major projects.

Our draft decision is to accept Barwon Water's self-rating of 'Standard' for the Performance element of PREMO, on the basis that we consider it met expectations for delivery against outcome commitments (noting it achieved an overall rating of 'Advanced' for PREMO in 2018). By self-rating as 'Standard', Barwon Water has effectively self-assessed that it fell short of performance expectations in the current period. We consider this self-rating is appropriate given the increase in controllable costs above baseline in 2021-22.

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).⁷⁴

In support of its self-rating of 'Advanced' for the Risk element of PREMO, Barwon Water's price submission provided an overview of eight material risks and the allocation of these risks, based on its internal risk management framework.

Key factors supporting its self-rating include:

- its performance incentive mechanism, providing financial accountability on the business so it returns funds to customers where it does not meet performance commitments (it is one of the few businesses that either has such a scheme in place, or has proposed such a scheme)
- the proposal for a new guaranteed service level focused on addressing customer concerns about sewage spills inside a premises
- excluding capital investment of around \$111.7 million from customer prices due to uncertainty related to associated projects, thereby helping to ensure customers do not pay for projects that do not ultimately proceed or change in scope
- maintaining a price cap form of price control for major services, which means the business bears demand and revenue risk (and not its customers).

⁷⁴ Essential Services Commission 2021, *2023 Water Price Review: Guidance Paper*, p. 45.

For these reasons, our draft decision is to accept Barwon Water’s proposed rating of ‘Advanced’ for the Risk element of PREMO.

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 people and those experiencing vulnerability.⁷⁵

Our draft decision is to accept Barwon Water’s self-rating of ‘Leading’ for the Engagement element of PREMO on the basis of the overall quality of its engagement program and the level of influence it afforded its stakeholders.

We note the influence of past engagement activities on its price submission engagement, including its 2-year deliberative process undertaken to develop its long-term strategy ‘Water for our future’ the recommendations from which were incorporated into proposed outcomes. Further, its engagement on ‘Water for our future’ was recognised by engagement professionals, with Barwon Water winning the Environment category in the 2022 IAP2 Core Values Awards.

Barwon Water also received positive feedback from participants and observers of its engagement activities, relating to the diversity and inclusiveness of its engagement – affirming our view that Barwon Water stepped up its engagement for the 2023 price review from an already high base. See Section 3.1 for more detail.

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.⁷⁶

In support of its self-rating of ‘Advanced’ for the Management element of PREMO, as noted in Section 4.1.1, Barwon Water proposed one of the highest efficiency improvement rates for controllable operating expenditure over the next regulatory period (2 per cent), contributing to the (real) price declines proposed by Barwon Water.

Our draft decision proposes some changes to the operating expenditure benchmarks included in Barwon Water’s prices. These proposed adjustments are less than 1 per cent of its forecast

⁷⁵ Essential Services Commission 2021, *2023 Water Price Review: Guidance Paper*, p. 45.

⁷⁶ Essential Services Commission 2021, *2023 Water Price Review: Guidance Paper*, p. 45.

operating expenditure. In terms of capital expenditure, our preliminary view is that Barwon Water has justified its forecast expenditure over the 2023–28 regulatory period.

While the financial model Barwon Water provided with its price submission needed some corrections to reflect its approved regulatory accounts, we found its submission generally was well presented and of a high standard. The Barwon Water Board has also attested to the accuracy of the information contained in its submission, as required by our guidance.

These factors support its PREMO rating. Accordingly, our draft decision is to accept Barwon Water’s self-rating of ‘Advanced’ 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.⁷⁷

As noted in Section 3.2, our preliminary view is that Barwon 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.

Key outcomes that link engagement findings to proposed outcomes include:

- boosting financial assistance through customer support programs for customers experiencing vulnerability and those impacted by family violence
- installing digital meters in areas that will benefit most from water efficiency measures
- developing new public open space as an environmental and cultural asset at Porronggitj Karrong and rehabilitating Bellarine Basin.

Our preliminary view is that we consider Barwon Water’s outcomes are clear, and its measures and targets will provide a sound basis to track performance and delivery against each outcome. Most targets indicate Barwon Water will deliver its customers increased service in the 2023–28 period, which along with a proposed reduction in (real) prices, indicates that customer value will be improved.

As noted above, Barwon Water will continue its performance incentive mechanism in the 2023–28 regulatory period to compensate customers if outcomes are not delivered.

⁷⁷ Essential Services Commission 2021, *2023 Water Price Review: Guidance Paper*, p. 45.

Barwon Water has also committed to reporting annually to its customers on how it has performed against its outcome commitments. It will continue to communicate performance by publishing its annual customer scorecard, which is assessed by its Customer and Environmental Advisory committees, on its website. Additionally, it will implement a robust communications and engagement strategy to provide further insights on performance and capture more feedback from customers and key stakeholders.

Accordingly, our draft decision is to accept Barwon Water's self-rating of 'Advanced' for the Outcomes element of PREMO.

Appendix A — Submissions received

Name or organisation	Date received
Anonymous	6 October 2022
Anonymous	7 October 2022
Barwon Water	3 November 2022
Nasser Kotb	3 November 2022
Michelle Davidson	3 November 2022
Anonymous	6 November 2022
Matthew Bradshaw	9 November 2022
Forrest District Community Group	14 November 2022
Anonymous	14 November 2022
Kingsley Davidson	24 November 2022
Matthew Bradshaw	28 November 2022
Forrest and District Community Group	28 November 2022
Land and Water Resources Otway Catchment	29 November 2022
Margaret Keegan	30 November 2022
Consumer Action Law Centre	30 November 2022
Byron Pakula	1 December 2022
People for a Living Moorabool	1 December 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 Barwon 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.⁷⁸ 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 Barwon 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 Barwon 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).

⁷⁸ 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 Barwon 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 business to retain the benefits of any cost efficiencies it generates until the end of its regulatory period. In other words, a water business has an incentive to outperform the operating and capital expenditure benchmarks we accept for the purpose of estimating its revenue requirement and prices. This is consistent with providing incentives for water businesses to pursue efficiency improvements.

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

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

The following chapters and sections of our 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 Barwon Water to recover borrowing costs associated with its investment in services, and generate a return on assets.⁷⁹

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

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

We have had regard to this matter in Chapter 6.

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

In preparing our draft decision, we have had regard to the extent Barwon 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).

⁷⁹ 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 business to propose outcomes, tariff structures and expenditure that reflect its particular circumstances. We consider that taking into account the particular circumstances of each water business is consistent with taking into account the particular circumstances of the water industry.

The following chapters and sections of our 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 decision. This includes adopting operating and capital expenditure benchmarks that we consider will allow Barwon 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 Barwon 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 Australia⁸⁰
- operating and capital expenditure costs per connection throughout Australia⁸¹
- tariff structures applied by water businesses throughout Australia⁸²
- the regulatory rate of return set by other regulators.⁸³

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

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

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

The following chapters and sections of our 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 Barwon Water’s proposals, including through submissions and public meetings.

⁸⁰ Bureau of Meteorology, *National performance report 2020-21; urban water utilities, part A*, February 2022.

⁸¹ Bureau of Meteorology, *National performance report 2020-21; urban water utilities, part A*.

⁸² Includes Icon Water, Sydney Water, Hunter Water, Central Coast Council, Power and Water Corp, Urban Utilities, Unity Water, SA Water and TasWater.

⁸³ 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 Barwon 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 Barwon Water’s prices enable customers or potential customers to easily understand prices, or the manner in which prices are calculated, determined or otherwise regulated:

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

The following sections of our 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 Barwon 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 Barwon 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 Barwon 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 Barwon 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, Barwon 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.

Commission’s consideration of legal requirements

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 businesses. Our PREMO water pricing approach provides incentives for a water business to provide its “best offer” to customers in its price submission. This is described in further detail in a report we released in 2016.⁸⁴

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

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

- Implementing a price review process so that water businesses may receive streamlined price reviews if they submit a high quality price submission. This reduces the costs of regulation for water businesses and the commission.
- Focusing our assessments of price submissions on the materiality of proposals to customer interests (including low income and vulnerable services), including in terms of price, bill and service impacts.
- Designing our guidance so we minimise the compliance costs for water businesses. Our guidance noted that much of the information required in price submissions should be readily available to water businesses as it would be relevant for other purposes such as corporate planning and project prioritisation and justification.⁸⁵

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

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

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

⁸⁴ Essential Services Commission 2016, Water Pricing Framework and Approach, Implementing PREMO from 2018, October, pp. 11–13.

⁸⁵ Essential Services Commission, 2023 water price review: Guidance paper, p. 2.

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

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

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

- Implementing a price review process so that water businesses may receive streamlined price reviews if they submit a high quality price submission. This reduces the costs of regulation for water businesses and the commission.
- Focusing our assessments of price submissions on the materiality of proposals to customer interests (including low income and vulnerable services), including in terms of price, bill and service impacts.
- Designing our guidance so we minimise the compliance costs for water businesses. Our guidance noted that much of the information required in price submissions should be readily available to water businesses as it would be relevant for other purposes such as corporate planning and project prioritisation and justification.⁸⁶

⁸⁶ Essential Services Commission, 2023 water price review: *Guidance paper*, p. 2.