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# Gippsland Water: Review of expenditure forecasts

2023 Water Price Review

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## Glossary

<b>Term</b>	<b>Definition</b>
DEECA	Department of Energy, Environment and Climate Action, formerly DELWP
DELWP	Department of Environment, Land, Water and Planning
EA	Enterprise Agreement
ESC	Essential Services Commission
FTE	Full time equivalent
FTI Consulting	FTI Consulting (Australia) Pty Ltd
GL	Gigalitre
kWh	Kilowatt
ML	Megalitre
PEER	Public Entity Executive Remuneration
PREMO	Performance, Risk, Engagement, Management and Outcome
PS4	Price Submission for the fourth regulatory period (2017-18 to 2022-23)
PS5	Price Submission for the fifth regulatory period (2023-24 to 2027-28)
PV	Photovoltaic
RBA	Reserve Bank of Australia
SaaS	Software as a Service
Schneider	Schneider Electric Energy and Sustainability Services
SGC	Superannuation Guarantee Charge
WIRO	Water Industry Regulatory Order
WPI	Wage Price Index
WSAA	Water Services Association of Australia

## Executive Summary

FTI Consulting has been engaged by the Essential Services Commission (the Commission) to undertake an independent expert review of the Victorian water businesses' forecast (controllable) operating and capital expenditure for the 1 July 2023 to 30 June 2028 (PS5) regulatory period.

The Commission is required to assess the water businesses' proposals against a legal framework set out in the *Water Industry Regulatory Order 2014* and the Commission's PREMO pricing framework. We have assessed Gippsland Water's forecast operating and capital expenditure based on the guidelines contained in the Commission's *2023 Water Price Review: Guidance Paper*.

This report sets out our views as to whether Gippsland Water's forecasts of capital and operating expenditure over the regulatory period can be reasonably assessed to be prudent and efficient.

### Forecast operating expenditure

Gippsland Water's proposed controllable operating expenditure implies an average net increase (growth less efficiency factor) of -0.2 per cent per year for the PS5 regulatory period. When comparing this net result against other water businesses, Gippsland Water is fourth out of 13 urban water businesses subject to this review.

Gippsland Water's forecast operating expenditure reflects:

- baseline 2021-22 expenditure of \$77.77 million, which is \$1.68 million (or 2.1 per cent) below the benchmark allowance approved by the Commission in the previous price review
- a total step increase to the baseline of \$35.14 million across the regulatory period
- implied net growth in operating expenditure of -0.2 per cent per year. Rather than apply a growth factor, Gippsland Water addressed growth-related costs as a step change. Our estimate of Gippsland Water's implied net growth factor is different to the -0.5 per cent per year net growth factor that Gippsland Water identified. This reflects differences in our implied growth calculations based on its proposed controllable operating expenditure. This difference in the implied growth calculation does not impact our assessment of Gippsland Water's operating expenditure, which has focused on the step changes.

Based on Gippsland Water's PS5 submission, discussions with the business and the further information it provided, we have formed the view that the forecast controllable operating expenditure is consistent with a prudent business that operates efficiently and does not require any further adjustments.

This reflects our view that:

- the key drivers of the additional expenditure above the baseline appear reasonable, and the baseline does not appear to include any items that are non-recurring
- the proposed step changes are reasonable and supported by a sound rationale
- it is not reasonable to expect that these step changes could be absorbed by the business given the net growth factor of -0.2 per cent per year.

## Forecast capital expenditure

Gippsland Water has forecast capital expenditure of \$267.7 million for the PS5 regulatory period. This is:

- 3 per cent more than its actual capital expenditure (including 2022-23 forecast) over the PS4 regulatory period
- 11 per cent more than the forecast capital expenditure outlook for the PS5 regulatory period that it included in its PS4 submission.

Gippsland Water's price submission provides a breakdown of its forecast capital expenditure for the PS5 regulatory period, with further information provided as required to support our review.

Based on its PS5 price submission and subsequent information and responses provided by Gippsland Water, we are confident that:

- the proposed capital expenditure program is consistent with the actions of a prudent service provider acting efficiently
- the forecast capital expenditure is justified, robust and is capable of being delivered by Gippsland Water in the PS5 regulatory period.

As a result, we do not recommend any adjustments to Gippsland Water's forecast capital expenditure for the PS5 regulatory period.

# 1 INTRODUCTION

## 1.1 Purpose of this report

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

FTI Consulting has been engaged to undertake an independent expert review of the water businesses' forecast operating expenditure and capital expenditure for the PS5 regulatory period. The scope of our review of operating expenditure is limited to controllable operating expenditure.

This report sets out our independent expert view of the prudence and efficiency of Gippsland Water's controllable operating expenditure and capital expenditure forecasts for the PS5 regulatory period, in accordance with the requirements of the regulatory framework.

## 1.2 Context and challenges facing Victorian water businesses

The environment faced by most Victorian water business over the last few years has been significantly more challenging than envisaged in 2018 when the Commission approved the expenditure forecasts used to set water prices for the 1 July 2018 to 30 June 2023 (PS4) regulatory period.

The COVID-19 pandemic has been one of the unforeseen events that has impacted the Victorian water businesses' expenditure in several ways, including:

- requiring additional water and wastewater monitoring and treatment
- increasing customer hardship due to cost-of-living pressures
- disrupting business operations, including the ability to carry out maintenance activities and higher rates of staff absenteeism

<sup>1</sup> This includes 13 water businesses providing urban water and sewerage services include Barwon Water, Central Highlands Water, Coliban Water, East Gippsland Water, Gippsland Water, Goulburn Valley Water, GWMWater, Lower Murray Water, South East Water, South Gippsland Water, Wannon Water, Westernport Water and Yarra Valley Water and two businesses providing rural services including Lower Murray Water and Southern Rural Water.



- changing work practices, including social distancing and hygiene requirements as well as transitioning to enable staff to work from home
- disrupting supply chains, putting pressure on the availability and cost of inputs
- increasing migration from Melbourne to regional areas.<sup>2</sup>

These impacts have affected each water business's actual and forecast expenditure in different ways. Some water businesses have faced new costs or cost pressures, while others have experienced cost savings.

The effects of the COVID-19 pandemic continue to be felt nearly three years later. Some of these impacts are moderating as Victoria (and the rest of the country) adapts to a new phase of living with the pandemic. However, there is the potential for other more permanent changes, including changes to work practices and greater migration of people from major cities to regional areas. At the time of this review, the longer-term implications remain unclear.

There are other events and changes that were unforeseen (or at least unable to be fully anticipated) as part of the Commission's previous water price review. These include:

- the continued impacts of climate change on the frequency and severity of major weather events, including drought, bushfires, and floods
- the continued evolution in climate change and environmental policy, including emission reduction strategies and targets, and associated compliance and reporting obligations
- a continued hardening of the insurance market, which also (at least partly) reflects the impacts of major climate-related events domestically and globally
- a ramping up of the need to do more to mitigate cyber security risks, including mandated obligations.

These issues and challenges *do not* imply or support a premise that:

- water businesses should continue to increase their operating and capital expenditure, and hence water and sewerage prices
- there should be lower expectations in terms of the need to drive efficiency savings in the longer term for the benefit of customers
- businesses should avoid responsibility for managing the risk of cost increases and/or passing more of those risks on to customers.

<sup>2</sup> For example, refer: <https://population.gov.au/sites/population.gov.au/files/2021-09/the-impacts-of-covid-on-migration-between-cities-and-regions.pdf>, accessed 1 December 2022.

It further underlines the importance of scrutinising increases in expenditure, as well as proposed step changes, to ensure that they remain consistent with the actions of a prudent business operating efficiently, including in how it responds to the uncertainties and challenges in its operating environment. It also does not alter the standards that should be reasonably expected of businesses in supporting and justifying any increases in expenditure for the next regulatory period, including being able to provide adequate supporting documentation (such as Board-approved policies or strategies and business cases).

### 1.3 Water industry regulatory framework

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

The Commission's regulatory framework places an emphasis on efficient delivery of services. Assessing the prudence and efficiency of a water business's expenditure forecasts is fundamental to achieving this objective.

In 2018, the Commission introduced a new approach called PREMO to regulate the prices charged by Victorian water businesses. As Figure 1.1 describes, the PREMO approach contains both new and conventional elements related to price, risk, engagement, management, and outcomes. PREMO provides water businesses with incentives to put forward their best offer to customers and deliver the outcomes its customers value most and to deliver these as efficiently as possible.

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

<sup>4</sup> Essential Services Commission 2016, *Water Pricing Framework and Approach: Implementing PREMO from 2018*, October.

Figure 1.1: The Commission’s PREMO framework



More conventional elements of PREMO include the retention of the building block approach, which provides reasonable certainty that prudent and efficient costs can be recovered. This includes an expenditure review to determine whether a water business’s proposed operating and capital expenditure forecasts are consistent with the requirements of the regulatory framework.

Under the PREMO framework, each submission is expected to reflect the water business’s best offer to its customer base. Submissions may be fast tracked through the assessment process based on several factors. Some water businesses’ proposals may require a more detailed review of their proposed expenditure while others may only require a review of some elements of their proposed expenditure (for example, specific items where expenditure is increasing).

The *2023 Water Price Review: Guidance Paper* (the Guidance Paper) explains the Commission’s methodology and approach to assessing the water businesses’ price submissions and making a price determination and sets out the information each business is required to provide in its price submission.<sup>5</sup> The Guidance Paper also identifies the governing criteria for each component of the building block methodology, including forecast operating and capital expenditure.

This review is the second review under PREMO for these businesses. The Commission also expects price submissions to demonstrate how water businesses are building on their previous proposals to deliver value to their customers.

<sup>5</sup> Essential Services Commission 2021, 2023 Water Price Review: Guidance paper, 26 October.

## 1.4 Methodology and approach

The scope of our assessments is limited to examining each water business's forecast controllable operating expenditure and capital expenditure over the PS5 regulatory period. It does not include examining decisions about whether to fast track a water business's PS5 submission, nor does it involve assessing other elements of the PREMO framework such as past performance or engagement.

Our methodology for assessing Gippsland Water's operating and capital expenditure forecasts for the next regulatory period is consistent with the Commission's Guidance Paper. In summary, the scope of our review includes:

- for forecast operating expenditure, our assessment focuses on controllable expenditure only. We have assessed proposals using the base-step-trend approach as set out in the Commission's Guidance Paper and is consistent with the basis on which each water business has submitted information as part of their price review model templates
- for forecast capital expenditure, our assessment focuses on the top 10 major projects and major capital expenditure programs that comprise a significant proportion of the water business's total capital expenditure forecast.

Further detail about our assessment framework as it has been applied is set out in Section 3 (Operating expenditure assessment) and Section 4 (Capital expenditure assessment).

Our process has involved several steps:

- an initial review of PS5 price submissions, price review model templates and associated documentation
- comparison of each of the water business's proposed operating and capital expenditure proposals, including assumptions adopted in relation to growth trends, efficiency factors, and comparison of actual and proposed expenditure
- a Stage 1 (preliminary) assessment workshop undertaken with Commission staff identifying the key issues to be explored in our more detailed review
- visits and/or online discussions with each of the water businesses on key issues related to their proposal
- further review and analysis of further information or explanations provided.

We updated our review for an updated price review model submitted by Gippsland Water to the Commission in January 2023, which reflected adjustments for the reclassification of bulk water charges from controllable to non-controllable operating expenditure.

## 1.5 Structure of this report

The structure of this report is as follows:

- Chapter 2 provides a high-level summary of Gippsland Water's expenditure proposal
- Chapter 3 sets out our assessment of Gippsland Water's operating expenditure proposals
- Chapter 4 sets out our assessment of Gippsland Water's capital expenditure proposals.

Consistent with the Commission's guidance paper and the price review model completed by businesses, all forecasts and actuals are expressed in dollars as at 1 January 2023.

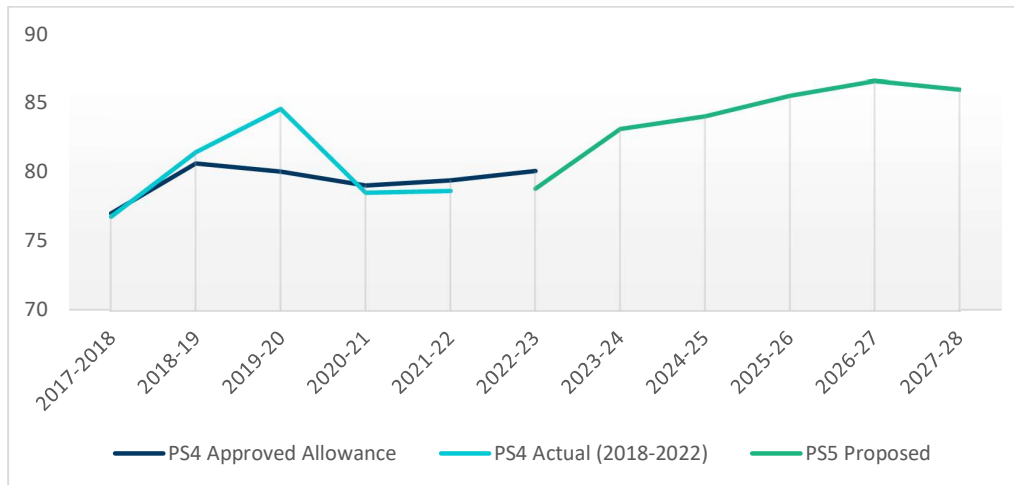
## 2 SUMMARY OF EXPENDITURE PROPOSAL

### 2.1 Forecast controllable operating expenditure

For the current PS4 regulatory period, the Commission approved a total controllable operating expenditure benchmark allowance for Gippsland Water of \$399.4 million (in \$ 1 January 2023).

For the first four years of the PS4 regulatory period, Gippsland Water's actual controllable operating expenditure was \$0.97 million (0.3 per cent) above the benchmark allowance approved by the Commission for those four years.

Figure 2.1: Gippsland Water's actual and forecast controllable operating expenditure by year (\$ 1 January 2023)



Source: Gippsland Water, 2023 Price Review Model - 20220929, 3 October 2022; Essential Services Commission 2018, Gippsland Water Determination Price Review Model: 1 July 2018 – 30 June 2023, 29 May.

Gippsland Water's baseline 2021-22 controllable operating expenditure is \$77.77 million, which is \$1.68 million (or 2.1 per cent) below the benchmark allowance approved by the Commission in the last price review. This is based on the updated price review model submitted to the Commission that reflects changes to the treatment of bulk water charges.

Gippsland Water has proposed a total step change increase to the baseline of \$35.14 million across the PS5 regulatory period, comprising the following.

Table 2.1: Gippsland Water’s proposed step changes (in \$ 1 January 2023, millions)

Step change	Value
Business continuity	15.74
IT investment	7.19
Growth-related costs	4.90
Additional chemicals costs	2.10
Regulatory costs	2.08
Community involvement	1.78
Additional electricity costs	1.35
<b>Total</b>	<b>35.14</b>

Source: Gippsland Water 2022, Price Submission 2023-28, pp.112-122.

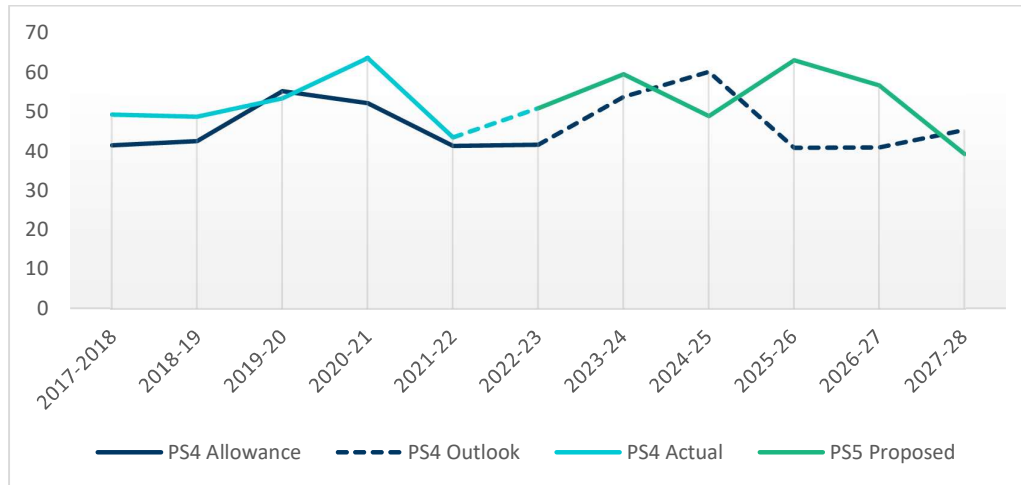
Gippsland Water has proposed an alternative methodology for addressing growth to recognise economies of scale. This has been proposed as a step change. It has forecast an (average) implied efficiency factor of 0.5 per cent per year over the PS5 regulatory period.

## 2.2 Forecast capital expenditure

Gippsland Water has forecast capital expenditure of \$267.7 million for the PS5 regulatory period. As shown in Figure 2.2, this is:

- 3 per cent more than its actual capital expenditure (including 2022-23 forecast) over the PS4 regulatory period
- 11 per cent more than the forecast capital expenditure outlook for the PS5 regulatory period that it included in its PS4 submission.

Figure 2.2: Gippsland Water’s actual and forecast capital expenditure by year (\$ 1 January 2023, millions)



'PS4 Approved Allowance' relates to the approved capital expenditure allowance for 2017-18 to 2022-23, and its 2018 forecast for 2023-24 to 2027-28.

Source: Gippsland Water: CGW\_2023 Price Review Model – 2022-08-30 (Sept 22 – Submission)-SENSITIVE; FD\_CGW\_Price Review Model; Essential Services Commission 2018 Gippsland Water Determination Price Review Model: 1 July 2018 – 30 June 2023, 29 May.

The key, projects and programs are defined in the submission, and include:

- renewals (\$110.6 million), which comprise 41 per cent of the total forecast capital expenditure
- improvements/compliance (\$57.6 million), which comprise 22 per cent of the total forecast capital expenditure
- growth (\$58.5 million), which comprise 22 per cent of the total forecast capital expenditure
- top 10 major projects (\$82.4 million, excluding bulk water entitlement purchase costs)
- defined programs and other discrete capital expenditure (\$185.3 million).

Gippsland Water’s top nine major capital expenditure projects, shown in Table 2.2, account for 35 per cent of its proposed capital expenditure for the PS5 regulatory period. Gippsland Water has excluded details relating to the tenth of its major capital projects, which is classified as either sensitive information or protected commercial information, from its submission. This information has been provided separately directly to the Commission as part of its submission for assessment of this item.



Table 2.2: Gippsland Water's top nine capital expenditure projects (\$ 1 January 2023, millions)

Major capital expenditure project	Forecast expenditure
Saline Water Outfall Pipeline	17.2
Factory Rd Sewerage Pump Station Rising Main Upgrade	14.3
Connect Traralgon and Morwell Water Networks Stage 1	11.2
Warragul Wastewater Treatment Plant Upgrade	10.0
New Basin at Clarkes Storage	9.3
Traralgon-Tyers Interconnect	6.7
Warragul Sewer North East Branch Augmentation	5.9
Drouin west water main	4.0
SCADA system replacement	3.8

Source: Gippsland Water 2022, 2023 Price Submission, 30 September, p.137; Gippsland Water, CGW\_2023 Price Review Model – 2022-08-30.

## 3 OPERATING EXPENDITURE ASSESSMENT

### 3.1 Overview of assessment approach

The Commission's Guidance Paper notes the requirement that forecast operating expenditure is:

*... operating expenditure which would be incurred by a prudent service provider acting efficiently to achieve the lowest cost of delivering on service outcomes over the regulatory period, taking into account a long-term planning horizon (prudent and efficient forecast operating expenditure).<sup>6</sup>*

The Commission has asked us to provide an independent expert view on whether Gippsland Water's controllable operating expenditure is prudent and efficient having regard to the base-step-trend approach and assessment criteria set out in its Guidance Paper.

We have assessed whether forecast operating expenditure is consistent with the actions of a prudent business acting efficiently, including if:

- the established 2021-22 controllable operating expenditure baseline has been appropriately adjusted for any one-off expenditure items and efficiency commitments
- operating costs reflect reasonable cost efficiency/productivity assumptions applied to the 2021-22 baseline operating expenditure, having regard to industry trends
- changes in operating costs are consistent with the timing of major capital projects
- operating costs can fulfil the business's obligations and meet customer service expectations as efficiently as possible
- any forecast divergence from historical trends in operating expenditure can be readily explained, for example, by changes in obligations imposed by government, including technical, regulatory and customer service expectations.

Each business's growth and efficiency factors will reflect their business and operating environment, and as discussed in section 1, over the PS4 regulatory period some businesses have experienced materially higher than expected growth.

In assessing proposed increases in expenditure, including step changes, we have had regard to each business's approach to allowing for growth and efficiency, and the resulting net

<sup>6</sup> Essential Services Commission 2022, 2023 Water Price Review: Guidance Paper, August Amendment, p.28.

growth factor for the PS5 regulatory period. For example, some businesses have proposed more ambitious efficiency targets (resulting in negative net growth in expenditure over the PS5 regulatory period) and/or have sought to recognise economies of scale in allowing for growth.

Gippsland Water has proposed an alternative approach to addressing growth (refer section 3.4.4). Rather than apply a growth factor based on the number of connections, Gippsland Water has sought to identify those costs that genuinely vary with connections growth. This also realises economies of scale. It has therefore proposed this as a step change. Gippsland Water claims that this results in a lower growth adjustment and hence a more ambitious efficiency commitment.<sup>7</sup>

This is relevant to considering the business's ability to absorb cost increases, including proposed step changes, which has required us to apply judgement in assessing the reasonableness of the business's proposals.

### 3.2 Key operating expenditure drivers across water businesses

There are several drivers of increased operating expenditure over the current PS4 regulatory period and/or forecast for the PS5 regulatory period that are common across water businesses, as summarised in Table 3.1.

Appendix A presents more detailed analysis and cross-industry metrics for electricity, labour and IT costs, using information submitted by the businesses in their respective price review models. We have not sought to directly benchmark these costs across the water businesses as the requirements of each business vary. However, such comparisons do further assist in identifying those businesses that might be looking at more material increases in expenditure. It also provides some context to assessing these costs for each business. A summary of the key implications of this analysis for our assessment approach is provided below.

<sup>7</sup> Gippsland Water 2022, Price Submission 2023-28, 30 September, p.88.

Table 3.1: Common operating expenditure issues

Expenditure category	What we have examined
<b>Electricity</b>	<p>The application of the Schneider Electric Energy and Sustainability Services (Schneider) electricity price forecasts. Schneider was commissioned by Intelligent Water Networks to prepare an electricity price forecast that could be consistently applied by all of the water businesses.</p> <p>The approach to meeting the Victorian water sector’s commitment to the State Government to source 100 per cent of their energy requirements from renewables by 2025, recognising that each business’s approach will reflect its own circumstances and operating environment (this can also include capital projects).</p>
<b>Labour</b>	<p>The rationale for any material growth in employee numbers.</p> <p>Remuneration increases, having regard to each organisation’s Enterprise Agreement (EA) as well as conditions in labour markets, with several regional businesses citing challenges in attracting and maintaining people with the right skills. Some businesses have also referred to the Victorian Government’s 2022 Public Entity Executive Remuneration (PEER) review of executive remuneration.</p>
<b>IT</b>	<p>Software as a Service (SaaS), with all businesses either having transitioned, or are in the process of transitioning, to Cloud-based services. This has also resulted in expenditure that would have been classified as capital expenditure now treated as operating expenditure.</p> <p>Cyber security, which is an important issue for all water businesses as well as utilities and other corporations more generally. This includes compliance with new obligations.</p>

### Electricity costs

The information submitted by each of the businesses indicates that most are applying the 75<sup>th</sup> percentile of Schneider’s long-term forecast of the electricity spot price. In its report, Schneider assumes that the water businesses are most likely to enter a contract rather than remain exposed to spot prices and that contract price will be around the 75<sup>th</sup> percentile of its forecast.<sup>8</sup>

<sup>8</sup> Schneider Electric 2022, Electricity Price Forecast, Covering financial year 23 to 2028, Base Case, 23 March, p.17.

This conclusion reflects the likelihood that generators will require a 'premium' above their expected spot price to enter a contract because:

- A premium will be required for the generator to be willing to forgo opportunities to sell that capacity if prices rise above the expected spot price (recognising that the generator is also benefiting if prices fall).
- If it is 'caught short' in terms of its ability to deliver the contracted capacity, it may need to go into the market to procure the shortfall at the prevailing spot price and is therefore exposed to short-term price increases.

Given this, we consider that relying on the 75<sup>th</sup> percentile of the Schneider forecasts appears reasonable.

We have reviewed each business's proposed energy expenditure within the context of its total forecast controllable operating expenditure proposal. Some businesses have proposed step changes for green power costs, which we have assessed on its own merits.

#### IT expenditure

As with other costs, we have not sought to directly benchmark IT operating expenditure across the businesses. This is because the needs of each business are likely to vary due several factors, including its size, customer base, the nature and scope of its operations and the age and maturity of its IT architecture and systems. Some businesses may also need to undertake capital expenditure.

We have assessed proposed increases for IT expenditure by each business on their own merits. We have used this context to satisfy ourselves that the level of IT expenditure for each business is reasonable and justified, particularly for those businesses that appear higher on the comparative metrics.

For businesses that have proposed material increases in IT expenditure that have contributed to increases in baseline expenditure and/or step changes, we have sought to assess whether:

- it appears reasonable for the business to be incurring this expenditure, having regard to necessity/risk as well as the expected benefits
- it is supported by appropriate evidence, such as an IT strategy or business plan
- the evidence aligns with the forecasts proposed in the business's price review model.

## Labour costs

As for IT expenditure, we have used the information in Appendix A as context when assessing each business's proposed operating expenditure. For most businesses identifying increases in labour costs, this has tended to be a combination of increases in staffing as well as remuneration.

For businesses that have proposed material increases in labour-related expenditure (either as reflected in a baseline uplift and/or step change), we have reviewed the rationale for the proposed increase and sought further supporting information where relevant. This included material increases in FTE numbers and/or increases in remuneration. Where increases have also been attributed to the Superannuation Guarantee Charge (SGC), we have confirmed with the business that this reflects an increase in total remuneration payable.

The following sections summarise our assessment of Gippsland Water's forecast controllable operating expenditure for the PS5 regulatory period.

### 3.3 Assessment of the baseline

After adjusting for non-recurring items, Gippsland Water's adjusted controllable operating expenditure in 2021-22 was \$77.77 million. This is \$1.68 million or 2.1 per cent less than the \$79.45 million benchmark allowance approved by the Commission as part of the last price review (\$ 1 January 2023).

We verified that the adjustments to the baseline were appropriate, which included:

- non-recurring items
- normally incurring items that were not represented in the baseline year.

As noted above, Gippsland Water submitted an updated price review model to the Commission that reflected changes to the treatment of bulk water charges to be non-controllable operating expenditure. This involved:

- removing \$0.91 million from baseline expenditure, reflecting non-controllable bulk water charges paid to Southern Rural Water
- the re-classification of \$6.6 million in bulk water charges (paid to Melbourne Water) from controllable to non-controllable operating expenditure, which had been included in the proposed Business Continuity step change. This has reduced the total value of that step change for the PS5 regulatory period to \$15.74 million.

These changes have been reflected in our assessment.

As Gippsland Water's proposed baseline is below the benchmark approved by the Commission for 2021-22, we can be satisfied that the expenditure reflects the costs

incurred by a prudent business operating efficiently. We have therefore not sought to interrogate this baseline expenditure in any more detail, apart from (where relevant) providing context for the assessment of the proposed step changes.

### 3.4 Assessment of the step changes

Gippsland Water has proposed step changes to the baseline of \$35.14 million across the PS5 regulatory period. Table 3.2 summarises the information provided by Gippsland Water in its PS5 submission.

Table 3.2: Gippsland Water’s key step change drivers (\$ 1 January 2023, millions)

Key drivers	Value	Explanation
Chemicals	2.10	Reflects increases in chemicals costs under procurement contracts. Gippsland Water is proposing to absorb some of the currently known increase, as well as any further increases for the PS5 regulatory period.
Community involvement	1.78	Emerging from the customer engagement, this includes expenditure on community involvement and education, as well as an Aboriginal employment pathways and retention program.
Electricity prices	1.35	Reflects forecast increases in energy prices, informed by the Schneider forecasts.
Growth	4.90	Instead of applying a growth factor based on customer connections, Gippsland Water’s proposed allowance for growth reflects specific costs directly rising from growth. This includes operating expenditure associated with the new Drouin Wastewater Treatment Plant.
Business continuity	15.74	This reflects additional resources (and associated costs) that the business has identified as necessary to deliver what its customers want.
IT investment	7.19	This is for initiatives emerging from the Digital Enablement Plan and Enterprise Architecture Strategy, which were completed during the PS4 regulatory period.
Regulatory costs	2.08	This includes: (1) additional resources to enable Gippsland Water to strengthen and maintain its in-house regulatory capability; and (2) expenditure on consultants for the next PS6 price review.
<b>Total</b>	<b>35.14</b>	

Source: Gippsland Water 2022, Price Submission 2023-28, pp. 112-122.

We assessed the reasonableness of the step change increases by examining whether the proposed step changes meet one or more of the following criteria:

- comply with new, or changed, legislative or regulatory obligations
- achieve an outcome or implement an initiative that is endorsed by customers or broadly meets accepted changes in community expectations
- recategorisation of expenditure between capital and operating expenditure, where the business can demonstrate that it is necessary or appropriate to do so
- incremental operating expenditure associated with a new prudent and efficient capital project
- sufficiently material that the costs are not able to be met by an efficient business operating within its approved budget (including the growth allowance) or be otherwise mitigated.

Our assessment of the step changes is outlined below.

### 3.4.1 Chemicals

#### Proposal

Gippsland Water is proposing a \$2.1 million step change over the PS5 regulatory period for increases in chemicals costs. This reflects increases in chemicals prices, which are being experienced in the current period and are expected to continue into the PS5 regulatory period. Gippsland Water procures its chemicals under contracts with suppliers, which are subject to periodic price adjustment.

Gippsland Water states that chemicals costs have already increased by \$0.696 million per year and is already expected to increase further to \$0.846 million by April 2023.<sup>9</sup> It recognises that these future price increases are uncertain. Gippsland Water proposes to seek an additional \$0.42 million per year via its proposed step change and absorb \$0.276 million of the current known increase, as well as any additional increases for the duration of the PS5 regulatory period. It is intending to mitigate this impact by reviewing chemicals use within the business and implementing new procurement strategies.

#### Assessment

We reviewed Gippsland Water's business case, which also showed the allocation of chemicals costs across key activities.<sup>10</sup> Gippsland Water also provided detailed data showing the price review frequency and mechanism for each chemical, along with recent

<sup>9</sup> Gippsland Water 2022, Price Submission 2023-28, 30 September, p.118.

<sup>10</sup> Gippsland Water, GW PS23 Opex Business Case Chemicals, OX002.



increases in contract prices across the chemicals used.<sup>11</sup> This included explanations of the underlying drivers of some of the increases, including raw materials prices, labour costs, energy costs and supply chain costs. We note that increases in chemicals costs are being experienced across the water businesses.

Gippsland Water provided additional information supporting the further projected increase of between \$0.1 million and \$0.15 million.

We have reviewed the detailed information provided by Gippsland Water and we are satisfied that it clearly substantiates its proposed step change for chemical costs. The amount sought appears reasonable, noting that Gippsland Water is not seeking to pass the full amount of the increase (realised to date) to customers.

### 3.4.2 Community involvement

#### Proposal

Gippsland Water is proposing a \$1.78 million step change over the PS5 regulatory period for additional costs for community involvement. It identifies this step change as emerging from its community engagement, where customers said that they value the business's involvement in the community. At a Customer Reference Group deliberation session held in June 2022, "investing in community involvement was the highest voted output under the 'be involved in the community' outcome."<sup>12</sup>

The most material item in this category is the establishment of an Aboriginal employment pathways and retention program, including a dedicated resource for managing Traditional Owner initiatives (up to \$0.23 million per year). Gippsland Water states that this reflects a desire by the Aboriginal community to work in partnership with it and is also seen as addressing its obligations under the *Letter of Expectations – Water for Aboriginal Cultural, Spiritual and Economic Values* issued by the Minister under the *Water Act 1989*.<sup>13</sup> Other activities include programs supporting community wellbeing, along with the expansion of school education programs and the translation of website content.

#### Assessment

We reviewed Gippsland Water's business case which provided more detail on the feedback received from the Aboriginal engagement and the initiatives it is proposing in response to

<sup>11</sup> Gippsland Water, Recent chemical cost increase data, RO10.

<sup>12</sup> Gippsland Water 2022, Price Submission 2023-28, 30 September, p.118.

<sup>13</sup> Gippsland Water 2022, Price Submission 2023-28, 30 September, p.118.

that feedback.<sup>14</sup> It also itemised all the individual initiatives underpinning the step change for the PS5 regulatory period.

We reviewed the detailed information provided by Gippsland Water and we are satisfied that it clearly substantiates its proposed step change for community involvement. The step change is material and aligns with our second step change criterion, which is that it achieves an outcome or implements an initiative that is endorsed by customers or the community. The amount sought appears reasonable, noting that it covers a range of activities associated with community involvement.

### 3.4.3 Electricity prices

#### Proposal

Gippsland Water is proposing a \$1.35 million step change over the PS5 regulatory period for additional costs for electricity. This increase, which is sought for the last three years of the PS5 regulatory period, reflects the projected increase in electricity prices beyond the expiry of its current retail electricity contracts in 2024-25. This is based on the forecasts produced by Schneider procured by Intelligent Water Networks (refer section 3.2 and Appendix A). Independent advice provided to Gippsland Water by Key Energy noted the considerable volatility in this market and that further increases in those years can be expected.<sup>15</sup>

Gippsland Water noted strategies that it intends to employ to mitigate further electricity price risk, including investment in renewable energy sources under its capital program, as well as the employment of an energy market specialist (captured as part of the Business Continuity step change).

#### Assessment

We reviewed additional supporting documentation provided by Gippsland Water relating to the management of the use and cost of energy. This includes its approach to meeting the Victorian water sector's commitment to the State Government to source 100 per cent of their energy requirements from renewables by 2025 and its Statement of Obligations (Emissions Reduction) under the *Water Industry Act 1994* (refer Appendix A).

<sup>14</sup> Gippsland Water, PS23 Opex Business Case Community Involvement, OX003.

<sup>15</sup> Gippsland Water 2022, Price Submission 2023-28, 30 September, p.119.

Gippsland Water's Energy Management Strategy 2022-28 details its overall approach to managing energy within the context of growing demand, climate change and the volatile (and changing) energy market. The key initiatives identified under this strategy include:

- building capacity to capture and analyse energy data
- building capacity for demand response
- synchronising diesel generation to improve business continuity and demand response
- pursuing energy efficient equipment renewals and replacements
- investing in renewable energy generation.

Specific deliverables are identified under each initiative.

We also reviewed its Program Synopsis for Energy, dated September 2022, which identified the key program driver as its obligation to comply with the Statement of Obligations (Emissions Reduction). This detailed its planned capital investment in renewable and energy projects (refer Section 4.3), which is expected to generate annual savings in operating expenditure of \$0.1 million.

In developing its electricity cost forecast, Gippsland Water confirmed that it has applied the 75th percentile of the Schneider forecasts of long-term spot prices, which Schneider had indicated will include a premium for contract costs (refer Section 3.2). This is consistent with the approach applied by most of the water businesses in applying those forecasts.

We also note Gippsland Water's proposal within the context of proposed electricity expenditure for the PS5 regulatory period across the water businesses (refer Appendix A). From this analysis we note that:

- While several businesses are proposing to reduce total energy costs in the PS5 regulatory period (compared to expenditure in the PS4 regulatory period), Gippsland Water's total energy expenditure is projected to increase by around one per cent only.
- Gippsland Water's energy costs per water volume (in dollars per ML) is amongst the lowest of all the businesses.
- Gippsland Water's projected average unit cost for large sites (18.4 cents per kWh) is just under the industry average of around 19 cents per kWh.
- Gippsland Water's total energy costs comprise around 5.1 per cent of total controllable operating expenditure, which is below the industry average.

Given the differences between each business and its operating environment we have referred to this data in providing context only. We have not sought to use these

comparisons as a basis for our assessment of the reasonableness of Gippsland Water's forecast electricity costs.

Gippsland Water's proposed increases in electricity costs are material and are also being incurred in compliance with Gippsland Water's obligations under the Statement of Obligations (Emissions Reduction).

We consider that Gippsland Water has clearly substantiated this step change and the amount sought appears reasonable.

### 3.4.4 Growth

#### Proposal

Gippsland Water is proposing a \$4.9 million step change over the PS5 regulatory period for costs relating to growth. During the PS4 regulatory period Gippsland Water identified the need to better understand the relationship between its costs and growth. Rather than apply a growth factor, it undertook a bottom-up review of new expenditure that is driven by growth.

#### Assessment

We reviewed additional background material provided by Gippsland Water regarding its approach to estimating its allowance for growth.

It provided a report prepared by Utilities Regulation Advisory (URA) that summarised the findings of its historical analysis of the relationship between connections growth and Gippsland Water's operating expenditure.<sup>16</sup> This analysis confirmed the presence of scale economies however it also noted that these outcomes will not necessarily be representative of outcomes for the PS5 regulatory period because there has been no significant growth-related capital expenditure over that historical period. URA advised that the statistical outcomes can therefore not be readily applied to the PS5 regulatory period where material growth-related capital expenditure will be undertaken.

Gippsland Water's business case for the Growth step change explained the costs underpinning this proposal in more detail.<sup>17</sup> The Growth step change comprises the following costs:

<sup>16</sup> Utilities Regulation Advisory 2022, Impact of Growth on Operating Expenditure, R009.

<sup>17</sup> Gippsland Water 2022, PS23 Opex Business Case Growth, OX005.

- The operating expenditure associated with the Drouin Wastewater Treatment Plant, which will be fully operational from 2022-23 (comprising \$3.12 million of the total proposed step change).
- New staff required to service growth, being two field-based multi-skilled operators and a land development officer/engineer (to facilitate early planning processes for new developments). The business case provides a summary of the tasks that these new staff will be undertaking. It is also understood that this is in response to feedback from developers.
- The forecast increase in costs in servicing approximately 200 new connections under the plumbing contract.

We have reviewed Gippsland Water’s business case and annual budgeted operating expenditure for the PS5 regulatory period to assess its most material individual operating expenditure item – the Drouin Wastewater Treatment Plant.

We consider that Gippsland Water’s approach to growth is reasonable, and all the costs identified within the proposed step change are required to respond to growth. This also recognises economies of scale and passes those benefits through to customers (compared to the application of a ‘blanket’ growth factor that does not recognise those scale economies). Gippsland Water has provided adequate information to substantiate this step change and the forecast costs appear reasonable.

### 3.4.5 Business continuity

#### Proposal

Gippsland Water’s largest proposed step change is for expenditure related to Business Continuity (\$15.74 million). This comprises labour related costs, including additional FTEs, remuneration increases associated with the Victorian Government’s 2022 PEER review and additional expenditure for the new employees.

Gippsland Water identified all additional FTEs to be employed in the PS5 regulatory period in its price submission<sup>18</sup> and the accompanying business case.<sup>19</sup> This includes ‘embedded labour requirements’, being six additional resources employed (or to be employed) in 2022-23.

<sup>18</sup> Gippsland Water 2022, Price Submission 2023-28, 30 September, p.8.

<sup>19</sup> Gippsland Water 2022, PS23 Opex Business Case Template Business Continuity, OX006.

## Assessment

Given the nature and materiality of this expenditure, we explored this in detail with the business.

### Business context

Gippsland Water's overarching case for this step change reflects the changes in its business and operating environment over the PS4 regulatory period and the planning and review that it undertook in developing its PS5 submission.

Consistent with the experience of the other businesses, Gippsland Water has been navigating a challenging operating environment over the current PS4 regulatory period (refer section 1.2). Some of the most significant challenges could not have been anticipated at the start of the period. One key trend that has impacted the business has been continued higher than expected growth.

It is evident (including in our discussions with the business) that despite these challenges and associated cost pressures, the business continued to focus on efficiency and managing expenditure within the allowance approved by the Commission for the PS4 regulatory period. Consequently, it is one of only three businesses whose baseline 2021-22 expenditure is below the Commission's benchmark allowance.

The business has also described the "cultural transformation" that it has undertaken in the PS4 regulatory period to become a customer-centric organisation. As part of this it undertook extensive customer engagement, resulting in the identification of six themes that have formed by the basis of the submission. One of these themes relates to affordability and a commitment to continue a declining cost to serve per customer.

At the same time, with growth continuing to exceed forecast and an expectation that this strong growth will continue, Gippsland Water explained to us that in seeking to manage costs within the benchmark expenditure allowances approved by the Commission, it has absorbed any spare capacity within the organisation. Consequently, it advised that its staff are now "stretched beyond capacity" and it has reached the point where further investment in this capacity is needed to meet customer expectations and maintain service levels.

We note that it has already expanded its labour force during the PS4 regulatory period, which has been largely funded through efficiency savings. Gippsland Water submitted that the FTE forecast underpinning the operating expenditure allowance approved by the Commission for the PS4 regulatory period did not allow for growth. It has also made a

strategic decision to internalise some of its labour resources to achieve efficiency improvements.

This experience has underpinned the Business Continuity step change, which as outlined above, includes a significant increase in employee numbers in the PS5 regulatory period. Gippsland Water outlined the process that was used to develop its proposed forecast and provided supporting documentation. This involved an organisation-wide review of the capacity required to deliver the commitments made to its customers, including a team-by-team resourcing gap analysis, which was ultimately subject to review and challenge by the Board and executive.

#### Labour-related costs: FTEs

Given the materiality of the proposed increase in FTEs for the PS5 regulatory period, which also follows an expansion in the labour force over the PS4 regulatory period (that has been largely funded by efficiencies), we scrutinised this in detail. Gippsland Water has also been very open and transparent in its discussions with us, as well as the detailed information it has shared in justifying each position.

The starting point for our assessment was the review and governance process, with the business explaining the ‘bottom up’ approach it had used to identify the resources each team within the business needed to meet required service standards. This includes how this information was then aggregated and subject to testing and challenge by Gippsland Water’s Board and executive.

Gippsland Water identified some roles that emerged from specific customer and stakeholder feedback. This ranged from field resources to direct customer support, as well as a Traditional Owner resource, the need for which emerged from discussions with that stakeholder group. As noted above, resources that are proposed specifically in response to growth have been captured as part of that step change. The proposal also includes three additional graduates as part of Gippsland Water’s graduate program, which it submitted is supported by community feedback to provide pathways for local people.

As a matter of process, we exercise significant caution in undertaking an FTE-by-FTE assessment. The business is best placed to identify the resources it needs to run its business, comply with its obligations and most importantly, deliver the outcomes desired by its customers.

However, in satisfying ourselves that the proposal aligned with that overarching objective, we found that we could not do this without reviewing each position. This involved applying a ‘regulatory lens’ recognising that the benchmark operating expenditure allowance is not

intended to dictate employment decisions – it only determines the costs that can be recovered from customers via water prices.

We therefore further explored the extent to which the additional resources linked to our step change criteria, including (as emphasised by the business) its linkage to delivering customer outcomes. This included understanding how existing activities (where relevant) are being managed within the business and the risks and impacts if the person is not employed. In terms of initiatives such as the graduate program, in addition to providing local employment pathways Gippsland Water also identified business drivers in terms of building internal capability, providing necessary resource flexibility, and managing the impacts of turnover, particularly in engineering and other critical roles.

Gippsland Water has evidenced the robust planning and governance that it describes as having underpinned the development of its operating expenditure forecast for the PS5 regulatory period, including the resourcing requirements underpinning its Business Continuity step change. Overall, we are satisfied that the proposed increase in FTEs in the PS5 regulatory period supports one or more of our step change criteria (such as complying with existing or new regulatory obligations or delivering an outcome endorsed by customers) and will assist the business in maintaining its capability to deliver the outcomes it has committed to its customers.

#### [Victorian Government’s PEER review](#)

This involves the implementation of the Victorian Government’s 2022 PEER review of executive remuneration (refer Appendix A). We note that some businesses have sought to capture this by way of a baseline uplift. Gippsland Water’s baseline is below the benchmark allowance approved by the Commission, meaning that it has been absorbing these costs (and funding them through efficiency savings) to date. These costs are material, totalling \$1.55 million over the PS5 regulatory period. We understand that the businesses must comply with these determinations.

#### [Comparison on industry-wide labour cost metrics](#)

We have compared Gippsland Water’s proposed labour costs for the PS5 regulatory period against the other businesses (refer Appendix A). This shows that Gippsland Water’s:

- average cost per FTE is around the industry average
- average cost per connection is above the industry average (it is the fourth highest)
- FTEs per connection is above the industry average for the urban businesses, but is still exceeded by four other businesses



- labour costs as a percentage of total controllable operating expenditure are below the industry average.

While caution should be exercised in comparing labour costs between the businesses, this analysis does not suggest that Gippsland Water's total labour costs for the PS5 regulatory period are unreasonable, or an outlier. We have referred to this information for context only, rather than in directly informing our decision regarding the prudence and efficiency of these costs.

#### Conclusion

In conclusion, we are satisfied that Gippsland Water has substantiated all the key elements comprising its Business Continuity step change and that the costs are reasonable. We have also considered this within the context of its net growth target for the PS5 regulatory period. We are therefore not proposing to make any adjustments to this step change.

### 3.4.6 IT investment

#### Proposal

Gippsland Water is proposing a \$7.19 million step change over the PS5 regulatory period for IT investment. Most of this expenditure (\$5.6 million) is for the implementation of the business's Digital Enablement Plan and Enterprise Architecture Strategy, which were developed during the current PS4 regulatory period. Gippsland Water also identified several ICT themes emerging from its customer engagement workshops.<sup>20</sup> The balance of the proposed step change is for three additional resources "required to support digital efficiencies through enhanced service offerings and introduction of new emerging technology such as Artificial Intelligence and Machine Learning."<sup>21</sup> Gippsland Water's submission separately identifies and explains the need for these positions.<sup>22</sup>

#### 1.1.6.2 Assessment

We reviewed Gippsland Water's Digital Enablement Plan<sup>23</sup> and Enterprise Architecture and Roadmap.<sup>24</sup>

The Digital Enablement Plan documents a detailed review and consultation process, which identified five key pillars that underpinned the strategy (simplification, visibility,

<sup>20</sup> Gippsland Water 2022, Price Submission 2023-28, 30 September, p.121.

<sup>21</sup> Gippsland Water 2022, Price Submission 2023-28, 30 September, p.121.

<sup>22</sup> Gippsland Water 2022, Price Submission 2023-28, 30 September, pp.116-117.

<sup>23</sup> Gippsland Water 2022, Digital Enablement Plan, April, OX008.

<sup>24</sup> Gippsland Water 2022, Enterprise Architecture Strategy, July, OX013.

optimisation, structure and customer). Initiatives are identified under each pillar for implementation between 2022 and 2025. This is supported by detailed budget costings for capital and operating expenditure.

The Enterprise Architecture and Roadmap identifies and maps initiatives to bridge the gap in Gippsland Water's ICT capability from the 'current state' to the 'target state'. The current state assessment included benchmarking Gippsland Water's current ICT architecture on several key dimensions.

Further to the budget estimates contained in these documents, we sought further information from Gippsland Water on the breakdown of costs. This enabled us to reconcile the total estimates submitted in the price review model with the key initiatives that underpinned them, as well as confirm if all of these costs were ongoing. Gippsland Water also provided detailed information on software licence fees.

The cost breakdown provided by Gippsland Water showed that these costs primarily comprise system and licence fees, as well as additional labour resources (FTEs). In terms of the additional resources, Gippsland Water also provided information on the requirement for each position, which was identified and assessed as part of its strategic resourcing process (as discussed under Business Continuity, noting that these positions are not included in that step change). This includes a Business Intelligence Lead, a SCADA Data and Business Analyst position and a Technical Business Analyst. This detailed the activities that would be undertaken by each employee, the budgeted cost and the link to Gippsland Water's price submission. Based on our review, it appears that the costs proposed as part of this step change are ongoing costs, rather than one-off costs that could potentially be capitalised.

We also considered its proposal within the context of proposed IT expenditure for the PS5 regulatory period across the water businesses (refer Appendix A). From this analysis we note that based on Gippsland Water's proposed total IT expenditure for the PS5 regulatory period, it has the third highest IT costs per connection. However, its total IT expenditure as a percentage of total controllable operating expenditure in the PS5 regulatory period is around the average of all the businesses.

Caution needs to be exercised in drawing conclusions from these comparisons as the need for IT expenditure in the PS5 regulatory period will depend on the level of maturity of each business's IT infrastructure. There can also be differences in the categorisation of expenditure. For example, Gippsland Water advised that it includes operational technology costs (SCADA) as part of its reported IT expenditure, whereas this may not be the case for

other water businesses. We have therefore only referred to this information for context. It has not directly informed our assessment of this proposed step change.

Overall, we are satisfied that Gippsland Water has provided adequate substantiation of its IT step change for the PS5 regulatory period, which is supported by an overarching strategy and detailed program of work.

### 3.4.7 Regulatory costs

#### Proposal

Gippsland Water has proposed a step change for regulatory costs of \$2.08 million over the PS5 regulatory period. This provides for two additional resources to strengthen Gippsland Water's internal regulatory capability – a Regulatory and Strategy Lead and a Communications and Engagement Advisor (0.8 FTE).<sup>25</sup> It also includes costs for consulting services to assist with its PS6 price submission (including customer engagement, capital estimating and risk services, demand and growth forecasting and strategic regulatory advice), as well as the Urban Water Strategy.<sup>26</sup>

#### Assessment

For the two additional resources, we reviewed Gippsland Water's strategic resourcing documentation that summarised the need for the resources, the key responsibilities of each role and the estimated budget. Gippsland Water advised that it currently does not have dedicated internal regulatory resources and has therefore had to rely more heavily on external consultants. With this internal capability gap, which was identified early in the submission planning process, Gippsland Water had to rely more heavily on external consultants, including in relation to the delivery of key processes and outcomes.

The Regulatory and Strategy Lead is expected to assume responsibility for the coordination and management of the price submission as well as ongoing regulatory activities. We agree that it is reasonable for a regulated business of this size and scope to have a dedicated in-house regulatory capability. The other resource will be focussed on customer engagement.

The balance of the proposed step change (accounting for \$1.1 million) comprises consulting costs it plans to incur as part of the PS6 price submission and Urban Water Strategy. Gippsland Water provided information on its actual expenditure incurred to develop the PS5 price submission. It initially advised total (indicative) consultancy costs for the PS5

<sup>25</sup> Gippsland Water 2022, Price Submission 2023-28, 30 September, p.117.

<sup>26</sup> Gippsland Water 2022, Price Submission 2023-28, 30 September, p.122.

regulatory period of \$1.285 million (in January 2023 dollars).<sup>27</sup> It subsequently advised that the total cost of external consultants was \$1.398 million.<sup>28</sup> It also noted a further \$1.2 million in 'diverted internal resources', who worked with the external consultants to develop Gippsland Water's PS5 submission and embed future intellectual property into its BAU processes.

We questioned Gippsland Water as to the extent to which the decision to bolster its internal regulatory capability will result in reduced consultancy costs at the next review. Gippsland Water advised that its proposed program for the PS6 review includes similar deliverables to the current period, including facilitating customer engagement, capital budgeting, external quality assurance and strategy assessment reviews for capital programs. Overall, its proposal for external consultancies to assist with its PS6 submission is around \$300,000 (or around 21 per cent) lower than its actual costs for the PS5 submission.

Gippsland Water also subsequently provided a more detailed list of the consultancies underpinning its proposed \$1.1 million step change, including a description and costing of each. Based on our review of these activities, we can verify the relevance of these activities as well as why it is appropriate for them to be undertaken by external consultants (rather than in-house), including for a business of the size and scope of Gippsland Water. The consultancies either require specialist expertise, resourcing that would not be permanently required by the business and/or the provision of independent assurance.

We note an explicit allowance was not sought for these consultancy costs as a step change for the PS4 regulatory period. Gippsland Water has removed \$900,000 in PS5 price submission consultancy costs incurred in 2021-22 from the baseline.

As a regulated business, the management of regulatory matters, including the five yearly price reviews undertaken by the Commission, is core business, which therefore supports the need for in-house regulatory resources (that Gippsland Water did not have previously). Gippsland Water is also required to comply with its obligations and responsibilities as a regulated business. Customer engagement has become an important part of this process, not only for the purpose of developing the price submission but also on an ongoing basis.

<sup>27</sup> Email from Gippsland Water, 8 November 2022.

<sup>28</sup> Memorandum from Gippsland Water, Response to draft review of expenditure forecast, 13 February 2023.

We consider it appropriate for Gippsland Water's operating expenditure allowance to include funding for an ongoing in-house regulatory capability. We therefore consider that the proposal for the two additional resources is reasonable and adequately substantiated.

We note that the proposed expenditure on external consultancies is around 21 per cent lower than its actual expenditure incurred as part of its PS5 price submission. The more detailed information provided by Gippsland Water on the activities underpinning its proposed \$1.1 million in expenditure for the PS5 regulatory period enabled us to conclude that the nature and level of that expenditure is appropriate. It has also removed \$900,000 in consultancy costs incurred for the PS5 review in 2021-22 from its baseline expenditure.

We are therefore not proposing any adjustment to this step change.

#### 3.4.8 Summary of assessment of step changes

As outlined above, we are satisfied that Gippsland Water has substantiated all of its proposed step changes for the PS5 regulatory period and that the costs appear reasonable. We have considered this also within the context of Gippsland Water's implied net growth factor of -0.2 per cent per year, which is the fourth most ambitious of the water business (refer Section 3.5).

We are therefore able to confirm that:

- there is a clear rationale for the step changes and that they are consistent with a prudent business acting efficiently, having regard to our step change criteria
- they are sufficiently material to allow these increases to baseline operating expenditure rather than assume that they should be absorbed by the net growth factor.

We therefore consider it appropriate for Gippsland Water's baseline operating expenditure allowance to be increased for the full amount of the forecast step changes.

### 3.5 Forecast growth and efficiency factors

Gippsland Water's approach of addressing growth as a step change rather than applying an efficiency factor was explained in section 3.4.4. In its price submission it states that it has therefore applied a growth factor of zero per cent and an efficiency target of 0.5 per cent per year, resulting in net growth in operating expenditure of -0.5 per cent per year.<sup>29</sup>

<sup>29</sup>Gippsland Water 2022, Price Submission 2023-28, 30 September, p.109.

Gippsland Water provided further information to explain how it has arrived at this. It states that its approach to growth implies an equivalent annual growth factor across the PS5 regulatory period of 1.2 per cent per year.

It has then applied a bottom-up approach to determining its implied efficiency factor. This is based on the difference between:

- total prescribed operating expenditure (including non-controllable costs)
- the bottom-up budget, which is based on the 'Opex-breakdown' tab in the price review model (which also includes non-controllable costs).

This also results in a different factor in each year of the PS5 regulatory period. Gippsland Water states that these savings result in a compounding net efficiency outcome of 0.5 per cent per year.

In the first instance we note that this analysis includes non-controllable costs, which we consider should be excluded. However, as they are included in both above line items the net impact of this on Gippsland Water's estimates should be nil.

We have done an alternative (and comparatively simple) calculation that calculates the total implied growth over the five years of the PS5 regulatory period based on the difference between:

- total controllable operating expenditure in the last year of the PS5 regulatory period (2027-28), inclusive of efficiency and adding in the growth step change for that year (\$77.25 million)
- total controllable operating expenditure in the last year of the current PS4 regulatory period (2022-23), which will be inclusive of efficiency and growth (\$77.93 million).

This implies total savings in controllable operating expenditure of -0.87 per cent, which equates to an average efficiency factor of -0.2 per cent per year over five years. We have applied this in our comparisons below.

Gippsland Water is one of only five businesses proposing negative net growth in operating expenditure. The potential difference between our estimate and Gippsland Water's calculations does not impact its actual proposed controllable operating expenditure, nor does it impact our overall assessment of its proposed operating expenditure, which has been based on a review of the step changes.

Table 3.2: Net average increase in operating expenditure per year by business

Water business	Net average annual increase
South East Water	-0.9%
GWMWater	-0.8%
Wannon Water	-0.3%
<b>Gippsland Water</b>	<b>-0.2%</b>
Yarra Valley Water	-0.2%
Lower Murray Water (Urban)	0.0%
Barwon Water	0.1%
South Gippsland Water	0.2%
Westernport Water	0.5%
Coliban Water	0.5%
East Gippsland Water	0.7%
Goulburn Valley Water	1.1%
Central Highlands Water	1.2%

Source: Calculated from pricing models submitted by water businesses.

### 3.6 Summary of controllable operating expenditure assessment

Based on Gippsland Water’s PS5 submission, discussions with the business and the further information it provided, the adjusted operating expenditure in 2021-22 is consistent with a prudent business that operates efficiently. This reflects our view that:

- the key drivers of the additional expenditure above the baseline appear reasonable, and the baseline does not appear to include any items that are non-recurring
- the proposed step changes are reasonable and supported by a sound rationale
- it is not reasonable to expect that these step changes could be absorbed by the business given the net growth factor of -0.2 per cent per year. Our estimate of its implied net growth factor is different to the implied factor of -0.5 per cent per year advised by the business, however this reflects differences in our implied growth calculations based on its proposed controllable operating expenditure. It also has not impacted our assessment of Gippsland Water’s operating expenditure.

As a result, we do not recommend any adjustments to Gippsland Water's forecast controllable operating expenditure for the PS5 regulatory period.



## 4 CAPITAL EXPENDITURE ASSESSMENT

### 4.1 Overview of assessment approach

The Commission's Guidance Paper states that forecast capital expenditure is:

*... capital expenditure that would be incurred by a prudent service provider acting efficiently to achieve the lowest cost of delivering service outcomes, taking into account a long-term planning horizon (prudent and efficient forecast capital expenditure).*

We have assessed Gippsland Water's forecast capital expenditure for the PS5 regulatory period focusing on the significant areas of expenditure.

The assessment considered the details provided in the submission and any additional information requested against the criteria set out in Figure 4.1.

Figure 4.1: Capital expenditure assessment criteria

Assessment of capital program
<ul style="list-style-type: none"><li>• Link to customer service outcomes, regulatory obligations and risk management</li><li>• Comparison of forecast and actual capital expenditure</li><li>• Reliability of cost estimation</li><li>• Deliverability of capital program</li></ul>
Assessment of major capital projects and programs
<ul style="list-style-type: none"><li>• Major capital projects and programs are clearly justified</li><li>• Proposed delivery solution is reasonable</li></ul>

Having regard to the above factors, we have considered whether any adjustments to the proposed expenditure forecast would be considered appropriate, material and justified.

The assessment of Gippsland Water's major project capital expenditure is based on the information provided in the PS5 submission, additional supporting documents, and Gippsland Water's overall approach to the development of the program, the cost estimation, and the delivery within the PS5 regulatory period.

The assessment of the program expenditure has been based on supporting documents that underpin the level of expenditure within key programs and additional information provided.

## 4.2 Assessment of overall capital program

### 4.2.1 Link to customer outcomes and obligations

Gippsland Water's PS5 submission includes major project summaries that clearly link the projects to customer outcomes, risk and/or regulatory obligations. The proposed capital program seeks to achieve the following broad outcomes:

- water and wastewater capacity upgrades to address current deficiencies and provide for future growth
- water network interconnections for service reliability, network resilience and growth
- a range of renewals programs to provide reliable services.

Gippsland Water's PS5 submission also lists the individual programs, which are also well linked to customer outcomes.

### 4.2.2 Comparison of forecast and actual capital expenditure – PS4

Gippsland Water expects to deliver a capital expenditure program of \$260.4 million within the PS4 regulatory period. This is 12 per cent higher than the capital expenditure benchmark allowance approved by the Commission for the PS4 regulatory period.

Eight of the top 10 major projects are forecast to be completed in the PS4 regulatory period. Two projects (Saline water outfall and Warragul sewer) have been delayed or deferred, with approximately \$23 million of capital expenditure associated with those projects now included within the PS5 regulatory period. Significant additional expenditure is associated with the Drouin Wastewater Treatment Plant project (\$20 million cost increase) and additional investment in shared assets to service unexpected growth (\$15 million) within the PS4 regulatory period. Gippsland Water's submission provides additional information around these increases, which are offset by \$8 million in cost efficiencies across programs and projects.

### 4.2.3 Forecast capital expenditure – PS5

Gippsland Water's capital expenditure forecast for the PS5 regulatory period is \$267.7 million. This is \$7.3 million more than the actual/forecast for the PS4 regulatory period and is \$26.3 million (11 per cent) more than the forecast capital expenditure outlook for the PS5 regulatory period that it included in its PS4 submission.

The key drivers for the PS5 capital expenditure program are:

- Renewals – \$110.6 million, which is 41 per cent of total capital expenditure

- Improvement/compliance – \$57.6 million, which is 22 per cent of total capital expenditure
- Growth – \$55.3 million, which is 21 per cent of total capital expenditure.

Gippsland Water's top nine major capital projects together account for \$82.4 million and the remaining total program expenditure accounts for \$185.3 million. The major areas of expenditure are:

- water and wastewater capacity upgrades to address current deficiencies and provide for future growth (\$56 million)
- water and wastewater facility renewals (\$48.7 million)
- water and wastewater network renewals (\$21.5 million)
- water network interconnections for service reliability, network resilience and growth (\$17.9 million)
- saline water outfall (\$17.2 million), which is fully customer funded
- other discrete water and wastewater projects (\$52.3 million).

Based on the information contained in Gippsland Water's PS5 submission project summaries, the major projects are well linked to regulatory and customer service outcomes and provide the justification for the proposed capital projects. We selected three major projects, (bulk water entitlement purchase, Tyers interconnection and the Traralgon-Morwell interconnection), to assess the level of supporting planning and detail (see Section 4.3.1). In all cases we concluded that there is a good level of planning underpinning the projects.

Gippsland Water provided additional information around the significant program expenditure, which provides a reasonable level of confidence around the planning undertaken to support the forecast expenditure for the PS5 regulatory period.

Based on the current levels of capital expenditure delivered in the PS4 regulatory period and the similar scale of the PS5 capital program, we are confident that Gippsland Water can deliver the overall level of capital expenditure in the PS5 regulatory period.

#### 4.2.4 Underlying processes for developing the program

Gippsland Water has an Asset Management framework and capital governance and approvals process guiding the development of its capital program.

Gippsland Water has developed synopsis documents for each major project, program clusters and other projects. We reviewed these documents as part of the assessment of major projects and programs (see Section 4.3.2). Together these documents provide a good level of supporting detail around the expenditure including links to drivers and outcomes,

project development and governance, cost increases and explanations, scoping, prioritisation, itemised projects and costs and guidance on procurement and delivery.

Gippsland Water has used scenario analysis in its Water Network program synopsis to determine investment profiles that balance customer service levels and future costs. Gippsland Water's submission outlines typical data used in the analysis for pipe replacement that indicates a prudent approach to asset replacement. Additionally, the submission has referenced performance measures around the effectiveness of the replacement programs, which will be in place for the PS5 regulatory period, and that will inform future asset planning.

Gippsland Water has used a risk management framework and processes along with an evaluation process to develop and prioritise its capital expenditure, with an objective being to ensure there is no inappropriate risk transfer to customer prices. Gippsland Water has identified capital planning and estimating as high risks and its submission references a range of mitigation measures such as excluding expenditure for two uncertain projects (\$8.2 million), independent reviews of expenditure forecasts and methodology, use of the P50 Monte Carlo analysis for the top 10 project cost estimates and market testing the delivery of the water mains renewals program.

The information in Gippsland Water's PS5 submission, along with the additional information, provides confidence that there is a well-developed process around the development of the capital expenditure program, which is considered consistent with a prudent service provider acting efficiently.

#### 4.2.5 Reliability of cost estimation

Gippsland Water's PS5 submission has highlighted unprecedented increases in construction costs, upward pressure on material costs and increased demand for construction resources as factors impacting capital expenditure.

The significant \$20 million increase in the cost of the Drouin Wastewater Treatment Plant and the factors stated above, has led Gippsland Water to introduce additional processes to manage the cost estimating risks, including independent reviews of expenditure forecasts and methodology and exclusion of uncertain projects from the capital program. The submission references continual refinement of cost estimates with any unexpected cost increases to be justified at each phase of the project.

Gippsland Water uses P50 cost estimates for its top 10 capital projects, which have been independently reviewed to test prudence and efficiency. Contingencies for other projects are based on the project risk profile and the design stage.

The key renewals programs use historical costs, previous completed projects and submitted tenders in developing cost estimates. For water and sewer network renewals, scenario analysis is used to balance investment and customer service risk.

The information in Gippsland Water's submission indicates that it has adjusted its approach in response to the increased risks with cost estimation. Notwithstanding the risk factors discussed above, Gippsland Water's approach to cost estimation appears to provide an appropriate basis for developing the budget estimates for its PS5 capital expenditure program.

#### 4.2.6 Deliverability of capital program

In response to the significant cost increases experienced in the PS4 regulatory period, Gippsland Water has implemented improved internal processes including the Capital Review committee, a Project Management Framework and internal steering committees for strategic and significant projects.

Gippsland Water's submission has outlined relevant procurement and delivery processes including, but not limited to:

- implementation of improved governance arrangements with the Capital Review Committee and Project Management Framework
- use of market data and indicators to inform decisions on the delivery model adopted
- bundling of similar renewals projects to achieve efficiencies with scale
- assessment of a range of methods for procurement and delivery for each project and program
- use of multi-year contracts for pipe renewals to generate economies of scale and attract greater competition
- use of key performance indicators within contracts
- early oversight and intervention with cost overruns
- resource levelling the project management effort across the regulatory period.

Gippsland Water's submission has clearly highlighted the current capital expenditure risks that are likely to continue into the PS5 regulatory period. Whilst this presents challenges around cost efficiency and delivery decisions, Gippsland Water has improved its governance arrangements to manage that risk as far as practicable. Given that the capital program is of similar scale to what has been delivered in the PS4 regulatory period and based on the governance arrangements and approaches outlined above, we are confident that Gippsland Water can deliver the program in the PS5 regulatory period.

## 4.3 Assessment of major projects and major programs

### 4.3.1 Major projects

Gippsland Water's major project capital expenditure totals \$82.4 million (excluding bulk water entitlement purchase costs), which accounts for 31 per cent of its forecast capital expenditure for the PS5 regulatory period. Gippsland Water's PS5 submission includes major project summaries, which provide sufficient justification and links to customer outcomes, risk and/or regulatory obligations. The projects seek to achieve the following broader outcomes:

- water network interconnections and water entitlement purchases to improve water security, service reliability and network resilience
- water and wastewater capacity upgrades to address current deficiencies and provide for future growth.

A range of supporting strategies and synopsis documents were referenced for the major projects.

We selected three synopsis documents to assess the level of detail supporting the major projects. The bulk water entitlement purchase, the Tyers interconnection and the Traralgon-Morwell interconnection project synopsis documents provided a sufficient level of detail around the justification, planning and development of the project and forecast investment. Based on the assessment of the selected projects there is a good level of confidence that the projects are well supported by a robust planning process.

The major project summaries and associated supporting documentation, along with the approaches to developing the program, the cost estimation and delivery, provide sufficient confidence that the major project expenditure is consistent with a prudent service provider acting efficiently.

### 4.3.2 Major programs

Gippsland Water's PS5 submission includes a summary list of 12 consolidated capital programs (from 43 total programs), totaling \$175.3 million, which accounts for 66 per cent of the total capital expenditure for the PS5 regulatory period. Three of these programs are titled as 'other projects' for corporate, water and wastewater, which comprise 155 smaller discrete projects across the renewals, compliance/improvement and growth drivers. The specific smaller projects and their costs are included in the supporting documents.

Each program has an associated and supporting synopsis document that outlines historical spend comparisons (where available), links to customer outcomes and risks, procurement and delivery strategies, program expenditure scenario analysis, prioritisation, cost

estimation and contingencies. The documents are sufficiently comprehensive to indicate there is a robust process underpinning the program expenditure.

Gippsland Water's submission indicates that the overall capital program spend is 9.5 per cent or \$10.4 million higher than the PS4 regulatory period. This overall increase has resulted from, in part, the replacement of aging infrastructure and the introduction of proactive condition inspections and associated risk-based renewals of larger mains and civil facilities. It is noted that increases have been offset by a \$12.8 million reduction in the growth expenditure program, hence the increase in the remaining programs is \$23.2 million.

The key contributions to the \$23.2 million increases were assessed further as follows.

**Water and wastewater asset renewals expenditure (\$11.4 million increase)** – the four key synopsis documents linked specifically to renewals (water and wastewater network and facility renewal programs) were reviewed. In all cases, the quantum of the increase and explanations were included in the documents. The two significant increases related to the following.

- The sewer facility renewal program, which was 27 per cent more than the PS4 regulatory period actual expenditure. This resulted from updated asset criticality and likelihood of failure assessments, inclusion of bulk waste system assets and a sewer pump station renewal program.
- The water network renewal program, which was 58 per cent more than the PS4 regulatory period actual expenditure. This largely resulted from the introduction of proactive distribution and trunk main condition inspections and renewals that did not occur in 2018-2023, a smoothing of reticulation main renewals over a longer period to avoid bow waves of expenditure and a focus on bulk entitlement water meters to comply with legislation and metering guidelines around accuracy obligations for water extraction. We sought and reviewed further details around the basis for the bulk meter and transfer-distribution main expenditure profiles. A combination of details within specific asset class plans and written responses from Gippsland Water provided sufficient confidence that the expenditure is justifiable and reasonable.

**Corporate renewals and improvement compliance (\$7.9 million increase)** – the corporate renewal expenditure is spread across the IT program and the 'Other projects – Corporate program'. The increases are summarised as follows.

- The IT program, which was 53 per cent more than the PS4 regulatory period actual expenditure. This resulted from implementation costs associated with the

Digital Enablement Plan, enhancement of Cyber Security resilience, replacement of the Digital Mobile Radio and Mitel telephone systems prior to the equipment's end of life, and replacement of old insecure network hardware.

- Other projects – Corporate: there was no comparison to the PS4 actual expenditure available, however the program totals \$3.3 million. We sought further details around the carbon offset project (\$1 million) and the classification of property services miscellaneous charges (\$0.05 million) as capital expenditure. The carbon offset options, solution and costs are defined in Gippsland Water's Carbon Offsets Program – Stage 2 Strategic Assessment and includes a carbon sequestration project on Gippsland Water land to meet the net zero greenhouse gas emissions target. Gippsland Water advised that the project title for the property services charges project is inadvertently misleading – this project is actually related to a series of software upgrades to the billing system (FLOW) that commenced in the 2022-23 year (\$52,545 estimated expenditure) and will be finalised in the 2023-24 financial year.

**Energy program (\$2.4 million increase)** – the synopsis document included the quantum of the increase, which was 30 per cent more than the PS4 regulatory period actual expenditure. The increase is driven by the requirement to meet the Government energy mandates by 2025 and 2030. The program consists of a prioritised list of 16 renewable energy projects.

The overall increases assessed above are spread across several areas and are offset in part by the reduction in the growth program. The information provided around the program expenditure was sufficiently comprehensive to provide confidence that the expenditure has a good level of supporting information, is justified and reasonable.

#### 4.4 Summary of capital expenditure assessment

Based on the information provided around the major projects, the increases in the individual program expenditure, along with the approaches to developing the program, the cost estimation, and the delivery of the program, we consider that:

- the proposed capital expenditure program is consistent with a prudent service provider acting efficiently
- the forecast capital expenditure is justified, robust and is capable of being delivered by Gippsland Water in the PS5 regulatory period.

As such, we do not propose any adjustments to Gippsland Water's forecast capital expenditure for the PS5 regulatory period.



## APPENDIX A: CROSS-INDUSTRY OPERATING EXPENDITURE ISSUES

### Overview

There are several drivers of increased operating expenditure over the current PS4 regulatory period and/or forecast for the PS5 regulatory period that are common across water businesses. While the base-step-trend methodology does not involve a 'bottom up' or category-by-category assessment of expenditure, we consider it important to ensure that we have regard to the key drivers and trends in baseline increases and/or proposed step changes in assessing each business's proposal.

This appendix reviews some of those expenditure drivers in more detail, being:

- energy
- IT
- labour.

It also presents some comparative data submitted to the Commission by each of the water businesses as part of their respective price review models. Section 3.2 of this report outlines the implications of this analysis for our approach.

### Energy expenditure

#### Background

Energy costs have been increasing in recent years. This has been driven by several factors, including increases in the wholesale price of electricity, the impact of the Ukraine war on global energy prices, increasing network costs and the costs associated with the transition to renewable energy. This has impacted actual energy costs for the water businesses over the current PS4 regulatory period. The uncertainty and volatility in the electricity market has also made it more challenging for water businesses to forecast electricity costs for the PS5 regulatory period. The Victorian water businesses have also all committed to sourcing their energy requirements from 100 per cent renewable sources by 2025.

#### The Schneider report

The Intelligent Water Network is a collaboration between the Victorian water businesses, VicWater and the Department of Energy, Environment and Climate Action (DEECA, formerly the Department of Environment, Land, Planning and Water (DELWP)). The Intelligent Water Network engaged Schneider Electric Energy and Sustainability Services (Schneider) to provide forecast electricity prices for the PS5 regulatory period.

Victorian Government Purchasing Board reforms have mandated use of the State Purchase Contracts for electricity (large and small market) managed by the Department of Treasury and Finance and Schneider. We understand that some water businesses are already using these contracts while others are in the process of transitioning to these new contracts.

The Schneider report, finalised in March 2022, addressed the following key assumptions:

- energy commodity rates (peak and off-peak)
- Large-scale Generation Certificates
- Small-scale Technology Certificates
- Victorian Energy Efficiency Certificates
- network forecast charges
- market operator charges.

It appears that all the water businesses have used the Schneider report as the basis for their forecast electricity costs for the PS5 regulatory period. We have undertaken a high-level review of the Schneider report and the methodology and assumptions used (including data sources) appear reasonable. We have also examined how it has been applied by each business.

#### Industry emissions reduction target

Under the Water for Victoria Plan, the Victorian water sector has committed to achieving net zero emissions by 2035. The sector has also committed to sourcing 100 per cent of its electricity needs from renewables by 2025. The Statement of Obligations (Emission Reduction) made pursuant to the *Water Industry Act 1994* requires all Victorian water businesses to:

- prioritise the implementation of actions that avoid or reduce emissions resulting from its operations
- achieve emission reductions efficiently, making full use of the time available to do so.<sup>30</sup>

In pursuing these reductions, Section 3.2 of the Statement of Obligations (Emission Reduction) encourages water businesses to:

- pursue actions and targets at the lowest possible cost, seeking to minimise any impact on water customer bills
- have regard to any price impacts on their vulnerable customers.

<sup>30</sup> Statement of Obligations (Emission Reduction), Section 3.1.

Five yearly targets have been set under the Statement of Obligations on the transition to net zero by 2035. This means that a business that has committed to achieving an annual emissions target in a target year (for example, by 1 July 2030) must ensure that it keeps its emissions at or below that level in all subsequent years leading up to their next five-yearly emissions target (for example, 1 July 2035). The requirement to source 100 per cent of their electricity from renewable sources applies from 2025 onwards.

Table A1 shows the baseline level of emissions for each water business and the reductions required by the 2024-25 financial year. It shows that the reductions required by each business vary materially depending on their current baseline.

Table A1: Victorian water businesses emission reduction targets

Business	Emissions baseline	Annual reportable emissions 2024-25 (tonnes CO2 e)	% reduction from baseline
Barwon Water	42,986	15,926	-63
Central Highlands Water	18,351	14,738	-19.6
Coliban Water	33,604	29,304	-12.8
East Gippsland Water	8,272	6,496	-21.5
Gippsland Water	42,021	32,080	-23.7
Goulburn Valley Water	49,575	37,416	-24.5
Grampians Wimmera Mallee Water	20,017	16,244	-18.8
Lower Murray Water	44,188	24,708	-44.1
South East Water	41,744	23,016	-44.9
South Gippsland Water	7,663	6,480	-15.4
Southern Rural Water	1,559	0	
Wannon Water	31,626	18,976	-40
Westernport Water	6,062	5,598	-7.7
Yarra Valley Water	32,004	11,664	-63.6

Source: <https://www.water.vic.gov.au/climate-change/reduced-emissions-in-the-water-sector/net-zero-emissions-by-2050>

The businesses must then transition over the following five years to their next target (for the 2029-30 financial year). All businesses are required to achieve net zero by 2034-35, although some businesses are forecasting to achieve net zero by 2029-30.

It is evident from water businesses' PS5 submissions and discussions with them that different initiatives are being employed to achieve the 2025 target including one or more of the following:

- direct capital investment in 'behind the meter' renewable capacity (for example, installing solar photovoltaic (PV) at water treatment plants)
- purchasing energy generated from renewable sources (greenpower), which can involve an additional cost compared to conventional sources
- purchasing offsets, such as Large Generation Certificates.

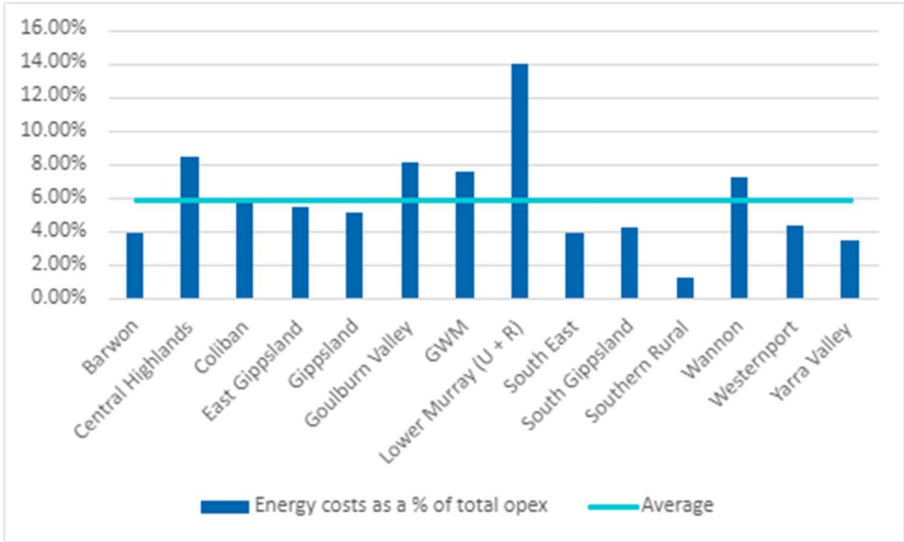
The most appropriate strategy depends on the needs and circumstances of the business, including the feasibility (and cost) of direct action measures such as solar PV.

Some businesses have proposed step changes in operating expenditure for additional costs associated with the above initiatives.

#### Cross-sector expenditure trends

Overall, proposed electricity expenditure for the PS5 regulatory period accounts for a relatively small proportion of controllable operating expenditure, averaging around 6 per cent, as shown below.

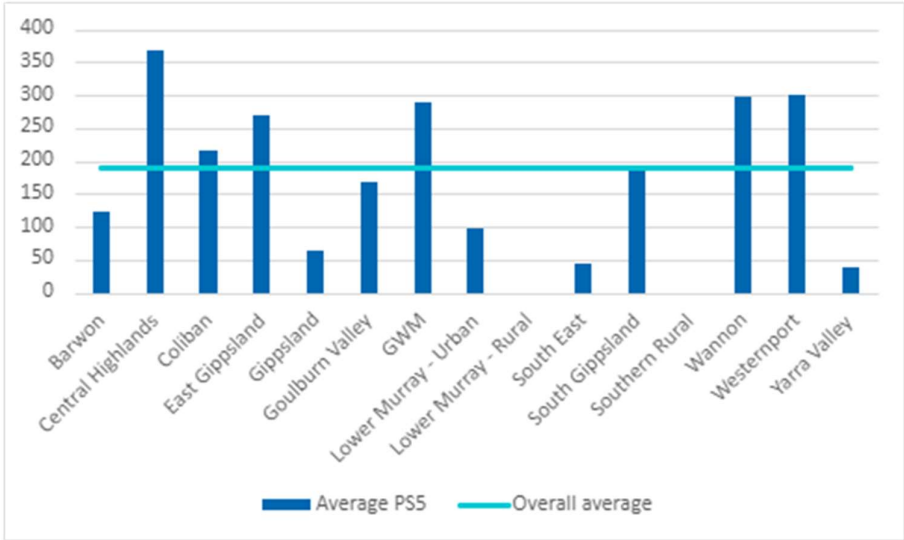
Figure A1: PS5 forecast total energy expenditure as a percentage of total controllable operating expenditure (%)



Source: Victorian water businesses, 2023 Price Review Models.

For the urban businesses, Figure A2 shows electricity expenditure per volume of water delivered (in ML).

Figure A2: PS5 forecast energy costs per volume of water delivered (\$ per ML, 1 January 2023)

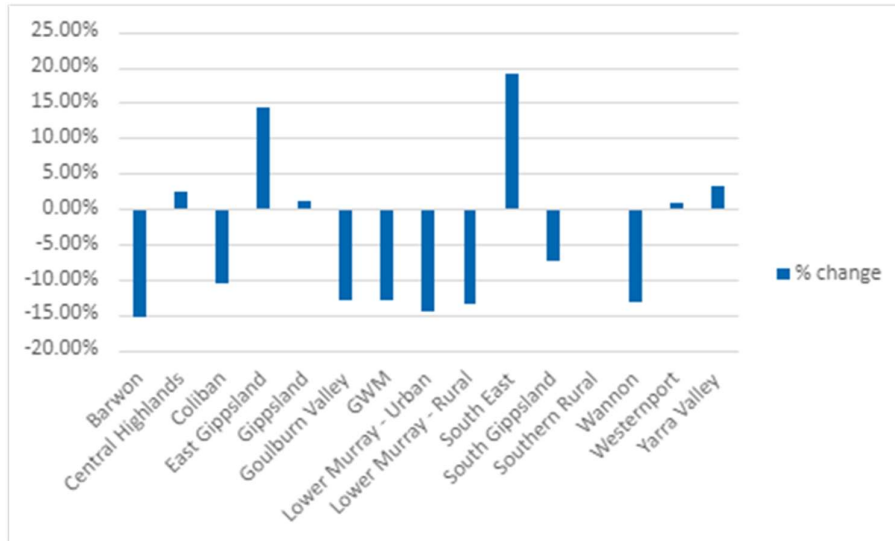


Source: Victorian water businesses, 2023 Price Review Models.

As noted above, energy costs have been increasing over the current PS4 regulatory period. However, most businesses are forecasting a decline in energy costs in the PS5 regulatory period for several reasons, including efficiency initiatives and targets. Figure A3 shows the change between total actual PS4 energy expenditure<sup>31</sup> and proposed PS5 energy expenditure for each business.

<sup>31</sup> Note that the water businesses’ Price Review Models submitted to the Commission for this PS5 review include updated forecasts for financial year 2022-23.

Figure A3: Total energy expenditure: total proposed for PS5 regulatory period less total actual for PS4 regulatory period (%)



Source: Victorian water businesses, 2023 Price Review Models. Note PS4 actuals include an updated forecast for the 2022-23 financial year.

## IT expenditure

### Background

Several businesses have experienced increases in IT-related operating expenditure in the PS4 regulatory period, which have impacted the 2021-22 baseline, and/or are proposing step changes for IT expenditure in the PS5 regulatory period. This is reflected in three main categories:

- Cloud-based services
- cyber security
- other IT expenditure.

### Cloud-based services

Consistent with trends in other businesses and industries, most of the water businesses are either in the process of transitioning, or have transitioned, to Cloud-based services (also referred to as Software as a Service (SaaS)). Rather than each business having all its own hardware and software infrastructure on-site, this is a software distribution model where key applications are centrally hosted via a third-party provider. Services are then delivered via the Cloud and the third-party provider manages all hardware and software

requirements. Users then contract and pay for services based on a licence or subscription fee model.

Several water businesses source key applications from Technology One. In 2021 Technology One announced that it will commence transitioning all on-premises customers to its SaaS platform. Based on its timetable, it will cease providing on-premises support services to customers on 1 October 2024.<sup>32</sup>

A key implication of the change to this different service delivery model is that expenditure formerly categorised as capital expenditure will now be characterised as operating expenditure (i.e. relevant licence and subscription fees). Holding all else constant, this will be reflected in a reduction in capital expenditure and an uplift in operating expenditure (noting that this is not a 'dollar for dollar' substitution and that the profile for capital expenditure will have depended on the investment needs of the business). In terms of the impact on operating expenditure, this is evidenced by several businesses either attributing SaaS costs as a driver of the baseline uplift or proposing as a step change.

Additional costs may be incurred in the process of transitioning to Cloud-based services. In this regard, we understand that the Commission has advised the water businesses that it will consider capitalising transition-related expenditure where appropriate. Where proposed, this is considered as part of the review of each business's capital expenditure.

### Cyber security

The need to upgrade cyber security has accelerated over the PS4 regulatory period and is also now receiving increased scrutiny from government agencies, customers and the wider community. Activities range from ensuring that water assets and operations remain resilient to cyber attacks through to protecting customer data.

Victorian water businesses are required to comply with several requirements and standards including:

- the Victorian Protective Data Security Framework established pursuant to the *Privacy and Data Protection Act 2014*, which sets out mandatory standards for Victorian public sector agencies and bodies
- Victoria's Cyber Security Strategy 2021
- the Victorian Critical Infrastructure Resilience Framework, with water one of the eight critical infrastructure sectors. This has driven the requirement for a Water Sector Resilience Plan. Cyber security is one of several risks identified under that

<sup>32</sup> <https://technologyonecorp.com/saas/pathway-to-saas#> {Accessed 13 December 2022}.



framework, which also extends to climate-related risks, pandemics and key supply chain disruptions. DEECA now leads the Water Sector Resilience Network, which aims to collaborate on matters relating to resilience by sharing information and experiences

- Implementation of the recommendations of the Victorian Auditor-General's Office's performance audit of Security of Water Infrastructure Control Systems.<sup>33</sup>

Cyber security initiatives can be expected to continue to develop and evolve over the PS5 regulatory period.

#### Other IT-related expenditure

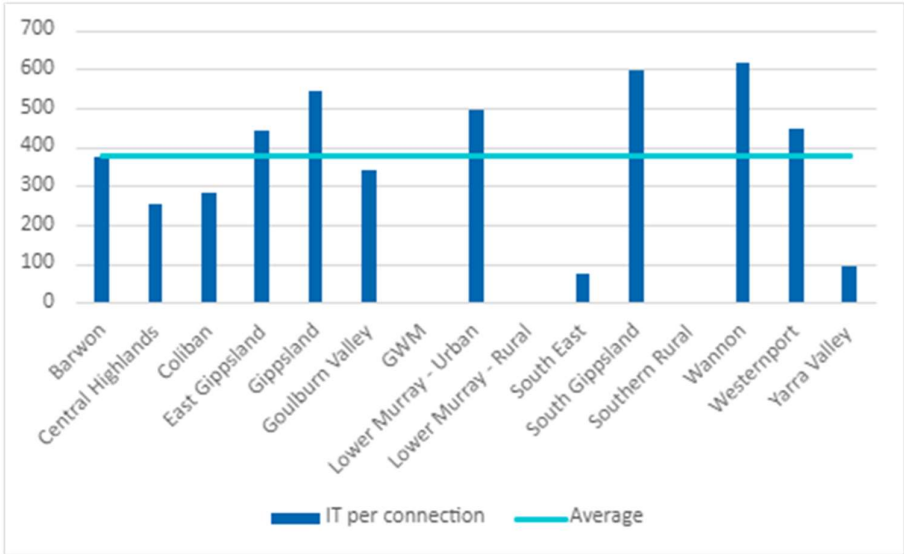
Depending on the functionality and maturity of each water business's current IT-architecture, other business-specific expenditure may be incurred in reviewing and upgrading this capability.

#### Cross-sector expenditure trends

As part of the Commission's price review model, water businesses are required to report on total IT expenditure. For urban networks, this includes metrics such as IT expenditure per average water connection. Figure A4 shows that most of the water businesses with a higher average expenditure per water connection are smaller organisations, suggesting the presence of economies of scale.

<sup>33</sup> Victorian Auditor-General's Office 2019, *Security of Water Infrastructure Control Systems*, 9 May.

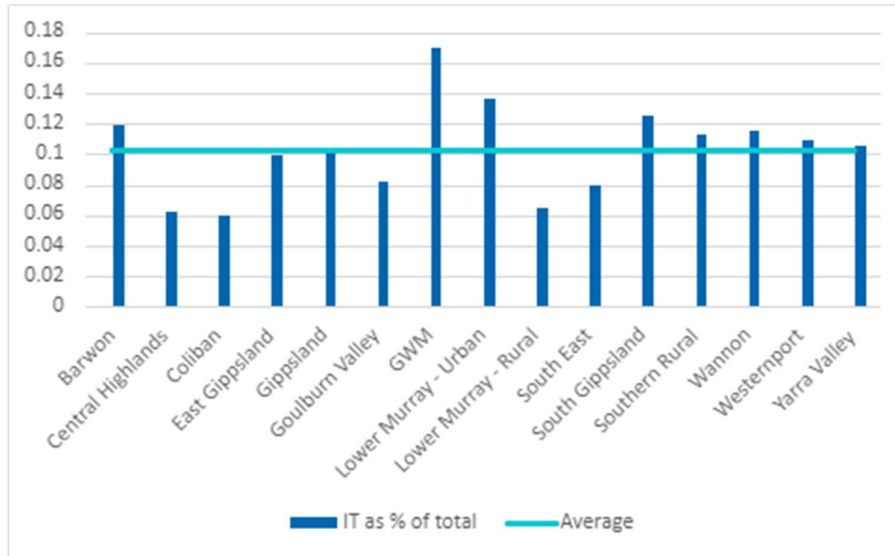
Figure A4: PS5 forecast: ICT operating expenditure per water connections (\$ per average number of water connections, 1 January 2023)



Source: Victorian water businesses, 2023 Price Review Models.

Figure A5 shows total forecast PS5 IT operating expenditure as a percentage of total controllable operating expenditure. This includes the rural businesses.

Figure A5: PS5 forecast: ICT operating expenditure as a percentage of total controllable operating expenditure (%)



Source: Victorian water businesses, 2023 Price Review Models.

## Labour costs

### Background

Labour costs tend to account for the largest proportion of operating expenditure for the water businesses. On average across the businesses, labour costs account for just under 50 per cent of total forecast controllable operating expenditure for the PS5 regulatory period (see Figure A9 below).

Labour costs are a function of employee numbers (measured in terms of FTEs)<sup>34</sup> and the costs of remuneration (including salaries, wages and other employee-related expenses).

### Labour force

The size of each organisation’s labour force varies according to their business and operating environment, including their geographical location and service area (which, amongst other things, will influence the size and dispersion of field staff).

Some businesses supplement internal labour resources with external contractors – this can be a temporary response to labour shortages, a need for specialist expertise that does not

<sup>34</sup> Full-time equivalent employees.

reside in-house and/or decisions to outsource certain activities. The optimal balance between internal and external labour will be a management decision for the business.

### Remuneration

A key driver of remuneration is the water business's Enterprise Agreement (EA), which typically have four-year terms. Each water business is likely to have an EA expiring and a new EA commencing during the PS5 regulatory period. As a result, each water business needs to forecast the impact of any anticipated change in EA terms.

Some common themes have emerged in terms of labour costs over the PS4 regulatory period.

- First, Victorian public sector entities must ensure that executive remuneration complies with any determinations and guidelines issued by the Victorian Independent Remuneration Tribunal. They must also continue to comply with the requirements of the Public Entity Executive Remuneration Policy (PEER).<sup>35</sup> The Premier typically announces an annual adjustment guideline rate for adjustments to executive remuneration. For 2021-22 and 2022-23, that rate was 1.5 per cent. Several businesses refer to the application of this rate in their PS5 submissions.
- Second, several of the regional water businesses have commented on challenges in attracting and retaining staff. This appears to have become a more significant problem for some businesses as the labour market tightens following the economic recovery from the COVID-19 pandemic. Some businesses have cited the need to offer higher salaries (including above the EA rate) to attract and retain staff. This appears to have underpinned increases in baseline expenditure as well as step changes for the PS5 regulatory period. Changes have also occurred in terms of employee expectations and practices around flexible working.

These challenges appear to be consistent with overall labour market trends in recent years, as well as the outlook. This reflects a material shift relative to the subdued outlook for wages that prevailed at the time of the last price review, as summarised below.

### Labour market conditions and wage growth pressures

When the Commission made its determinations for the water businesses in 2018, Victoria had been experiencing a period of subdued wages growth, consistent with the experience

<sup>35</sup> Refer: <https://vpsc.vic.gov.au/executive-employment/victorian-public-entity-executive-employment/public-entity-executive-handbook/4-remuneration/> {accessed 14 December 2022}.

of most other advanced economies.<sup>36</sup> The forecasts underpinning the 2018-19 State Budget was for wages to grow by 2.5 per cent in 2018-19 and 2.75 per cent in 2019-20.<sup>37</sup>

Actual growth in the Victorian Wage Price Index (WPI) was 2.6 per cent to 30 June 2019. It then contracted as COVID-19 impacted the economy, falling to 1.5 per cent for the year ended 30 June 2021 and then recovering to 2.3 per cent to 30 June 2022.<sup>9</sup> In terms of industry trends, for Australia, the annual change in total hourly rates of pay for the Electricity, Gas, Water and Waste Services sector was 2.9 per cent to 30 June 2022, compared to 3.2 per cent for all industries.

The most recent 2022-23 Victorian State Budget forecast was for an increase in the WPI of 2.75 per cent in 2022-23. It is then expected to increase further to 3.00 per cent per year to 2025-26 as the economy expands and labour market conditions remain tight.<sup>38</sup> The Reserve Bank of Australia (RBA) is forecasting stronger growth in the WPI for Australia, increasing to 3.7 per cent by 30 June 2023 and then rising to 3.9 per cent by December 2024.<sup>39</sup>

This presents a mixed picture of wages growth over the current PS4 regulatory period, which was significantly impacted by the COVID-19 pandemic. The current outlook is more bullish, driven largely by the tight labour market and high inflation, with spare labour market capacity at record lows.<sup>40</sup> In its November 2022 Statement on Monetary Policy, the RBA also observed that job mobility is higher than the years preceding the pandemic and is now around the levels observed prior to the Global Financial Crisis. It also noted the considerable uncertainty associated with the current economic outlook.

Overall, this highlights the current wage growth pressures that many of the water businesses has observed. The data doesn't enable any insights into the trends in regional labour markets in Victoria or specific pressures that might emerge for the skillsets required by the water businesses. However, the duration and extent of these wage growth pressures is highly uncertain.

<sup>36</sup> State of Victoria 2018, Strategy and Outlook 2018-19 Budget Paper No. 2, Department of Treasury and Finance, p.23.

<sup>37</sup> State of Victoria 2018, Strategy and Outlook 2018-19 Budget Paper No. 2, Department of Treasury and Finance, p.22.

<sup>38</sup> State of Victoria 2022, Strategy and Outlook 2022-23 Budget Paper No. 2, Department of Treasury and Finance, p.32.

<sup>39</sup> Reserve Bank of Australia 2022, Statement on Monetary Policy, November.

<sup>40</sup> Reserve Bank of Australia 2022, Statement on Monetary Policy, November.

### Superannuation Guarantee Charge

The compulsory Superannuation Guarantee Charge (SGC) has been progressively increasing to a rate of 12 per cent by 1 July 2025. This has been identified by some businesses as contributing to increases in labour costs.

The extent to which this will result in an increase in labour costs for employers depends on the nature of the employment arrangement. For example, for salaried workers whose salary package is inclusive of superannuation, the increase in the SGC may be offset by a reduction in take-home pay, which would result in no net change in costs to the employer. In other cases, where employees are on a 'salary plus superannuation' arrangement, it will result in an increase in total remuneration for the employee, which will increase the cost to the employer.

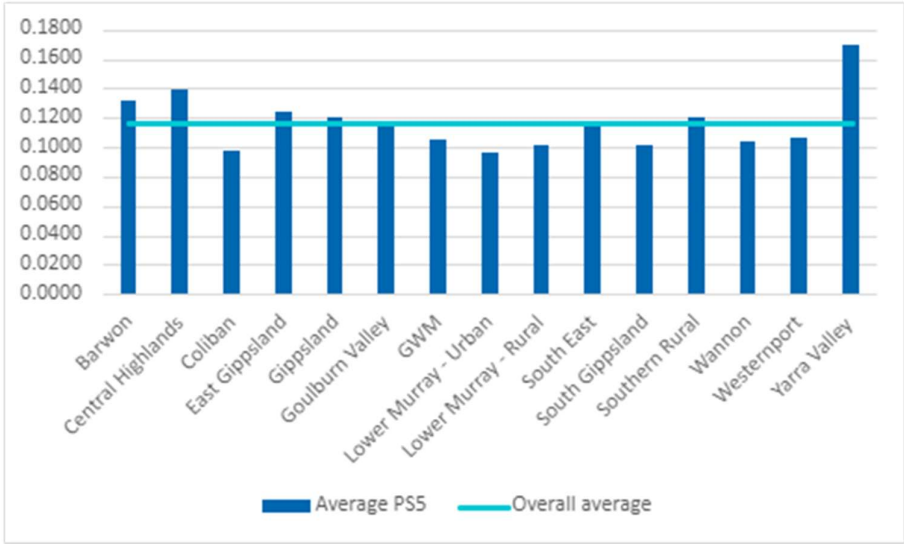
The impact of this will therefore vary between businesses and potentially within businesses given employees may be subject to different types of arrangements.

### Cross-sector expenditure trends

Businesses are required to report several metrics on labour costs in the Commission's price review model, including FTEs and unit labour costs. Key metrics are summarised below.

Figure A6 shows average unit cost per FTE as forecast for the PS5 regulatory period, as reported by the businesses.

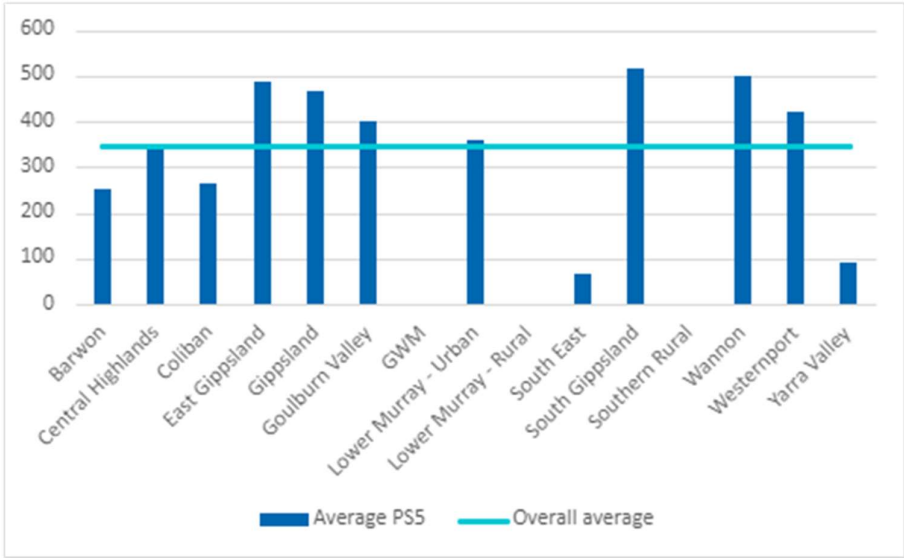
Figure A6: PS5 forecast average unit cost per FTE (\$ million per FTE, 1 January 2023)



Source: Victorian water businesses, 2023 Price Review Models.

Based on forecast labour costs for the water businesses for the PS5 regulatory period, Figure A7 shows the average labour cost per water connection (based on the average of the forecast number of connections over the period). It shows that most of the water businesses with a higher average expenditure per water connection are smaller organisations, suggesting the presence of economies of scale.

Figure A7: PS5 forecast: Average labour cost per water connection (\$ per average number of water connections, 1 January 2023)

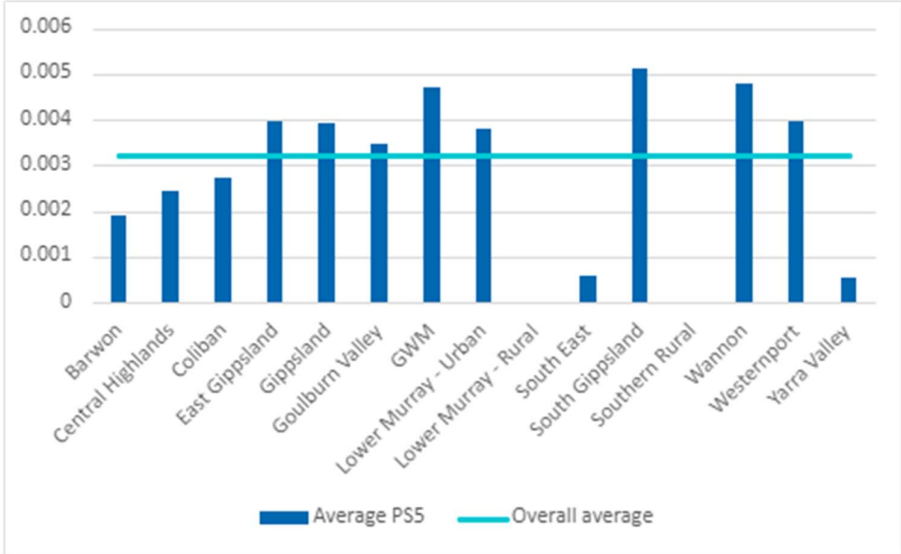


Source: Victorian water businesses, 2023 Price Review Models.



These scale economies are similarly evidenced based on the average number of FTEs per water connection (see Figure A8).

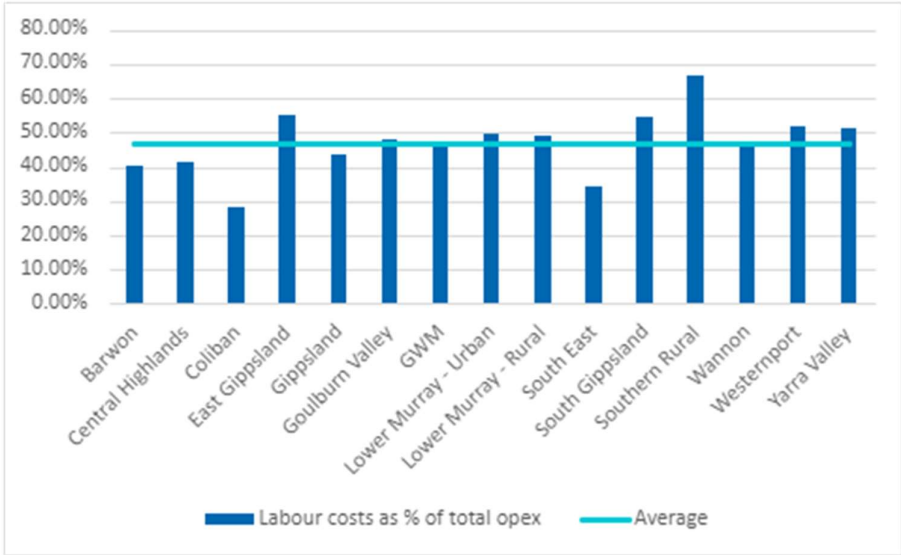
Figure A8: PSS forecast average number of FTEs per water connection



Source: Victorian water businesses, 2023 Price Review Models.

Figure A9 shows forecast labour costs as a percentage of total controllable operating expenditure for each of the water businesses over the PS5 regulatory period.

Figure A9: PS5 forecast labour costs as a percentage of total controllable operating expenditure (%)



Source: Victorian water businesses, 2023 Price Review Models.

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