

Review of the 2023 Victorian water price reviews

How effectively did the 2023 water price review process and outcomes deliver on the objectives of PREMO?

8 August 2024

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Glossary

Term	Definition
2018 price review	The regulatory process to determine the prices charged by 17 Victorian water business for the regulatory period commencing 1 July 2018. See https://www.esc.vic.gov.au/water/water-prices-tariffs-and-special-drainage/water-price-reviews/water-price-review-2018 for more information
2023 price review	The regulatory process to determine the prices charged by 14 Victorian water business for the 2023-2028 regulatory period, which is the subject of this report. See https://www.esc.vic.gov.au/water/water-prices-tariffs-and-special-drainage/water-price-reviews/water-price-review-2023 for more information
2024 price review	The regulatory process to determine the prices charged by 2 Victorian water business for the 2024-2028 regulatory period. See https://www.esc.vic.gov.au/water/water-prices-tariffs-and-special-drainage/water-price-reviews/water-price-review-2024 for more information
CALC	Consumer Action Law Centre
capex	Capital expenditure
Commission or ESC	Essential Services Commission
DEECA	Department of Energy, Environment and Climate Action
DTF	Department of Treasury and Finance
ESC Act	<i>Essential Services Commission Act 2001 (Vic)</i>
NCCs	New customer contributions
opex	Operating expenditure
PREMO	PREMO stands for Performance, Risk, Engagement, Management and Outcomes. It is the approach adopted by the commission for the 2018 and 2023 price reviews for setting regulated prices for water businesses
PREMO's objectives	The commission's objectives when introducing PREMO, as summarised in Figure 1 in the executive summary
WACC	Weighted Average Cost of Capital
Water business	Regulated metropolitan water corporations, regional urban water authorities or rural water authorities, as defined in the <i>Water Industry Act 1994 (Vic)</i> . See Table 2.1 for a list of water businesses covered by the commission's price review processes
Water Industry Act	<i>Water Industry Act 1994 (Vic)</i>
WIRO	Water Industry Regulatory Order, made under section 4D of the <i>Water Industry Act 1994</i>

Executive summary

OUR SCOPE

The Essential Services Commission (ESC or commission) engaged farrierswier to undertake this independent review of the 2023 water price review. The 2023 price review was the second time the commission applied its PREMO water pricing framework to these Victorian water businesses and the first time it applied the **P**erformance element of PREMO to any water businesses' price review.

The scope of our review covered:

- an assessment of how well the 2023 price review delivered on the objectives of the PREMO framework, including business-specific factors that may have helped or hindered achievement of these objectives; and
- feedback on the commission's processes and approach to the 2023 water price review and identifying what worked well and any areas for improvement.

While our review focussed on the 2023 price review, we also reviewed the final decisions the commission published in June 2024 for the 2024 water price review and interviewed the 2 water businesses in that review. We consider that our findings are generally also applicable to the 2024 price review.

This report sets out the findings of our review. It is intended to be published by the commission, alongside our *Key findings and insights* summary report. Given that we have also prepared the separate *Key findings and insights* summary report, this executive summary is limited to explaining our methodology and listing our key findings, with more explanation and evidence of those findings set out in the body of this report.

OUR APPROACH

Our findings are primarily based on our interviews and surveys with stakeholders who participated in the 2023 and 2024 price reviews. We also undertook our own qualitative and quantitative analysis of the commission's decisions, stakeholder submissions and water businesses' price submissions.

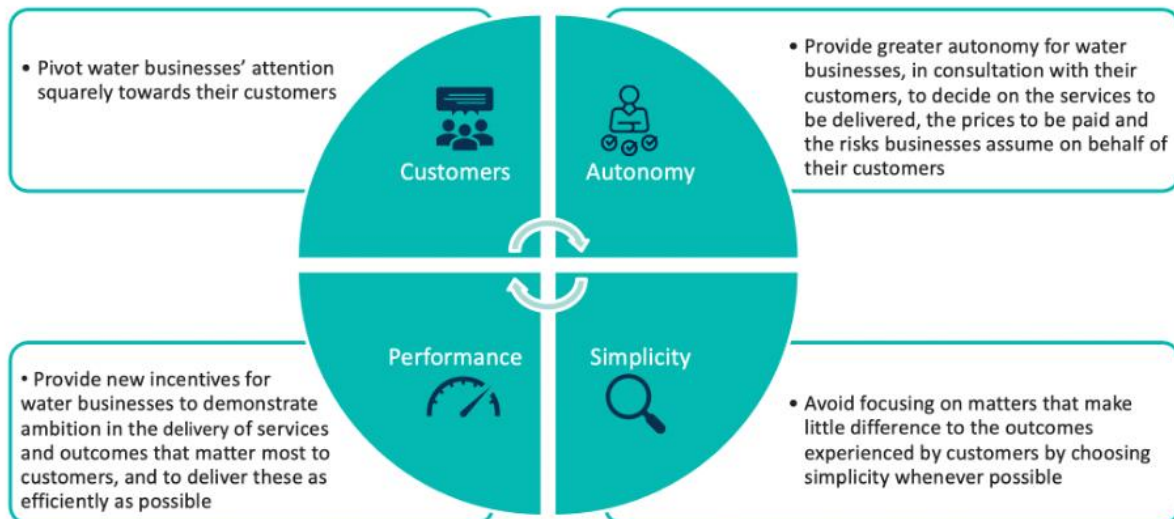
We undertook 24 interviews with water businesses involved in the 2023 and 2024 price reviews, stakeholders who made submissions to the 2023 price review, government officials, commissioners and commission staff. We carried out online surveys of the businesses that were part of the 2023 price review and people who made submissions to the 2023 price review. We also met with various consultants and the Water Services Association of Australia.

This report records the feedback we received in our interviews and surveys. We have not assessed the accuracy of the comments that were made to us. The inclusion in this report of quotes from the surveys or interviews does not indicate that we agree with those comments. The fact that several stakeholders held a certain view on an issue is instructive even if that view may not be considered entirely accurate by others. For example, it may indicate areas that could benefit from clearer commission guidance to avoid confusion or misunderstandings in future price reviews, or where the contrasting practices of different water business led to different price review outcomes for those businesses. We understand that the commission will assess this feedback when considering its approach to future price reviews.

DID THE 2023 PRICE REVIEW PROCESS DELIVER ON THE OBJECTIVES OF PREMO?

We examined the extent to which the 2023 price review process delivered on the objectives of PREMO, based on the four overarching objectives that were set out by the commission when it introduced PREMO in 2016 as shown below.

Figure 1: PREMO's objectives



Overall, there was very strong support for PREMO. Almost everyone we interviewed or surveyed supported the PREMO framework and did not want the commission to move away from it or make major changes to it. We received a number of suggestions for improvements to how PREMO is applied by water businesses and the commission in practice, which are discussed in this report, but those proposals do not involve material changes to the fundamental design of PREMO.

Customers

We consider that the 2023 and 2024 price review processes were very effective in delivering on PREMO's customers objective.

Almost everyone we interviewed considered that the engagement element of PREMO has been a success and led to a much greater focus by water businesses on their customers and improved customer outcomes. Customer engagement is now seen by water businesses as a valuable core part of how they operate and not just something they do once every 5 years to meet the commission's requirements.

Businesses have continued to expand how they use customer engagement to inform their price submissions. Water businesses committed to a range of customer outcomes and associated performance measures and targets as part of their price submissions, with the outcomes informed by customer engagement. This is contributing to meeting PREMO's customers and performance objectives by encouraging businesses to focus on delivering the outcomes that matter most to their customers and transparently reporting on the extent to which they are meeting those outcomes. In response to rising prices for water services and broader cost of living challenges faced by their customers, most water businesses also materially increased their support for customers experiencing financial difficulties.

Performance

We consider that the 2023 and 2024 price review processes were broadly effective in delivering on PREMO's performance objective, with some areas where the commission could consider refinements to its incentives for future price reviews.

The outcomes of the 2023 and 2024 price review and the feedback from our interviews and surveys indicate that PREMO has been effective in incentivising water businesses to pursue cost efficiencies and minimise prices for customers.

PREMO seeks to provide procedural, reputational and financial incentives for water businesses to provide high-quality price submissions that reflect their best offers. The price review's procedural and reputational incentives have been effective in achieving these objectives. PREMO's ratings system creates useful reputational incentives, and fast-tracking is seen by businesses as delivering valuable procedural and reputational incentives.

Only 2 water businesses were fast-tracked in the 2023 price review and none were fast-tracked in 2024. Water businesses are not clear on the criteria to be fast-tracked, which may limit its effectiveness as an incentive. The commission should consider whether there is scope to clarify the fast-tracking criteria and increase the use of fast-tracking. This could provide further incentives for high-quality submissions and help achieve the simplicity objective that the commission focusses its resources on the issues and businesses that need the most attention.

PREMO seeks to provide financial incentives for high-quality submissions that represent a water business' 'best offer' by adjusting the business's return on equity based on its PREMO rating. Business rated this incentive as less important than reputational or procedural incentives in the 2023 price review process, and said it had no impact or only a minor impact on their price submissions. The intended effect of this incentive was not understood or valued by most water businesses, and many businesses considered it to create a 'perverse incentive' because it results in higher customer prices.

The 2023 price review was the first time PREMO's Performance element was applied. The majority of water businesses agreed or strongly agreed that it was effective in achieving PREMO's objective of holding businesses accountable for their proposals and their customer outcomes from the previous period.

Autonomy

We consider that the 2023 and 2024 price review processes largely delivered on PREMO's objective of providing greater autonomy for water businesses, in consultation with their customers, to decide on the services to be delivered, the prices to be paid and the risks businesses assume on behalf of their customers.

Under PREMO, water businesses have much more autonomy for these matters than under the previous approach to price reviews. As discussed above, the process of water businesses setting and reporting on their performance against customer outcomes was seen as a successful and effective part of the price review process. Businesses also took a range of different approaches to how they addressed affordability impacts when setting their prices and proposing measures to support customers experiencing financial difficulties.

Consistent with the autonomy objective and the Risk element of PREMO, each business also had considerable scope to propose its own approach to managing risk and uncertainty. However, we consider that this is an area that could be given more attention by water businesses in future price reviews. Several

businesses raised concerns that they face an increasing level of uncertainty in the broader environment in which they operate, but we observe that most businesses are not currently making use of the full suite of tools that are available under PREMO for managing risk and uncertainty.

A key concern raised by several water businesses in our interviews was a perception that there is too much of a short-term focus by government and the commission on prices over the 4-5 year regulatory period and too little focus on longer term asset management, investment needs and financial health of the business. We consider that most of the underlying causes of this concern related to matters that are outside of the scope of PREMO and largely outside of the commission's control, for example how water businesses responded to government's desire to minimise price rises. The commission approved most businesses' proposed expenditures with only minor adjustments.

There were a small number of decisions by the commission that water businesses considered were inconsistent with the autonomy objective and overly focussed on short-term price impacts. Businesses recognised that the commission had the power to take an active role in providing direction to businesses on these issues, but felt it should use the guidance paper at the start of the process rather than taking actions late in the process. The main example provided by businesses was the change the commission made to how it sets inflation shortly before the 2023 final decisions.

Simplicity

We consider that PREMO's simplicity objective was only partly met in the 2023 and 2024 price reviews and there are areas where the commission could consider giving more guidance to businesses on what simplicity means and how it can be achieved.

PREMO's simplicity objective has a number of elements. The overall objective was described by the commission when it introduced PREMO as 'the pricing approach attempts to avoid focusing on matters that make little difference to the outcomes experienced by customers. The Commission seeks to achieve this by choosing simplicity whenever it can.' The commission also stated that the simplicity objective seeks to achieve the following outcomes:

- Businesses focus on material issues for customers
- Price submissions and decisions are as clear and succinct as possible
- Compliance costs are minimised where possible
- A flexible assessment process that is tailored to the quality of each price submission and allows the commission to focus its resources on the businesses and issues where it would add the most value.

Several parts of the design of PREMO promote these objectives compared with the pre-PREMO price review framework. Examples include the simplified approach to setting the WACC, the commission's tailored review process including fast-tracking, and businesses being primarily responsible for customer engagement rather than the commission.

Stakeholders have divergent views on what simplicity should mean and how it impacts how PREMO should be applied in practice. Many water businesses considered that there is scope for the commission to target its review of building blocks inputs on material issues and adopt a more holistic and integrated approach that has greater regard to overall customer outcomes.

In our surveys, we asked water businesses and people who made a submission to rate how effectively various aspects of the 2023 price review process met PREMO's objectives. The question with the lowest rating in both surveys was 'How effective do you consider the price review process was in enabling water businesses to keep their price submissions clear and succinct and focussed on material issues for customers?'

The length of price submissions increased significantly in the 2023 and 2024 price reviews, with a correlation between longer submission and higher PREMO ratings. To some stakeholders, this appears inconsistent with PREMO's simplicity objectives of minimising compliance costs and clear and succinct price submissions. Businesses had different views on whether the commission wanted short submissions, and many felt it was difficult to meet the commission's detailed guidance requirements while also meeting the guidance that submissions should be succinct. The commission could clarify its simplicity objective and guidance on its expectations for price submissions, focussing on relevance not length.

Some businesses are also concerned about the increasing costs of the price review process. In particular, we heard concerns that the cost of engagement is increasing and that further increases in the scale of engagement are unlikely to be justified. There has been a material step-up in water businesses' customer engagement since PREMO was introduced. However, the scale and cost of engagement appears to have reached a point where many businesses are looking for reassurance from the commission that it will not expect even more extensive engagement at the next price review in 2028.

WHAT BUSINESS-SPECIFIC FACTORS IMPACTED THE EXTENT TO WHICH PREMO'S OBJECTIVES WERE MET?

We used the outcomes of our interviews and surveys to seek to identify factors that may have materially affected the extent to which PREMO's objectives were met for different water businesses. We identified several important differences between how water businesses approached the price review process that appear to impact the extent to which they met PREMO's objectives.

These factors are:

- How businesses navigate government's desires for lower prices
- Integration of the price submission into broader corporate planning, data and reporting systems
- Board and staff turnover
- Proactive engagement with the commission
- Attitudes towards debt.

FEEDBACK ON THE COMMISSION'S PRICE REVIEW PROCESS, APPROACH, ENGAGEMENT AND GUIDANCE

We used the interviews and surveys and our own review of the commission's decisions, stakeholder submissions and other materials to develop observations on what worked well and what could be improved in the process aspects of the 2023 and 2024 price reviews. The scope of this part of our review covered the commission's processes and timing, guidance materials, engagement with water businesses and other stakeholders, decision documents and other communications materials. This feedback is intended to inform potential changes to the commission's processes for future price reviews.

Stakeholders' key feedback on what worked well in the price review process was:

- There is strong support for PREMO and the commission's overall approach
- The commission's engagement methods were seen as useful
- The commission's guidance was generally seen as clear and helpful, but could be improved in several areas.

The main areas where stakeholders considered that improvements could be made to the commission's processes, guidance and engagement for future price reviews were:

- New customer contributions (NCCs) is a valuable case study on how engagement processes could be improved for material issues that are common to several businesses
- Changes to the timing of the price review process could deliver benefits
- Some improvements could be made to aspects of the commission's decision documents and communication materials
- The commission may need to consider broader process changes in future to address the challenges of making decisions for 16 water businesses at the same time.

1. Introduction and background

1.1 PURPOSE AND STRUCTURE OF THIS REPORT

Purpose of this report

The commission published its 2023 water price review final decisions for 14 Victorian water businesses in June 2023. The 2023 price review was the second time the commission applied its PREMO water pricing framework to these businesses and the first time it applied the P (performance) element of PREMO to any water businesses' price review.

The commission has engaged farrierswier to undertake an independent review of the 2023 water price review and prepare a report providing:

- an assessment of how well the 2023 price review delivered on the objectives of the PREMO framework, including business-specific factors that may have helped or hindered achievement of these objectives; and
- feedback on the commission's processes and approach to the 2023 water price review and identifying what worked well and any areas for improvement.

While our review focussed on the 2023 water price review, we also reviewed the final decisions the commission published in June 2024 for the 2024 water price review and interviewed the 2 water businesses in that review. We consider that our findings are generally also applicable to the 2024 water price review.

This report sets out the findings of our review. It is intended to be published by the commission, alongside our *Key findings and insights* summary report.

Structure of this report

The remainder of this report is structured as follows:

- Section 1.2 provides a short background on the development of PREMO and its objectives.
- Section 1.3 explains the scope and methodology for our review.
- Chapter 2 provides a summary of the 2023 water price review process and its outcomes.
- Chapter 3 sets out our key findings and insights on the extent to which the 2023 price review process delivered on the commission's objectives of the PREMO framework (PREMO's objectives).
- Chapter 4 discusses factors that may have materially affected the extent to which PREMO's objectives were met for different water businesses.
- Chapter 5 sets out stakeholders' feedback and our observations on what worked well and what could be improved in the process aspects of the 2023 and 2024 price reviews, including the commission's processes and timing, guidance materials, engagement with water businesses and other stakeholders, and decision documents.
- The Appendices contain case studies from the commission's 2023 price review final decisions that illustrate our findings in chapters 3 to 5.

1.2 THE DEVELOPMENT OF PREMO AND ITS OBJECTIVES

The commission is responsible for the economic regulation of Victorian water businesses under the *Essential Services Commission Act 2001* (Vic) (ESC Act), the *Water Industry Act 1994* (Vic) (Water Industry Act) and the *Water Industry Regulatory Order 2014* (WIRO).

The commission's overarching objective under the ESC Act is 'to promote the long term interests of Victorian consumers'.¹

The commission's objectives in relation to the regulated water industry under the Water Industry Act are:

- wherever possible, to ensure that the costs of regulation do not exceed the benefits;
- to ensure that regulatory decision making and regulatory processes have regard to any differences between the operating environments of regulated entities; and
- to ensure that regulatory decision making has regard to the health, safety, environmental sustainability (including water conservation) and social obligations of regulated entities.

The commission regulates the prices water businesses can charge for a regulatory period, which is usually 5 years but shorter or longer periods are possible. This results in the commission undertaking a price review process for most Victorian water businesses every 5 years.

By 2013, three water price reviews had been conducted by the commission under the previous economic regulatory framework. Faced with an emerging perception of shortcomings with the framework, the Victorian Government engaged Professor Graeme Samuel to conduct an independent review in 2014. Following this review, the Victorian Government amended the WIRO in 2014, which in turn gave the commission the flexibility to undertake a far-reaching review of economic regulation for the water sector in 2015 and 2016.

This review by the commission resulted in a new framework for regulating water businesses which the commission called PREMO – an acronym for **P**erformance, **R**isk, **E**ngagement, **M**anagement and **O**utcomes.

The PREMO framework is described in the commission's October 2016 paper *Water Pricing Framework and Approach: Implementing PREMO from 2018*. As explained in that paper, PREMO had 4 overarching objectives, which we have summarised in Figure 1 in the executive summary.

Under PREMO, water businesses' revenue requirements are still derived using the traditional 'building blocks' method, but key changes to how the commission sets water businesses' prices include:

- A stronger emphasis on the role of customer engagement to inform and influence water businesses' price submissions.
- Each water business is required to develop and report on a set of outcomes focused on what it will deliver to its customers.
- A water business' return on equity is linked to the outcomes it delivers to customers. The return on equity varies according to the level of ambition shown in a price submission, as indicated by the water businesses' PREMO rating, and the extent to which the commission agrees with the business' PREMO self-rating.
- Each business' price submission is rated as 'leading', 'advanced', 'standard' or 'basic', and is assessed against the five PREMO elements of Performance, Risk, Engagement, Management and Outcomes to determine its rating.

¹ ESC Act, section 8(1).

- Water businesses are incentivised to submit price submissions that reflect their ‘best offers’.
- A more flexible assessment approach seeks to tailor the scope of the commission’s assessment to the quality of a price submission, with potential ‘fast-tracking’ of high-quality submissions.
- A requirement for water business boards to attest to the quality and accuracy of the information included in price submissions and the submission’s compliance with the commission’s guidance.

1.3 OUR SCOPE AND METHODOLOGY

1.3.1 Scope

The commission engaged us to undertake an independent review of the 2023 water price review and prepare a report providing feedback on the commission’s processes and approach to the 2023 water price review and an assessment of how well the 2023 price review delivered on PREMO’s objectives. The scope of our review is explained below.

The commission’s processes and approach to the 2023 water price review

The first part of our scope is to provide feedback on the commission’s processes and approach to the 2023 water price review and identify what worked well and any areas for improvement. As discussed below, this part of our review was primarily based on interviews and surveys.

Issues we examined in this part of the review included:




- **Guidance** | How effective was the commission’s guidance paper in providing clear guidance for water businesses on the expectations for price submissions? How effective was the commission’s guidance for water businesses’ PREMO self-ratings?
- **Engagement** | How did water businesses and the commission engage with each other prior to lodging the price submissions and during the price review process, and how useful was that engagement? How effective was the commission’s engagement with other stakeholders and what means of engagement were most effective? Did stakeholders feel their submissions and other input were heard and appropriately responded to by the commission? Were there challenges engaging on price reviews that covered 14 water businesses at the same time?
- **Fast-tracking** | Was issuing early draft decisions for 2 water businesses seen by water businesses, the commission and other stakeholders as useful? What factors limited greater use of fast-tracking? How effective was fast-tracking in incentivising high quality price submissions?
- **Assessment** | What were the key challenges in developing the building blocks elements of price submissions and undertaking the assessment of those elements (e.g. opex, capex, depreciation)?
- **Commission’s decisions** | How clear and well-justified were the commission’s reasons in its draft and final decisions? Did the draft decisions give water businesses clarity on what was needed in their responses to address any issues the commission raised? How accessible and understandable were the commission’s decisions and other communications materials?
- **Other process and approach issues** | Was the timing of the price review process appropriate? Did stakeholders observe material changes from previous price review processes and, if so, what was their impact? How fit for purpose were the commission’s financial templates? What other comments do stakeholders have on the commission’s process and approach?


How effectively did the price review process deliver on PREMO's objectives

We were asked by the commission to assess how well the 2023 price review delivered on PREMO's objectives, including business-specific factors that may have helped or hindered achievement of these objectives. We based our assessment on PREMO's objectives as they are described in Figure 1 in the executive summary.

The issues we considered in this part of our review are summarised in Table 1.1.

Table 1.1: Key considerations for assessing how effectively the 2023 price review process delivered on PREMO's objectives

Objective	Issues considered
Customers 	<ul style="list-style-type: none"> • Did the price review process result in a strong emphasis on customer engagement by water businesses? • Did businesses' customer engagement and setting and reporting on customer outcomes lead to a better understanding of customers' priorities and price submissions that are focused on those priorities? • How effectively did businesses' price submissions and the commission's decisions address the major challenges confronting the community at the time of the price review process, e.g. COVID, climate change and cost of living pressures? • What measures did businesses propose to support vulnerable customers, customers experiencing hardship, First Nations communities or other customers needing additional support? • How effectively did the price review balance shorter-term considerations related to price impacts over the 5 year regulatory period with longer-term considerations related to efficient investment levels, asset resilience and financial sustainability of water businesses?
Performance 	<ul style="list-style-type: none"> • Did the price review process provide incentives for water businesses to have greater ambition to improve the delivery of services and outcomes that matter most to consumers? • How important were each of reputational, procedural and financial incentives? • To what extent did businesses pursue cost efficiency improvements and what were the trends over time in prices, opex and capex? • How effective was the P element of PREMO? Was the ratings process clear? Did it hold businesses accountable for their proposals from the previous period? • How did performance levels vary between businesses and over time and what were the potential causes of those differences? Was PREMO effective in lifting up poor performers? Was PREMO effective in rewarding strong performers or are there challenges applying it to businesses that are near the efficiency frontier? • How did water businesses' internal processes affect their performance and the quality of their price submissions, e.g. integration of the price review process into broader corporate planning and reporting processes?
Autonomy 	<ul style="list-style-type: none"> • Did the price review process provide autonomy for water businesses, in consultation with their customers, to decide on the services to be delivered, the prices to be paid and the risks businesses assume on behalf of their customers? • Did businesses seek to allocate risk to the party best positioned to manage that risk? Did businesses use appropriate mechanisms to manage uncertainty?

Objective	Issues considered
	<ul style="list-style-type: none"> • Did businesses submit their best offers? • Did the commission’s approach strike the right balance between enabling business autonomy and providing guidance or oversight of material common issues?
Simplicity 	<ul style="list-style-type: none"> • Did the price review process promote simplicity? • Did businesses focus on material issues for customers? • Were price submissions and decisions as clear and simple as possible? • Were compliance costs minimised where possible? • Did the process result in a flexible assessment process that was tailored to the quality of each price submission and allowed the commission to focus its resources on the businesses and issues where it would add the most value?

Limitations on our scope

The following limitations applied to the scope of our review:

- **2024 water price review process** | Our review focussed on the 2023 water price review. We also interviewed the 2 businesses that were part of the 2024 water price review process, which was being undertaken as we conducted our review with final decisions published on 18 June 2024. However, we did not undertake quantitative analysis of data on the 2024 process and our online survey was not sent to the 2024 price review businesses as they had not received their final decisions when we sent out the survey. Our focus was on identifying the common issues and differences in feedback between the businesses involved in the 2023 and 2024 price reviews. Our interviews revealed that the feedback from the 2024 price review businesses was consistent the comments from the 2023 price review businesses and we consider that our findings are generally also applicable to the 2024 price review process.
- **New customer contributions (NCCs)** | NCCs were a material issue in the decisions for several water businesses in the 2023 price reviews. In response, the commission stated in its final decisions that it would undertake a review of the regulatory framework for NCCs. Several stakeholders raised NCC issues in the interviews and we have used NCCs as a case study on the commission’s guidance and engagement with water businesses to identify potential lessons for the commission’s process and approach for future price reviews. However, the scope of our review excluded substantive matters related to NCCs given they will be covered by a separate commission review process.
- **Government policies** | Water businesses’ price submissions were influenced by a range of government policies and requirements imposed by other government bodies. Those policies are outside of the scope of our review, but we have considered issues raised by stakeholders that relate to tensions between the objectives of PREMO and other government policies.
- **Recommending reforms to PREMO** | We have not been asked to make specific recommendations for reforms to PREMO for future price reviews. The feedback and issues identified as part of our review are intended to inform the commission’s assessment of any potential changes it may make to its guidance, approach and processes for future price reviews and its next steps.

1.3.2 Approach and methodology

Our review was informed by interviews and surveys of water business and other key stakeholders who were involved in the 2023 and 2024 price reviews, a review of the published price review materials, commission responses to our quantitative data requests, and our own qualitative and quantitative analysis.

Interviews

Farrierswier directors Richard Owens and Robert McMillan undertook 24 interviews with stakeholders during late May to early July 2024. The interviews were generally one hour long and were undertaken on the basis that comments would not be attributed to individuals or organisations. The organisations we interviewed are summarised in Table 1.2.

We also held discussions with the Water Services Association of Australia and 5 consultants who had experience advising the commission on water businesses.

We thank everyone who participated in the interviews and discussions for their input. We were very pleased with the high level of participation by senior executives and Board members and the insightful and frank feedback we received.

Table 1.2: Stakeholder interviews

Organisation type	People interviewed
Water businesses involved in the 2023 price review	We offered interviews to each of the 14 water businesses that were involved in the 2023 water price review. The interviews were aimed at Managing Directors and Board members. All but one of the water businesses participated in interviews, with one business declining on the basis of significant Board and staff turnover since the price review process. Managing Directors attended each of the interviews and 11 of the interviews were also attended by the Chair, with senior executives or other Board members also attending several interviews. ²
Water businesses involved in the 2024 price review	We interviewed Goulburn-Murray Water and Greater Western Water, who were part of the 2024 water price review process. The interviews were attended by the Managing Director and Board members or senior executives.
Victorian government	We interviewed senior staff from the Department of Energy, Environment and Climate Action (DEECA).
Stakeholders who made submissions to the 2023 water price review	We reviewed all of the submissions to the 2023 price review process and interviewed representatives of the Consumer Action Law Centre (CALC), the Concerned Waterways Alliance and People for a Living Moorabool.
Commission	We held separate interviews with each of the commissioners, the commission's Executive Director Price Monitoring and Regulation, and other commission staff who worked on the 2023 price review.

Surveys

We undertook two surveys:

- **A survey of water businesses:** This survey was sent to each of the water businesses who were part of the 2023 price review. It was designed to be answered by senior management and regulatory staff who were directly involved in the price review process. It asked questions related to how well the price review process delivered on PREMO's objectives and sought feedback on key elements of the price

² One water business requested separate interviews for (1) its Managing Director and senior executives and (2) other Board members, which we agreed to as a useful way to obtain their different perspectives.

review process and the effectiveness of the commission’s guidance and processes. We received responses to the survey from all 14 water businesses.

- **A survey of people who made submissions to the price review process:** This survey was sent to each organisation who made a non-confidential written submission to the 2023 water price review process. It asked questions on water businesses’ engagement with stakeholders, the commission’s engagement with stakeholders and how well the price review process delivered on PREMO’s objectives. This survey had a 23% response rate.

These surveys supplemented the interviews by enabling us to reach a wider range of people and ask standardised questions. Where possible, we asked some of the same questions as in the review farrierswier undertook of the 2018 water price review process³ so that we could compare results over time.

The surveys were undertaken in June and July 2024 and were open for responses for 3-4 weeks. They were conducted on the basis that we would not attribute responses to the organisations who responded or share individual responses with the commission.

Thank you to everyone who completed the survey.

2. The 2023 water price review process

2.1 OVERVIEW OF THE 2023 PRICE REVIEW PROCESS

The 2023 water price review process applied to 14 water businesses as shown in Table 2.1.

This was the second price review under PREMO for each of these businesses, with their first PREMO price review occurring in 2018.⁴

Table 2.1: Victorian water businesses covered by the 2023 price review

Category	Included in 2023 price review	Not included in 2023 price review
Metropolitan water corporations	South East Water Yarra Valley Water	Greater Western Water (covered by the 2024 water price review) Melbourne Water (next regulatory period starts 1 July 2026)

³ Farrierswier, *Victoria’s water sector: The PREMO model for economic regulation*, March 2019, available at www.esc.vic.gov.au/sites/default/files/documents/victorias-water-sector-the-premo-model-for-economic%20regulation-20190411.pdf

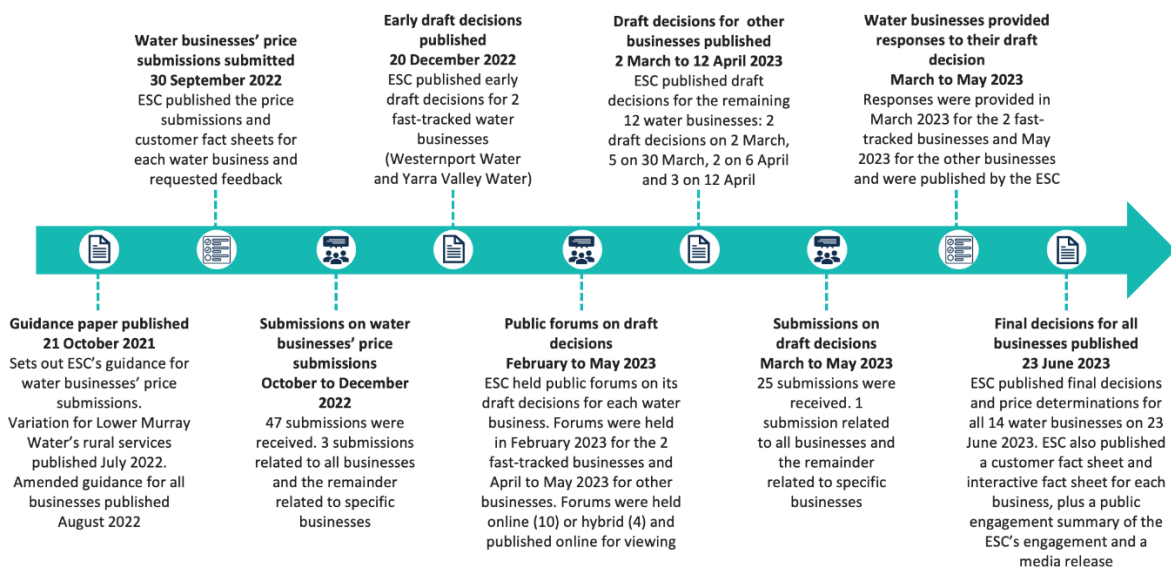
⁴ In the 2018 price review, PREMO was applied to Lower Murray Water’s urban water services but not its rural services.

Category	Included in 2023 price review	Not included in 2023 price review
Regional urban water authorities	Barwon Water Central Highlands Water Coliban Water East Gippsland Water Gippsland Water Goulburn Valley Water Lower Murray Water (urban water services) South Gippsland Water Wannon Water Westernport Water	North East Water (next regulatory period starts 1 July 2026)
Rural water authorities	Southern Rural Water GWM Water Lower Murray Water (rural services)	Goulburn-Murray Water (covered by the 2024 water price review)

Goulburn-Murray Water and Greater Western Water were part of the 2024 water price review process and had final decisions published on 18 June 2024. These two businesses had 4 year regulatory periods rather than the usual 5 year period that applied to each of the 2023 price review businesses. This means that all 16 of these water businesses will have their next scheduled price review in 2028.

The key steps and timing of the 2023 price review process are summarised in Figure 2.1.

Figure 2.1: Overview of the 2023 water price review process



Source: farrierswier analysis, 2024

2.2 OUTCOMES OF THE 2023 PRICE REVIEW PROCESS

This section provides a brief overview of the key outcomes of the 2023 price review process. More detailed findings on outcomes are discussed in chapter 3, which sets out our assessment of the extent to which the price review process delivered on PREMO’s objectives.

2.2.1 PREMO ratings

Table 2.2 summarises each water business’ PREMO rating for the 2023 price review and how it compared to its 2018 price review rating and its 2023 price review self-rating. It also shows which businesses were fast-tracked in the 2018 and 2023 price review processes.

Table 2.2: PREMO ratings

Water business	2018 commission rating	2023 self-rating	2023 commission rating
Barwon Water	Advanced	Advanced	Advanced
Central Highlands Water	Advanced	Standard	Standard
Coliban Water	Advanced	Standard	Standard
East Gippsland Water	Standard Fast-tracked	Standard	Standard
Gippsland Water	Standard	Advanced	Advanced
Goulburn Valley Water	Leading	Advanced	Standard
GWM Water	Advanced	Advanced	Advanced
Lower Murray Water	Standard	Standard	Standard
South East Water	Advanced Fast-tracked	Advanced	Advanced
South Gippsland Water	Not rated ⁵	Standard	Standard
Southern Rural Water	Advanced	Standard	Standard
Wannon Water	Basic	Standard	Standard
Westernport Water	Standard Fast-tracked	Standard	Standard Fast-tracked ⁶
Yarra Valley Water	Advanced Fast-tracked	Advanced	Advanced Fast-tracked

⁵ The commission determined that South Gippsland’s price submission for the 2018 price review did not meet the standards required by the commission’s guidance.

⁶ As noted in Figure 2.1, the commission published its draft decisions in 5 tranches in December 2022 and between 2 March to 12 April 2023. All final decisions were published at the same time in June 2023. We have treated a business as fast-tracked if it received an early draft decision in December 2022. The timing of the tranches of other draft decisions reflected the commission’s ability to assess some submissions more quickly than others and the commission’s view of the quality of submissions and was arguably a form of limited fast-tracking for the 2 businesses that received draft decisions on 2 March 2023.

The commission agreed with the overall self-rating by each business except Goulburn Valley Water. In the 2018 price review the commission did not accept the overall ratings for two businesses.

The commission also disagreed with self-ratings of individual PREMO elements for the following water businesses:

- **Central Highlands Water:** Management was rated basic instead of standard, primarily due to Central Highlands Water making changes to the financial model issued by the commission.
- **Coliban Water:** Performance was rated standard instead of advanced mainly due to a higher than average increase in controllable operating expenditure (opex). Risk was also rated as basic instead of standard, mainly due to proposing a 16 year asset life for depreciation, which the commission rejected.
- **Goulburn Valley Water:** Management was rated basic instead of standard and risk was rated standard instead of advanced, mainly due to the comparatively low proposed efficiency improvement rate for controllable opex. This resulted in the commission adopting an overall rating of standard rather than advanced.
- **Lower Murray Water:** Performance was rated standard instead of advanced primarily due to controllable opex in 2021-22 being 15-20% higher than the benchmark adopted in the 2018 price review decision. The Performance rating only applies to Lower Murray Water's urban services – the Performance element did not apply to its rural services as this was the first PREMO decision for those services.
- **Southern Rural Water:** Management was rated basic instead of standard due to its proposed treatment of non-prescribed costs and making changes to the financial model.
- **Wannon Water:** Performance was rated basic instead of standard due to not meeting its overall performance expectations. Management was initially rated by the commission as basic in the draft decision due to an inadequate explanation for the large increase in opex in the 2021-22 baseline year compared with previous years of the period, but the commission increased its rating to standard in the final decision based on Wannon Water's explanation in its response to the draft decision.

In the 2024 price review, Goulburn-Murray Water and Greater Western Water were both rated as Standard and neither business was fast-tracked. The P element of PREMO did not apply to Goulburn-Murray Water as this was its first price review under PREMO.

2.2.2 Customer prices

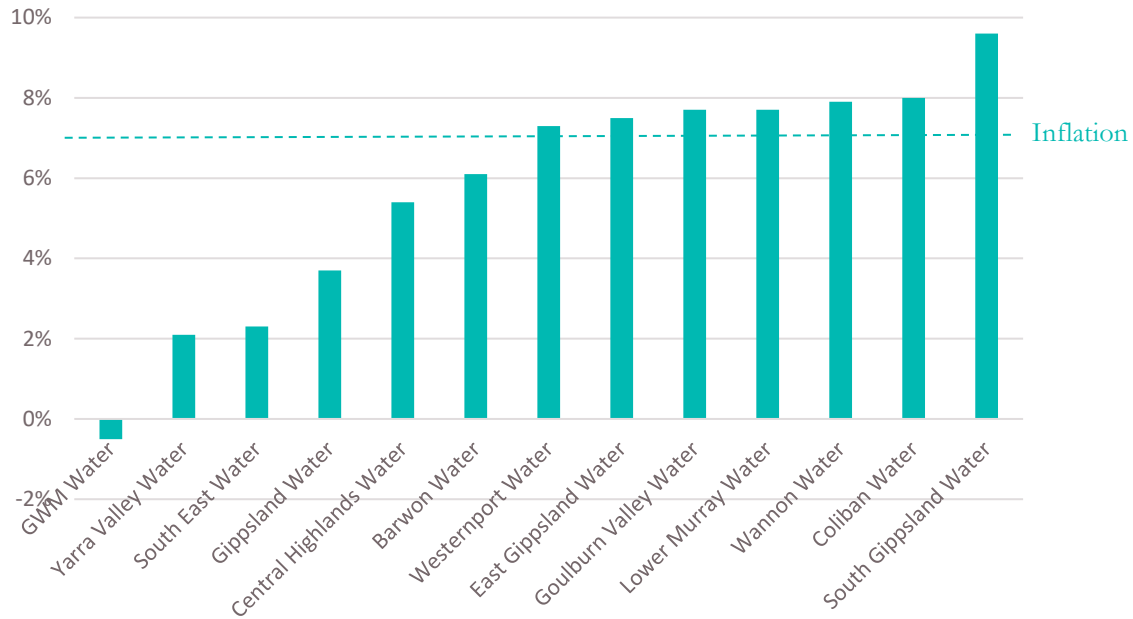
The 2023 price review process occurred in a challenging environment with most water businesses facing increased costs due to a range of factors and many customers experiencing cost of living challenges.

The change in nominal prices for 2024 (the first year of the regulatory period) for each water business is shown in Figure 2.2. Price rises ranged from a decrease of 0.5% to an increase of 9.6%, with an average increase of 5.9%. Price rises were on average lower for metropolitan Melbourne customers at around 2% compared with regional Victorian customers at around 6.5%. For most businesses, prices in later years of the regulatory period increased broadly in line with forecast inflation.

Adjusting for inflation of 7%, real prices decreased by around 1% on average in 2024.

As discussed in section 3.2.4, water businesses also significantly increased their support for customers experiencing financial difficulties.

Figure 2.2: Nominal price changes for year 1 (2023-24)

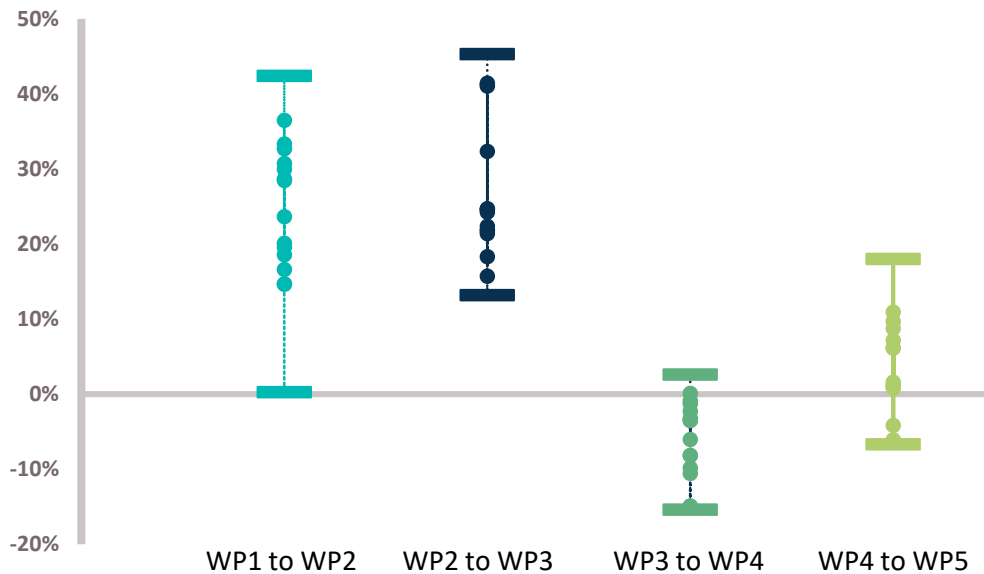


Source: Essential Services Commission and farrierswier analysis, 2024

Figure 2.3 shows the pricing outcomes across the five water regulatory periods to date: WP1 (the 2005 price review, which only had a 3 year regulatory period), WP2 (the 2008 price review), WP3 (the 2013 price review), WP4 (the 2018 price review, which was the first price review under PREMO) and WP5 (the 2023 price review). It measures the change in average revenue per customer between regulatory periods after controlling for the effects of changes in the Weighted Average Cost of Capital (WACC) and the number of years in the regulatory period.

This figure shows that after adjusting for changes in WACC, price rises in the 2023 price review (WP5) were higher than under the first PREMO price review in 2018 (WP4), but were generally much lower than under the last two price reviews prior to the introduction of PREMO (WP2 and WP3, the 2008 and 2013 price reviews).

Figure 2.3: Regulatory period-on-period changes in prices (controlling for changes in WACC)



Source: Essential Services Commission and farrierswier analysis, 2024

2.2.3 Trends in expenditure

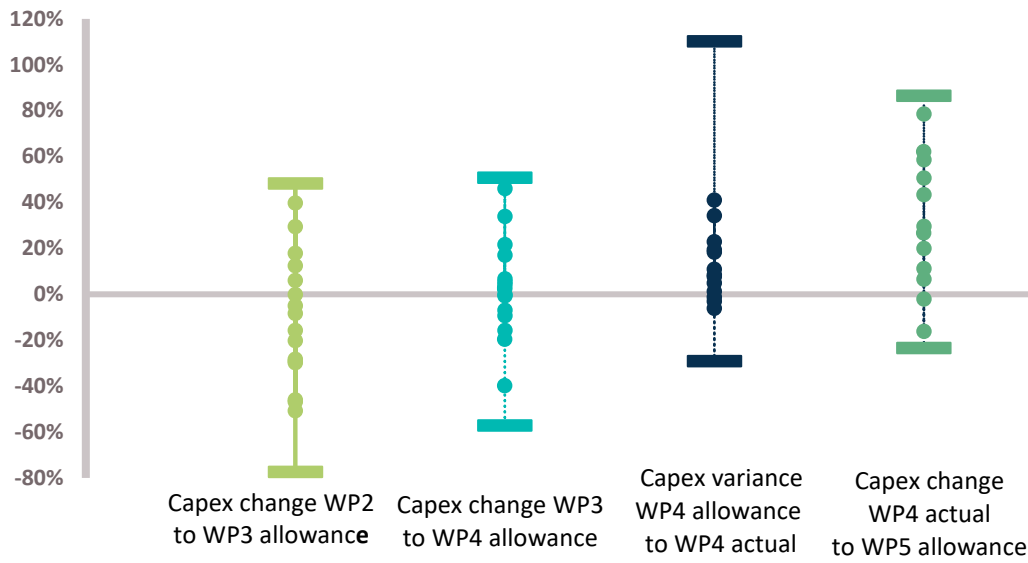
PREMO has some unique features as summarised in section 1.2, above, but a key input into the commission's price determinations remains an assessment of prudent and efficient capital and operating expenditure (capex and opex), like in most other similar economic regulatory regimes.

The figures below summarise the key outcomes of the commission's assessment of capex and opex and the trends in expenditure levels over price review periods.

These figures illustrate that:

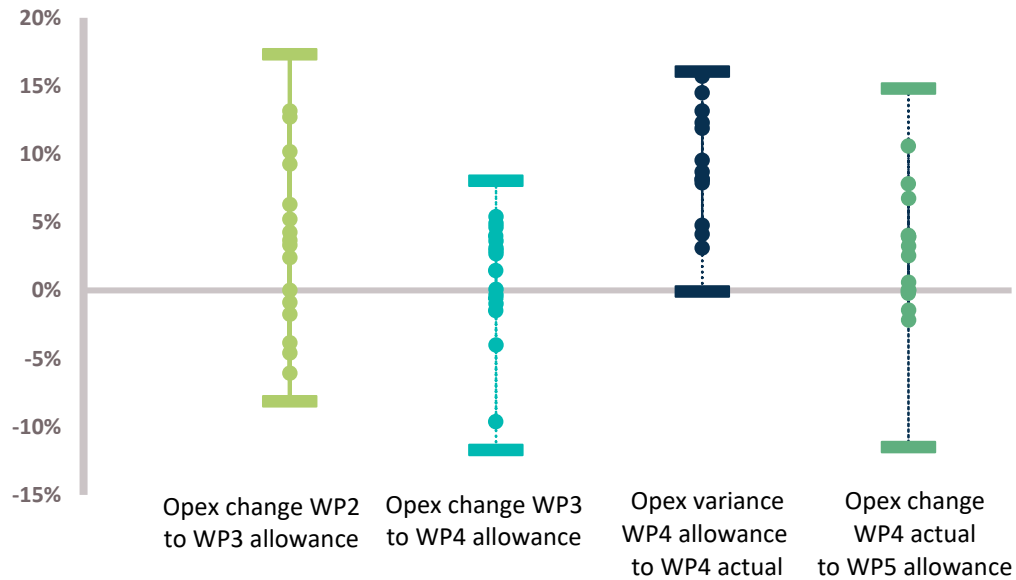
- The levels of approved capex vary markedly between businesses but on average they have been steadily increasing over time. Most water businesses obtained increased capex allowances in the 2023 price review decisions compared with their actual expenditure during the 2018-23 period.
- Approved opex also increased for most businesses in the 2023 final decisions compared with their actual 2018-23 opex, but some businesses had material reductions in approved opex compared with their previous expenditure.
- Most water businesses spent more capex in the 2018-23 period compared to their forecast capex from the commission's 2018 price review decisions, with one business' actual capex exceeding its capex allowance by over 100% and the average overspend being 20%.
- Every water business spent more opex in the 2018-23 period compared to its forecast opex from the 2018 decisions, with the average overspend being 9%. This increased level of opex is not surprising given that water businesses faced a range of cost pressures over this period due to high inflation, the impacts of COVID, increased costs of complying with regulatory requirements, significant customer growth in some regions and devastating floods in parts of Victoria.
- Water businesses' proposed opex efficiency improvement rates (efficiency hurdles) averaged 1.3% in the 2023 price review. This is lower than the 1.8% average opex efficiency hurdle in the 2018 price review, but higher than the standard 1.0% rate the commission applied prior to the introduction of PREMO.

Figure 2.4: Capex outcomes over successive PREMO periods



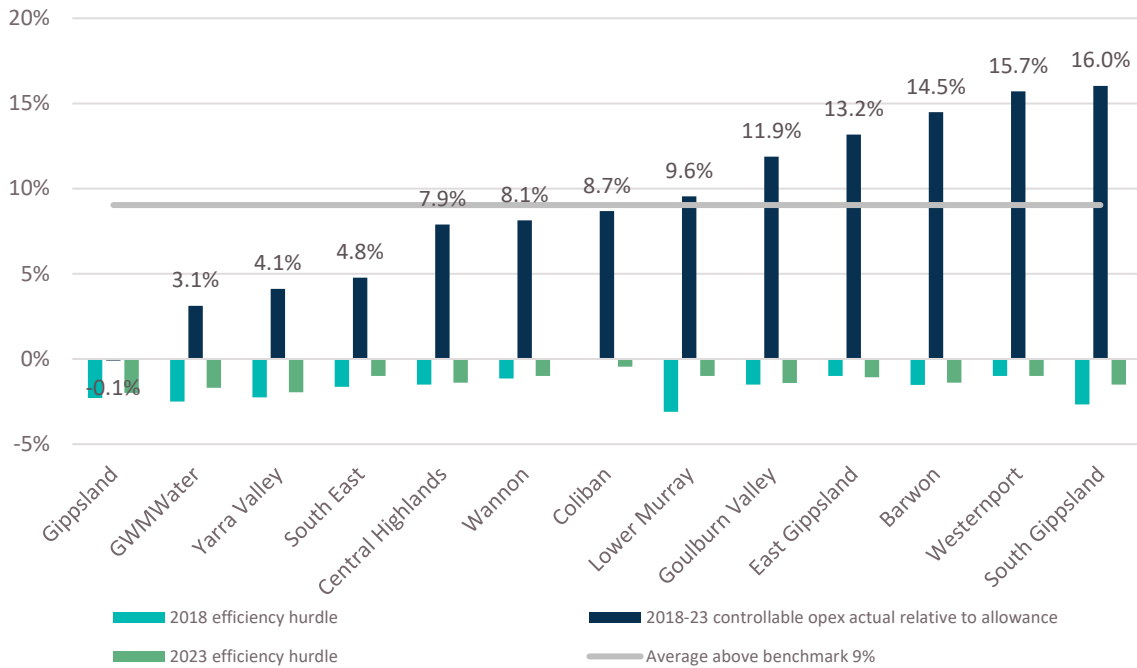
Source: Essential Services Commission and farrierswier analysis, 2024

Figure 2.5: Controllable opex outcomes over successive PREMO periods



Source: Essential Services Commission and farrierswier analysis, 2024

Figure 2.6: Opex efficiency hurdles and outcomes⁷ since PREMO commencement (% p.a.)



Source: Essential Services Commission and farrierswier analysis, 2024

3. Did the 2023 price review process deliver on PREMO’s objectives?

This chapter sets out our key findings and insights on the extent to which the 2023 price review process delivered on the PREMO’s objectives (as those objectives are summarised in section 1.2 above). It is based on the outcomes of our interviews, surveys and qualitative and quantitative analysis of the commission’s decisions and other materials.

We consider that these findings and insights are also generally applicable to the 2024 price review process based on the consistent feedback we received in our interviews with the businesses that took part in the 2023 and 2024 price reviews.

3.1 THERE IS STRONG STAKEHOLDER SUPPORT FOR PREMO AND ITS OBJECTIVES

There was almost universal support for PREMO across our interviews with water businesses, Victorian government, the commission, people who made submissions to the price review process and consultants who worked in the sector. Almost everyone we spoke to supported the PREMO framework and did not want the commission to move away from it or make major changes to it.

⁷ The opex efficiency hurdle shows the annual percentage by which the rate of change in opex allowance for the coming period was reduced to reflect a target improvement in efficiency. The outcomes show the difference between the commission’s opex allowance for the 2018-23 period (including the efficiency hurdle) as set out in its 2018 price decisions and the business’ actual controllable opex for that period.

Several people started their interviews with unprompted comments that PREMO is the best regulatory framework in Victoria or the best economic regulatory framework in Australia. Board members of water businesses that had worked in the sector for many years commented that they had experienced the commission's price review process prior to PREMO and the earlier process where prices were set annually by the Minister, and they considered PREMO was a far better regime that delivered much better outcomes.

Although there was strong support for the PREMO framework and no desire for making wholesale changes it, most people we interviewed suggested areas in which the application of the framework could be improved in future price reviews. The comments are explained in the remainder of this report.

Many of these comments related to improvements to the practical application of PREMO by the commission and water businesses rather than changes to the design of PREMO. Several stakeholders considered that the commission should take steps to align aspects of how PREMO is applied in practice with its original intent and objectives.

The agenda we sent out ahead of each interview contained our summary of PREMO's objectives, as set out in Figure 1 in the executive summary. Stakeholders supported these 4 objectives. However, several water business Board members and other stakeholders we spoke to commented that they had not seen the overarching objectives of PREMO clearly expressed before and that it would be useful for the commission to remind people of these objectives.

We developed our summary of PREMO's objectives based on papers the commission published during the development of PREMO in 2016. Given the feedback we heard in our interviews and surveys on potential improvements to the practical application of PREMO to align it with its overarching objectives, there could be value in the commission reviewing and restating its current view of the objectives of PREMO and using those objectives to guide any changes it makes for future price reviews.

3.2 PREMO'S ENGAGEMENT ELEMENT IS A CLEAR SUCCESS STORY AND HAS DELIVERED ON PREMO'S CUSTOMERS OBJECTIVE

Almost everyone we interviewed considered that the engagement element of PREMO has been a success. It has led to a much greater focus by water businesses on their customers and improved outcomes for customers. Evidence of the impact of an increased focus on customers was seen in each of the following 4 areas from our interviews, surveys and analysis.

3.2.1 Customer engagement is now seen by water businesses as a core part of how they operate

The impact of PREMO's engagement focus is seen in the general attitude of many water businesses to how they integrate the interests of their customers and engagement with their customers into all aspects of how they run their businesses. Engagement with their customers is now seen by almost all Victorian water businesses as a valuable core part of how they operate and not just something they do once every 5 years to meet the commission's requirements for their price submissions.

Almost all water business Board and senior executives we spoke to considered that this change has delivered significant benefit for their customers. This view was shared by consumer groups and government officials we interviewed.

3.2.2 Businesses continued to expand how they use customer engagement to inform their price submissions

Table 3.1 shows the commission’s ratings for the engagement element of PREMO for each water business that was part of the 2023 price review. The commission agreed with every business’ engagement self-rating.

Table 3.1: PREMO engagement ratings

Basic	Standard	Advanced	Leading
	East Gippsland Water Lower Murray Water South Gippsland Water Westernport Water	Central Highlands Water Coliban Water Goulburn Valley Water South East Water Southern Rural Water	Barwon Water Gippsland Water Wannon Water Yarra Valley Water GWM Water
0	29% of businesses	36% of businesses	36% of businesses

These ratings are similar to the 2018 water price review, with a small decrease in the average rating. In the 2018 water price reviews, no businesses were rated basic, 19% were rated standard, 44% were rated advanced and 38% were rated leading.

Appendix C provides two customer engagement case studies from the commission’s final decisions.

Based on our interviews, surveys and review of submissions to the price review, stakeholders generally had positive feedback on the engagement undertaken by water businesses when developing their price submissions. Almost all stakeholders we interviewed considered that customer engagement had increased dramatically over the last 2 price reviews due to the introduction of PREMO and that this increased engagement had led to better customer outcomes.

In our survey of water businesses, we asked businesses to rate how effectively various aspects of the price review process met PREMO’s objectives on a scale from 1 (completely ineffective) to 5 (very effective). The question with the highest rating at 4.2 out of 5 was ‘How effective do you consider the 2023 water price review process was at having your business focus on customers and engage with customers in developing your proposal’.

Our review of the price submissions and commission’s decisions shows that most businesses expanded their customer engagement compared with the 2018 price review, and undertook far greater engagement than in the 2013 or earlier price reviews. Commissioners and commission staff also commented on the high quality of engagement that was undertaken by several smaller regional water businesses that were considered to have undertaken highly effective customer engagement programs despite having more limited budgets than their larger peers.

There were some exceptions to this positive feedback on customer engagement.

In our interviews and surveys with people who made a submission, there was a consistent view that some water businesses engaged much more effectively than others. For example, a stakeholder who had made submissions to the price review process and participated in engagement with multiple water businesses stated in its survey response:

While the quality of engagement between businesses varied, on balance we believe that businesses have improved their customer engagement since the first round of PREMO, and this is reflected in the quality of their submissions.

A common theme from comments in our survey of people who made submissions was that some businesses should start their engagement earlier. For example, one person who made a submission said:

Generally, the businesses who did better started earlier, went broader, employed multiple methods to engage people, considered diversity of customer base, and had senior people actively involved

New customer contributions (NCCs) was a key area where our interviews and surveys and the commission's final decisions show that several water businesses could have engaged better with some of their customers. We discuss this issue in more detail in section 5.2.1.

Some stakeholders we spoke to also considered that water businesses did not engage on the right issues, engaging on issues that were too broad or which it was difficult for customers to give meaningful feedback. These stakeholders considered that businesses had improved 'how' they engaged, but some businesses struggled to determine 'what' to engage on that would have a meaningful impact on customers.

There were also concerns from numerous stakeholders that the cost of engagement is increasing and that further increases in the scale of engagement are unlikely to be justified, particularly where businesses' within-period business as usual engagement already provided rich insights for business planning. This issue is discussed in section 3.7.4 below in relation to PREMO's simplicity objectives.

3.2.3 Businesses are developing customer outcomes in consultation with their customers and reporting on their performance against those outcomes

Consistent with PREMO's Outcomes element, water businesses committed to a range of customer outcomes and associated performance measures and targets as part of their price submissions.

The development of these outcomes was informed by customer engagement. Many businesses also involved customers in assessing whether the business had met its customer outcome commitments from the previous regulatory period.

The development of these outcomes is contributing to meeting PREMO's customers, performance and outcomes objectives by encouraging businesses to focus on delivering the outcomes that matter most to their customers and transparently reporting on the extent to which they are meeting those outcomes.

This process of developing customer outcomes is a significant change from the approach adopted prior to PREMO where service standards were set by the commission in its Customer Service Code.

The customer outcomes for each water business are summarised in Appendix A. As shown in the table in Appendix A, the customer outcomes vary significantly between water businesses. Outcomes adopted by water businesses generally covered matters such as:

- high quality and reliable services
- fair and affordable prices
- customer service
- supporting customers in need
- improving environmental outcomes
- partnering with local communities.

Appendix B provides a case study of how these relatively-high level customer outcomes are translated into to meaningful outputs, performance measures and targets that can be reported on over the price

review period and used as the basis for assessing the business' Performance rating at the next price review.

In our survey we asked water businesses to rate how effective the process of developing customer outcomes and reporting on meeting those outcomes was in improving outcomes for customers. Water businesses gave an average rating of 4.1 out of 5.

3.2.4 Businesses expanded their measures to support vulnerable customers

In response to rising prices for water services and broader cost of living challenges faced by their customers, most water businesses materially increased their support for customers experiencing financial difficulties.

Businesses adopted a wide variety of measures to support customers, as summarised in Table 3.2. These measures were generally developed in consultation with customers as part of businesses' engagement processes.

Table 3.2: Measures to assist vulnerable customers proposed by water businesses

Measure	Businesses offering that measure ⁸
<p>Prices:</p> <ul style="list-style-type: none"> • Adopt a price path designed to manage affordability impacts • Set prices that are forecast to recover less revenue than the businesses' revenue requirement 	<ul style="list-style-type: none"> • South Gippsland Water, Wannon Water, Yarra Valley Water • South Gippsland Water, Wannon Water, South East Water⁹
<p>Direct financial support:</p> <ul style="list-style-type: none"> • Increase direct financial support through customer support payments for vulnerable customers, customers experiencing hardship or customers experiencing family violence • Continue current financial support and assistance for customers experiencing difficulty paying bills • Implement a co-payment program for customers with outstanding payments to assist in reducing their debt • Provide funds to allow additional customers to access the utility relief grant scheme • Implement water efficiency rebates, programs or tools • Extend customer support measures to non-residential customers • Formalise the target number of customers provided with hardship assistance and add an outcome measure for the value of assistance provided 	<ul style="list-style-type: none"> • Barwon Water, Central Highlands Water, Coliban Water, East Gippsland Water, Goulburn Valley Water, Wannon Water, Westernport Water • GWM Water, Lower Murray Water • South Gippsland Water • South Gippsland Water • East Gippsland Water, Goulburn Valley Water, Yarra Valley Water • South Gippsland Water • GWM Water

⁸ This list is primarily based on measures that are discussed in the commission's final decisions and may not be exhaustive.

⁹ South East Water was rated Advanced but adjusted the commission's model so that its revenues and prices were based on the lower return on equity that applies to a Standard business.

Measure	Businesses offering that measure ⁸
Customer support: <ul style="list-style-type: none"> • Increase access to and awareness of customer support, hardship support programs or flexible payment options, and/or offer more proactive communication and support • Improve turnaround times for processing utility relief grant scheme applications • Introduce a target for the number of utility relief grants the business facilitates each year • Develop more formal arrangements and increase interaction with external agencies supporting vulnerable customers 	<ul style="list-style-type: none"> • Barwon Water, Coliban Water, East Gippsland Water, Gippsland Water, GWM Water, Wannon Water • Coliban Water • Westernport Water • East Gippsland Water
Other measures: <ul style="list-style-type: none"> • Implement an additional billing cycle to avoid potential bill shock • Implement tariff reforms informed by customer engagement 	<ul style="list-style-type: none"> • Central Highlands Water • South East Water

3.3 PREMIO INCENTIVISES WATER BUSINESSES TO PURSUE EFFICIENCIES AND MAKE HIGH-QUALITY PRICE SUBMISSIONS

3.3.1 PREMIO creates incentives for cost efficiency improvements

Water businesses' responses to our survey indicate that PREMIO is effective in incentivising water businesses to pursue cost efficiencies, as shown in Figure 3.1 and Figure 3.2.

Figure 3.1: Survey responses to the question 'To what extent did the 2023 price review process affect the extent to which you pursued cost efficiency improvements?'

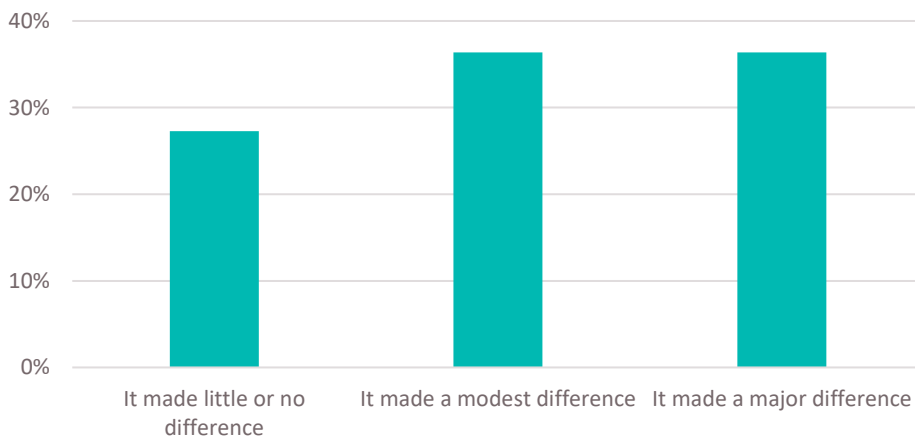
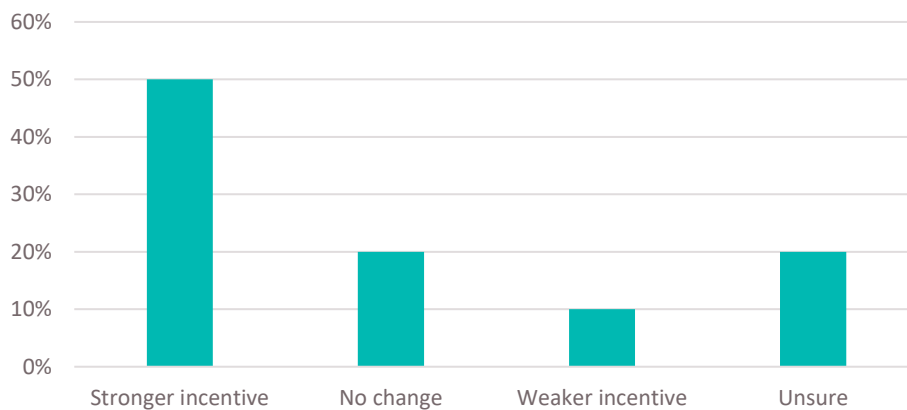


Figure 3.2: Survey responses to the question ‘Was the incentive for pursuing and achieving cost efficiency improvement different to the 2018 PREMO price review?’



3.3.2 The PREMO ratings provide useful reputational incentives

PREMO seeks to provide procedural, reputational and financial incentives for water businesses to provide high-quality price submissions that reflect their best offers.

One of the unique features of PREMO is the process by which each water businesses’ price submission is rated as basic, standard, advanced or leading. Each of the 5 PREMO elements is self-rated by the business and the commission, along with an overall rating. This system aims to create reputational and financial incentives for water businesses to submit high-quality price submissions that represent their best offers.

This PREMO ratings system was reasonably well-supported in our interviews and surveys. It was considered to create valuable reputational incentives for some businesses, but the impact of those incentives varies significantly between businesses and is limited for many businesses.

In our water business survey, we asked businesses to rate the importance of each of PREMO’s reputational, procedural and financial incentives. These results are shown in Table 3.4 below. Reputational incentives were rated as the most important of these three types of incentives, with an average rating of 7.6 out of 10 and more than a third of businesses rating their importance at least 9 out of 10. However, we did not specify in the survey question that we were only asking about reputational incentives related to the PREMO ratings and we expect that many businesses considered a broader set of reputational incentives.

Although reputational incentives were rated highly in the survey, in our interviews most Boards and senior executives said that the reputational effect of PREMO’s ratings was relatively short-lived and not as important as other incentives external to PREMO to prepare a price submission that delivered on the needs of the business and its customers.

Many water businesses stated in their interviews that the most important incentive that guides the preparation of their price submissions is to deliver good outcomes for their customers. PREMO’s incentives are important, but are generally considered to be secondary to this overarching objective. This is consistent with PREMO’s objective of having businesses focus on customer outcomes.

For many water businesses, meeting the objectives of their shareholding Ministers is also a key incentive that impacts their price submissions and how they operate their businesses. This incentive can complement PREMO’s incentives, but it can sometimes run counter to them and risk an overly-strong focus on keeping prices low in the short term as discussed in section 3.6.

The reputational effect of the ratings system may also be limited by the fact that the ratings for all businesses in the 2023 and 2024 price reviews were compressed into standard or advanced. No businesses were rated as basic or leading, unlike in the 2018 price review.

Several businesses rated themselves overly conservatively (i.e. lower) in their PREMO self-ratings, with the commission indicating in its final decisions or in discussions with businesses that they could have been rated more highly. This appears to be an unintended consequence of the design of PREMO's best offer financial incentives where the business' return on equity is based on its PREMO rating. Businesses receive a higher return on equity if they have a higher PREMO rating, provided that their self-rating is the same as the commission's rating. The rating system is also asymmetric, with the commission able to reduce a business' rating but the commission never increases a rating. This appears to create a strong incentive in practice for businesses to be conservative in their self-ratings as they do not want the reputational and financial impacts of the commission reducing their rating. This feedback raises a question about whether reputational incentives alone could be sufficient to achieve PREMO's desired best offer incentive without also needing a financial incentive tied to the ratings.

As discussed below, most businesses do not see the increased return for being rated as leading or advanced as useful and many consider it to be a perverse incentive. This reduces the incentive to rate themselves as advanced and in some cases creates an incentive to conservatively rate themselves as standard to avoid needing to increase their prices to account for the increased rate of return that would apply if they were advanced.

3.4 FAST-TRACKING IS A VERY EFFECTIVE INCENTIVE AND THERE IS LIKELY TO BE BENEFIT IN INCREASING ITS USE

3.4.1 Fast-tracking is effective at incentivising high-quality price submissions that reflect businesses' best offers

Many water businesses see fast-tracking as valuable. It is seen by water businesses' Boards and senior executives as creating important procedural and reputational incentives for high-quality price submissions. It can also help deliver the simplicity objective by reducing compliance costs for businesses and enabling the commission to focus its limited resources where they are most needed.

Businesses told us that fast-tracking provides very valuable procedural benefits by enabling them to complete most of the work of the price review early in the process and get back to focussing on their core business. Even if they only receive an early draft decision and still need to undertake some work between the draft decision and final decision, this is still seen as having significant benefits.

For example, one fast tracked business said in its interview:

fast-tracking let us get on with the planning a lot quicker. It was a huge advantage to hit the ground running for the next financial year. The standard timing doesn't work well from a process perspective for planning works delivery in the next financial year... We still got the benefits from the fast-tracked draft decision even though the final still came out at the same time as everyone else.

Fast-tracking also provides useful reputational benefits, with several businesses considering that being fast-tracked had at least as much reputational benefit as being rated as leading or advanced.

Although only 2 water businesses were fast-tracked in 2023, many other water businesses told us in the interview that they had aimed to be fast-tracked and would aim for that again in the next price review.

This is consistent with the results of the water business survey questions on this issue, which are summarised in Table 3.3 below.

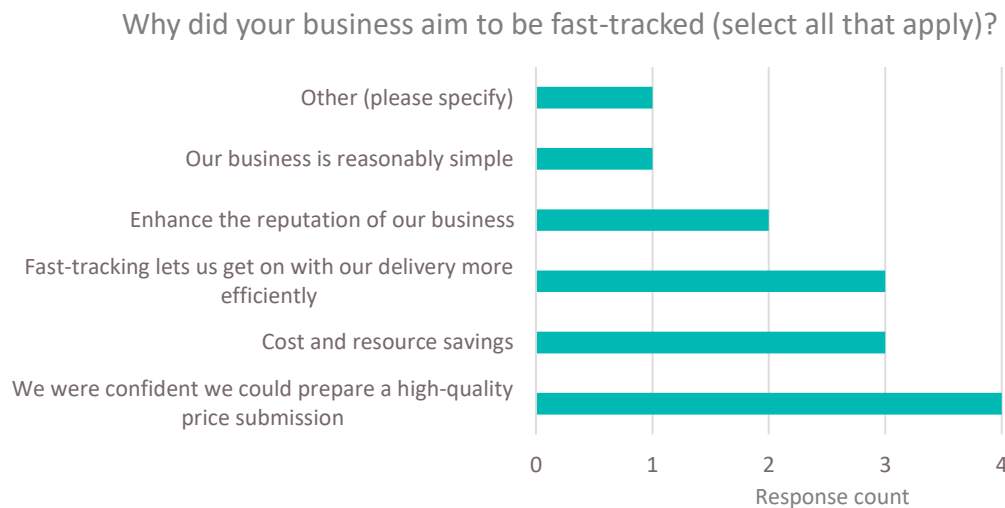
While these results show significant support for fast-tracking, the level of support is lower than when we asked the identical questions in our previous survey of water businesses that participated in the 2018 price review. The 2018 and 2023 results are compared in Table 3.3.

Table 3.3: 2023 water businesses survey questions regarding fast-tracking

Survey question	Year	Yes	Unsure	No
Did your business aim to be fast-tracked at the 2023 water price review	2023 price review results:	46%	36%	18%
	2018 price review results:	65%	7%	28%
Based on your experience with fast-tracking at the 2023 price review and assuming the commission makes its assessment in a similar way, would your business aim to be fast-tracked in the next water price review	2023 price review results:	27%	36%	36%
	2018 price review results:	65%	35%	0%

In our survey of the 2023 water price review water businesses, we asked businesses that said they had aimed to be fast-track for the reasons why that was the case (from a list of options). Their responses are set out in Figure 3.3.

Figure 3.3 Reasons why water businesses sought to be fast-tracked



Notes: The other specified response was: ‘The ambition to be fast tracked provides greater confidence to the Board that the submission: 1) Outcomes are supported, 2) Business cases demonstrate the prudence and efficiency of expenditure’.

3.4.2 Fast-tracking provided valuable incentives even though only two businesses were fast-tracked in the 2023 price review

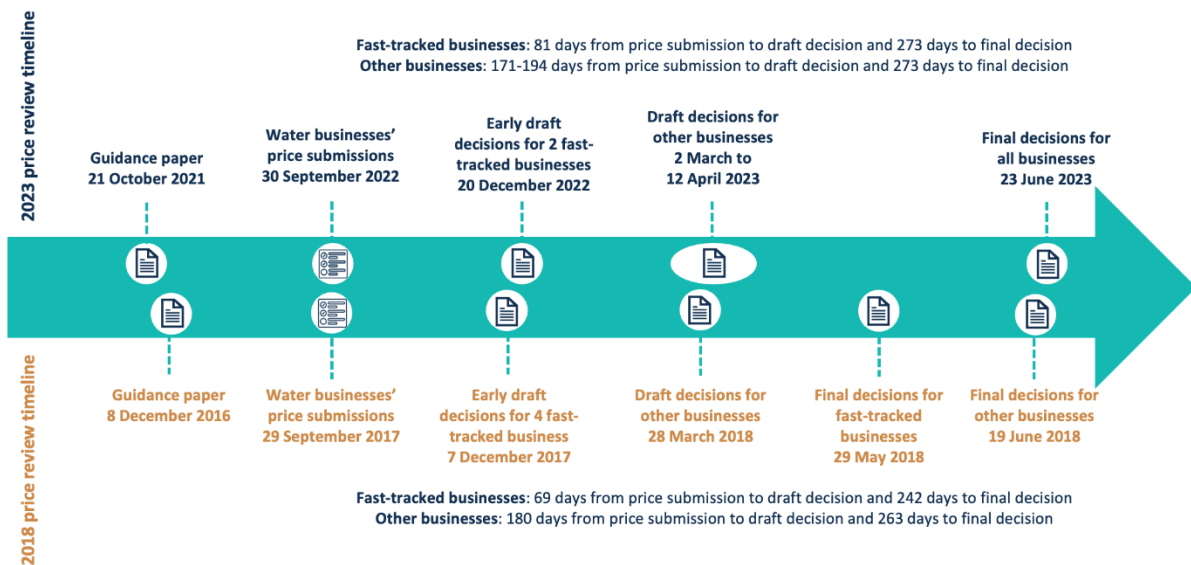
In the 2023 water price review, only 2 businesses were fast-tracked by receiving early draft decisions – Westernport Water and Yarra Valley Water. Those businesses only received early draft decisions and their final decisions were published at the same time as the other 12 businesses.

The commission published its draft decisions in 5 tranches on 20 December 2022 and between 2 March to 12 April 2023. The timing of the tranches of other draft decisions reflected the commission’s ability to assess some submissions more quickly than others and the commission’s view of the quality of submissions. We have treated businesses as fast-tracked if they received an early draft decision in December 2022, but note that the staged timing of draft decisions also resulted in a form of limited fast-tracking for the 2 businesses that received draft decisions on 2 March 2023 (Gippsland Water and GWM Water).

This compares with the 2018 price review where 4 water businesses were fast-tracked. Those 4 businesses received early draft decisions in early December. All other businesses received their draft decisions at the same time in late March.

Figure 3.4 compares the timeline of the 2023 and 2018 price reviews.

Figure 3.4: Comparison of timelines for 2023 and 2018 price reviews



Source: farrierswier analysis, 2024

We understand that the commission undertook an initial assessment of all submissions to consider whether they could be fast-tracked. This initial assessment indicated that up to 6 businesses could potentially be fast-tracked, but following further assessment only 2 businesses ultimately met the requirements to be fast-tracked. Most of the other 4 businesses received draft decisions in the first or second tranches of draft decisions in March 2023.

The length of the price review process for non-fast-tracked businesses has not materially changed under PREMO, but the process is much shorter for fast-tracked businesses:

- The timeframe from price submission to draft decision was 163-179 days in the 2013 price review, compared with 180 days for non-fast-tracked businesses in 2018 and 171-194 days in 2023.
- This period was reduced by about 60% for fast-tracked businesses, dropping to 69 days in 2018 and 81 days in 2023.
- The overall timeframe from price submission to final decision was 236-271 days in 2013, compared with 263 days in 2018 and 273 days in 2023.

3.4.3 Water businesses want greater clarity on the criteria for fast-tracking

A key issue with the current use of fast-tracking is that water businesses consider that the criteria to be fast-tracked are not clear.

When the commission introduced PREMO, it stated:¹⁰

The opportunity for a price submission to be fast tracked through the assessment process is not directly linked to its PREMO rating, rather to the quality and clarity of the submission and its proposals, and the supporting information. The Commission does not intend to provide a check-list set of criteria for a business to qualify for fast tracking. Instead, it considers that a price submission can be fast tracked to an early draft decision if it is satisfied with the proposals in the price submission, and considers that no further enquiry is required because of the significant, transparent and credible evidence put forward in the submission. In this regard, it is up to each water business to prepare a clear, accurate, consistent and easily understood price submission.

Consistent with this approach, the commission's guidance paper for the 2023 price review only provides high-level guidance on what is required to be fast-tracked:¹¹

to facilitate a quick and simple stage 1 assessment (and the possibility of fast tracking), a price submission must clearly convey its key messages and data to us. This guidance informs businesses on what to include in their price submissions, consistent with this stage 1 assessment. The financial model template (Section 3.23.3) must also be accurately completed for a water business to be eligible for fast tracking.

The decision to fast track a price submission remains at our discretion, taking into account the quality and accuracy of the submission and any other matter we consider is relevant. Our decision on fast tracking will be heavily informed by how well a business demonstrates it has captured the views of its customers and explains how it has considered feedback.

There are a range of different views between commission staff and businesses on what the current criteria are. This limits its effectiveness as an incentive, as businesses do not know what to aim for, may focus on the wrong things or may not try as hard to be fast-tracked because they are unable to accurately assess their prospects of being fast-tracked.

When we asked water businesses what they considered the criteria for fast-tracking were, we received a wide variety of answers. Most water businesses said they did not know what the criteria were and that they needed to be clarified. One business referred to fast-tracking in our interview as 'the mystery called the fast-tracking process'.

¹⁰ Essential Services Commission, *Water Pricing Framework and Approach: Implementing PREMO from 2018*, p48.

¹¹ Essential Services Commission, *2023 water price review: Guidance paper*, p13.

In our survey of water businesses, we asked those businesses that said they did not seek to be fast-tracked in 2023 for the reasons why that was the case. 60% of them said it was because ‘it was challenging to understand the commission’s requirements to be fast-tracked’ or ‘we did not understand how the ESC would determine whether to fast-track our submission’. One business provided the following comment to explain its response:

The assessment process for fast-tracking is a black box that has not been explained post 2018 and again post 2023.

Several water businesses commented in our interviews that a relatively minor issue or a negative submission from a single stakeholder will stop a well-justified proposal being fast-tracked.

One business that had been fast-tracked said in our interview it thought the criteria were clear and gave us a long list of what it thought the criteria were. However, those criteria do not appear in the commission’s guidance and are different to what commission staff told us the criteria were.

Commission staff told us in our interview that there are no set criteria for fast-tracking and the decision on which businesses to fast-track is primarily based on ‘how quickly we can do the assessment’, ‘how easy it was to understand what was being proposed’ and ‘how well supported it was’. We understand that the commission has a structured process for assessing whether to fast-track a business.

There is a risk that fast-tracking currently incentivises ‘simple’ proposals that are quick for the commission to assess, rather than high-quality proposals.

There is also a risk that fast-tracking currently incentivises very detailed proposals that try to predict every question the commission and its consultants may ask. This is at odds with the simplicity objective and may be contributing to the significant increase in the length of price submissions that is discussed in section 3.7. One of the businesses that was fast-tracked in 2023 had the longest price submission of any water business.

Consistent with the commission's comments when it introduced PREMO, a check-list for fast-tracking may not be possible or desirable. However, there would likely be value in the commission providing greater clarity on the criteria to be fast-tracked and what it looks for when assessing which businesses to fast-track. This could potentially be achieved by simply restating or expanding upon the following comments from the commission’s original 2016 PREMO paper, if those comments remain accurate today:¹²

the Commission will deliver a flexible price review process by... fast tracking high quality price submissions

The opportunity for a price submission to be fast tracked through the assessment process [is linked to] the quality and clarity of the submission and its proposals, and the supporting information

A price submission can be fast tracked to an early draft decision if [the commission] is satisfied with the proposals in the price submission, and considers that no further enquiry is required because of the significant, transparent and credible evidence put forward in the submission.

As part of clarifying the criteria, the commission should consider whether there is scope to increase the use of fast-tracking. It is seen by water businesses as one of the most powerful incentives for high-quality

¹² Essential Services Commission, *Water Pricing Framework and Approach: Implementing PREMO from 2018*, pp47-48.

price submissions, but our survey indicates that its incentive value has decreased since 2018. Fast-tracking may not continue to be seen as a valuable incentive if its use remains as limited as it was in 2023. Increased use of fast-tracking can also help achieve PREMO’s simplicity objective that the commission focusses more of its resources on the issues and businesses that need the most attention.

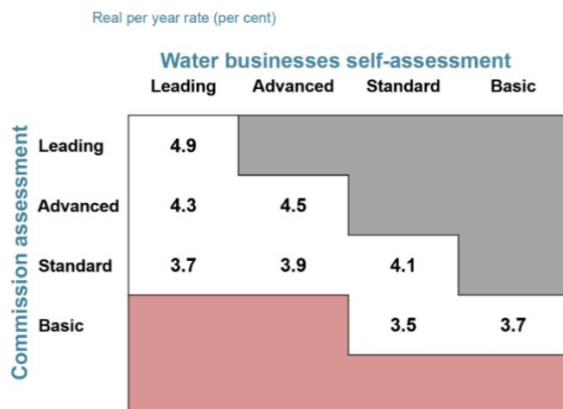
An increased use of fast-tracking may need changes to the timelines for the price review process. The current gap between price submissions and fast-tracked draft decisions is very short and appears to limit the ability to use fast-tracking effectively given the amount of work the commission needs to do in this very short period to confidently decide to fast-track a business without risking adverse impacts for customers. Reviewing and assessing 14 price submissions, deciding which ones to fast-track and drafting and approving the relevant draft decisions within about 50 business days from receipt of price submissions to issuing draft decisions is extremely challenging and seems unrealistic if a larger number of businesses are fast-tracked. The commission could consider bringing forward the timing of price submissions to allow more scope for fast-tracking without an overly compromised commission review process. However, such a change would involve a balance of considerations as it would extend the overall price review process and we understand water businesses wanted a shorter overall price review process when PREMO was introduced.

3.5 PREMO’S FINANCIAL INCENTIVES HAVE NOT HAD THE INTENDED EFFECT ON BUSINESSES

3.5.1 Most water businesses are not motivated by the opportunity to obtain a higher return on equity

PREMO seeks to provide financial incentives for high-quality submissions that represent a water business’ ‘best offer’ by adjusting the business’s return on equity based on its PREMO rating, as shown in Figure 3.5.

Figure 3.5: PREMO return on equity



Source: ESC, 2023 water price review: Guidance paper

Our interviews revealed that this incentive was not understood or valued by water businesses. Many Boards and Managing Directors told us that they consider it to be a ‘perverse incentive’ that a higher

quality price submission results in higher customer prices.¹³

The original intent of this incentive was that it rewards a higher level of ambition in price submissions. For example, this could involve a water business taking on a greater level of risk on behalf of its customers or adopting a higher opex efficiency target, for which it is rewarded with a higher return that corresponds to this higher risk. In this way, the increased rate of return may not result in higher overall prices for customers, as it reflects cost savings or improved risk allocation in other areas.

Most businesses did not understand or agree with this intent, which significantly reduces the incentive effect of the current design of this part of PREMO in practice.

Only one business we interviewed applied this type of approach, saying that it targeted an advanced rating and then used the increased return to fund innovation projects, uncertain capital projects that are not included in its capex allowance and a rebate mechanism where customers receive reduced prices if it does not meet its customer outcome targets.

Other businesses said they considered that the risks involved in the actions they would need to take to be rated as advanced were too great to justify the potential reward, for example they would need to commit to efficiency targets that they felt were unachievable, particularly businesses with low customer growth or who considered they were close to the efficiency frontier.

Several businesses went out of their way to avoid receiving this incentive because of the impact it has on prices. Some businesses told us they rated themselves as standard when they could have justified an advanced rating but did not want the increased return and prices that go with it. South East Water rated itself as advanced but set its revenues and prices as if it had been rated as standard.

These comments from the interviews are supported by the results of our water business survey.

Businesses were asked to rate the importance of PREMO's incentives on a scale from 1 (not important) to 10 (very important). The results show that financial incentives were rated as significantly less important than procedural or reputational incentives. The ratings were very similar to the survey we undertook as part of our review of the 2018 price review process where we asked water businesses the same question.

The results from our survey on the 2023 price review and the equivalent results from our previous survey on the 2018 price review are set out in Table 3.4.

Table 3.4: Survey results on the importance of different types of incentives

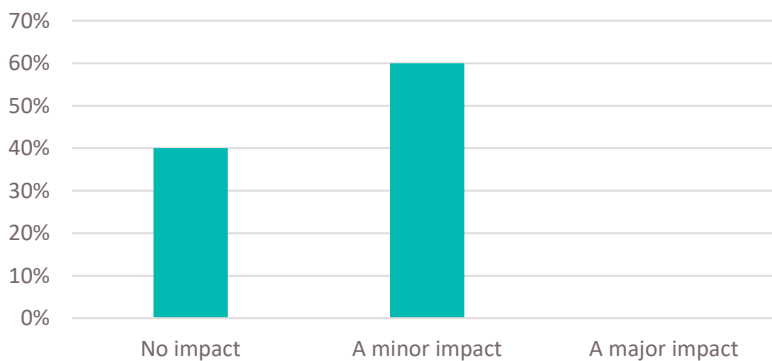
Incentive	Average rating: 2023 price review survey	Average rating: 2018 price review survey
Financial incentives (the opportunity to earn a higher return on equity)	4.6	4.7
Procedural incentives (e.g. the opportunity of fast-tracking)	6.5	6.6
Reputational incentives	7.6	7.4

¹³ We note that the commission only approves maximum prices and businesses can chose to charge less than these maximum prices. Businesses can also propose prices that are less than the revenue requirement calculated by the commission, as 2 businesses did in the 2023 water price review. The increased return from an advanced or leading rating therefore does not need to be passed on to consumers through increased prices. However, it would not appear to create the intended financial incentive effect if a business receives a higher return due to an advanced rating but then elected not to include that higher return when setting its prices.

This appears to be a change from the views expressed by water businesses when the commission developed PREMO in 2015-2016, where we understand that water businesses considered financial incentives to be an important part of the design of PREMO and a valuable incentive.

We also asked the 2023 price review businesses how much impact the different rates of return that apply to each PREMO rating had on the content of their price submission and their approach to developing their price submission, with the results shown in Figure 3.6.

Figure 3.6: Survey responses on the impact on price submissions of the different rates of return for each PREMO rating

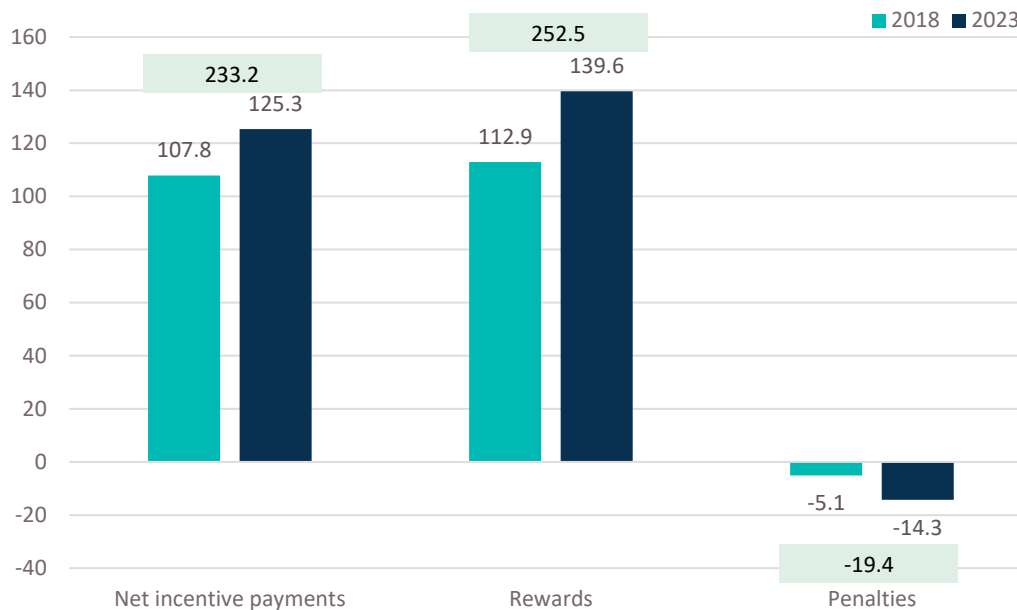


A water business' PREMO rating determines its rate of return on equity as shown in PREMO seeks to provide financial above. If a business rates itself as Advanced and the commission agrees with this rating, the business is rewarded with 0.4% increase in its return on equity compared with a standard rating. If the business rates itself as leading and the commission agrees, its return is 0.8% higher than for a standard business. There is a similar 0.4% reduction in the return on equity if a business is rated as basic, as well as reductions if the business rates itself more highly than the commission's rating.

As discussed above, this increased rate of return was intended to acknowledge that advanced or leading businesses have made price submissions that have higher ambition and may take on more risk on behalf of customers or reduce costs for customers in other areas, for example through more ambitious opex efficiency targets. As a result of this risk-return trade-off, it is difficult to determine the overall financial impact of this aspect of PREMO on customers. However, in light of our findings that most businesses do not see this increased return as an incentive that materially affects their price submissions, we considered that it would be useful to calculate the amount this increased rate of return has cost customers in incentive payments.

Figure 3.7 shows the financial incentive for an increased rate of return for an advanced or leading rating has cost customers about \$233 million in increased regulated revenues across the two PREMO reviews to date. This is less than 1% of water business' total regulated revenues over that period, but is still a material amount in dollar terms.

Figure 3.7: Value of PREMO financial incentives (\$2023, million)



Source: farrierswier analysis, 2024

In light of the feedback we heard from stakeholders, the commission may wish to consider changes to the design of PREMO's financial incentive, or whether other incentives that were said by businesses to be more meaningful to water businesses could be enhanced or added in its place.

3.6 BUSINESSES ARE CONCERNED THERE IS TOO MUCH FOCUS ON SHORT TERM PRICE IMPACTS AND INSUFFICIENT ATTENTION ON LONGER TERM CHALLENGES FACED BY THE SECTOR, BUT IT IS UNCLEAR HOW MUCH OF THIS CONCERN RELATES TO PREMO

3.6.1 The biggest concern raised by Boards in our interviews was an excessive focus on short term prices that may not be sustainable

A key concern raised by numerous water businesses in our interviews was a perception that there is too much of a short-term focus by government and the commission on prices over the 4-5 year regulatory period and too little focus on longer term asset management, investment needs and financial health of the business.

The causes of this concern raised by water businesses related to issues including:

- increased capital investment needed to maintain and replace aging assets;
- capex that has been deferred over the current and previous period to reduce prices but cannot be deferred any longer;
- increased expenditure to address climate change risks and improve resilience;
- increased opex to meet new or increased regulatory obligations imposed by other parts of government;
- increased interest rates; and
- increased debt levels.

We do not consider that these comments indicate weaknesses in the underlying PREMO framework or the need for material changes to the design of PREMO. Instead, as discussed below many of these comments related to actions by government or how water businesses responded to government’s desire to minimise price rises. To the extent that these comments related to PREMO and the price review process, they generally related to how PREMO is applied in practice by water businesses and the commission rather than the design of PREMO.

Some of these comments were also intended as a warning that government and the commission are likely to need to manage public expectations about future prices and not assume that the recent period of stable or decreasing real prices can continue in the medium to long term given the above challenges.

One Managing Director summed up these concerns in the interview by stating:

The implementation of PREMO inherently drives short-term focus, for a sector which is inherently needing to be long-term. This is a huge challenge for the Victorian water sector and for the sector’s financial sustainability.

However, not all water businesses shared this view, or considered that the focus on short-term prices was due to PREMO. For example, one Managing Director said:

Some water corporations are unhappy about flat or declining prices, but they haven’t actually proposed to put them up.

We note that the commission approved most water businesses’ proposed capex and opex with only relatively minor changes. Consistent with the second view cited above, this indicates that concerns about an overly short-term focus are not necessarily based on the commission’s decisions on businesses’ proposed expenditure levels and major capital projects.

Our survey asked water businesses to consider the following statement and respond whether they agreed or disagreed: ‘Recognising that the Commission’s objective is to promote the long-term interests of Victorian consumers, the commission’s 2023 water price review decisions appropriately balanced shorter-term considerations related to price impacts over the 5 year regulatory period with longer-term considerations related to efficient investment levels and the financial sustainability of water businesses.’ The responses are shown in Table 3.5.

Table 3.5: Survey results on whether the 2023 price review process appropriately balances short and long term considerations

Response	Percentage of responses
Strongly disagree	0%
Disagree	36%
Neither agree or disagree	46%
Agree	18%
Strongly agree	0%

The comments that were provided in the survey as reasons for these responses included:

The price review process consistently brings an overwhelming focus on prices for a five-year period, without balancing it with the need for long term sustainable investment. It creates an environment of competition for a five-year price point, without supporting businesses to adequately manage and plan for uncertainty.

3.6.2 Some of these concerns relate to PREMO, but many relate to broader government actions and how businesses responded to the desires of government and their customers to minimise price rises

It is difficult to clearly delineate the extent to which the above concerns relate to actions by the commission as part of the price review process as opposed to actions by government that are largely outside of the commission's control.

Some of the concerns relate to decisions by the commission as discussed in section 3.6.3 below, but those issues only had a relatively minor impact on businesses' prices and revenues.

A large part of the concerns that were raised related to the impact of the desire of government and customers to minimise price rises, or government decisions such as the impact of the efficiency dividend applied by government shortly after the 2023 price review final decisions.

Several businesses said that government had made it clear to businesses before they lodged their price submissions that price rises should not exceed inflation and that this had had a material impact on some businesses' price submissions. However, in our interview with DEECA staff we found that they were very conscious of the challenges discussed above and the need to take a longer term view of pricing and investment issues.

As discussed in section 4.1, water businesses took different approaches to how they managed government's expectations around price levels. Some businesses undertook engagement with government and consumers to justify why higher prices were needed and proposed the prices and revenues they felt were required to deliver services in the long-term interests of their customers. Other businesses appear to have proposed price rises that were less than inflation even where they felt higher prices were needed to meet their prudent investment needs. Two businesses proposed prices that were less than the efficient revenue requirement calculated by the commission's models, and numerous businesses proposed deferring uncertain capital projects to the next price review.

The commission can only do so much to address these issues in its role as regulator. Government and the commission can endeavour to create an environment where water business feel able to make price submissions that reflect the long-term interests of customers, but there is little the commission can do if businesses adjust their price submissions based on external considerations.

Government also needs to play its role as the shareholder of Victorian water businesses to deliver outcomes that are in the long term interests of consumers. Several water businesses suggested that government could provide clearer guidance to water businesses through its statements of obligations and letters of expectations. Water businesses also need to play their role in proposing the revenues and prices they consider are needed to meet those expectations and the long-term interests of their customers. The commission could then have regard to those documents and the outcomes of customer engagement when assessing the prudent and efficient expenditure required to meet the obligations and expectations set out in those documents.

3.6.3 Stakeholders raised concerns with commission actions they felt were inconsistent with PREMO's autonomy objective and overly focussed on short term prices

Although some of the concerns about an excessive short-term focus relate to factors that are beyond the commission's control as discussed above, several businesses also expressed concerns with a small number of actions by the commission that they considered indicated it was too focussed on short-term price impacts rather than applying the PREMO framework as it was intended and focussing on the long term interests of consumers.

As noted above, the commission largely approved water businesses proposed opex and capex. However, water businesses provided a few examples of actions by the commission that they considered undermined the autonomy and engagement objectives of PREMO by requesting or requiring businesses to take actions that were perceived as being inconsistent with the approaches businesses had developed based on consultation with their customers.

Some businesses also considered that the commission's justification for its approach to these issues was not well communicated and not consistent with the commission's guidance. Businesses recognised that the commission had the power to take an active role in providing direction to businesses in relation to these issues, but felt that if it wished to do so then it should use the guidance paper it issues at the start of the price review process rather than taking actions late in the process like it did in these examples.

The main issue raised by businesses in this regard was the commission's approach to inflation in the 2023 price review.

The commission made a change shortly before the 2023 final decisions to how it sets inflation forecasts. The commission changed its approach from using a 10 year forecast period as set out in its guidance paper to using a 5 year forecast because it considered a 10 year forecast would underestimate inflation in the current high inflation environment. This change was notified to water businesses in May 2023, a month before the final decisions,. It resulted in changes to the inflation and cost of debt inputs into businesses' revenue requirements and reduced revenues and prices.

Other more minor issues were raised by one or two businesses in relation to changes that the commission suggested the business consider (but did not mandate in its draft or final decisions) in relation to price paths or customer outcomes.

Some environmental groups we interviewed who made submissions to the price review process also expressed concerns that the commission was overly focussed on short term price impacts and not sufficiently focussed on environmental issues, climate change resilience or opportunities for integrated water cycle management. In their submissions, some environmental groups expressed disappointment that the commission had rejected investments to improve environmental outcomes that had been proposed by water businesses, although we note that some of these projects were ultimately approved in the final decision after water businesses provided more justification. An environmental group also noted in its submission that environmental sustainability is one of the commission's objectives under the relevant provisions of the Water Industry Act but does not appear to be given appropriate regard and prominence in the commission's decision documents.

3.6.4 Water businesses could take actions to help manage some of these longer-term issues and some considered PREMO affords them adequate opportunity to do so

The integration of long-term asset planning and forecasts of investment needs and prices into water businesses' price submissions and customer engagement could assist in managing some of the challenges discussed above. Some businesses currently do this, but most price submissions take a primarily short-term focus.

We interviewed one business that had proposed, and had approved by the commission, above-inflation price increases to address increased investment needs. We asked what it considered had helped it get its proposals approved and its response was that a key reason was that it had forecast the investment needs and price impacts in each of its last two price submissions and had engaged with consumers and government over multiple price reviews to explain why it was needed.

Water businesses are required to include in their price submissions a 10 year forecast of their capex over the coming price review period and the next period. For example, price submissions for the 2023 price review included annual capex forecasts for each year from 2023/24 to 2032/33. These forecasts could help provide a greater long-term focus and indication of future investment and pricing challenges.

However, these forecasts appear to be overly conservative. We analysed the 10 year capex forecasts that were contained in the 2018 price review submissions for the 2023-2028 period and compared them with the latest forecasts that were contained in the 2023 price review submissions for the same period. We recognise that forecasting capex 10 years in advance is challenging, but would expect the uncertainty to result in a mix of over and under-forecasting. However, every business except one provided 2023 price review forecasts that were materially higher than their 2018 price review forecasts. The average increase in forecast capex was 65%, with 3 businesses' forecasts increasing by more than 100%.

As discussed in section 3.9, water businesses could also potentially make greater use of the range of tools that are available in the PREMO framework for managing risk and uncertainty. This could help address some of the concerns businesses raised about long-term investment issues and increased uncertainty.

Water businesses also had varying approaches to the efficient use of debt, as discussed in section 4.5.

3.7 BUSINESSES ARE SEEKING MORE CLARITY ON PREMO'S SIMPLICITY OBJECTIVE

3.7.1 Stakeholders consider that PREMO's simplicity objective has been only partially met

In our surveys, we asked water businesses and people who made a submission to rate how effectively various aspects of the 2023 price review process met PREMO's objectives on a scale from 1 (completely ineffective) to 5 (very effective). The question with the lowest rating in both surveys was 'How effective do you consider the price review process was in enabling water businesses to keep their price submissions clear and succinct and focussed on material issues for customers?'

Water businesses rated this question at an average of 3.8 out of 5. Stakeholders who made a submission to the 2023 price review process gave an average rating of only 2 out of 5, but this question had a very low response rate.

These ratings are consistent with comments in our interviews where many water businesses said that they did not consider that the 2023 and 2024 price review processes had delivered on the commission's

simplicity objective that the price review process encourages businesses to focus on issues that are material for customers, incentivises clear and simple price submissions and minimises compliance costs.

3.7.2 Some businesses consider the commission's assessment could be more targeted with a greater emphasis on overall customer outcomes

PREMO's simplicity objective has a number of elements. The overall objective was described by the commission when it introduced PREMO as:¹⁴

the pricing approach attempts to avoid focusing on matters that make little difference to the outcomes experienced by customers. The Commission seeks to achieve this by choosing simplicity whenever it can.

The commission also stated when developing PREMO that the simplicity objective seeks to achieve the following outcomes:

- Businesses focus on material issues for customers
- Price submissions and decisions are as clear and succinct as possible
- Compliance costs are minimised where possible
- A flexible assessment process that is tailored to the quality of each price submission and allows the commission to focus its resources on the businesses and issues where it would add the most value.

Several parts of the design of PREMO promote these objectives compared with the pre-PREMO price review framework. Examples include the simplified approach to setting the WACC, the commission's tailored review process including fast-tracking, and businesses being primarily responsible for customer engagement rather than the commission.

Our interviews revealed that there are divergent views about what the simplicity objective means and how it impacts how PREMO should be applied in practice.

Many businesses see PREMO as a building blocks economic regulatory regime with some important additions to better focus on customer outcomes, enhance customer engagement, incentivise best offers and reward performance. In contrast, some stakeholders think PREMO was intended to be a totally different way of regulating that should put more weight on whether businesses' proposals are their best offers and supported by their customers and have less focus on a traditional building blocks assessment.

Some water businesses considered that there is scope for the commission to target its review of building blocks inputs on material issues and adopt a more holistic and integrated approach that has greater regard to overall customer outcomes. For example, several businesses considered that the assessment undertaken by the commission and its consultants of opex, capex, and other building block inputs and tariffs was too focussed on template data requests, too siloed and not sufficiently focussed on material issues.

Several businesses commented that PREMO required businesses to base their submissions on customer engagement and customer outcomes, but the commission and its consultants did not take a similar approach in their assessments. These businesses felt that different parts of the assessment were allocated to different staff and consultants without sufficient consideration of the linkages between issues and how they contributed to overall customer outcomes.

¹⁴ Essential Services Commission, *Water Pricing Framework and Approach: Implementing PREMO from 2018*, p4.

One business explained this concern as follows:

There was too much ESC focus on the process and template information requests and not enough focus on outcomes.

Another water business summarised these concerns eloquently by referring to the concept of a ‘golden thread’ running through a price submission, referencing the commission’s statement when it introduced PREMO that ‘[t]he narrative describing each customer outcome will form the backbone of a pricing submission — the ‘golden threads’ that bind a price submission into a coherent story about the outcomes customers will enjoy.’¹⁵ The water business stated that it puts significant effort into weaving this ‘golden thread’ through its price submission, tying everything together and linking it to customer outcomes. However, it considered that the commission then breaks up the price submission and allocates it to separate staff members and consultants to analyse those individual parts, which loses the golden thread.

Several businesses also considered that the assessment by the commission’s consultants did not focus on material issues, with businesses receiving extensive information requests for projects that were very minor as a proportion of their total revenues. Businesses suggested that the commission could provide a clearer scope to its consultants on how to assess proposals. The commission’s expenditure consultant acknowledged that the commission’s guidance was not very detailed on some issues and that it had to develop its own assessment criteria for some important issues such as opex step changes.

Two water businesses summed up these concerns with the following comments:

Our submission was sliced up and the slices went out to consultants. Different people looking at different parts of it didn’t work.

The expenditure review felt deep but narrow and focussed on particular issues. There were lots of open-ended questions that were time-consuming to respond to.

3.7.3 The length of price submissions has increased significantly and stakeholders are unclear on whether the simplicity objective means they should aim to submit short price submissions

Businesses also had different views on what the simplicity objective meant in relation to whether the commission wanted short submissions.

The commission’s original PREMO materials and its 2023 price review guidance paper do not refer to seeking ‘short submissions’. However, the guidance paper refers to seeking ‘clear and succinct price submissions’ in several places.¹⁶ For example, it says:¹⁷

Price submissions must clearly and succinctly identify and explain how a business’s proposals demonstrate value for money for customers.

We encourage businesses to keep their price submissions as clear and succinct as possible.

Some businesses said they did not believe that a short price submission was important to the commission. Other businesses considered that the commission wanted short submissions, based on the commission’s guidance or previous comments. Some businesses said they put a lot of effort that probably was not needed in hindsight into shortening their price submissions. Some businesses said they made a short

¹⁵ ESC, *Water Pricing Framework and Approach: Implementing PREMO from 2018*, p20.

¹⁶ We note that ‘succinct’ is generally defined as ‘briefly expressed’, ‘said in a clear and short way’ or ‘concise’.

¹⁷ Essential Services Commission, *2023 water price review: Guidance paper*, pp 2 and 15.

submission but then felt they faced increased questions and information requests because their submission did not contain the level of evidence required by the commission’s staff and consultants, which created extra work. One business said it kept its submission to about 100 pages despite advice from consultants that it should add significantly more material to address the requirements of the commission’s guidance.

Commission staff indicated to us that they want price submissions to focus on material that is most relevant and important, with additional information made available if requested.

In our interviews, numerous businesses stated that it is challenging to meet the commission’s guidance requirements through a short submission.

The length of price submissions increased significantly in the 2023 and 2024 price reviews, with a correlation between longer submission and higher PREMO rankings.

The length of price submissions (excluding attachments) for recent price reviews is summarised below.

Table 3.6: Length of price submissions

	2013	2018	2023	2024
Average length of price submissions	94 pages	108 pages	148 pages	200 pages
Range of lengths of price submissions	50-164 pages	42-214 pages	71-263 pages	110-290 pages
Average length of submissions rated as standard	N/A	99 pages	117 pages	200 pages
Average length of submissions rated as advanced or leading	N/A	118 pages	203 pages	N/A
Price submissions that are less than 100 pages	53%	63%	29%	0%

This material increase in the length of submissions in the 2023 and 2024 price reviews compared with the 2013 and 2018 price reviews appears inconsistent with PREMO’s simplicity objective, which includes objectives of minimising compliance costs for businesses and keeping price submissions clear and succinct.

For the 2023 price review, there also appears to be a correlation between the length of price submissions and the business’ PREMO rating. The average length of submissions for businesses rated as advanced was almost twice as long as for business rated as standard. All but 1 of the business rated as advanced made a price submission that was materially longer than average, with the shortest advanced-rated submission being 132 pages and the longest being 263 pages. This suggests that it is difficult to meet the expectations of the commission’s guidance for a rating higher than standard while also keeping submissions succinct.

This correlation was not seen in the 2018 price review. In that review, the average length of submissions for businesses rated advanced or leading was only slightly longer than standard businesses. In addition, the 1 business that was rated leading made a 51 page price submission and 2 advanced-rated businesses made 42-43 page submissions.

We recommend that the commission clarifies its guidance on its expectations for price submissions, focussing on relevance and materiality not length.

3.7.4 Some businesses are concerned about increasing costs of the price review process

We heard concerns from many stakeholders that the cost of engagement is increasing and that further increases in the scale of engagement are unlikely to be justified.

As discussed in section 3.2, there has been a material step-up in water businesses' customer engagement since PREMO was introduced. However, the scale and cost of engagement appears to have reached a point where many businesses are looking for reassurance from the commission that it will not expect even more extensive engagement at the next price review in 2028.

The costs of engagement are a particular challenge for smaller regional water businesses. One person we spoke to estimated that price submission engagement for a small water business could cost up to \$10 per customer connection and be 5-10 times more expensive than for a large business on a per customer basis.

We note that the section of the commission's guidance paper that addresses stakeholder engagement is not prescriptive about how water businesses undertake engagement. It sets out high-level principles that should guide the engagement undertaken by water businesses, but states:¹⁸

Water businesses are best placed to design and undertake engagement to suit their circumstances and those of their customers. Accordingly, we have not prescribed how a water business should engage.

This guidance should give water businesses sufficient flexibility to target their engagement approach in a way that is proportionate to the costs and benefits. However, given the feedback we heard from several businesses on this issue, there may be benefit in the commission reiterating that water businesses have flexibility in how they engage and providing more explicit guidance that customer engagement should be proportionate and targeted, and that some customer preference data may remain relevant for longer than 5 years. For example, one water businesses suggested that there should be clearer guidance that businesses can rely in their price submission on the prior engagement they have undertaken to understand their customers' preferences and priorities and can then focus their specific price submission engagement on complementing this previous work with targeted engagement on topical issues.

Other aspects of the costs of the price review process were also considered by water businesses to have increased materially. The reasons for this view included an increased use of consultants by some water business due to the complexity and perceived level of detail and rigour that is needed to meet the commission's requirements and a lack of suitable internal resources. Several water businesses and consultants also commented on the extensive use of information requests by the commission and its consultants, some of which did not appear to be sufficiently targeted and proportionate to the materiality of the issues.

Some water businesses also commented that the commission's price submission financial models adopt a 'one size fits all approach' that may not be suitable for all businesses. One business recommended that there should be a clearer process for water businesses to engage with the commission before they lodge their price submissions if they consider that changes to the template model are needed.

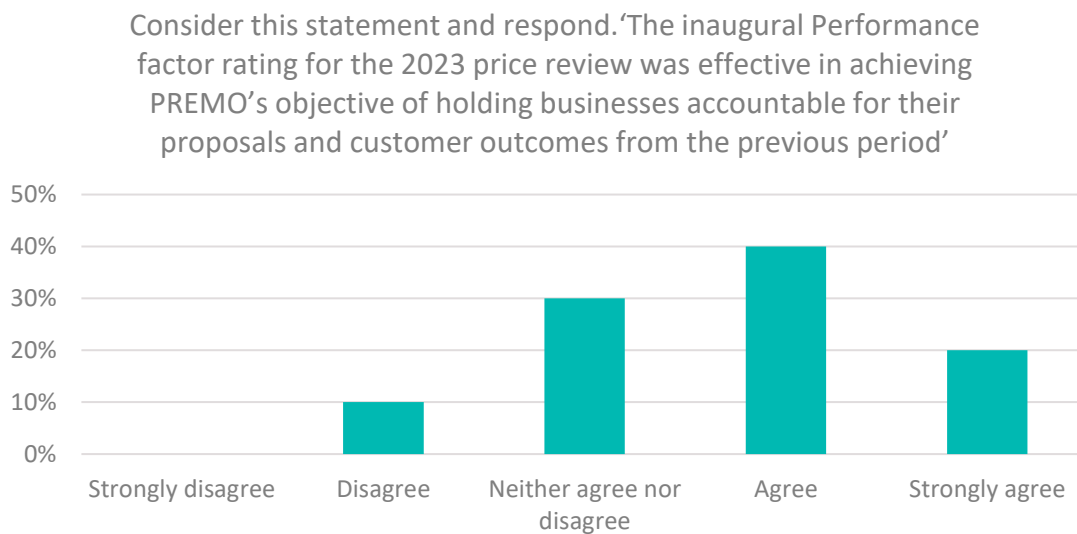
¹⁸ Essential Services Commission, 2023 water price review: Guidance paper, p20.

3.8 THE PERFORMANCE ELEMENT OF PREMO WAS EFFECTIVE, BUT CLEARER GUIDANCE COULD HELP

3.8.1 The 2023 price review was the first time PREMO’s P element was applied and it was considered to have met its objectives

The 2023 price review was the first time the P element of PREMO was applied. Based on our interviews and surveys, it appears to be effective in delivering the objectives of holding businesses accountable for their promises to customers and creating a link between performance across price review periods.

Figure 3.8: Survey responses on the effectiveness of PREMO’s P element



3.8.2 Clearer guidance on assessing performance ratings could be useful

The commission’s guidance paper for the 2023 price review set out the following guiding questions for assessing a business’ P rating:

- To what extent has the business demonstrated delivery of its customer outcomes commitment over the current regulatory period? Did its customers get what they paid for?
- How does actual operating expenditure across the current period compare with the established benchmark allowance, and to what extent has the business rationalised any discrepancies?
- How does actual capital expenditure across the current period compare with the established benchmark allowance, and to what extent has the business rationalised any discrepancies?
- To what extent does customer sentiment demonstrate satisfaction in the business’s performance over the current regulatory period? Are customers happy with the value they receive from their water business?¹⁹

An Appendix to the guidance paper set out examples reflecting different rating levels.

¹⁹ The commission largely relies on its own annual customer sentiment survey to assess this limb of the performance rating in practice. See <https://www.esc.vic.gov.au/water/sector-performance-and-reporting/how-customers-rate-their-water-business> for details of this survey.

Performance is rated differently to the other elements of PREMO in that a water business' P rating for the current price review period is tied to its overall rating from the previous period. This approach is summarised in the figure below from the commission's guidance paper.

Figure 3.9: Example of how the Performance element is rated

Overall PREMO rating from previous price review	Performance rating in price submission for 2023 water price review		
	Exceeded expectations	Achieved expectations	Did not meet expectations
Leading	Leading	Leading	Advanced/Standard/Basic
Advanced	Leading	Advanced	Standard/Basic
Standard	Leading/Advanced	Standard	Basic
Basic	Advanced/Standard	Standard	Basic

Source: ESC, 2023 water price review: Guidance paper

There is some unavoidable discretion and subjectivity in the P ratings, especially in an environment like the 2023 price reviews where almost all businesses overspent against their previous opex estimates due to external events. Businesses generally agreed with the commission's performance ratings, but several businesses considered that there would be value in clearer guidance on how P ratings are assessed.

In our survey, we asked water businesses to rate from 1 to 5 how clear, easy to use and easy to interpret the commission's guidance was on each of the 5 elements of PREMO. The results are discussed in section 5.1.3. The P element received the second-lowest rating at 3.7 out of 5.

Comments on the reasons for this rating included:

There were elements that still required ESC judgement in the guidance. Second time should be refined guidance and a better understanding of what aspects they weight higher than others.

It was late, and provided limited detail

The following issues were also raised in our interviews:

- Some businesses considered that there is too much focus by the commission on the proposed opex efficiency improvement rate and comparisons of these rates between businesses without considering the specific circumstances of each business including their starting level of efficiency and uncontrollable external cost pressures
- Several water business and other stakeholders raised concerns that businesses take inconsistent approaches to how rigorously they rate their performance against their customer outcome commitments, with some businesses involving customers in an independent and robust rating process while other businesses largely rate it themselves
- Several water businesses and other stakeholders raised concerns that the commission's customer sentiment survey is not fit for purpose and robust enough for the commission to use in assessing Performance ratings.

3.9 WATER BUSINESSES COULD GIVE MORE ATTENTION TO THE RISK ELEMENT OF PREMO AND TOOLS FOR MANAGING UNCERTAINTY

3.9.1 PREMO enables water businesses to use a variety of mechanisms for managing uncertainty

In our interviews, several water businesses raised concerns that they face an increasing level of uncertainty in the broader environment in which they operate. Climate change, drought risks, increased government obligations, interest rates and inflation, aging assets and customer demand were among the causes of uncertainty raised by businesses.

A building block based economic regulation regime like PREMO relies to an extent on using past expenditure levels and performance to predict the future and set the businesses' regulated revenues, prices and customer outcome commitments. This is more challenging in an environment of increased uncertainty where it is difficult to use past trends to predict future requirements.

Consistent with the autonomy objective and the Risk element of PREMO, the commission's price review process allows each water business considerable scope to propose its own allocation of risks between the water business and its customers.

The commission standardised 3 price adjustment mechanisms that apply to all water businesses in the 2023 price review, which are summarised in the Box below.

Box D.1: Standard price adjustment mechanisms

The commission's price determinations for each water business included the following standard price adjustment mechanisms:

- **Price adjustment for uncertain or unforeseen events:** All price determinations contain a standard provision that allows the water business to apply for an amendment to prices to reflect increased or decreased costs or revenue as a result of events which were uncertain or unforeseen at the time the determination was made
- **Pass through of changes to prices for storage operator and bulk water services:** Where relevant, the price determinations include a standard provision that allows the commission to adjust prices to pass through the impact of changes to prices for services provided by the relevant storage operator and bulk water service provider.
- **Annual updates to trailing average cost of debt:** All price determinations contain a standard provision that updates the cost of debt each year.

Apart from these standard mechanisms, each water businesses can propose its own:

- form of control, e.g. price cap or revenue cap;
- tariff structures;
- price adjustment mechanisms;
- incentive mechanisms; and
- other mechanisms to manage risk and uncertainty.

The forms of control and additional mechanisms to share risk and manage uncertainty adopted by each water business are summarised in Appendix D.

3.9.2 Only limited use is made of the available uncertainty mechanisms

As set out above, the commission's 2023 price determinations contain a relatively broad adjustment mechanism for uncertain and unforeseen events. This mechanism is much broader than equivalent pass through mechanisms in many other sectors, for example in electricity network regulation where it is limited to a small number of specified events.

However, this mechanism is almost never used in practice. Businesses often raised concerns about uncertainty in our interviews, but did not have clear reasons when we asked why Victorian water businesses did not appear to use the existing tools. We noted that the use of pass throughs is much more common in other sectors such as electricity and gas networks. The reluctance to use this mechanism appears to be due to a combination of concerns about how it would be perceived by stakeholders and the commission and a lack of clarity on how the mechanism would work. Some businesses stated that commission staff have indicated to them that the whole price determination would be reopened rather than just making a targeted adjustment, which deters them from using it and is different to the approach in other sectors.

Water businesses take a variety of approaches to proposing tailored uncertainty mechanisms, as summarised in Appendix D. However, they do not appear to make as much use of the suite of available mechanisms in other regulated industries.

For example, PREMO is relatively unusual compared with other economic regulatory regimes in the level of autonomy provided to water businesses to determine how they manage uncertainty, including the choice of form of control, e.g. a price cap or revenue cap. Most water businesses are on a price cap, but a small number are on revenue caps. In their interviews, several businesses raised concerns about the revenue risk they face when water consumption is materially lower than forecast, e.g. due to water restrictions during a drought. The risk borne by a water business in these circumstances is much greater under a price cap than a revenue cap. When we asked these businesses if they had considered proposing a revenue cap, they generally responded that they had not considered it or that based on discussions with commission staff they considered it would be challenging to get such a change approved.

This reluctance to use some of the available uncertainty mechanisms means that Victorian water businesses tend to manage uncertainty by simply funding any unforeseen costs themselves within the regulatory period then seeking recovery for some of those costs at the start of the next regulatory period. This approach leads to lower prices for customers in the short term, but may not be an efficient way to manage risk and uncertainty in the long term. This approach may have contributed to material capex and opex overspends by many businesses in the 2018-2023 period and can create increased price volatility between regulatory periods. It could also create future financeability challenges for water businesses, although we note that the commission's price review decisions assess the financial viability of each water business against a set of financial indicators and check that the proposed prices do not create financeability risks.

The commission may also wish to consider whether PREMO strikes the appropriate balance between autonomy for businesses to determine their approach to managing uncertainty in consultation with their customers and the commission providing guidance on common material issues. The current application of PREMO provides water businesses with considerable discretion in relation to matters such as the form of control, uncertainty mechanisms, guaranteed service levels (GSLs), the pace of capital recovery (i.e. depreciation) and other performance rebates or incentives, and tariff structures. This approach has the benefit of empowering water businesses and their customers to propose the approach that best suits their circumstances. However, it results in a wide variety of approaches and inconsistency that often does not appear to us to be based on local circumstances and customer engagement outcomes.

4. What business-specific factors impacted the extent to which PREMO's objectives were met?

This chapter sets out our findings on factors that may have materially affected the extent to which PREMO's objectives were met for different water businesses.

We identified several important differences between how water businesses approached the price review process that appear to impact the extent to which it met PREMO's objectives. We do not identify individual businesses in this chapter. Instead, we seek to identify themes from the interview comments and survey responses that could explain material differences in attitudes and outcomes across businesses.

4.1 HOW BUSINESSES NAVIGATE GOVERNMENT'S DESIRES FOR LOWER PRICES

As discussed in section 3.5 above, there is an understandable desire from government to minimise prices over the 5 year regulatory period, especially during a period of high inflation and cost of living pressures as was the case for the 2023 and 2024 price review processes. How water businesses respond to this desire was a key factor that affected businesses' views on the effectiveness of PREMO and how effectively the price review process met PREMO's objectives.

Our interviews with water business Board members and senior executives identified that there seem to be two different approaches taken by businesses to managing government's concerns about price rises and the impact on the cost of living.

One approach is to put significant weight on government's views when preparing the price submission and ensure the business proposes prices that rise by less than inflation even if the business thinks this approach may create long term issues. There is little the commission can do in this case, but some of the strongest criticisms that PREMO was not suitable for the future and focussed too much on short term prices came from businesses whose feedback suggested they took this approach.

The alternative approach is to be mindful of government's objectives and the impact of price rises on customers and seek to minimise prices and reduce costs where possible, but still propose the price levels the business considers are required. The businesses that took this approach also undertook extensive engagement with customers to understand customers' views on whether they were willing to pay for the required investment and how to prioritise investment needs, and some engaged on longer-term price trajectories and investment profiles. They also engaged with government to explain the reasons for the price rises and how they had sought to mitigate them. This approach is likely to result in better long term outcomes for Victorian water consumers.

4.2 INTEGRATION OF THE PRICE SUBMISSION INTO BROADER CORPORATE PLANNING, DATA AND REPORTING SYSTEMS

The extent to which the price submission process is integrated into water businesses' broader corporate planning appears to be a key factor that influences how effectively PREMO's objectives were met across different businesses.

The businesses that had the most favourable views of whether the price review process met PREMO's objectives were businesses that viewed the price submission as part of the organisation's broader corporate planning processes. Only a minority of businesses expressed this view, but it was not confined to large businesses, with several smaller regional and rural businesses saying they took this approach.

For example, one business said in its interview:

I don't think [the price submission] requires much more documentation than you should have anyway for running the business. We find it straight forward for our business even with a small size.

Integration of operational and financial data reporting systems was seen as a key enabler by businesses that viewed the price review as part of their broader corporate planning and reporting processes. PREMO's objectives are more likely to be met where businesses have invested in data management and reporting systems so they can easily develop their price submission and report on and track their performance against their price review expenditure allowances and customer outcome commitments.

This view of the price submission as part of a business' corporate planning processes was best demonstrated by the following comment by a Managing Director:

Our performance reporting is quite integrated into the business. The price submission is really just the corporate plan and the two documents are very integrated so not a lot of extra work is required to prepare the price submission. All the data is integrated across our finance and regulatory teams so it is relatively easy to produce what's needed for the price submission. It's also all linked into our asset investment and management decisions during the regulatory period.

Another business commented that it had invested in developing better reporting on its performance against the measures in its price submission and found this had been extremely valuable.

However, investing in these reporting systems can be expensive, particularly for smaller businesses. One business said:

We probably have less resources for some of the sophisticated systems that would aid forecasting... we don't have money to invest in technology as an enabler of those things that make what we need for the price submission part of our business as usual process

In contrast to the above view that the price submission is part of the broader corporate planning process, several businesses we interviewed saw the price review process as a one-off exercise they need to undertake for the commission every 5 years that involves too much cost and time for the Board and management. Those businesses had less favourable views of PREMO and the extent to which the price review process met PREMO's objectives and generally had lower PREMO ratings.

For example, one business commented in its interview:

It's an awful lot of work and took a couple of years leading into the submission date. The amount of effort is out of whack with the cost and effort that a small water corporation should put into the regulatory process. For about 18 months it took all of the strategic focus of the organisation. I appreciate the logic of it, but it's not the right size for all of the Victorian water corporations.

4.3 BOARD AND STAFF TURNOVER

Several water businesses and other stakeholders we interviewed expressed the view that turnover in senior staff and Board members has a material effect on the effectiveness of the price review process and its ability to meet PREMO's objectives for some water businesses.

Several water businesses considered that their low turnover at senior levels had made the price review process easier and more effective for them. We also interviewed a number of Chairs and other Board members that had served on the boards of several Victorian water businesses and it was clear that this experience had proven valuable.

In contrast, other water businesses experienced more significant turnover shortly before or during the 2023 price review process.

Many water businesses' Boards also experienced turnover shortly after completion of the 2023 price review. Water business Board terms are generally 4 years and the government appointed some new Board members to every water business on 1 October 2023.

The timing of the 4 yearly Board appointment process also creates a risk of significant Board turnover part way through the next price review process (price submissions will be due at about the same time that current Board members' terms expire in 2027), which will require steps by water businesses and the commission to manage.

The commission has published various guidance materials on PREMO and its price review process that can assist new Board members or staff. The commission also undertakes various briefings and workshops with businesses. Water businesses considered that the meetings between commissioners and water businesses' Boards early in the 2023 price review process were very valuable, especially for new Board members.

The commission may wish to consider whether its existing briefings and materials are sufficient or whether there are other steps it could take, in conjunction with water businesses and government, to provide briefings and explanatory materials on PREMO and the price review process for new water business Board members and staff prior to the start of the next price review.

4.4 PROACTIVE ENGAGEMENT WITH THE COMMISSION

Our interviews revealed significant differences in how effectively and proactively water businesses engaged with the commission during the price review process.

The commissioners met with water businesses prior to price submissions being lodged, but considered that it was generally not appropriate to meet with water businesses between lodgement of price submissions and publication of final decisions. This meant that engagement was primarily undertaken by commission staff.

All water businesses said they had good relationships with the commission's project staff. However, there were a variety of approaches to how businesses engaged with commission staff and identified and escalated issues above the project team when needed.

Several businesses considered that effective engagement with the commission and the ability to proactively raise material issues and escalate them when needed was critical for an effective price review process. For example, one Managing Director said that being able to raise issues with senior commission

staff was extremely valuable for both the water business and commission and ‘helped lift the ESC out of silos to make outcomes-based decisions’. They also said:

If you don’t know what the ESC expects and how to escalate issues..., you won’t do well

However, businesses considered that the onus was largely on water businesses to implement such engagement measures. Several businesses also said that the extent to which businesses did so partly depended on whether they had existing relationships with commission staff that meant they felt able to raise such issues and comfortable doing so. It does not appear that there was a clearly communicated process for escalating issues or obtaining the commission’s guidance. For example, another Managing Director said:

I have shared with [the commission] that I’m not clear on what the escalation process was during the price review process.

There would be value in the commission clarifying how and when water businesses should engage with the commissioners and commission staff during the price review process, including how to escalate issues or seek guidance when needed.

4.5 ATTITUDES TOWARDS DEBT

Increasing debt levels was a concern raised by several water businesses in their interviews. However, we observed that water businesses’ attitudes towards the use of debt varies markedly.

Several water business directors we interviewed had a good understanding of the benefits and risks associated with debt and efficient gearing levels. Some of them expressed concerns that their debt levels have increased to above the commission’s benchmark gearing of 60%.²⁰ They considered that further increases to debt levels to fund major capital projects could create financial viability risks or require an injection of equity by government, noting the current financial challenges being experienced by Thames Water in the UK.

These businesses also expressed the view that increasing debt has been used in the past to reduce short-term price impacts of major capital projects, but that this approach will be unsustainable in future price reviews due to current debt levels. As discussed in section 3.9.2, many businesses also use debt to fund uncertain capital projects during a regulatory period and then only seek to recover the costs at the next period, which reduces short-term prices but is only possible if the business has sufficient borrowing headroom.

However, several other directors expressed concerns about increasing debt levels even though their debt levels were well below the commission’s assumed 60% gearing. Some directors appeared to have a limited understanding of why the commission considers 60% debt to be an efficient gearing ratio and how debt and equity costs are accounted for when the commission sets their prices. This is understandable given the range of backgrounds of Board members. There may be value in the commission or government providing materials or briefings to help water businesses’ Boards understand these issues.

²⁰ We do not have information on water businesses’ debt levels and have not sought to verify the accuracy of these comments.

5. Feedback on the commission's price review process, approach, engagement and guidance

This chapter sets out feedback from stakeholders and our observations on what worked well and what could be improved in the process aspects of the 2023 and 2024 price reviews. It covers the commission's processes and timing, guidance materials, engagement with water businesses and other stakeholders, decision documents and other communications materials. It is based on the outcomes of our interviews, surveys and analysis of the commission's decisions. This feedback is intended to inform potential changes to the commission's processes for future price reviews.

5.1 WHAT WORKED WELL IN THE PRICE REVIEW PROCESS

5.1.1 There is strong support for PREMO and the commission's overall approach

There was strong support for PREMO and the commission's overall approach to the price review process. As noted earlier, several people started their interviews with unprompted comments that PREMO is the best regulatory framework in Victoria or the best economic regulatory framework in Australia.

Water businesses generally considered that the commission managed the process issues of the price review very well. For example, one Managing Director stated:

Being a regulator is difficult. From a process perspective, some regulators don't stick to their own processes and statutory timeframes. The ESC gave guidelines and timelines, and to their credit they largely ran the process as described.

Another Managing Director said:

What worked well was genuine and open engagement between the ESC and us as it progressed the review of our submission... There were no surprises between the draft and the final decisions... The draft decision was clear on what we had to do.

In our interviews, water businesses and stakeholders who made submissions were all very complementary of the commission staff. Their knowledge and accessibility was highly appreciated.

Several water businesses considered that the commission having several long-serving senior staff that had been involved in the development of PREMO significantly contributed to the success of the 2023 and 2024 price review processes. However, they also noted the risks this creates if those staff leave.

5.1.2 The commission's engagement methods were seen as useful

The commission arranged meetings with each water business early in the price review process before price submissions were lodged. Most of these meetings were attended by the commission's Chair and senior staff, with some attended by other commissioners or staff. The Boards of numerous water businesses told us that these meetings were very valuable.

In our survey of people who made a submission, we asked which methods of engagement were most useful and effective for them, and the answers were written submissions and meetings.

We interviewed two groups who had made submissions and had met with commission staff as part of the price review process. They considered that these meetings were extremely valuable and informative.

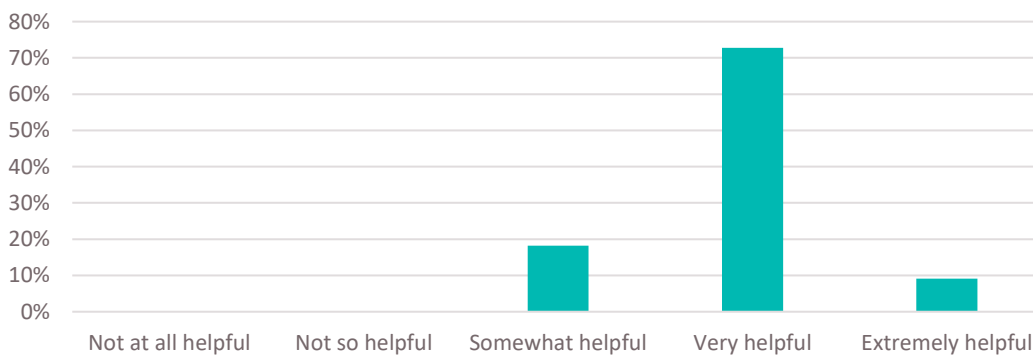
The commission held a public forum for each business following the draft decision. In their comments in our interviews and surveys, stakeholders who attended these forums and made submissions to the price review process considered the forums to be useful. However, some of these stakeholders told us that forums should allow more time for questions, as too much time was spent on prepared presentations and they ran out of time for questions.

Our survey of organisations who made submissions asked whether they considered that their submissions or comments were heard and appropriately responded to by the commission. 67% of responses agreed with this statement and 23% neither agreed nor disagreed.

5.1.3 The commission’s guidance was generally seen as clear and helpful, but could be improved in several areas

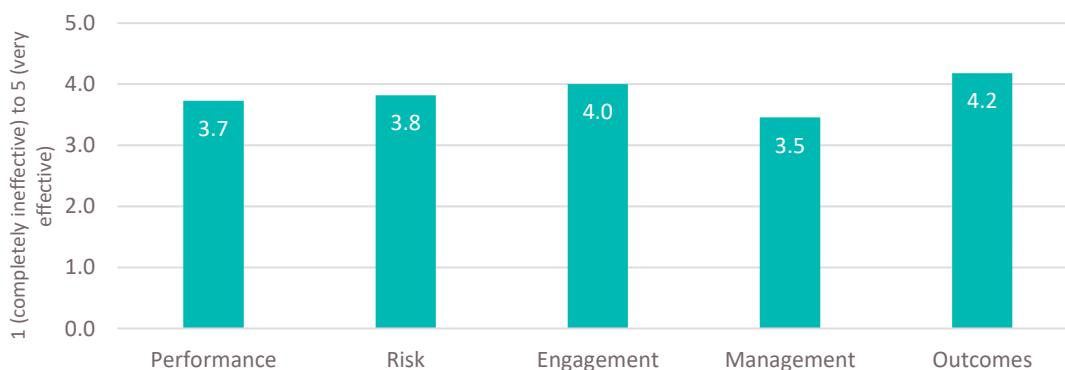
The commission’s guidance paper was generally seen by water businesses as clear and helpful, as shown in the summary of survey responses in Figure 5.1.

Figure 5.1: Survey responses on the usefulness of the commission’s guidance



Our survey asked businesses to rate from 1 to 5 how clear, easy to use and easy to interpret the commission’s guidance was on each of the 5 PREMO elements. The results are summarised in Figure 5.2.

Figure 5.2: Survey responses on the effectiveness of the guidance on each PREMO element



There was recognition in the interview and survey comments that the written guidance cannot address every issue. Businesses said that commission staff were very helpful in providing additional clarification and guidance when it was sought.

There were some specific suggested areas for improvement in the guidance, including the opex step-change assessment criteria, treatment of unregulated services, fast-tracking criteria, NCC guidance and guidance on the expected length of submissions. As discussed below, several water businesses also recommended that the guidance be published earlier.

5.2 WHAT COULD BE IMPROVED IN THE COMMISSION'S PROCESSES, GUIDANCE AND ENGAGEMENT FOR FUTURE PRICE REVIEWS

5.2.1 NCCs is a valuable case study on how engagement processes could be improved for material issues that are common to several businesses

In our interviews and surveys, new customer contributions (NCCs) were raised as one of the most challenging aspects of the 2023 and 2024 price review processes by multiple water businesses and commission staff.

NCCs were a material issue in the decisions for several water businesses in the 2023 and 2024 price reviews. In response to NCC issues that were raised in the 2023 price reviews, the commission stated in its 2023 final decisions that it would undertake a review of the regulatory framework for NCCs. As noted in section 1.3.1 on the scope of our review, substantive matters related to NCCs are excluded from the scope of our review given they will be covered by a separate commission review process. However, the commission asked us to use NCCs as a case study on the commission's guidance and engagement with water businesses to identify potential lessons for the commission's process and approach for future price reviews.

We consider that NCCs are a useful case study on potential improvements to guidance and engagement between the commission and water businesses and the process for managing material common issues.

The relevant businesses and commission staff have very different views of what happened and why, which suggests there was a break-down in effective communication and engagement.

Commission staff felt that the information provided by several water businesses was insufficient to enable the commission to approve the proposals and not compliant with the commission's guidance. In contrast, in our interviews NCCs were given as an example of an area where businesses considered that the commission was overly focussed on data issues and not sufficiently focussed on outcomes.

NCCs were also raised by water businesses in their survey comments as the one exception to their view that the commission's draft decisions provided clear reasons.

These experiences in relation to NCCs indicate that there may be value in a more structured process for identifying and addressing material issues and proposed changes in approach early in the price review process. These issues should ideally be raised by water businesses at the time the commission's guidance is developed. There should be a clear onus on businesses to identify any proposed material changes in approach or other material issues very early in the process and engage with the commission on these issues. Businesses should also identify early in the process if they are unclear on what information is required by the commission to justify their proposed approaches to material issues. There should also be an expectation that where this happens, the commission will provide clear feedback on any concerns it has about what is proposed and what evidence it requires for such a proposal to be capable of acceptance.

There would also appear to be benefit in a more explicit process for separating out material common issues so they can be engaged on and assessed in a clear and consistent way across businesses early in the process rather than just as part of each business' draft and final decisions.

5.2.2 Changes to the timing of the price review process could deliver benefits

Findings in this report suggest that it may be useful for the commission to consider several possible changes to the timing of the price review process to address feedback we received. However, some of these changes would extend the overall price review process and may cause challenges with year-end reporting requirements and the availability of input data, so the commission would need to consider the advantages and disadvantages of any such timing changes.

Several water businesses said that their main issue with the process aspects of the 2023 and 2024 price reviews was the timing of the final decisions. They recommended that the publication of final decisions should be brought forward to give businesses more time to finalise and communicate price changes.

The 2023 final decisions were published on 23 June. The 2024 final decisions were published on 18 June. This timing left water businesses only 5 to 8 business days to complete all of the actions they need to undertake to determine and notify prices for the new pricing year commencing on 1 July. Several water businesses said this timing was extremely challenging.

Multiple water businesses recommended earlier publication of the final decisions. Several businesses suggested they should be published 1-2 months before the start of the new financial year, for example as occurs in the electricity sector. Businesses recognised that bringing the final decisions materially forward would require the commission to use the December quarter CPI results instead of the March quarter, but did not consider this to be problematic.

Several businesses also recommended that the commission should publish its guidance paper earlier, as it is currently published after they have commenced preparation of their price submissions. We note that bringing the entire price review process forward, including the guidance paper, would also be needed to accommodate our other comments on the timing of the draft and final decisions.

We also recommend that the commission consider bringing forward the timing of price submissions to allow more scope for fast-tracking without an overly compromised commission review. As discussed in section 3.4.3, the current gap between price submissions and fast-tracked draft decisions is very short and limits the ability to use fast-tracking effectively.

An earlier price submission date could also allow the commission to introduce a more structured process for dealing with price submissions that contain errors or do not meet the commission's guidance. Commission staff indicated that errors in some submissions made their assessment process challenging and suggested there may be value in a process where the commission undertakes an initial review of submissions and requires businesses to resubmit the price submission if it is not compliant with the commission's guidance or is internally inconsistent. We note that a similar process is adopted by some other regulators, for example the Australian Energy Regulator is required to undertake a preliminary examination of electricity network regulatory proposals and can require resubmission if they are non-compliant. This could potentially occur in parallel with the fast-tracking process so that it does not delay publication of non-fast-tracked draft decisions.

The commission should also consider its approach to staging of the draft decisions. The 2023 price review approach involved releasing draft decisions in multiple tranches, with those seen as the 'hardest' left to last. This is undesirable as it reduces the time between draft and final decisions for water businesses and the commission to resolve issues in the most complex decisions.

5.2.3 Some improvements could be made to aspects of the commission's decision documents and communication materials

Stakeholders generally considered the commission's draft and final decisions and other communications materials to be clear and accessible. However, a small number of improvements were suggested.

The commission's decisions and communications materials are currently all structured around individual decisions for each water business, with the only exception being media releases it publishes on its website at key milestones such as publication of the final decisions. There may be value in the commission publishing communication materials on key common issues alongside the draft and final decisions to assist stakeholders understand and engage on these issues.

The focus on single decision documents means there are not any easily accessible summaries of how water businesses collectively and the commission addressed key issues affecting consumers. The commission's media releases discuss price impacts for each water business, but there are no public materials on other important aspects of the decisions. This seems to be a missed opportunity to demonstrate how the price review process is benefitting Victorian consumers. For example, almost all businesses significantly increased their support for vulnerable customers as discussed in section 2.2.5. This is an aspect of the commission's decisions that delivered significant benefits to customers, but stakeholders would not be aware of it unless they read the relevant sections buried deep in each of the 14 final decisions.

The commission should also review its submissions process to ensure it is easy for stakeholders to lodge submissions that relate to multiple water businesses, which was raised as an issue by a stakeholder who made submissions in relation to multiple businesses.

Several businesses told us that the commission does not provide its final decision financial models to businesses, which makes it difficult for them to implement the decisions and track their performance against the commission's expenditure forecasts and reduces transparency. However, commission staff told us that these models are provided on request.

A small number of businesses also provided feedback that the commission should consider some of the language it uses in its decision documents and how it could be perceived, for example where it downgrades the rating of a business' management to 'basic' or makes other criticisms of the business' price submission. Their concern was that these comments can be taken out of context by media or other stakeholders and have an unintended negative impact on the business' staff.

5.2.4 The commission may need to consider broader process changes in future to address the challenges of making decisions for 16 water businesses at the same time

The 2023 price review decisions had a 5 year regulatory period, while the 2024 price review decisions had a 4 year regulatory period. This means all of these water businesses will have their next price review decisions in 2028.

The 2023 price review process was a major undertaking for the commission, the 14 water businesses and other stakeholders who participated in the process. The 2028 price review will cover 16 water businesses, which will be even more challenging for the commission to resource. The commission has undertaken price reviews for this many or more businesses in the past, e.g. the 2018 price review covered 17 businesses, but the commission will need to consider how to undertake the 2028 review effectively and efficiently.

Several of the suggestions contained in this report could assist the commission's resourcing of the next price review, for example increased use of fast-tracking, undertaking a more targeted building blocks review, publishing its guidance earlier and setting an earlier price submission date to allow more time between price submissions and fast-tracked draft decisions.

In the longer term, the commission may wish to consider whether doing price reviews for 16 water businesses at the same time is the best approach. Some stakeholders suggested in our interviews splitting the price reviews into 2 or more groups that were on different regulatory cycles. For example, there could be value in splitting the price reviews for metro and regional businesses to manage workload while still allowing benchmarking between similar businesses. This could also address the comments made by some regional businesses in their interviews that they currently feel they are unfairly compared with the large metro businesses. Any such changes could not take effect in 2028 and would not apply until the early 2030s as they would require some businesses to have a regulatory period that is longer or shorter than 5 years for the next regulatory period starting in 2028.

Appendix A Summary of customer outcomes

Table A.1: Summary of water businesses' customer outcomes

Water business	Customer outcomes: 2023 price review final decisions
Barwon Water	<ul style="list-style-type: none"> • Safe, secure, sustainable water • Innovative, reliable services • Healthier environment • Trust, affordability and value
Central Highlands Water	<ul style="list-style-type: none"> • Customer care • Equity • Sustainability
Coliban Water	<ul style="list-style-type: none"> • We will supply high quality water you can trust • We will provide services to meet the needs of our customers now and into the future • We will reduce our environmental footprint and achieve a socially responsible, sustainable business for future generations • Our investment will support the economic prosperity of our region • We will support customers in need
East Gippsland Water	<ul style="list-style-type: none"> • Reliable services, done well • Fair prices for all • Improved environmental outcomes • Prepare for population growth and a changing climate • Contributing to community
Gippsland Water	<ul style="list-style-type: none"> • Be affordable and fair • Do its job well • Be easy to deal with • Be involved in the community • Be environmentally responsible • Plan for the future
Goulburn Valley Water	<ul style="list-style-type: none"> • Provide reliable water and wastewater services customers can trust • Lead action and partner with its communities to grow the region • Care for the environment and adapt to a future impacted by climate variability • Deliver respectful and responsive customer service, balancing affordability, value for money and fairness
GWM Water	<ul style="list-style-type: none"> • Safe drinking water • Clean non-drinking water – urban • Clean non-drinking water – rural • Reliable and affordable services • Healthy and liveable region
Lower Murray Water	<p>For urban services:</p> <ul style="list-style-type: none"> • Services provide customers value for money • Provide customers reliable and safe drinking water • Provide customers with reliable sewerage services • Provide customer service avenues that are responsive to resolve requests or enquiries within agreed key performance indicators

Water business	Customer outcomes: 2023 price review final decisions
	<ul style="list-style-type: none"> • Service its communities in a socially responsible and environmentally sustainable manner <p>For rural services:</p> <ul style="list-style-type: none"> • Services provide customers value for money • Provide customers with water when they need it • Provide customer service avenues that are responsive to resolve requests and enquiries • Service our communities in a socially responsible and environmentally sustainable manner
South East Water	<ul style="list-style-type: none"> • Get the basics right, always • Warn me, inform me • Fair and affordable for all • Make my experience better • Support my community, protect our environment
South Gippsland Water	<ul style="list-style-type: none"> • Reliability: plan for the future, be reliable and minimise unplanned interruptions to services • Water: provide safe, clean drinking water • Wastewater: provide a safe wastewater service that contributes to the liveability of our communities • Environment: be environmentally sustainable and adapt to a future impacted by climate variability • Integrity: act with honesty, respect and strive to balance affordability, value-for money and fairness
Southern Rural Water	<ul style="list-style-type: none"> • Reliable water supply • Sustainable water • Great service • Community value • Fair and reasonable prices
Wannon Water	<ul style="list-style-type: none"> • Ongoing reliability of water and sewerage services • Ongoing protection of the environment through action and education, prioritising Country and our communities • Fair and reasonable bills for all • Improved water quality in identified communities • Improved customer experience of our products and services • Active partnerships for healthy and resilient communities
Westernport Water	<ul style="list-style-type: none"> • Provide high-quality drinking water • Reduce its environmental impact and adapt to climate change • Resolve sewer blockages quickly • Keep water interruptions to a minimum • Be there when needed • Keep essential services affordable
Yarra Valley Water	<ul style="list-style-type: none"> • Safe and pleasant drinking water • Reliable water and sewerage services • Timely response and repair • Service that meets everyone’s needs • Saving water for the future • Looking after our natural environment

Appendix B Case study of customer outcomes and targets

Table B.1: Case study of customer outcomes and associated performance measures – Coliban Water’s price submission

Customer outcome	Outputs	Performance measures	2027-28 targets ²¹
We will supply high quality water you can trust	Safe, healthy drinking water	Samples compliant with Schedule 2 of the Victorian Water Quality Regulations	100%
	Fit for purpose water pressure	Systems with more than 20 metres pressure 90% of the time	18 systems
	Good tasting water	Systems where 95% of water quality samples meet AWG guidelines for salient parameters	19 systems
	High reliability	Average customer minutes off water supply (unplanned)	11 minutes
	Access to fit-for-purpose water	Number of towns on water restrictions (not including PWSR)	0
We will provide services to meet the needs of our customers now and into the future	Proactive customer notifications of leaks and outages	Provide customers with plumbing leak notifications if >60 l/hr (where digital metering installed)	100% of leaks
		Percentage of customers impacted by planned water outage notified	100%
	Customers interact with us efficiently and effectively	Percentage of inbound customer contacts that experience first-call resolution increases	75%
	Utilisation of email billing	Percentage of customers receiving digital bills	50%
We will reduce our environmental footprint and achieve a socially responsible, sustainable business for future generations	Enhance biodiversity	Deliver measurable biodiversity enhancement on land we manage each year	40 hectares
	Prevent sewer spills	Number of kilometres of sewer mains checked and cleaned	350 km
	Achieve electricity-related carbon reductions	Reduce carbon emissions through electricity consumption	0 tonnes CO ₂ equivalent
	Proactive catchment protection	Undertake catchment improvement works	100% of annual works plan
	Educate customers about water consumption	Number of people reached with water education	5,000 people
Our investments will support the economic prosperity of the region	Promote local employment	Percentage of open tenders with ‘Local Benefit’ included in the evaluation criteria	100%
	Keeping pace with growth	Completion of capital investment	100% of annual program
We will support customers in need	Support customers experiencing vulnerability	Processing of Utility Relief Grants and customer support program requests within 2 days	95%
		Raise awareness of customer support programs	70%
		Assistance provided, including direct financial support	\$570,000 p.a.

²¹ The price submission contains targets for each year of the regulatory period. 2027-28 is shown here as an example.

Appendix C Customer engagement case studies

Customer engagement case study 1: South Gippsland Water

South Gippsland Water is an example where the commission considered that a relatively small water business undertook effective engagement with customers, including vulnerable customers and Traditional Owners. It was rated as standard for engagement.

The commission's draft decision gave the following reasons for considering that South Gippsland Water had engaged effectively with its customers:

- It engaged early, building on its Urban Water Strategy engagement in 2021 as a starting point for engagement on its price submission.
- It engaged widely, drawing on feedback from 900 customers across 20 of its 21 serviced towns through surveys, social media interactions, community workshops, formal committee meetings, face-to-face interviews, town visits, phone polling, its Community Advisory Committee and deliberative workshops.
- Its engagement was reflective of the diversity of its customer base, engaging across different age groups, locations and customer types (including landlords and renters). It engaged extensively with customers experiencing vulnerability, their advocates, and local support services, initially to better understand customer needs.
- Its engagement was inclusive, ensuring it had a good understanding of the issues facing its customer base, including its Traditional Owners. It spent time with Gunaikurnai Land and Water Aboriginal Business working on their whole-of-country self-determination plan as well as a Memorandum of Understanding which seeks social justice through economic development opportunities.
- It engaged on matters that could influence services and prices, including safe clean water, reliability, wastewater management, environment, customers experiencing vulnerability, small businesses, bill impacts and price paths.
- Actions proposed to be taken by South Gippsland Water provide evidence that its engagement influenced its proposals. For example, it proposed expanding eligibility for its customer support program, introducing a co-payment program for residential and small business customers, improving wastewater reuse at its Foster treatment plant, purchasing additional water from the Melbourne supply system for its Lance Creek system, and introducing a new guaranteed service level that would provide a Community Resilience Grant to any community affected by a Boil Water Advisory.

Customer engagement case study 2: GWM Water

GWM is an example of a business that was rated as leading for engagement.

The commission's draft decision gave the following reasons for this rating:

- It engaged early in its planning, noting its submission was informed by insights from the committees and forums it ran throughout the current regulatory period.
- It engaged using a range of methods such as surveys, workshops, participation at regional events, an online hub, and an independently chaired community panel. The methods it used were diverse and robust, allowing for a depth of deliberation well suited to the price and equity trade-offs GWM Water took to customers.
- It engaged on matters that are material to liveability in its communities such as access to quality drinking water, the reliability of water services and service standards.
- It engaged deeply using a community panel – a method well suited to the complex price and service trade-offs that participants were asked to consider, and which had a demonstrated and high level of influence on the final set of proposals.
- Its engagement was tailored to the diversity of its customers, including those who are experiencing vulnerability and First Nations people. For example, it engaged hard-to-reach customers through the involvement of community workers in workshops. Its engagement was representative of the diversity of its customer base, which is notable given the large geographical footprint of GWM Water and the variety of services it provides.
- Its engagement achieved a high level of collaboration and influence through the appointment of an independent chair of its community panel and the opportunities for the chair to inform the decision making of GWM Water.
- Its response to the community panel's preferences provide evidence that its engagement influenced its proposals.

Appendix D Mechanisms for managing uncertainty

Table D.1: Mechanisms to manage risk and uncertainty adopted by water businesses

Water business	Form of control	Additional mechanisms to manage risk and uncertainty
Barwon Water	Price cap	<ul style="list-style-type: none"> Uncertain capex excluded from prices and will be added at the 2028 price review if incurred Performance Incentive Mechanism: returns revenue to customers if the business fails to deliver on specified performance measures Proposed that there would be no adjustment to prices for changes to the Environmental Contribution Levy
Central Highlands Water	Tariff basket	<ul style="list-style-type: none"> Proposed energy costs pass-through mechanism rejected by the commission, but it noted that some such changes may fall within the standard uncertain and unforeseen events mechanism
Coliban Water	Price cap	<ul style="list-style-type: none"> Sewer Growth Capital Expenditure Guarantee: Provides a rebate to wastewater new customer contributions if wastewater growth capex is materially less than proposed
East Gippsland Water	Price cap for water and waste water tariffs; tariff basket for major trade waste tariffs	<ul style="list-style-type: none"> N/A
Gippsland Water	Price cap	<ul style="list-style-type: none"> Proposed price adjustment mechanism for tax liabilities rejected by commission
Goulburn Valley Water	Price cap	<ul style="list-style-type: none"> Pass through mechanism for willingness to pay projects: Allows the business to pass through the costs of two customer willingness to pay projects if the commission approves the expenditure
GWM Water	Price cap	<ul style="list-style-type: none"> N/A
Lower Murray Water	Tariff basket	<ul style="list-style-type: none"> Real price increases for individual tariffs cannot exceed the weighted average price increase by more than 3% Capex projects with uncertain timing either delayed to next regulatory period or a cost estimate included in this period with recovery of any additional costs to be sought in the next period
South East Water	Tariff basket for core charges; price cap for miscellaneous charges	<ul style="list-style-type: none"> Real price increases for individual tariffs within tariff basket form of control must not exceed 3% per year Capex projects with uncertain timing delayed to next regulatory period

Water business	Form of control	Additional mechanisms to manage risk and uncertainty
South Gippsland Water	Price cap	<ul style="list-style-type: none"> • Capex projects with uncertain timing or scope not included in prices for this period other than project development costs • Proposed pass through mechanism for taxes such as environmental contributions was rejected by the commission, but it noted that uncertain and unforeseen changes in taxes are covered by the standard mechanism • Standard cost of debt adjustment is modified to reflect the fact that the business set its prices below its revenue requirement
Southern Rural Water	Hybrid revenue cap	<ul style="list-style-type: none"> • Price increases for individual tariffs subject to the revenue cap must not exceed the weighted average price increase plus 10% • Proposed a set of additional caps on price increases for specific customer groups, with prices capped to CPI or CPI plus a specified percentage. These caps are not part of the price determination
Wannon Water	Price cap	<ul style="list-style-type: none"> • Standard cost of debt adjustment is modified to reflect the fact that the business set its prices below its revenue requirement
Westernport Water	Price cap	<ul style="list-style-type: none"> • Reduced fixed prices and increased variable prices based on customer engagement, which puts more revenue at risk if demand varies from forecasts
Yarra Valley Water	Revenue cap	<ul style="list-style-type: none"> • Proposed several additional adjustment mechanisms that pass through cost savings to customers. These are included as part of the annual adjustments to the revenue cap and include changes in bulk charges, savings in interest costs as a result of deferring any of the top 10 projects and an adjustment for non-achievement of service outcomes • Price increases for individual tariffs must not exceed a nominal 5% per year for years 2 and 3, and must not exceed the average price increase plus a real 2% for years 4 and 5

Box D.2: Explanation of the different forms of control

- A **price cap** imposes a cap on each of the individual prices charged by a water business. Each price that can be charged in the first year of the regulatory period is set out in the price determination. Each price can only be adjusted by inflation plus the amount specified in the determination. If demand increases compared with forecasts, the business will recover more revenue, and if demand decreases it will recover less. Where the commission accepted a proposed price cap, it stated that it considered that a price cap provides customers with price certainty and means the business is managing demand risk on behalf of its customers, which the commission considers to be more efficient than customers managing the risk. A potential downside of a price cap is that it prevents the business from restructuring its tariffs during the regulatory period, but the commission's price determinations for all businesses that are subject to a price cap allow the business to apply to change from a price cap to a weighted average price cap or tariff basket within the regulatory period.

- A **tariff basket** (also known as a weighted average price cap) imposes a cap on the weighted average price of all services covered by this form of control. Each price that can be charged in the first year of the regulatory period is set out in the determination. The business then has flexibility as to how it adjusts individual prices in subsequent years, provided that the weighted average price movement is no more than the amount specified in the determination. The commission's tariff basket controls for some businesses also limit the maximum amount by which any individual price can increase in a year. Where the commission accepted proposed tariff basket price controls it stated that it considered it was appropriate because the business carries most of the demand risk, which the commission considers to be more efficient than customers managing the risk, and it allows the business to rebalance tariffs during the regulatory period.
- A **revenue cap** imposes a cap on the total amount of revenue the business can recover for each year during the regulatory period. Each price that can be charged in the first year of the period is set out in the price determination. The business then has flexibility as to how it adjusts individual prices in subsequent years, provided that the total amount of revenue forecast to be recovered meets the requirements of the price determination. Yarra Valley Water's revenue cap also limits the maximum annual price increase for any individual price. The commission stated that it accepted the revenue cap proposed by Yarra Valley Water because it was a continuation of its current approach, would provide sufficient revenue to recover the efficient costs of providing services, and was consistent with the requirements of the commission's guidance.
- The **hybrid revenue cap** for Southern Rural Water is a combination of the above approaches for different services. A revenue cap applies to charges for most services, but some services are subject to a weighted average price cap, some are subject to pricing principles and some are charged on a cost recovery basis. The commission stated that it accepted the revenue cap proposed by Southern Rural Water because it largely reflected a continuation of its current approach, would provide sufficient revenue to recover the efficient costs of providing services, and was consistent with the requirements of the commission's guidance.