

East Gippsland Water draft decision

2018 Water Price Review

7 December 2017



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Contents

Summary	iv
1. Our role and approach to water pricing	1
2. Our assessment of East Gippsland Water's price submission	5
Regulatory period	6
Customer engagement	6
Outcomes	7
Guaranteed service levels	7
Revenue requirement	8
Operating expenditure	9
Regulatory asset base	12
– Closing regulatory asset base	13
– Forecast regulatory asset base	14
– Capital expenditure	15
– Customer contributions	16
Cost of debt	17
Return on equity – PREMO rating	17
Regulatory depreciation	18
Tax allowance	18
Demand	18
Form of price control	19
Prices and tariff structures	20
Adjusting prices	22
New customer contributions	22
Financial position	23
3. PREMO rating	25
Our review of East Gippsland Water's PREMO self-rating	25
4. We invite feedback on our draft decision	27
Attend a public meeting	27
Provide written comments or submissions	27
Next steps	28
APPENDIX A – submissions received	29

Summary

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

This draft decision sets out our preliminary views on East Gippsland Water's price submission.¹ Our draft decision is to accept East Gippsland Water's proposed revenue requirement of \$170.8 million over the five year period starting 1 July 2018, for the purpose of approving maximum prices.²

The typical bill impacts of East Gippsland Water's proposal and our draft decision are provided below.

Table 1.1 Typical water and sewerage bills
\$ 2017-18

Customer group	Average consumption (kL p.a.)	2017-18 annual bill	2018-19 annual bill	2022-23 annual bill
Residential (Owner occupier)	146	\$1,167*	\$1,169	\$1,169
Residential (Tenant)	146	\$290*	\$308	\$308
Non-residential (Small)	50	\$1,107	\$1,080	\$1,080
Non-residential (Medium)	580	\$3,254	\$3,188	\$3,188

* Following a \$28 rebate paid to customers from a government efficiency review

Note: Numbers have been rounded

We invite interested parties to comment on our preliminary views in this draft decision before we make a final decision and issue a price determination. Details on how to make a submission on our draft decision are provided in Chapter 4.

¹ Clause 16 of the WIRO requires us to issue a draft decision.

² The revenue requirement is the forecast amount a water corporation needs to deliver on customer outcomes, government policy, and obligations monitored by technical regulators including Environment Protection Authority Victoria and the Department of Health and Human Services. Along with forecast demand, it is an input to calculating the prices to be charged by a water corporation.

Our draft decision should be read together with East Gippsland Water's price submission.³

We have released an early draft decision for East Gippsland Water

East Gippsland Water's submission provided clear and comprehensive information supporting its proposals. East Gippsland Water also provided evidence that its engagement captured the main priorities and concerns of customers and that it has taken this feedback into account. This enabled us to quickly assess its price submission against the legal framework that governs our role.

We also accept East Gippsland Water's proposals.

For these reasons we are releasing this draft decision now, rather than March 2018 as currently planned for most other water corporations. We are releasing a fast tracked draft decision for four of the sixteen water corporations that have provided a submission to us.⁴

Our draft decision provides an opportunity for us to test our preliminary views with stakeholders before we make a final decision and determination on East Gippsland Water's prices in May 2018.

Our draft decision should allow East Gippsland Water to deliver the outcomes outlined in its price submission

Our draft decision should allow East Gippsland Water to deliver on its customer service commitments, government policy, and obligations monitored by Environment Protection Authority Victoria and Department of Health and Human Services.

Some of the ways East Gippsland Water plans to improve outcomes for customers are by:

- investing in water and sewerage assets to address future demand
- improving awareness about its assistance for customers experiencing payment difficulty
- providing a bill rebate for outdoor community recreation groups
- offering grants to schools and community groups to support native revegetation projects.

Tariff structures are the same

Our draft decision approves East Gippsland Water's proposed tariff structures, which are the same as its current structures. For water services, East Gippsland Water proposed a fixed service charge and a variable component that depends on water used. For sewerage services, East Gippsland Water proposed a fixed charge only.

³ East Gippsland Water's price submission is available on our website at www.esc.vic.gov.au.

⁴ At the time of preparing this draft decision, Western Water has not yet lodged its price submission with the commission. We will provide separate guidance specific to Western Water, requiring its price submission to be lodged early in 2018.

We propose to approve East Gippsland Water's proposed form of price control - a price cap. This means its maximum prices are fixed subject to updates for inflation, and any other price adjustments we approve in our price determination.

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

Our draft decision is to accept East Gippsland Water's PREMO self-rating of its price submission of 'Standard'.

1. Our role and approach to water pricing

We are Victoria's independent economic regulator

Our role in the water industry is based on the Water Industry Regulatory Order 2014 (WIRO) which is made under the *Water Industry Act 1994* (Vic) (WI Act) and sits within the broader context of the *Essential Services Commission Act 2001* (Vic) (ESC Act). Our role under the WIRO includes regulating the prices and monitoring service standards of the 19 water corporations operating in Victoria.

We are reviewing the prices 17 water corporations propose to charge customers from 1 July 2018

Our review of the prices proposed by the water corporations covers the prescribed services listed in the WIRO.⁵ The prescribed services include retail water and sewerage services, and bulk water and sewerage services delivered by the water corporations.⁶

In September 2017, East Gippsland Water provided a submission to us proposing prices for a five year period starting 1 July 2018. Our task is to assess the price submission against the legal framework that governs our role, and make a price determination that takes effect from 1 July 2018. The price determination will specify the maximum prices East Gippsland Water may charge for prescribed services, or the manner in which prices are to be calculated, determined or otherwise regulated. We also issue a final decision that explains the reasons for our price determination.

We assess prices against the WIRO and other legal requirements

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

- the objectives and matters specified in clause 8 of the WIRO, which include economic efficiency and viability matters, industry specific matters, customer matters, health, safety, environmental

⁵ The review excludes Melbourne Water and Goulburn-Murray Water. In 2016 we approved prices for Melbourne Water to 30 June 2021 and for Goulburn Murray Water to 30 June 2020.

⁶ The prescribed services are listed at clause 7(b) of the WIRO.

and social matters and other matters which are specified in sections 8 and 8A of the ESC Act and section 4C of the WI Act

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

A separate document lists the specific objectives and the various matters the commission must have regard to when making a price determination and provides a guide to where the commission has done so in this draft decision.⁸

In 2016, we issued guidance to East Gippsland Water to inform its price submission. The guidance set out how we will assess East Gippsland Water's submission against the matters we must consider under clause 11 of the WIRO.

If we consider the price submission has adequate regard for the matters in clause 11 of the WIRO and complies with our guidance, we must approve East Gippsland Water's proposed prices.⁹

If we consider the submission does not have adequate regard for the matters specified in clause 11 of the WIRO or comply with our guidance, we may specify maximum prices, or the manner in which prices are to be calculated, determined or otherwise regulated.¹⁰

The 2018 price review is the first we've undertaken under our new water pricing approach

In 2014, the Victorian Government reviewed and revised the WIRO. The changes allowed us more flexibility to decide on the pricing approach we use in Victoria's water sector. In April 2015 we released a consultation paper to start reviewing our pricing approach.¹¹

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

⁷ Essential Services Commission 2016, *2018 Water Price Review – Guidance paper*, November.

⁸ Essential Services Commission 2017, *East Gippsland Water draft decision: 2018 Water price review – commission's consideration of legal requirements*, 7 December. This is located on our website at www.esc.vic.gov.au

⁹ This is a requirement of the WIRO, clause 14(b).

¹⁰ This is provided for under the WIRO, clause 14(b)(i).

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

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

We finalised our new approach to water pricing in October 2016.¹³

Our new pricing approach builds on many aspects of the previous approach. We continue to use the building blocks to estimate the revenue requirement for a water corporation.¹⁴ Our guidance explains the building blocks and how we use it to estimate the revenue requirement.¹⁵

Among the key changes, the new approach introduces new incentives to help ensure water corporations deliver the outcomes most valued by customers. Our new PREMO framework rewards stronger customer value propositions in price submissions, and a fast-track provision is now available for price submissions we can readily assess in a short timeframe. These incentives are described next.

Our consultation on the pricing approach informed the guidance we issued water corporations in November 2017 to inform price submissions for the 2018 water price review.

PREMO

PREMO stands for **P**erformance, **R**isk, **E**ngagement, **M**anagement, and **O**utcomes. The purpose of PREMO is to provide an incentive for water corporations to deliver outcomes most valued by customers. It includes incentives for a water corporation to engage with customers to understand their priorities and concerns, and take these into account.

PREMO links the return on equity allowed in the revenue requirement to the value delivered by a water corporation to its customers. Under PREMO, a higher level of ambition in terms of delivering customer value results in a higher return on equity.

For the 2018 water price review, a water corporation's ambition in terms of delivering customer value is being assessed against four elements of PREMO – Risk, Engagement, Management and Outcomes.¹⁶

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

¹³ For more detail on the new water pricing approach see: Essential Services Commission 2016, *Water Pricing Framework and Approach: Implementing PREMO from 2018*, October

¹⁴ The revenue requirement is the forecast amount that a water corporation needs to deliver on customer outcomes, government policy, and obligations monitored by technical regulators including Environment Protection Authority Victoria and the Department of Health and Human Services.

¹⁵ Essential Services Commission 2016, *Guidance paper*, op. cit., pp. 8-9.

A water corporation must self-assess and propose a rating for its price submission as 'Leading', 'Advanced', 'Standard' or 'Basic'. Its proposed return on equity will then reflect its PREMO rating. A 'Leading' submission has the highest return on equity, and a 'Basic' submission the lowest. We assess the justification for the PREMO rating, and also rate the price submission. This process determines the return on equity reflected in the revenue requirement.¹⁷

Early draft decisions

We may fast track a water corporation's price submission to an early draft and final decision if it provides comprehensive and clear information in support of its proposals. Final decisions for fast tracked price submissions will be made in May rather than June 2018.

We may release a fast tracked draft decision in response to a price submission if we consider that:

- the price submission is sufficiently clear and comprehensive to facilitate our timely assessment against our legal framework
- the price submission demonstrates that customer priorities and concerns have been identified and taken into account
- any changes required to allow us to accept prices are relatively minor
- the overall PREMO rating proposed in the price submission is appropriate.

¹⁶ The performance element of PREMO will be assessed at the review following the 2018 water price review.

¹⁷ For more information, see Essential Services Commission 2016, *Guidance paper*, op. cit., pp. 45–49.

2. Our assessment of East Gippsland Water's price submission

We have made our draft decision on East Gippsland Water's price submission after considering: East Gippsland Water's price submission, its responses to our queries, and written submissions from interested parties (a list of submissions is provided in Appendix A).

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

East Gippsland Water's price submission presented clear and comprehensive information to support its proposals. East Gippsland Water also provided evidence that its engagement sought to capture the main priorities and concerns of customers, and that it has taken this feedback into account (see customer engagement on page 6).

For these reasons, we were able to form an early view to accept East Gippsland Water's proposals for our draft decision.

If consultation on our draft decision does not result in significant further review being required, we intend to make a price determination for East Gippsland Water in May 2018. If consultation, or our ongoing assessment, causes us to form a view that significant further review is required, we may defer our price determination for East Gippsland Water until June 2018.

Our guidance included a number of matters water corporations must address in their price submissions. East Gippsland Water's price submission addressed each of these matters. Our preliminary assessment of these matters is provided throughout this chapter.

East Gippsland Water must submit a response to our draft decision and provide an updated financial model by 9 March 2018 (via email to water@esc.vic.gov.au). The response will be published on our website.

All financial values referred to in this chapter are in \$2017-18.

Regulatory period

East Gippsland Water proposed a five year regulatory period. Our draft decision approves East Gippsland Water's proposal as it is consistent with our guidance. Our guidance proposed to approve a five year regulatory period, subject to any alternative and justified proposal.¹⁸

Customer engagement

Our guidance required East Gippsland Water to engage with customers to inform its price submission. The engagement by East Gippsland Water:

- took place between November 2015 and September 2017
- used a range of methods including face-to-face conversations, online and paper surveys, and pop-up water cafes held at school fairs and community markets
- sought views from customer groups including Indigenous organisations, year nine students, sporting groups and a disability organisation
- was informed by a customer committee that reviewed engagement material, conducted community surveys, and made recommendations on pricing and guaranteed service levels
- covered topics such as prices and service levels, the nature of its customer financial assistance program, service levels and East Gippsland Water's contribution to liveability.

More detail on East Gippsland Water's engagement is available in its price submission.¹⁹

Evidence that East Gippsland Water's engagement influenced its price submission includes:

- East Gippsland Water proposing to maintain service levels, in response to feedback that customers did not want to pay more for more or better services
- introducing email billing in response to customer feedback
- responding to feedback there is low awareness of existing programs for customers experiencing financial hardship by increasing its education efforts.

The influence of East Gippsland Water's engagement on its proposals supports the objectives in our pricing framework relating to efficiency and the interests of consumers.²⁰

¹⁸ For detail on the reasons for using five years as the default regulatory period, see: Essential Services Commission 2016, *Guidance paper*, op. cit., p. 21.

¹⁹ East Gippsland Water's price submission is available on our website at www.esc.vic.gov.au. See pages 12–15.

²⁰ See for example, WIRO clauses 8(b)(i), 8(b)(ii), 8(b)(iii), 11(d)(iii), and ESC Act Sections 8(1), 8A(1)(a).

Outcomes

The outcomes East Gippsland Water proposes to deliver over the five year period starting 1 July 2018 are:

- current levels of water and sewerage services maintained
- safe, high quality drinking water supplies delivered
- no increase to average customer bills (beyond inflation)
- commitment to environmental sustainability
- enhanced liveability and resilience in its region.

East Gippsland Water proposed measures and activities it will use to report on progress against achieving each outcome. These are set out at pages 18 to 21 of its price submission. To report on its performance East Gippsland Water proposes to publish an annual ‘scorecard’.

The WIRO provides us with the power to specify standards and conditions of service in a code we make under the WI Act. In early 2018-19, we will update our urban customer service code to reflect the outcomes proposed by East Gippsland Water and the measures it will use to report on performance.²¹ We will engage with East Gippsland Water to finalise the measures, and how it will publicly report on outcomes.

Guaranteed service levels

Guaranteed service levels (GSLs) define a water corporation’s commitment to deliver a specified level of service. For each GSL, a water corporation commits to a payment or a rebate on bills to those who have received a level of service below the guaranteed level.

East Gippsland Water’s proposed GSLs are set out on page 23 of its price submission. It has made no changes to the hardship GSL, and proposed to modify some existing GSLs. New GSLs relate to notification about planned interruptions and tree planting.

Some of East Gippsland Water’s proposed GSLs were developed and independently set by its customer committee. Its justification for accepting the changes to GSLs is included on page 23 of its price submission.

In early 2018-19, we will update our urban customer service code to reflect the proposed GSLs, subject to our consideration of any feedback following the release of our draft decision.²²

²¹ Essential Services Commission 2017, *Customer Service Code Urban Water Businesses*, April.

²² Essential Services Commission 2017, *ibid*.

Revenue requirement

The revenue requirement is the forecast amount a water corporation needs to deliver on customer outcomes, government policy, and obligations monitored by technical regulators including Environment Protection Authority Victoria and the Department of Health and Human Services. Along with forecast demand, it is an input to calculating prices.²³

East Gippsland Water proposed a revenue requirement of \$170.8 million over a five year period starting 1 July 2018. Our draft decision proposes to accept the revenue requirement proposed by East Gippsland Water as set out at Table 2.1. This reflects our assessment of each element that comprises the revenue requirement.

Our final decision will be based on the latest available information. Accordingly, as well as responding to our draft decision, East Gippsland must update its revenue requirement and prices following our April 2018 updates to estimates for the cost of debt and inflation.

There may be changes in laws or government policy before we make a price determination. If any such changes occur between the draft decision and the price determination, and impact on the revenue requirement, East Gippsland Water should update its price submission and also provide us with an updated financial model. Any updates will be published on our website.

²³ We met with officers of the Department of Environment, Land, Water and Planning, Department of Health and Human Services, and Environment Protection Authority Victoria, to discuss their expectations of East Gippsland Water in the regulatory period from 1 July 2018. We had regard to their views in our draft decision.

Table 2.1 Revenue requirement
\$ million 2017-18

	2018-19	2019-20	2020-21	2021-22	2022-23	Total
Operating expenditure	19.9	19.9	19.3	19.3	19.4	97.9
Return on assets	5.9	6.1	6.3	6.5	6.6	31.4
Regulatory depreciation	7.0	7.6	8.2	8.8	8.8	40.4
Non-prescribed revenue offset	-0.2	-0.2	-0.2	-0.2	-0.2	-0.9
Tax allowance	0.0	0.0	0.4	0.8	0.8	2.0
Revenue requirement	32.7	33.4	34.1	35.2	35.5	170.8

Note: Numbers have been rounded

Operating expenditure

Operating expenditure is an input to the revenue requirement. East Gippsland Water's forecast operating expenditure is provided at Table 2.2, broken down into controllable and non-controllable components. East Gippsland Water's price submission provides detail on its forecast operating expenditure from pages 27 to 31.

For controllable operating expenditure, our assessment process first confirms an efficient baseline, based on the last year of actual costs prior to our price review (that is, 2016-17). We then consider the forecast costs relative to this baseline, including the proposed efficiency improvement rate and forecast growth, and any proposed cost changes relative to the baseline.

For non-controllable expenditure (including bulk water and sewerage services, government charges and licence fees) we confirm the proposed forecasts, and refer with the relevant regulatory body where appropriate.

Table 2.2 Operating expenditure
\$ million 2017-18

	2018-19	2019-20	2020-21	2021-22	2022-23
Controllable costs ^a	18.4	18.3	17.9	17.9	18.0
Non-controllable costs ^b	1.6	1.5	1.5	1.5	1.4
- Bulk services ^c	0.0	0.0	0.0	0.0	0.0
- Environmental contribution ^d	1.5	1.5	1.4	1.4	1.4
- Licence fees ^e	0.1	0.1	0.1	0.1	0.1
- Other non-controllable costs	0.0	0.0	0.0	0.0	0.0
Operating expenditure	19.9	19.9	19.3	19.3	19.4

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

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

^c Bulk services covers the supply of bulk water and sewerage services.

^d The Environmental Contribution collects funds from water corporations under the *Water Industry Act 1994*.

^e License fees are paid to cover costs incurred by Department of Health and Human Services, Environment Protection Authority Victoria, and the Essential Services Commission in their regulatory activities related to the water corporation.

Note: Numbers have been rounded

For the reasons set out below, we have accepted the forecast controllable operating expenditure proposed by East Gippsland Water in making our draft decision on its revenue requirement.

Baseline controllable operating expenditure:

- East Gippsland Water has proposed downward adjustments of \$1.16 million to its actual 2016-17 baseline year controllable operating expenditure, producing a reasonable starting point for forecast annual operating expenditure. The resultant figure of \$17.61 million is 2 per cent below the 2016-17 benchmark allowance of \$18.06 million established in the previous price determination. We consider this reflects an efficient baseline cost to forecast annual operating expenditure. We also note in a benchmarking study undertaken for the commission, East

Gippsland Water ranks seventh among Victorian urban water corporations on technical efficiency.²⁴

Efficiency improvement:

- East Gippsland Water's proposed efficiency improvement rate on controllable operating costs is 1.15 per cent per annum. This is slightly above the benchmark of 1 per cent set by the commission during the current 2013–18 regulatory period. It largely offsets East Gippsland Water's forecast connection growth rate of 1.3 per cent per annum, giving a slightly increasing annual baseline operating cost.

Proposed cost changes:

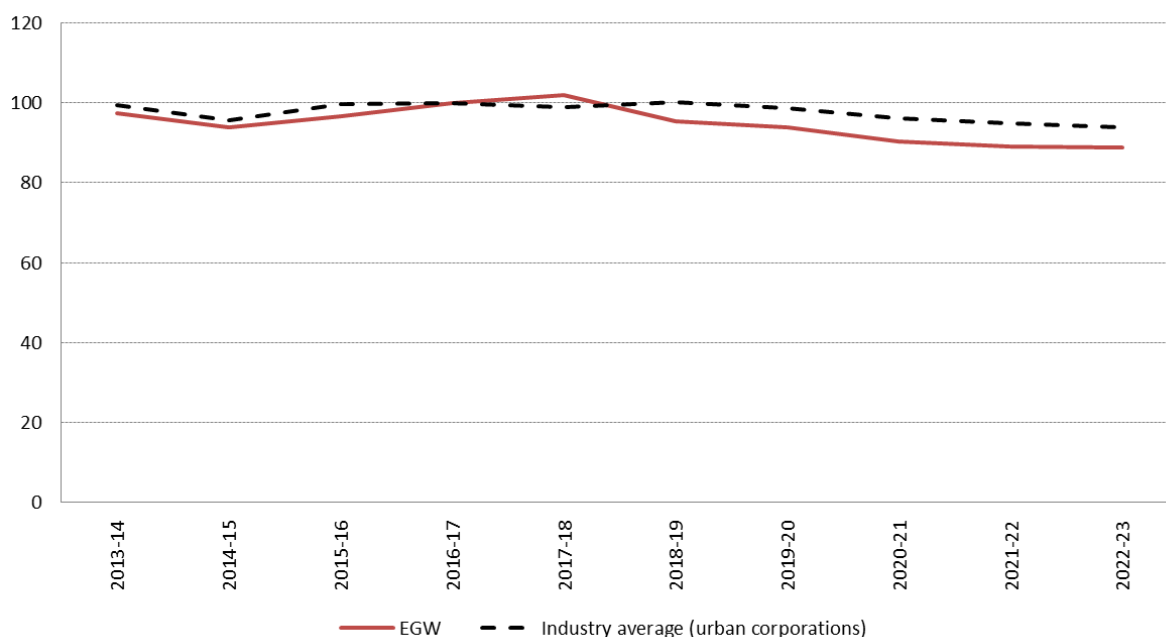
- East Gippsland Water has proposed a number of additional operating expenditure changes, with a net increase of 2.2 per cent above the baseline. Most of these items are minor costs not material to prices (under \$100,000 over the period). The more significant items have been reasonably justified, including:
 - Increasing electricity prices, forecast to increase 24 per cent in the first year and 3 per cent per year after that. However, these increases are largely offset by forecast energy efficiency upgrades, so will not directly impact customer prices.
 - Adjustments (both up and down) for variations in annual lagoon desludging costs relative to the \$0.2 million included in the base.
 - \$0.45 million in grants to schools and community groups to undertake tree planting, which East Gippsland Water justified based on a research study that 50 per cent of customers were willing to pay at least \$3.60 more on their bill to increase vegetation planting.
 - Small increases in wages above inflation, totalling \$0.23 million across the period.

We consider East Gippsland Water's approach to forecasting its operating expenditure is consistent with the requirements of our guidance, and we are satisfied that its proposed forecast represents efficient controllable operating expenditure. There is evidence that the corporation has tested its controllable expenditure requirements, resulting in a forecast decline (in real terms) in controllable operating expenditure per customer connection. The rate of the forecast decline in controllable operating expenditure per customer connection is greater than the average of all urban water corporations in our review (Figure 2.1).

²⁴ Economic Insights 2014, *Victorian Urban Water Utility Benchmarking*, 31 July. Available at www.esc.vic.gov.au

Figure 2.1 Controllable operating expenditure per water connection

Index: 2016-17=100



Non-controllable operating expenditure increases by \$0.3 million in 2018-19, due to an increase in the environmental contribution as advised by the Department of Environment, Land, Water and Planning. The environmental contribution levy is flat in nominal terms, so it falls slightly each year in real terms to reflect inflation.

We will accept East Gippsland Water's proposed non-controllable operating expenditure for our draft decision. Prior to making our final decision, we will update the forecast values for licence fees with the relevant regulatory bodies, and also adjust for the latest inflation figures.

Our draft decision is to accept East Gippsland Water's proposed operating expenditure, as set out in Table 2.2.

Regulatory asset base

The regulatory asset base is used to estimate the return on assets and regulatory depreciation in the revenue requirement. Our guidance required East Gippsland Water to propose its:

- closing regulatory asset base at 30 June 2017
- forecast regulatory asset base for each year of the regulatory period from 1 July 2018.

Closing regulatory asset base

We update the regulatory asset base to reflect actual capital expenditure, government and customer contributions, and asset disposals for the period to 30 June 2017. This helps to ensure prices reflect the actual expenditure of a water corporation.

Table 2.3 sets out East Gippsland Water's proposed regulatory asset base at 30 June 2017.

We compared East Gippsland Water's actual net capital expenditure for the period from 2012-13 to 2016-17 with the forecast used to approve maximum prices for the period from 1 July 2013.²⁵

East Gippsland Water's net capital expenditure was \$0.5 million lower than forecast.²⁶ It also calculated its closing regulatory asset base in accordance with the requirements of our guidance. For these reasons, our draft decision accepts East Gippsland Water's proposed closing regulatory asset base for 30 June 2017 of \$145.5 million.

Table 2.3 Closing regulatory asset base
\$ million 2017-18

	2012-13	2013-14	2014-15	2015-16	2016-17
Opening RAB at 1 July	136.6	140.2	144.6	143.1	144.1
Plus gross capital expenditure	10.7	11.6	6.4	9.0	9.6
Less government contributions	0.0	0.0	0.0	0.0	0.0
Less customer contributions	0.6	0.4	0.6	0.4	0.1
Less proceeds from disposals	0.3	0.3	0.2	0.1	0.1
Less regulatory depreciation	6.2	6.5	7.0	7.5	7.9
Closing RAB at 30 June	140.2	144.6	143.1	144.1	145.5

Note: Numbers have been rounded

²⁵ Net capital expenditure is calculated by deducting government and customer contributions from gross capital expenditure.

²⁶ We take a risk-based approach to including past capital expenditure in the regulatory asset base. We undertake a prudence and efficiency review where a water corporation has exceeded its net capital expenditure forecasts by more than 10 per cent. We believe this approach is reasonable given capital expenditure can be relatively 'lumpy' in nature.

Forecast regulatory asset base

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

Table 2.4 sets out East Gippsland Water's proposed opening regulatory asset base from 1 July 2018.²⁷ Our draft decision is to accept East Gippsland Water's forecast regulatory asset base for the period from 1 July 2018, as we are satisfied it meets the requirements of our guidance.

Table 2.4 Forecast regulatory asset base
\$ million 2017-18

	2017-18	2018-19	2019-20	2020-21	2021-22	2022-23
Opening RAB at 1 July	145.5	146.7	149.0	156.9	160.1	162.5
Plus gross capital expenditure	9.6	9.4	15.5	11.5	11.3	14.1
Less government contributions	0.0	0.0	0.0	0.0	0.0	0.0
Less customer contributions	0.0	0.0	0.0	0.0	0.0	0.0
Less proceeds from disposals	0.1	0.1	0.1	0.1	0.1	0.1
Less regulatory depreciation	8.3	7.0	7.6	8.2	8.8	8.8
Closing RAB at 30 June	146.7	149.0	156.9	160.1	162.5	167.7

Note: Numbers have been rounded

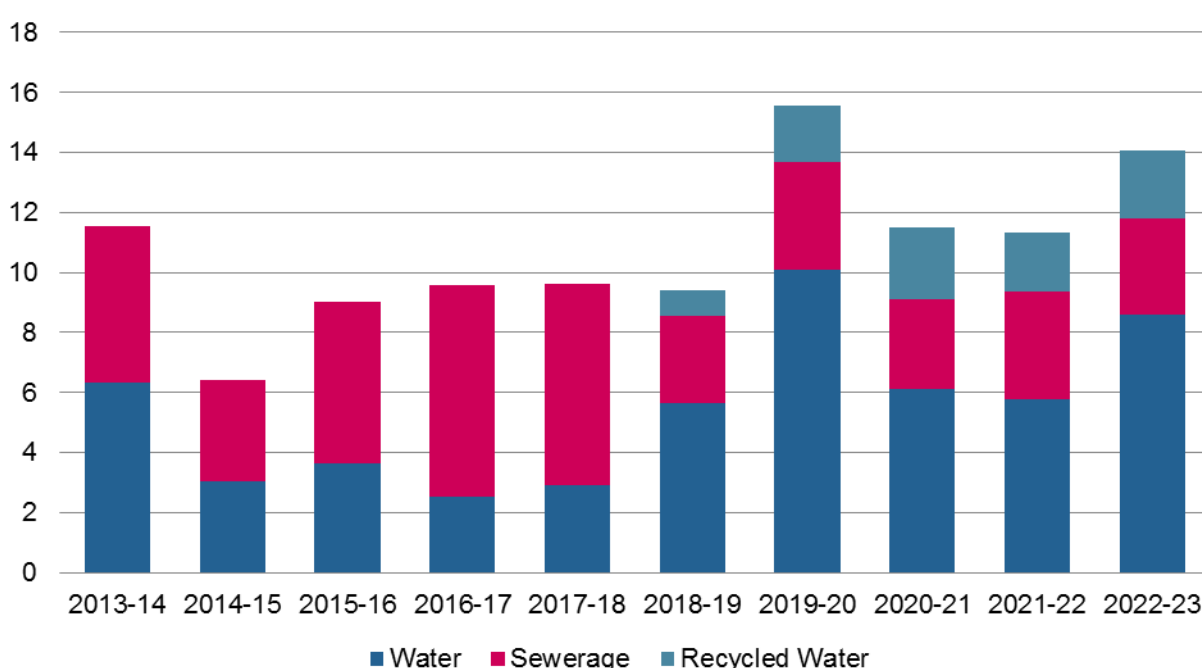
²⁷ Our guidance required water corporations to provide an estimate of the components of its regulatory asset base for 2017-18. This is so we can assess the opening asset base for 1 July 2018. Our guidance noted that where the 2017-18 forecasts for net capital expenditure (gross capital expenditure less government and customer contributions) is lower than the forecast benchmark for that year in its 2013 price determination, the lower amount must be used. The estimates for 2017-18 will be confirmed at the price review following the 2018 water price review.

Capital expenditure

Capital expenditure is an input to estimating the regulatory asset base. East Gippsland Water's forecast capital expenditure and supporting information is provided at pages 32 to 41 of its price submission.

A summary of capital expenditure over the ten years to June 2023 is provided in Figure 2.2. Values in the period to 2016-17 reflect actual expenditure, with following years reflecting East Gippsland Water's forecasts.

Figure 2.2 Gross capital expenditure by service category
\$ million 2017-18



Note: actuals 2013-14 to 2016-17 and forecasts for 2017-18 to 2022-23

For the reasons set out below, we have accepted the forecast operating expenditure proposed by East Gippsland Water for our draft decision on its revenue requirement:

- East Gippsland Water's price submission provided evidence that its forecasts for capital expenditure are efficient. Total capital expenditure forecast for the 2018–23 period of \$61.8 million is \$8.4 million higher than the expected total of \$53.4 million for the current 2013–18 period, driven largely by the inclusion of one major project to address water storage at Wy Yung.
- We requested selected documents from East Gippsland Water as a representative sample to demonstrate its asset management processes and justification for its capital expenditure program. Based on the sample of documents reviewed, these demonstrate that East Gippsland

Our assessment

Water has a robust approach for developing project scope, the timing of works and cost estimates.

- We requested and reviewed business cases for the Wy Yung water storage augmentation, the Paynesville wastewater treatment plant winter storage upgrade, and the Woodglen raw water storage dam safety upgrade. We also reviewed East Gippsland Water’s asset renewals strategy, because renewals is the main cost driver for the period, with a significant increase of about 50 per cent compared with the 2013–18 period.
- We consider the planned capital expenditure program is achievable, given East Gippsland Water’s past track record delivering its capital expenditure program. We note that over the 2013–18 period, East Gippsland Water is expected to deliver two of its four major projects on schedule, with the other two having been deferred into the coming 2018–23 period following a strategic supply review.²⁸
- Where there is uncertainty in timing, cost, scope or benefits, East Gippsland Water has included the costs early in the 2023–28 period. This is to avoid charging customers for these works during the coming 2018–23 period, but clearly identifies anticipated costs on the planning horizon. This results in about \$10 million of uncertain project costs being excluded from pricing, in accordance with our guidance. For our draft decision, we accept East Gippsland Water’s proposal for addressing uncertainty, noting the following:
 - East Gippsland Water will need to demonstrate the efficiency of these costs if they are indeed incurred during the 2018–23 period if seeking to include them in the regulatory asset base.
 - Variations in capital expenditure from forecast during the 2018–23 period will form a key part of our assessment of the Performance element of PREMO at the next price review.
- We consider East Gippsland Water’s approach to forecasting its capital expenditure is consistent with the requirements of our guidance.

Our draft decision is to accept East Gippsland Water’s forecast gross capital benchmark as set out in Table 2.4.

Customer contributions

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

²⁸ Essential Service Commission 2016, *Performance of Victorian urban water and sewerage businesses 2015-16*, December, p. 112.

East Gippsland Water has not proposed any forecast customer contributions.²⁹ We consider East Gippsland Water's zero forecast contributions are reasonable given its approved transition to a zero charge for standard New Customer Contributions during the current regulatory period. Our draft decision accepts East Gippsland Water's forecasts for zero customer contributions.

Cost of debt

Our guidance required East Gippsland Water to use estimates of the cost of debt provided by the commission to estimate its revenue requirement.³⁰ East Gippsland Water used the cost of debt values we specified to calculate its revenue requirement. For this reason, our draft decision accepts the cost of debt proposed by East Gippsland Water, as set out in Table 2.5.

Table 2.5 Trailing average cost of debt

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

* Estimated cost of debt – we will update the 2017 18 figure before the final decision and price determination

From 2016, we accepted a ten-year trailing average approach to estimating the benchmark cost of debt, changing from an on-the-day approach. The trailing average approach better aligns the actual cost of debt for an efficient business to the regulated benchmark, compared with an on-the-day approach.³¹ We consider the ten year trailing average approach helps to minimise risk to water corporations and provides incentives for long-term investment.

Return on equity – PREMO rating

East Gippsland Water rated its price submission as 'Standard'. Based on its PREMO self-rating, East Gippsland Water proposed a return on equity of 4.5 per cent per annum. This reflects the maximum return rate allowed in our guidance for a price submission rated as 'Standard'.³²

²⁹ East Gippsland Water 2017, op. cit., p. 44.

³⁰ Essential Services Commission 2016, *Guidance paper*, op. cit., pp. 43-44.

³¹ For more detail on the trailing average and on-the-day approaches to the cost of debt, see Essential Services Commission 2016, *Water Pricing Framework and Approach*, op. cit., p. 27.

³² Essential Services Commission 2016, *Guidance paper*, op. cit., p. 49.

The return on equity is similar to rates we have approved in past reviews for the water industry. We have also had regard to the return on equity allowed or estimated by regulators in other Australian jurisdictions recently for the water industry.³³

Our draft decision accepts East Gippsland Water's PREMO self-rating and proposed return on equity of 4.5 per cent per annum. Our assessment of East Gippsland Water's proposed PREMO rating is set out in Chapter 3.

Regulatory depreciation

Regulatory depreciation is an input to calculating the regulatory asset base.

East Gippsland Water's forecast regulatory depreciation was calculated using a straight line depreciation profile. We noted in our guidance that we prefer this approach.³⁴ East Gippsland Water also calculated regulatory depreciation in a manner consistent with our guidance.

For these reasons, our draft decision proposes to accept East Gippsland Water's forecast for regulatory depreciation.

Tax allowance

The tax allowance is an input to the revenue requirement. East Gippsland Water has assumed a company tax rate of 27.5 per cent per annum from year three of its five year regulatory period from 1 July 2018. This is lower than the current company tax rate of 30 per cent and is based on the anticipated passing of a bill.³⁵ In the event that this bill does not pass or is delayed or amended, East Gippsland Water will not seek to recover the additional expense from customers.³⁶ Our draft decision is to accept East Gippsland Water's forecast tax allowance.

Demand

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

East Gippsland Water's demand forecasts are set out at pages 46 to 48 of its price submission, and are also included in its financial model.

³³ Essential Services Commission of South Australia 2016, *SA Water regulatory determination 2016, Final determination*, June; Independent Pricing and Regulatory Tribunal 2017, *WACC biannual update*, August

³⁴ Essential Services Commission 2016, *Guidance paper*, op. cit., p. 42.

³⁵ Based on Treasury Laws Amendment (Enterprise Tax Plan No. 2) Bill 2017. As of 19 October 2017, the Treasury Laws Amendment (Enterprise Tax Plan No. 2) Bill 2017 is at the second reading stage in the House of Representatives.

³⁶ Provided in response to a request for further information. Email received 1 November 2017.

After receiving its submission, we queried East Gippsland Water’s approach to calculating its water connection forecasts. In response to our request, East Gippsland Water provided us with updated connections forecasts. Table 2.6 compares East Gippsland Water’s original September 2017 forecasts for water connections, with its updated forecasts.

The revisions increase the forecast for water connections, which will reduce estimated customer prices.

Table 2.6 Number of water connections

	2018-19	2019-20	2020-21	2021-22	2022-23
Original forecast (September 2017)	23,963	24,128	24,473	24,583	24,932
Updated forecast (November 2017)	23,931	24,252	24,577	24,888	25,184

Our draft decision proposes to accept East Gippsland Water’s demand forecasts (including its proposed revisions above) for the purpose of approving maximum prices. We have accepted the revised forecasts as we consider they were estimated in a manner that is consistent with the requirements of our guidance. This includes basing demand forecasts on the latest Victoria In Future population growth forecasts, issued by the Victorian Government.

Form of price control

East Gippsland Water proposed a price cap form of price control, changing from its current approach which is a weighted average price cap.

Our draft decision is to accept East Gippsland Water’s proposed form of price control. We agree with East Gippsland Water’s justification for a price cap form of price control on page 49 of its price submission. A price cap will allow East Gippsland Water to recover revenue sufficient to cover the forecast efficient costs of providing services. It also provides customers with greater price certainty than the weighted average price cap currently applied by East Gippsland Water. The change to a price cap is also consistent with findings from its engagement that customers value price certainty.³⁷

³⁷ We note our determinations will allow water corporations flexibility to apply to change from a price cap to a weighted average price cap or tariff basket within a regulatory period.

A price cap also means a water corporation is managing demand risk on behalf of its customers. We consider demand risk is more efficiently managed by a water corporation, rather than its customers.

Prices and tariff structures

East Gippsland Water's tariffs are set out at pages 50 to 54 of its price submission. Proposed prices for water and sewerage services applying to most residential and non-residential customers are set out at Tables 2.7 and 2.8.

From 2014-15, East Gippsland Water's residential customers receiving a bill including water usage charges received an annual rebate of \$28. The rebate reflects the outcomes of a government efficiency review, and ends after 2017-18. While East Gippsland Water proposed a fall in prices for most customers from 2018-19, the removal of the rebate means the bill impacts of the price changes on customer groups will vary. In particular, for some customers, such as relatively low water users, (including some residential tenants), bills may rise as a result of the rebate being removed. This issue was raised in a submission by the Consumer Action Law Centre.³⁸

Table 2.7 Proposed water prices
\$ 2017-18

	2017-18	2018-19	2019-20	2020-21	2021-22	2022-23
Residential						
Variable (\$/kL)	2.18	2.11	2.11	2.11	2.11	2.11
Fixed (20mm) (\$/year)	216.66	201.15	201.15	201.15	201.15	201.15
Non-residential						
Variable (\$/kL)	2.18	2.11	2.11	2.11	2.11	2.11
Fixed (20mm) (\$/year)	216.66	201.15	201.15	201.15	201.15	201.15

Note: the variable component differs to that shown in East Gippsland Water's price submission, as it has since revised its demand forecast

³⁸ Consumer Action Law Centre 2017, *Initial Feedback: 2018 Price Review*: November.

Table 2.8 Proposed sewerage charges
\$ 2017-18

	2017-18	2018-19	2019-20	2020-21	2021-22	2022-23
Residential						
Fixed (\$/year)	660.23	660.23	660.23	660.23	660.23	660.23
Non-residential						
Fixed (\$/year)	660.23	660.23	660.23	660.23	660.23	660.23

We consider East Gippsland Water’s proposed tariffs will allow it to recover sufficient revenue to cover efficient costs. As outlined in our guidance, we have provided the water corporations with a large degree of discretion to decide on individual tariff structures.³⁹ This recognises water corporations are often best placed to consider the interests of customers in designing tariffs, and that existing tariff structures have been developed over time to deal with a variety of local circumstances.

East Gippsland Water proposed to maintain its existing tariff structures. It proposed a two-part tariff with a fixed service charge and a variable water usage charge, and a fixed service charge only for sewerage.

We consider the two-part structure for water services will promote efficient use. It also provides customers a signal about their water use costs, and is an approach that is commonly applied in other states and territories.⁴⁰ We also consider two-part tariff structures are easy to understand

East Gippsland Water confirmed its proposed tariffs for trade waste, recycled water and miscellaneous services are calculated in accordance with the pricing principles referenced in our guidance.⁴¹

A submission by the Consumer Action Law Centre highlighted the impact price changes may have on some customers, particularly those with low or fixed incomes who ‘already carefully manage

³⁹ Essential Services Commission 2016, *Guidance paper*, op. cit., p. 55.

⁴⁰ Includes the tariffs of Icon Water, Sydney Water, Hunter Water, Gosford City Council, Wyong Shire Council, Power and Water Corp, Urban Utilities, Unity Water, SA Water and TasWater.

⁴¹ Request for information, email received 21 November 2017.

their consumption and budget'.⁴² On this we note East Gippsland Water has recognised the interests of low income and vulnerable customers by committing to maintaining its current level of support to those in financial hardship while increasing customer awareness of its financial assistance program.

It is also proposing to change its price control method to an individual price cap resulting in greater price certainty over the period. We consider these proposals reflect customer concerns and willingness for East Gippsland Water to provide support to customers experiencing financial difficulty.

For these reasons, our draft decision accepts East Gippsland Water's proposed tariff structures as set out at pages 50 to 54 of its price submission.

Prior to our final decision and price determination, East Gippsland Water must propose updated prices to reflect our draft decision on the revenue requirement, and our updates to cost of debt and inflation estimates, to be made in late April 2018.

Adjusting prices

East Gippsland Water proposes to continue with its existing uncertain and unforeseen events mechanism.⁴³ Our draft decision accepts East Gippsland Water's proposal to continue the existing uncertain and unforeseen events mechanism. We noted in our guidance that we propose that the mechanism continue in its current form.

East Gippsland Water has not included adjustments to reflect movements in the cost of debt, as set out in our guidance. We require East Gippsland Water to resubmit revised price adjustment formulas, allowing for adjustments to reflect movements in the cost of debt.

New customer contributions

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

⁴² Consumer Action Law Centre 2017, op. cit.

⁴³ This was not proposed in East Gippsland Water's price submission. We confirmed East Gippsland Water's intention to maintain the existing mechanism in a request for information.

East Gippsland Water has proposed to continue to apply a zero charge for standard new customer contributions in accordance with the commission's approved transition to a zero charge in our 2013 price determination. For negotiated new customer contributions, East Gippsland Water proposes to continue to calculate a charge in accordance with the requirements of the commission.⁴⁴

East Gippsland Water's negotiated new customer contributions are calculated in line with our new customer contribution principles.⁴⁵

Our draft decision proposes to accept East Gippsland Water's proposed zero charge for standard new customer contributions and its method of calculating negotiated charges in line with our principles.

Financial position

In approving prices, we must have regard to the financial viability of the water industry.⁴⁶ We interpret the financial viability requirements under the ESC Act and the WIRO to mean that the prices we approve should provide a high level of certainty that each water corporation can maintain an investment grade credit rating. Further, prices should enable each corporation to generate cash flow to service financing costs arising from investments to meet service expectations.

East Gippsland Water's price submission and financial model provided estimates of key indicators of forecast financial performance in a manner consistent with our guidance. We have reviewed these indicators and assessed that East Gippsland Water's forecast financial position, given its proposed prices, is consistent with an investment grade credit rating.

⁴⁴ East Gippsland Water 2017, op. cit., p. 56.

⁴⁵ Request for information, email received 20 October 2017.

⁴⁶ WIRO clause 8(b)(ii) and ESC Act s.8A(1)(b).

3. PREMO rating

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

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

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

In Chapter 2, we noted our draft decision is to accept East Gippsland Water's proposed return on equity of 4.5 per cent, based on the justification provided for the level of ambition in its price submission. Below, we set out our preliminary assessment of East Gippsland Water's proposed PREMO rating.

Our review of East Gippsland Water's PREMO self-rating

East Gippsland Water's proposed PREMO rating, and our draft decision is summarised below:

Table 3.1 PREMO Rating

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

We agree with East Gippsland Water's proposed overall PREMO self-rating of 'Standard'. This is reflected in the return on equity we have approved for East Gippsland Water at page 17.

We agree with East Gippsland Water's proposed self-rating for the Risk, Engagement and Outcomes elements of PREMO, for the reasons set out in its price submission.⁴⁷

In support of its proposed PREMO rating, we note the high quality of East Gippsland Water's price submission, which was clearly set out and provided sufficient justification for its proposals. East Gippsland Water also accepted greater risk on behalf of its customers, proposing to change to a price cap form of price control, from a weighted average price cap.

East Gippsland Water also effectively used a customer committee to guide its engagement approach, and demonstrated that its engagement findings influenced its proposals.

Our draft decision considers a rating of 'Standard' is more appropriate for the Management element of PREMO, rather than the 'Advanced' rating proposed by East Gippsland Water.

We note that East Gippsland Water's efficiency hurdle on operating costs (1.15 per cent per annum) is one of the lowest proposed among the water corporations in our review. Also, during our review a number of corrections had to be made to East Gippsland Water's financial model. While none were material in their own right, we consider the number of corrections does not support an 'Advanced' rating for the Management element of PREMO. For these reasons our draft decision for East Gippsland Water is to rate the Management element of PREMO as 'Standard'.

⁴⁷ East Gippsland Water's price submission is available on our website at www.esc.vic.gov.au.

4. We invite feedback on our draft decision

We invite feedback from stakeholders on our draft decision before we make a final decision and price determination. Our final decision and price determination will be made in May or June 2018.

Stakeholders may comment on any aspect of our draft decision, including the information we have relied upon in our assessment (such as East Gippsland Water's price submission). Feedback may also cover:

- additional matters or issues we should consider before making our final decision
- whether our draft decision to accept East Gippsland Water's price submission has adequate regard to the matters in clause 11 of the WIRO and our guidance.

How to provide feedback:

Attend a public forum

We may hold a public forum in February or March 2018. Forums provide an opportunity for interested parties to discuss key features of our draft decisions. We will publish details of public forums at www.esc.vic.gov.au/waterpricereview.

Provide written comments or submissions

Written comments or submissions in response to this draft decision will be due in early March 2018. We would prefer to receive comments and submissions via our website at www.esc.vic.gov.au/waterpricereview.

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

2018 Water Price Review
Essential Services Commission
Level 37, 2 Lonsdale Street
Melbourne VIC 3000

We usually make all comments and submissions publicly available in the interests of transparency. If you wish part or all of your submission to be private, please discuss with commission staff.

If you cannot access documents related to our price review, please contact us to make alternative arrangements (phone (03) 9032 1300).

We invite feedback

Next steps

Indicative dates are provided below. To keep up to date, visit our website at www.esc.vic.gov.au/waterpricereview.

- February or March 2018 – public forum.
- 9 March 2018 – closing date for submissions on our draft decision.
- May or June 2018 – release date for final decision and price determination.

APPENDIX A – submissions received

Name or organisation	Date received
Consumer Action Law Centre	15 November 2017
Mr G Mallon	7 November 2017