



Southern Rural Water draft decision

2023 Water Price Review

6 April 2023



Acknowledgement

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

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

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

An appropriate citation for this paper is:

Essential Services Commission 2023, *Southern Rural Water draft decision: 2023 Water Price Review*, 6 April

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Summary

Our draft decision considers Southern Rural Water's proposed prices for a 5-year period starting 1 July 2023

This draft decision sets out our preliminary views on Southern Rural Water's price submission.¹ Our draft decision should be read together with Southern Rural Water's price submission.



We invite interested parties to comment on our preliminary views in this draft decision before we make a final decision and issue a price determination in June 2023. For details of how to provide feedback, see our dedicated Engage Victoria page: <https://engage.vic.gov.au/water-price-review-2023>.

Southern Rural Water has committed to delivering outcomes that reflect customer priorities

Southern Rural Water plans to deliver the following outcomes for customers:

- Reliable water supply
- Sustainable water
- Great service
- Community value
- Fair and reasonable prices.²

Among the key initiatives to deliver on its commitments, Southern Rural Water will continue to modernise its assets in the Macalister and Werribee districts. In term of its bills and prices it will manage price paths for irrigation customers at or close to inflation. It will also help reconnect Aboriginal communities to water for cultural, economic, customary and spiritual purposes.

Our draft decision adopts a revenue requirement that is lower than Southern Rural Water's proposal

Our draft decision is to adopt a revenue requirement that will allow Southern Rural Water to deliver on its customer service commitments, government policy, statements of obligations, and

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

² Southern Rural Water, 2023 water price submission, September 2022, pp. 60–65.

obligations monitored by the Environment Protection Authority Victoria and the Department of Health.

Our draft decision adopts a revenue requirement of \$169.1 million for Southern Rural Water over the 5-year period starting 1 July 2023 (Chapter 4).³ This is 3.7 per cent lower than the \$175.6 million proposed by Southern Rural Water.

The lower amount we propose to adopt in our draft decision mainly reflects our exclusion of non-prescribed operating expenditure from the 2021-22 baseline year, that were originally included in Southern Rural Water's proposal.

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

In response to our draft decision, Southern Rural Water must consider the inflation environment and the impact on customer prices and bills

Southern Rural Water, unlike some other water businesses, proposes to increase prices in real terms over the 2023–28 regulatory period. The changes vary by each Southern Rural Water district but generally range from increases in line with the consumer price index to 1.9 per cent above inflation on average (for most customers, prices will move in line with changes in the consumer price index).

Given this and given that since lodgement of its price submission it has become increasingly likely that a relatively high inflation adjustment will be incorporated into 2023-24 prices, Southern Rural Water must provide us with further information illustrating how it intends to address the impacts of relatively high inflation on its proposed prices and customer bills.⁴

Prices and estimated bills will change following our draft decision to reflect updates for inflation and the cost of debt. The March Quarter 2023 annual outcome for the consumer price index due for release in late April 2023, will be added to 2023-24 real prices.⁵

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

⁴ This is relevant to clause 11(d)(ii) of the Water Industry Regulatory Order 2014 which states that when making a price determination, the commission, in considering the manner in which a regulated entity's prices are to be calculated, determined or otherwise regulated, must have regard to whether prices provide signals about the efficient costs of providing prescribed services to customers (either collectively or to an individual customer or class of customers) while avoiding price shocks where possible.

⁵ Published by the Australian Bureau of Statistics (All Groups – Australia).

Based on recent inflation outcomes and market expectations, the annual outcome for the March Quarter 2023 consumer price index is likely to be relatively high, noting the rate is expected to fall through 2023 and 2024.⁶ For the 2023–28 regulatory period, we have assumed an inflation rate of 3 per cent per year, which is significantly lower than near-term inflation expectations.⁷

Many of the drivers of higher inflation (such as fuel, food and travel) are not major cost items for water businesses. Some high-cost growth areas specific to the water sector such as insurance and chemicals have been accounted for in uplifts to their opening base costs for the 2023–28 regulatory period. Accordingly, it may be the case that the inflation that is added to prices in 2023-24 provides an uplift in revenue that is well above a business's actual costs for the year.

Tariff structures will generally remain the same but with some focused changes proposed

Southern Rural Water proposed to generally maintain its existing tariff structures. However, it proposed some modifications to existing tariffs while introducing four new charges (Section 5.3.1).

Our draft decision is to accept Southern Rural Water's proposal:

- to introduce four new charges (pre-application fees, site visits, peer review fees and public advertising fees) as they are in line with pricing principles and will contribute to a sustainable revenue stream
- to remove the 5 per cent price cap on bulk entitlement charges and calculate the charges in accordance with the bulk entitlement orders, as this will allow actual costs to be recovered and is based on pricing principles.
- to move bulk entitlement charges, recreation charges, charges related to its recycled water scheme and the Latrobe resource management fee from the schedule of rural prices to the list of miscellaneous charges as it reflects pricing principles.

For its form of price control, Southern Rural Water proposed to continue with:

- price caps for application fees, transfers and renewals
- pricing principles for recycled water charges
- a revenue cap for the remainder of its annual fees and charges.

⁶ The latest (February 2023) Reserve Bank of Australia Quarterly Statement on Monetary Policy forecast the consumer price index to change (over the year) to around 4.8 per cent by December 2023 and 3.2 per cent by December 2024.

⁷ The pricing model issued by the commission includes a forecast for inflation for the full 2023–28 regulatory period (currently 3 per cent). This assumption is used by businesses to enter expenditure values and prices in our pricing model in real terms.

Our draft decision is to accept Southern Rural Water's proposed form of price control as it meets the requirements of our guidance and largely reflects a continuation of current arrangements, with the changes to bulk entitlement charges allowing a more effective mechanism to recover these costs.

Our draft decision rates Southern Rural Water's price submission as 'Standard' under the PREMO framework

Our draft decision is to rate Southern Rural Water's price submission as 'Standard' under the PREMO framework (Table A). This is the same as the business's self-rating of its price submission.

Key factors supporting this PREMO rating include:

- we agree with Southern Rural Water's self-assessment that it has, overall, met its outcome commitments for the period to date
- Southern Rural Water's delivery of major projects (Section 4.2.1) compares favourably to other water businesses
- Southern Rural Water stepped up its engagement from its 2018 price review through the introduction of an independently facilitated customer reference group, providing additional assurance that customer preferences were considered at every stage of the development of its price submission
- our preliminary view that Southern Rural Water has justified its forecasts for capital expenditure, and its forecasts for operating expenditure (after correcting for the treatment of non-prescribed storage charges)
- Southern Rural Water's proposed targets for its outcome measures suggest an overall improvement in customer value.

Our preliminary view is that we agree with Southern Rural Water's self-ratings of its price submission for the Performance, Risk, Engagement and Outcomes elements of PREMO. Our draft decision is to not accept Southern Rural Water's self-rating of its price submission as 'Standard' for the Management element of PREMO, and instead adopt a rating of 'Basic'. We consider Southern Rural Water's price submission generally provided clear justification for its proposals. However, we found Southern Rural Water's financial model (lodged with its price submission) contained a number of errors and included unexplained changes to some formulas that we embedded in the model. This reflects the importance we place on submissions that reflect our pricing models and accuracy of information provided by water businesses.

Southern Rural Water received a PREMO rating of 'Advanced' at the 2018 water price review.

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



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

Table A **PREMO rating**

	Overall PREMO rating	Performance	Risk	Engagement	Management	Outcomes
Southern Rural Water’s self-rating	Standard	Standard	Standard	Advanced	Standard	Advanced
Commission’s rating	Standard	Standard	Standard	Advanced	Basic	Advanced

Among the 11 draft decisions we have released so far, Southern Rural Water is one of 6 businesses for which we propose to approve a ‘Standard’ rating (Table B).

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

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

We invite feedback on our draft decision

We invite feedback from stakeholders on our draft decision before we make a final decision and price determination. We expect to release our final decision and price determination in June 2023.

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

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

How to provide feedback and stay up to date

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

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

You can provide feedback by:

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

Taking part in a public forum

We plan to hold a public forum on 1 May 2023. Forums provide an opportunity for interested parties to discuss key features of our draft decisions. Details of our public forums will be published on the Engage Victoria website.

Provide written comments or submissions

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

We require submissions by this date so that we have time to fully consider submissions for our final decision. Comments or submissions received after this date may not be afforded the same weight as submissions received by the due date.

We would prefer to receive comments and submissions via the dedicated [Engage Victoria website](#).

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

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

Submission and privacy statement

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

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

Next steps

Activity	Indicative date
Public forum	1 May 2023
Closing date for submissions on our draft decision	9 May 2023
Release date for our final decision and price determination	June 2023

1. Our role and approach to water pricing

1.1 We are Victoria's independent economic regulator

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

1.2 We are reviewing the proposed prices of 14 water businesses

Our review is of the prices that the 14 water businesses propose to charge customers for prescribed services from 1 July 2023.⁸ The prescribed services include retail water and sewerage services, and bulk water and sewerage services delivered by the water businesses.⁹

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

1.3 We assess prices against the WIRO and other legal requirements

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

- the objectives and matters specified in clause 8 of the WIRO, which include economic efficiency and viability matters, industry specific matters, customer matters, health, safety, environmental and social matters, and other matters which are specified in sections 8 and 8A of the ESC Act and section 4C of the WI Act

⁸ The review excludes Melbourne Water, Goulburn-Murray Water, North East Water and Greater Western Water. In 2021 we approved prices for Melbourne Water to 30 June 2026 and in 2020 we approved prices for Goulburn-Murray Water to 30 June 2024. In 2018, we approved prices for North East Water to 30 June 2026. We have approved an extension to the regulatory period for Greater Western Water to 30 June 2024.

⁹ The prescribed services are listed at clause 7(b) of the WIRO.

- the matters set out in section 33(3) of the ESC Act, which include the return on assets, relevant benchmarking and any other matters that the ESC considers relevant
- the matters specified in our guidance¹⁰
- the principle that prices should be easily understood by customers and provide signals about the efficient costs of providing services, while avoiding price shocks where possible
- the principle that prices should take into account the interests of customers of the regulated entity, including low income and vulnerable customers.

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

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

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

If we consider the submission does not have adequate regard for the matters specified in clause 11 of the WIRO or does not comply with our guidance, we may specify maximum prices, or the manner in which prices are to be calculated, determined or otherwise regulated.¹²

¹⁰ Essential Services Commission, *2023 water price review: Guidance paper*, 26 October 2021.

¹¹ This is a requirement of the WIRO, clause 14(b).

¹² This is provided for under the WIRO, clause 14(b)(i).

Table 1.1 Matters businesses and the commission must have regard to

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

Continued next page

Table 1.1 (continued)

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

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

1.4 PREMO

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

Box 1.1 PREMO

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

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

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

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

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

Our PREMO framework rewards stronger customer value propositions in price submissions, and an early draft decision is available for price submissions we can assess in a short timeframe.¹³

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

Taking into account all five elements of PREMO, a water business must self-assess and propose a rating for its price submission as 'Leading', 'Advanced', 'Standard' or 'Basic'. Its proposed return on equity will then reflect its proposed PREMO rating. A 'Leading' submission has the highest return on equity, and a 'Basic' submission the lowest. We assess the self-rating and also assess the price submission more broadly, including the water business's justification for the proposed PREMO rating, and form our own view of the appropriate rating. This process determines the PREMO rating adopted and the return on equity reflected in the revenue requirement.¹⁴

¹³ In December 2022, we issued early draft decisions for Yarra Valley Water and Westernport Water.

¹⁴ Essential Services Commission, *2023 water price review: Guidance paper*, pp. 41–46.

2. Our assessment of Southern Rural Water's price submission

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

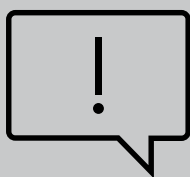
- Southern Rural Water's price submission
- Southern Rural Water's responses to our queries
- our consultants' reports
- written submissions from interested parties (a list of submissions is provided in Appendix A).

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

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

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

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



Southern Rural Water must submit a response to our draft decision and provide an updated financial model by 9 May 2023 (via email to water@esc.vic.gov.au). The response will be published on our website. We also invite other interested parties to make a submission.

We intend to make a price determination for Southern Rural Water in June 2023.

2.1 Draft decision paper outline

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

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

Our assessment of Southern Rural Water's price submission

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

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

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

2.2 Regulatory period

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

We are required to set the term of the regulatory period over which a water business’s price determination will apply.¹⁵ Our guidance proposed that we set a 5-year regulatory period, but also noted we were open to justified alternatives proposed in a price submission.¹⁶

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

¹⁵ This is a requirement of the WIRO, clause 9.

¹⁶ For detail on the reasons for using 5 years as the default regulatory period, see: Essential Services Commission, *2023 water price review: Guidance paper*, p. 18.

3. Customer outcomes

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

This chapter:

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

3.1 Customer engagement

Our guidance required Southern Rural Water to engage with customers to inform its price submission. Our guidance also identified principles to guide Southern Rural Water’s engagement.¹⁷

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

- engaged early in its planning, drawing on insights gathered through ongoing engagement activities that included farm visits, its established Southern Groundwater and Rivers Forum, customer consultative committees for its three irrigation districts, and its biennial customer surveys completed in 2019 and 2022
- used a range of methods well suited to the context including an online engagement hub, online survey, face to face meetings, and a customer reference group it convened to provide input into its overall engagement approach
- expanded its understanding of vulnerability experienced by its commercial and water licence customers by engaging with Rural Financial Counselling services
- leveraged its existing relationship with the Registered Aboriginal Parties of the lands it operates on, including deepening its understanding of their priorities and of its role in supporting First Nations self-determination
- was inclusive of the breadth of its customer base, including its bulk entitlement holders such as the Victorian Environmental Water Holder, Traditional Owners and industry representatives

¹⁷ Essential Services Commission, *2023 water price review: Guidance paper*, p. 20.

- covered matters that had a material impact on services and prices, including its investment priorities, service levels and performance measures, tariff reform options, and proposed price paths for each of its customer groups
- supported informed decision making in its engagement activities, through the quality of its written material and presentations.

More detail on Southern Rural Water’s engagement is available in its price submission.¹⁸

Actions proposed to be taken by Southern Rural Water in response to customer feedback provide evidence that its engagement influenced its proposals. For example, in its price submission, Southern Rural Water proposed:

- to manage price paths for irrigation customers at or close to inflation – in response to feedback that prices should be fair and reasonable¹⁹
- introducing new measures for reliable water supply and sustainable water – in response to feedback from customers that this was a priority area²⁰
- merging into a single tariff its recycled water and river water products – in response to feedback this would support a simpler billing arrangement²¹
- maintaining its existing expenditure on salinity and drainage services – in response to feedback customers did not support paying more for these services but would support service improvements where these could be funded through efficiencies and collaboration with organisations undertaking similar work.²²

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

Overall, our preliminary view is that Southern Rural Water has designed and delivered a highly robust engagement program well suited to its operating environment and the context of the communities it operates across.

Southern Rural Water’s engagement on its pricing submission built on its established engagement with its three customer consultative committees and water forum. It checked in with these groups at key points in its decision making on pricing proposals to ensure alignment with their views. In

¹⁸ Southern Rural Water’s price submission is available on our website at www.esc.vic.gov.au.

¹⁹ Southern Rural Water, 2023 water price submission, September 2022, p. 150.

²⁰ Southern Rural Water, 2023 water price submission, September 2022, p. 122.

²¹ Southern Rural Water, 2023 water price submission, September 2022, p. 154.

²² Southern Rural Water, 2023 water price submission, September 2022, p. 154.

this way, Southern Rural Water’s engagement approach ensured strong alignment between the ongoing deliberations of these forums, and the proposals in the price submission.²³

We consider that Southern Rural Water engaged widely, using its online engagement hub, online surveys and face to face meetings to gather input from a range of customers outside its established processes. We reviewed materials it used to engage with its customers and found these to be of a high quality, clearly laying out the service price trade-offs customers could influence. 174 customers responded to the surveys exploring price and service mix.

We also consider that Southern Rural Water achieved a high level of collaboration and influence through its deliberative process, including with its independently facilitated customer reference committee. The customer reference committee was formed to support deeper consideration of customer issues during the price submission process and decision making, as well as to support transparency. The committee met five times over eight months including during the final stages of its engagement program. Reference group members reported that Southern Rural Water supported them in their decision making with quality written material and presentations, entrusting the reference group with information appropriate to its task. Members of the group strongly endorsed both the process and the engagement outcomes, noting their direct influence on communication material, tariff reform options and pricing outcomes.

Based on the above, we consider that Southern Rural Water maintained what was already a high level of engagement demonstrated in its 2018 price submission. Accordingly, our draft decision is that we agree with its self-rating of ‘Advanced’ for its price submission engagement.

See Chapter 7 for more detail on our PREMO assessment of Southern Rural Water’s price submission.

3.2 Outcomes

3.2.1 Performance against outcome commitments 2018–23

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

A business’s price submission should account for its actual performance against its outcome commitments for the current period, from 1 July 2018 to 30 June 2023.²⁴

²³ Southern Rural Water operates three customer consultation committees – Macalister Irrigation Area, Bacchus March Irrigation District, Werribee Irrigation District – as well as its Southern Groundwater and Rivers Forum.

²⁴ Essential Services Commission, 2023 water price review: Guidance paper, 26 October 2021, p. 23.

We consider Southern Rural Water accounted for its annual performance for each measure in its price submission. Table 3.1 lists Southern Rural Water’s outcome commitments and includes its annual performance results as reported in its price submission and the period-to-date rating published in our 2021-22 Outcomes report.²⁵ The information in this table informs our assessment under the Performance element of PREMO, which is discussed in Chapter 7.

Table 3.1 Business self-assessment of performance against Outcome commitments

Outcome	2018-19	2019-20	2020-21	2021-22	Period to date ^a
1. SRW provides great customer service	Amber	Green	Green	Green	Green
2. SRW’s water supply system enables good practice irrigation	Green	Green	Green	Green	Green
3. SRW manages water resources well, maintaining a good balance between my needs as a water user and the sustainability of the resource	Green	Green	Green	Green	Green
4. SRW works with me to manage my needs and entitlements	Green	Red	Red	Amber	Red

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

In its 2021-22 outcomes report, Southern Rural Water considers it has achieved or exceeded its targets for 57 of its 80 reported measures over the first 4 years of the current regulatory period. Of these 80 performance measures, 16 (20 per cent) have been rated as amber ‘close to achieving target’ and 7 (9 per cent) as red ‘failed to meet target’ in the period to date.²⁶

Notably, Southern Rural Water failed to meet targets for outcome 4, resulting in it failing to meet its period to date outcome rating. In its price submission, Southern Rural Water attributes this to challenges with the legislative process of converting audited water savings (achieved through modernisation projects) to entitlements. In addition, it notes wetter than usual weather in years 2020-22 resulted in less demand for purchased water, impacting its ability to achieve its targets.²⁷

²⁵ Southern Rural Water provided a period-to-date rating for the purpose of compiling our 2021-22 Outcomes report.

²⁶ Essential Services Commission, Southern Rural Water’s outcomes performance 2021-22, October 2022.

²⁷ Essential Services Commission, Southern Rural Water’s outcomes performance 2021-22, October 2022; Essential Services Commission, Southern Rural Water’s outcomes performance 2020-21, October 2021; Southern Rural Water, 2023 water price submission, September 2022, p. 21.

Southern Rural Water performed well against outcome 2. Despite citing some operational challenges, it has continued to provide high levels of service, with 100 per cent of all order deliveries being unaffected by unplanned interruptions in its three irrigation districts.²⁸

In the current regulatory period, Southern Rural Water published its annual performance report on its website. We consider its self-assessment for the period to date to be reasonable as part of our annual outcomes reporting process.

Our draft decision is that we agree with Southern Rural Water's self-assessment that it has, overall, met its outcome commitments for the period to date.

3.2.2 Outcome commitments for 2023–28

Southern Rural Water engaged with its customers to refine its outcomes for the period from 1 July 2023 to 30 June 2028. It proposes to deliver five customer outcomes:

- Reliable water supply
- Sustainable water
- Great service
- Community value
- Fair and reasonable prices.²⁹

Among the key initiatives to deliver on its commitments, it will continue with projects to modernise its assets in the Macalister and Werribee districts. In term of its bills and prices it will manage price paths for irrigation customers at or close to inflation. It will also help reconnect Aboriginal communities to water for cultural, economic, customary and spiritual purposes.

3.2.3 Our assessment of measures and targets

Southern Rural Water proposed a set of 25 measures and targets that it will use to report on performance across the 5 outcomes. Its outcomes are set out on pages 60 to 65 of its price submission. Performance against these measures will inform our assessment during future price reviews.

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

- be relevant to, or be a reasonable proxy for, the delivery of the outcome they represent

²⁸ Southern Rural Water's three irrigation districts are Macalister Irrigation District, Bacchus March Irrigation District, and Werribee Irrigation District. Essential Services Commission, Southern Rural Water's outcomes performance 2021-22, October 2022.

²⁹ Southern Rural Water, 2023 water price submission, September 2022, pp. 60–65.

- be measurable
- be clearly defined and unambiguous
- be easy for customers to understand
- have performance targets listed for each year of the regulatory period.³⁰

Evidence provided by Southern Rural Water demonstrates that its measures and targets were developed in consultation with its customers, and that they are supported by its customers. Its performance measures and targets were developed in response to customer feedback, tested and finalised through its customer consultative committees, customer reference group, and via customer surveys.³¹

Generally, we consider Southern Rural Water's intentions are clear, and its measures and targets will provide a sound basis to track performance and delivery against each outcome, once the matters we identified in our assessment have been addressed.

We will provide Southern Rural Water with our standard Outcomes Reporting Template to complete and submit with its response to this draft decision. We identified some matters for follow up that we consider Southern Rural Water will need to address in its response to our draft decision, to address the clarity of targets. We will work with the business to ensure the final set of measures addresses the above matters and complies with our guidance requirements.

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

Southern Rural Water has committed to publishing its performance on its website twice a year. Through its website, it will seek public views on its performance and will discuss this feedback and its performance with its customer consultative committees.³²

Based on the above, our draft decision is to accept Southern Rural Water's self-assessment of 'Advanced' for the Outcomes element of PREMO, which is discussed further in Chapter 7.

3.3 Service standards related to service reliability and faults

Service standards are a common set of services applicable to all Victorian consumers required under clause 1.5 of the *Water Industry Standard – Rural Customer Service* (Water Industry Standard). Each water business must specify its own service levels against each of these service

³⁰ Essential Services Commission, 2023 water price review: Guidance paper, 26 October 2021, p. 23.

³¹ Southern Rural Water, 2023 water price submission, September 2022, pp. 51-52.

³² Southern Rural Water, 2023 water price submission, September 2022, p. 66.

standards. Rather than performance measures, these service standards and corresponding service levels are the minimum level of service customers can expect to receive.

Southern Rural Water's proposed service standards relating to reliability and faults can be found in its proposed service standards 2023–28 document.³³

The service standards proposed by Southern Rural Water are different to those of the current regulatory period. The revised service standards have been developed to align with Southern Rural Water's proposed customer outcomes and were informed by consultation with its customers. While the service levels in the current regulatory period are phrased as percentages, the proposed service standards are phrased in a more customer centric way with service levels expressed in other ways such as days, hours or volumes of water.

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

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

3.4 Monitoring of water extraction

The Concerned Waterways Alliance noted in its submission its view that water theft and excessive extraction heighten the risk of species extinction and cease to flow events.³⁴

Our guidance noted that the revenue requirement proposed in a price submission must provide the water business with sufficient revenue to meet all of its legislative, regulatory and policy obligations.³⁵ We consider this would include the obligations on water businesses to monitor water theft and extraction levels, insofar as they relate to the prescribed services in the Water Industry Regulatory Order 2014. Southern Rural Water has included 'Sustainable Water – allocations are managed in a sustainable way for customers, community and the environment to ensure a secure future' – as an outcome it is committed to over the 2023–28 regulatory period (Section 3.2).³⁶

People for a Living Moorabool made a submission which expressed concern about the impact and growth of private dams in the Moorabool Catchment. They submitted that Southern Rural Water should place greater emphasis on monitoring and enforcing compliance on potentially

³³ Southern Rural Water, Proposed service standards 2023–28, February 2023.

³⁴ Concerned Waterways Alliance submission to the Essential Services Commission on Southern Rural Water's 2023 price submission, 21 December 2022.

³⁵ Essential Services Commission, *2023 water price review: Guidance paper*, 26 October 2021, p. 27.

³⁶ Southern Rural Water, 2023 water price submission, September 2022, p. 60.

unauthorised dam construction or enlargement.³⁷ The regulation of private dams is not a prescribed service under the Water Industry Regulatory Order 2014, and therefore any costs associated with private dams are not within the scope of our price review. However, we will raise the issue of potentially unauthorised dam construction with the Department of Energy, Environment and Climate Action.

³⁷ People for a Living Moorabool, submission to the Essential Services Commission on Southern Rural Water's 2023 price submission, 30 November 2022.

4. Revenue requirement

The revenue requirement is the forecast amount a water business needs to deliver on customer outcomes, government policy, statements of obligations, and obligations monitored by technical regulators including the Environment Protection Authority Victoria and the Department of Health.³⁸ Along with forecast demand, it is an input to calculating prices.

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

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

Our draft decision is to not approve the revenue requirement of \$175.6 million proposed by Southern Rural Water and instead adopt a revenue requirement of \$169.1 million, which is 3.7 per cent lower than proposed.

Southern Rural Water proposed a revenue requirement of \$175.6 million over a 5-year period starting 1 July 2023. Our draft decision approves a revenue requirement of \$169.1 million (Table 4.1) reflecting the removal of some operating costs that are recovered through non-prescribed storage operator charges (Section 4.1.1), and minor changes to align with Southern Rural Water's approved regulatory accounts (Section 4.3).

³⁸ We met with officers of the Department of Energy, Environment and Climate Action, the Department of Health, and the Environment Protection Authority Victoria, to discuss their expectations of Southern Rural Water in the regulatory period from 1 July 2023. We had regard to their views in arriving at our draft decision.

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

	2023-24	2024-25	2025-26	2026-27	2027-28	Total
Operating expenditure	27.86	27.29	25.35	25.97	24.88	131.36
Return on assets	2.96	3.20	3.29	3.42	3.43	16.24
Regulatory depreciation	4.47	5.26	5.49	6.04	6.81	28.07
Non-prescribed revenue offset of revenue requirement ^a	-1.53	-1.47	-1.09	-1.30	-1.12	-6.52
Tax allowance	0.00	0.00	0.00	0.00	0.00	0.00
Draft decision – revenue requirement	33.76	34.28	33.04	34.07	33.99	169.14

Note: Numbers have been rounded. ^a Southern Rural Water’s activities from non-prescribed services are set out on p. 100 of its price submission.

Table 4.2 summarises how our draft decision on Southern Rural Water’s revenue requirement (row E) differs to the revenue requirement proposed by Southern Rural Water in its price submission (row A). Where our draft decision differs from Southern Rural Water’s price submission in relation to a component of the revenue requirement, the adjustment we propose is shown in rows B to D of Table 4.2.

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

There may be changes in laws or government policy before we make a price determination. If any such changes occur between the draft decision and the price determination that impact on its forecast costs and the revenue requirement, Southern Rural Water should update its price submission and provide us with an updated financial model. It also should notify us of any material changes that impact its forecast costs, revenue requirement or prices (including demand). Any updates to its submission or pricing model will be made publicly available on our website.

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

	2023-24	2024-25	2025-26	2026-27	2027-28	Total
A. Southern Rural Water’s proposed revenue requirement	34.51	35.31	34.34	35.64	35.83	175.63
B. Operating expenditure	-0.78	-1.06	-1.32	-1.60	-1.87	-6.63
C. Return on assets	0.01	0.01	0.01	0.01	0.01	0.05
D. Regulatory depreciation	0.02	0.02	0.02	0.02	0.02	0.09
E. Draft decision – revenue requirement (A+B+C+D)	33.76	34.28	33.04	34.07	33.99	169.14

Notes: Our proposed adjustments are the differences between our draft decision and what Southern Rural Water proposed in its price submission. Row A shows the total revenue requirement proposed by Southern Rural Water in its price submission. We have arrived at our draft decision (row E) by proposing the relevant adjustments to the components of the revenue requirement shown in rows B to D. Numbers have been rounded.

4.1 Operating expenditure

Our draft decision is to adopt a forecast operating expenditure of \$131.4 million, which is \$6.6 million or 4.8 per cent lower than proposed by Southern Rural Water.

Operating expenditure is a component of the revenue requirement. Southern Rural Water’s price submission provides detail on its forecast operating expenditure from pages 69 to 75.

We assess both:

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

We engaged FTI Consulting to provide expert advice to inform our assessment of controllable operating expenditure. FTI Consulting’s report on its assessment of Southern Rural Water’s expenditure forecast is available on our website.³⁹

³⁹ FTI Consulting, *Southern Rural Water – Expenditure Review for 2023 water price review*, March 2023.

Since lodging its price submission with us, we identified that Southern Rural Water had incorrectly applied an average annual productivity saving as an adjustment to the proposed baseline for 2021-22 rather than as a step change for each year of the next regulatory period. Southern Rural Water subsequently resubmitted a financial model using the correct methodology. We note this results in immaterial adjustments to the total proposed operating expenditure over the next regulatory period.

Consistent with our 2018 final decision for Southern Rural Water, we have also removed non-prescribed storage operator charges from its baseline year total prescribed operating expenditure in 2021-22. This methodology may be revisited prior to our final decision to ensure the benchmark we set is the most appropriate to assess against at the next price review.

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

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

	2023-24	2024-25	2025-26	2026-27	2027-28	Total
Controllable operating expenditure	23.41	23.15	22.90	22.64	22.38	114.47
Non-controllable operating expenditure	4.45	4.15	2.45	3.33	2.50	16.89
Bulk services	1.21	1.21	1.21	1.21	1.21	6.04
Environmental contribution ^a	0.51	0.49	0.48	0.47	0.45	2.40
Licence fees – Essential Services Commission ^b	0.03	0.03	0.03	0.03	0.03	0.16
Other non-controllable costs ^c	2.70	2.41	0.73	1.63	0.81	8.28
Draft decision – operating expenditure	27.86	27.29	25.35	25.97	24.88	131.36

Notes: Numbers have been rounded. ^a Environmental contributions are funds collected from water businesses under the *Water Industry Act 1994*. ^b Licence fees are paid to cover costs incurred by the Essential Services Commission in our regulatory activities related to the water business. ^c These costs refer to immediately recoverable capital works for Latrobe power companies.

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

Revenue requirement

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

Table 4.4 Our proposed adjustments to Southern Rural Water’s proposed operating expenditure
\$ million 2022-23

	2023-24	2024-25	2025-26	2026-27	2027-28	Total
A. Southern Rural Water’s proposed total operating expenditure	29.16	28.60	26.66	27.31	26.24	137.97
B. Our total proposed adjustments to controllable operating costs (B1 + B2)	-0.73	-0.99	-1.23	-1.50	-1.77	-6.22
B1 – Non-prescribed storage operator charges	-1.24	-1.24	-1.23	-1.24	-1.25	-6.20
B2 – Annual productivity saving reconciliation	0.51	0.25	0.00	-0.26	-0.52	-0.01
C. Our total proposed adjustments to non-controllable operating costs (C1)	-0.05	-0.07	-0.08	-0.10	-0.11	-0.41
C1 – Environmental contribution	-0.05	-0.07	-0.08	-0.10	-0.11	-0.41
D. Draft decision – total operating expenditure (D = A + B + C)	27.86	27.29	25.35	25.97	24.88	131.36

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

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

The operating expenditure that we propose to adopt for Southern Rural Water does not represent the amount that Southern Rural Water is required to spend or allocate to particular operational, maintenance and administrative activities. Rather, it is a benchmark that represents assumptions

about the overall level of operating expenditure (to be recovered through prices) that we consider sufficient to operate the business efficiently and to maintain services over the regulatory period.

4.1.1 Controllable operating expenditure

Southern Rural Water proposed a total forecast controllable operating expenditure of \$120.69 million over a 5-year regulatory period. For the reasons set out below, we propose to adopt a forecast controllable operating expenditure of \$114.47 million for the 2023–28 regulatory period, which is \$6.22 million (or 5.2 per cent) lower than proposed by Southern Rural Water. The reduction is mainly due to the removal of non-prescribed storage operator charges, consistent with the approach taken in our 2018 final decision for Southern Rural Water.

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

1. Establish a controllable operating expenditure baseline – the baseline comprises the efficient recurring costs from the last full year of data (2021-22) after non-controllable expenditure, one-off items are removed or normally occurring items are added in.
2. Make adjustments for additional costs or cost saving expected in future years.

4.1.1.1 Baseline controllable operating expenditure

Southern Rural Water has proposed a controllable operating expenditure baseline of \$24.14 million, after removing \$0.59 million in non-recurring operating expenditure that occurred in 2021-22. Southern Rural Water’s proposed baseline is \$2.08 million (or 9 per cent) higher than the benchmark figure of \$22.06 million of controllable operating expenditure for 2021-22 used for our 2018 price determination.

As identified above, Southern Rural Water subsequently submitted a revised financial model which removed the \$0.85 million average annual productivity saving which was incorrectly entered as an adjustment to the baseline. We also removed \$1.24 million of non-prescribed storage operator charges from its proposed 2021-22 baseline controllable operating expenditure, consistent with our 2018 final decision for Southern Rural Water. This produced an adjusted controllable operating expenditure baseline of \$23.75 million which is \$1.69 million (or 8 per cent) higher than the benchmark figure from the 2018 price determination.

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

Our expenditure consultant requested substantiation of Southern Rural Water's proposed increase to its baseline year operating expenditure benchmark.⁴⁰ Southern Rural Water explained the increase was due to a number of factors including:

- labour costs such as real increases to wages under its Enterprise Agreement and uplift to staff capability through reclassifications for operational and business demands
- increased water resource compliance costs and management of water theft
- cyber security costs to align with the Victorian Protective Data Security Framework and the transition to Cloud-based platforms
- other miscellaneous costs including costs related to health and safety and increased insurance costs
- non-prescribed storage operator charges which were taken out of operating expenditure in the 2018 price review but not accounted for in the current price submission.

Our expenditure consultant verified these additional costs were recurring and found Southern Rural Water's substantiation of these costs to be reasonable, noting that we would manage any adjustments to reflect the costs associated with non-prescribed storage operator charges. Accordingly, our consultant recommended accepting Southern Rural Water's proposed baseline increase, with no other adjustments required.

We reviewed Southern Rural Water's proposal and the advice from our expenditure consultant. Given the above, our preliminary view is that Southern Rural Water's proposal reflects an efficient baseline cost to forecast annual operating expenditure, after removal of the non-prescribed storage operator charges.

We had preliminary discussions with Southern Rural Water on the best approach to address the non-prescribed storage operator charges, to ensure the benchmark we establish is reflective of actual operating conditions and appropriate for the next regulatory period. In response to our draft decision, we invite Southern Rural Water to provide further information on the revenue and costs associated with its non-prescribed storage operator charges, including proposing alternative treatments within our financial model.

4.1.1.2 Cost adjustments

Southern Rural Water has not proposed any additional forecast operating expenditure above the annual baseline. Rather, Southern Rural Water has proposed an efficiency step change reduction of \$4.27 million over the regulatory period, or an average reduction of \$0.85 million per annum.

⁴⁰ FTI Consulting, *Southern Rural Water – Expenditure Review for 2023 water price review*, March 2023.

Given that Southern Rural Water had not proposed any additional cost step changes over the next regulatory period, our expenditure consultant has not recommended any adjustments to Southern Rural Water's proposal.

We have considered the advice from our expenditure consultant, and Southern Rural Water's proposal. We consider Southern Rural Water's approach to forecasting its operating expenditure is consistent with the requirements of our guidance. Our preliminary position is that we are satisfied that its proposed forecast represents efficient controllable operating expenditure.

4.1.2 Non-controllable operating expenditure

Our process for establishing non-controllable operating expenditure involves:

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

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

Southern Rural Water has proposed \$17.30 million in non-controllable operating expenditure over the 2023–28 regulatory period. This is an increase of \$5.37 million compared to the 2018–23 regulatory period, reflecting a \$5.41 million increase in immediately recoverable works for Latrobe power companies, and a decrease of \$0.04 million due to forecast decreases in the real value of the environmental contribution.

Our guidance paper sets out our approach for businesses to forecast their non-controllable operating costs. We consider businesses should forecast licence fees for the Department of Health, the Environment Protection Authority Victoria and the Essential Services Commission to remain flat in real terms, and for the environmental contribution to remain flat in nominal terms (decline in real terms) across the 2023–28 regulatory period. Southern Rural Water has partially followed this approach in its price submission but has increased the environmental contribution in 2022-23 which is then kept flat in real terms rather than nominal terms for the next regulatory period.

Our draft decision proposes to reduce Southern Rural Water's forecast non-controllable operating expenditure by \$0.41 million across the 2023–28 period, resulting from our adjustments to the environmental contribution to reflect a flat rate in nominal terms based on the actual figure from 2021-22.

While we note that the proposed \$8.28 million on works for Latrobe power companies are immediately recoverable, we also request Southern Rural Water to respond to our draft decision on why these costs are classified as non-controllable operating expenditure rather than capital expenditure.

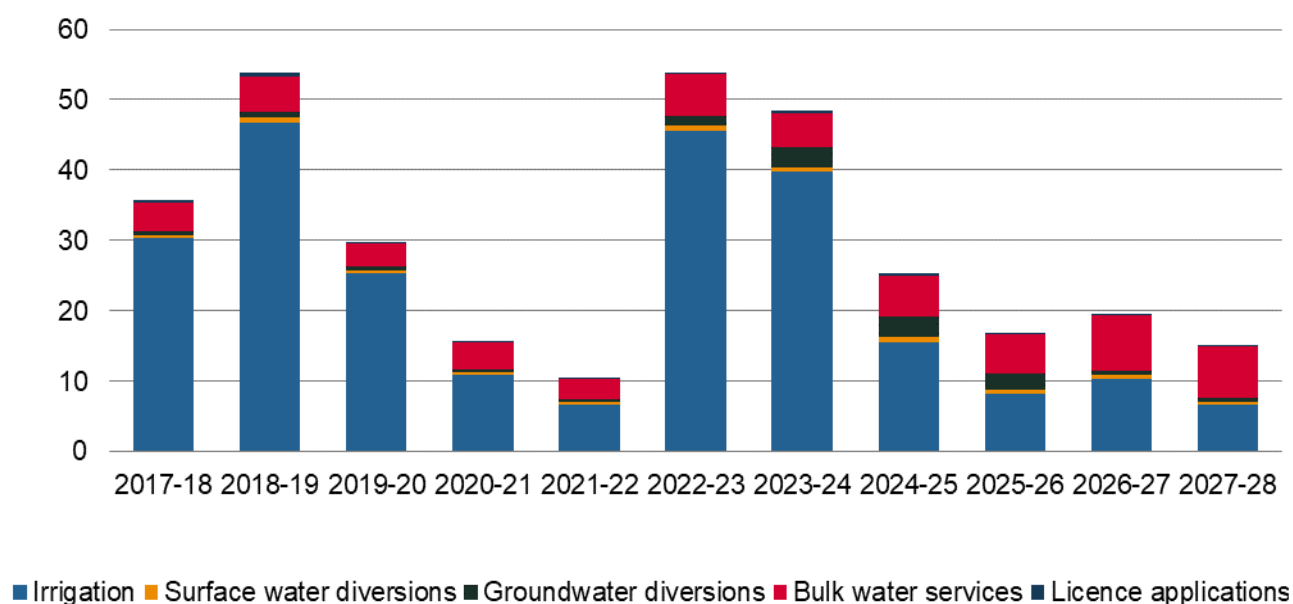
For the purpose of calculating the revenue requirement for our draft decision, we have provisionally accepted Southern Rural Water's proposed non-controllable operating expenditure after adjusting for a \$0.41 million reduction to the environmental contribution. Prior to making our final decision, we will update the forecast licence fee and environmental contribution values with the relevant regulatory bodies and adjust where necessary for the latest inflation and external bulk charges data.

4.2 Capital expenditure

Our draft decision is to accept Southern Rural Water's proposed forecast capital expenditure of \$125.1 million between 2023-24 and 2027-28.

Capital expenditure is an input to estimating the regulatory asset base, which is an input to the revenue requirement. Southern Rural Water's forecast capital expenditure and supporting information is provided at pages 76 to 95 of its price submission. Figure 4.1 shows Southern Rural Water's actual gross capital expenditure for 2017-18 and the first 4 years of the current regulatory period (2018-19 to 2021-22) and forecast gross capital expenditure from 2022-23 to 2027-28. The first 5 years of actual expenditure shown in Figure 4.1 (2017-18 to 2021-22) is relevant to the calculation of the closing regulatory asset base discussed in Section 4.3.1.

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



Note: This graph shows actual figures for 2017-18 to 2021-22, and Southern Rural Water’s forecasts for 2022-23 to 2027-28.

We engaged FTI Consulting to provide expert advice to inform our assessment of capital expenditure. FTI Consulting’s report on its assessment of Southern Rural Water’s expenditure forecast is available on our website.⁴¹

4.2.1 Actual capital expenditure

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

Southern Rural Water will incur \$145.4 million in actual gross capital expenditure over the period from 2017-18 to 2021-22. This is \$6.7 million or 4.4 per cent lower than the forecasts adopted at its 2018 water price review. It forecast gross capital expenditure of \$53.8 million for 2022-23, which is higher than the \$8.7 million benchmark for 2022-23 approved in the 2018 price determination.

⁴¹ FTI Consulting, *Southern Rural Water: Review of expenditure forecasts – 2023 Water Price Review*, March 2023.

In net terms (that is, once any contributions or disposals are accounted for), it will incur \$57.5 million in capital expenditure over the period from 2017-18 to 2021-22, which is \$27.0 million or 31.9 per cent lower than forecast. This amount of \$57.5 million will be reflected in Southern Rural Water's closing regulatory asset base at 30 June 2022 (Section 4.3.1).

Given Southern Rural Water's proposal to include amounts above the 2018 determination benchmarks for 2022-23 in its forecast regulatory asset base, we requested further detail on the specific projects underpinning the changes in its capital program over the 2018–23 regulatory period. Southern Rural Water's price submission and response to our request for additional information identified the following factors that have impacted its capital program delivery over the 2018–23 regulatory period:⁴²

- Southern Rural Water commenced the delivery of \$39.4 million of the Macalister Irrigation District Modernisation Phase 2 project in 2018–23 upon receipt of government grant funding in 2020, incurring \$28.8 million of additional expenditure above the \$10.6 million benchmark allowance.⁴³
- Forecast project cost of the Macalister Irrigation District Modernisation Phase 1B had increased by \$9 million due to works carried over from 2017-18 into 2018-19 and an expanded scope (60 per cent of the overall project costs were funded through government grants).
- Southern Rural Water brought forward the delivery of \$8.7 million of the Werribee Irrigation District Modernisation Stages 4 and 5 project upon receipt of \$11 million (50 per cent of the total project cost of \$22 million) in government grants.⁴⁴
- Southern Rural Water completed the new Macalister Irrigation District Siphon No. 1 replacement project to address risk of asset failure, and brought forward the Main Northern Channel Siphon No. 2 and Main Southern Channel Siphon No. 2 projects, incurring an additional \$5.1 million during 2018–23.

Our expenditure consultant found sufficient supporting information explaining Southern Rural Water's major capital program delivery performance over the current regulatory period and considers the increased investment has resulted in outcomes that are of significant benefit to customers. For this reason, and given that a number of these projects relate to projects funded by government grants and the bringing forward of works, our preliminary view is that the higher

⁴² Southern Rural Water, Response to request for information, 27 January 2023.

⁴³ \$13.0 million of the total expenditure over the current regulatory period is to be funded by customers and the remaining \$26.4 million via government contributions. The project scope, approvals and funding arrangements were pending at the time of the 2018 price submission development.

⁴⁴ The project scope and funding arrangements were not finalised at the time of the 2018 price submission development.

amount proposed by Southern Rural Water for inclusion in its forecast regulatory asset base is appropriate (Section 4.3.1).

Southern Rural Water's price submission reported on the status of its top 10 major capital projects. As at September 2022, Southern Rural Water reported that, of the top 10 major projects proposed for the 2018–23 regulatory period, 6 have been completed, 1 delayed with ongoing works expected to be completed in 2023-24, and the remaining 3 deferred to 2023–28:

- Ongoing Macalister Irrigation District channel bank renewal works are deferred due to the need for a revised strategy, and project scope has been reduced to reprioritise funds to accommodate the Macalister Irrigation District Siphon No. 1 replacement and additional Macalister Irrigation District Modernisation Phase 1B works.
- Glenmaggie spillway gate repainting is deferred to 2024–26 to reprioritise funds to accommodate the Macalister Irrigation District Siphon No. 1 replacement.
- Asset management system upgrade is deferred to 2023–25 pending the development of data management and finance system upgrades to ensure its efficient integration with broader enterprise systems.

4.2.2 Forecast Capital Expenditure

For the reasons set out below, our draft decision is to accept the forecast capital expenditure of \$125.1 million proposed by Southern Rural Water for the purpose of calculating its revenue requirement:

- Southern Rural Water's price submission provided evidence that its forecasts for capital expenditure are prudent and efficient. Its total proposed capital expenditure is \$38.4 million (23.5 per cent) lower than capital expenditure in the current 2018–23 period, but \$9.3 million (8 per cent) higher than the capital expenditure benchmarks approved for 2018–23 in its 2018 determination. This is due to two large irrigation modernisation projects which were subject to government funding. Southern Rural Water considered these projects were uncertain at the time of the 2018 price review, and therefore excluded a large portion of uncertain capital expenditure from its 2018 price submission forecasts for the 2018–23 and 2023–28 regulatory periods.
- Our expenditure consultant requested selected documents from Southern Rural 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 and Southern Rural Water's responses to questions, our expenditure consultant found that Southern Rural Water has a robust approach for developing project scope, the timing of works and cost estimates.⁴⁵

⁴⁵ FTI Consulting, *Southern Rural Water: Review of expenditure forecasts – 2023 Water Price Review*, March 2023, pp. 21–23.

- Our consultant reviewed information for two major projects as a representative sample of Southern Rural Water’s top 10 major projects. These were the Main Southern Carrier Tunnel No 5 Remediation project (\$3.3 million) and the Groundwater and River Meter Upgrade project (\$6.2 million). Our consultant found that each project’s scope and forecast costs were appropriate and did not recommend any adjustment to either project’s capital expenditure forecast.
- Our consultant also identified that a majority of Southern Rural Water’s forecast capital programs are driven by renewals. Our consultant reviewed information relating to a number of Southern Rural Water’s renewal programs and selected underlying renewal projects within each program and found the programs to be justified and reasonable. Our consultant recommended no adjustment to Southern Rural Water’s forecast expenditure related to its proposed capital programs.
- Overall, our expenditure consultant considered Southern Rural Water’s forecasts were consistent with a prudent service provider acting efficiently, and that the proposed expenditure was justified and deliverable. Our consultant recommended no adjustments to Southern Rural Water’s forecast capital expenditure.⁴⁶ We consider that, for the purposes of our draft decision, the prudence and efficiency of the expenditure has been justified, consistent with our guidance.
- Our preliminary view is that the planned capital expenditure program is achievable given Southern Rural Water’s past track record delivering its capital expenditure program. Over the current 2018–23 regulatory period, Southern Rural Water has delivered 6 of its top 10 major projects. Southern Rural Water has also deferred 3 projects due to reprioritisation, while its meter replacement project was 2 years behind schedule due to the pandemic and will continue into the 2023–28 regulatory period. Our expenditure consultant also considered the total forecast capital program for the 2023–28 period was deliverable by Southern Rural Water.
- Southern Rural Water has not specifically identified any project costs it has excluded from its price submission where there is uncertainty in timing, cost, scope and benefits of capital expenditure. For any additional capital expenditure in the 2023–28 regulatory period that Southern Rural Water proposes to include in the regulatory asset base at the end of the regulatory period, it should note the following:
 - Southern Rural Water will need to demonstrate the prudence and efficiency of any additional costs incurred during the 2023–28 regulatory period if seeking to include them in the regulatory asset base for the 2028–33 price review.

⁴⁶ FTI Consulting, *Southern Rural Water: Review of expenditure forecasts – 2023 Water Price Review*, March 2023, p. 28.

- Deviations from forecasted capital expenditure during the 2023–28 regulatory period will form a key part of our assessment of the Performance element of PREMO at the next price review.

We have reviewed Southern Rural Water’s proposals and advice from FTI Consulting. Our preliminary view is that we consider Southern Rural Water’s approach to forecasting its capital expenditure is consistent with the requirements of our guidance and the principles in the Water Industry Regulatory Order 2014.⁴⁷

Our draft decision for total gross capital expenditure is to accept Southern Rural Water’s proposed forecast. The benchmark we propose to adopt is set out in Table 4.6.

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

4.3 Regulatory asset base

A water business’s regulatory asset base is the value of the business’s assets for regulatory purposes.⁴⁸ The regulatory asset base is used to estimate the return on assets (discussed in Section 4.4), and regulatory depreciation (discussed in Section 4.5). Both the return on assets and regulatory depreciation are components of the revenue requirement.

Our guidance required Southern Rural Water to propose:

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

⁴⁷ Essential Services Commission, *2023 water price review: Guidance paper*, pp. 32–37.

⁴⁸ These values were set initially for the water corporations by the Minister for Water and are adjusted on an ongoing basis to account for new investments, asset disposals, depreciation and inflation.

4.3.1 Closing regulatory asset base

Our draft decision is to not accept Southern Rural Water's closing regulatory asset base.

We update the regulatory asset base to reflect actual gross capital expenditure, less government and customer contributions, and asset disposals for the period from 2017-18 to 2021-22.⁴⁹ This helps to ensure prices reflect the actual net expenditure of a water business.⁵⁰

Southern Rural Water's proposed closing asset base at 30 June 2022 is provided at page 103 of its price submission.⁵¹ Our draft decision proposes to make adjustments relating to Southern Rural Water's capital contributions and proceeds from disposals to align with its approved regulatory accounts.

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

Southern Rural Water's net capital expenditure over the period from 2017-18 to 2021-22 was \$57.5 million. This is \$27.0 million or 31.9 per cent lower than the forecast used to approve maximum prices for the period from 1 July 2018. This is well below the 10 per cent threshold identified above, so we propose to accept this amount for the purpose of calculating Southern Rural Water's closing regulatory asset base at 30 June 2022 (Table 4.5)

Table 4.5 sets out our draft decision on Southern Rural Water's closing regulatory asset base at 30 June 2022.

⁴⁹ See Section 4.2 for a discussion of Southern Rural Water's capital expenditure.

⁵⁰ Net capital expenditure is calculated by deducting government and customer contributions from gross capital expenditure. Customer contributions reflect revenue earned from new connections made to the water corporation's water, sewerage or recycled water networks.

⁵¹ Available at www.esc.vic.gov.au.

Table 4.5 Draft decision – closing regulatory asset base (RAB)
\$ million 2022-23

	2017-18	2018-19	2019-20	2020-21	2021-22
Opening RAB 1 July	49.4	61.2	72.4	91.1	73.6
Plus gross capital expenditure	35.7	53.8	29.8	15.7	10.5
Less government contributions	17.5	27.6	3.7	21.7	4.6
Less customer contributions	0.6	9.5	1.7	0.4	0.6
Less proceeds from disposals	0.8	1.3	0.4	5.0	0.6
Less regulatory depreciation	5.1	4.3	5.2	6.0	6.6
Closing RAB 30 June	61.2	72.4	91.1	73.6	71.7

Note: Numbers have been rounded.

4.3.2 Forecast regulatory asset base

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

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

Reflecting our preliminary view on Southern Rural Water’s closing regulatory asset base, our draft decision is to not accept Southern Rural Water’s forecast regulatory asset base.

Table 4.6 sets out our draft decision on Southern Rural Water’s forecast regulatory asset base from 1 July 2023.⁵² Our assessments of the components of the forecast regulatory asset base are outlined in different sections of this draft decision paper as follows:

- Section 4.2 (capital expenditure)
- Section 4.3.2.1 (customer contributions)

⁵² Our guidance required water businesses to provide an estimate of the components of their regulatory asset base for 2022-23. This was so we could assess the opening asset base for 1 July 2023. Our guidance noted that where the 2022–23 forecasts for net capital expenditure (gross capital expenditure less government and customer contributions) is lower than the forecast benchmark for that year in its 2018 price determination, the lower amount must be used. The estimates for 2022-23 will be confirmed at the price review following the 2023 water price review. Essential Services Commission, *2023 water price review: Guidance paper*, p. 38.

- Section 4.5 (regulatory depreciation).

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

	2022-23	2023-24	2024-25	2025-26	2026-27	2027-28
Opening RAB 1 July	71.7	102.8	129.6	141.9	149.5	159.7
Plus gross capital expenditure	53.8	48.4	25.3	16.8	19.6	15.1
Less government contributions	12.1	13.8	4.4	0.4	0.0	0.0
Less customer contributions	2.7	2.5	2.5	2.5	2.5	2.5
Less proceeds from disposals	0.8	0.8	0.8	0.8	0.8	0.8
Less regulatory depreciation	7.0	4.5	5.3	5.5	6.0	6.8
Closing RAB 30 June	102.8	129.6	141.9	149.5	159.7	164.7

Note: Numbers have been rounded.

4.3.2.1 Customer contributions

Our draft decision is to accept Southern Rural Water's forecasts for revenue from customer contributions.

Revenue from customer contributions is deducted from gross capital expenditure so it is not included in the regulatory asset base.⁵³

Unlike urban water businesses, where customer contributions to capital are mostly a result of standard new customer contribution charges, Southern Rural Water does not generate contributions from customer contribution charges.

For Southern Rural Water, customer contributions represent the expected proceeds from the sale of created water entitlements in the Macalister Irrigation District. We reviewed Southern Rural Water's forecast customer contributions and our preliminary view is that we consider that they have been estimated consistent with our guidance.

Our draft decision is to accept Southern Rural Water's forecasts for customer contributions.

⁵³ Revenue from new customer contributions reflects revenue earned from new connections made to the water corporation's water, sewerage or recycled water networks.

4.4 Rate of return

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

4.4.1 Cost of debt

Our draft decision is to accept the cost of debt proposed by Southern Rural Water.

Our guidance required Southern Rural Water to use estimates of the cost of debt provided by the commission to estimate its revenue requirement. Southern Rural Water used the cost of debt values we specified to calculate its revenue requirement. For this reason, as set out in Table 4.7, our draft decision is to accept the cost of debt proposed by Southern Rural Water, noting that the cost of debt estimates will be updated following the release of the Australian Bureau of Statistics March Quarter 2023 consumer price index.

Table 4.7 Draft decision – cost of debt

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

Note: Numbers have been rounded. ^a Estimated cost of debt – we will update the 2022-23 figure before the final decision and price determination.

4.4.2 Return on equity

Our draft decision is to adopt a return on equity of 4.1 per cent, which reflects Southern Rural Water’s PREMO self-rating.

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

Our guidance included a matrix proposing the return on equity we would adopt, based on the combination of the business's self-rating and our rating.⁵⁴ We reviewed the return on equity values in the matrix in mid-2022 given the change in market conditions that has occurred since we published our guidance in October 2021. We consider that the values in our matrix reflect the medium-term real rates of return.⁵⁵

Southern Rural Water rated its price submission as 'Standard'. Based on this PREMO self-rating, Southern Rural Water proposed a return on equity of 4.1 per cent per annum. This reflects the maximum return rate allowed in our guidance for a price submission rated as 'Standard'.⁵⁶

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

4.5 Regulatory depreciation

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

Regulatory depreciation is a component of Southern Rural Water's revenue requirement and is also an input to calculating the regulatory asset base. Southern Rural Water's forecast regulatory depreciation was calculated using a straight-line depreciation profile.⁵⁷ We noted in our guidance that we prefer this approach.⁵⁸ Southern Rural Water also calculated regulatory depreciation in a manner consistent with our guidance.

However, because our draft decision is to not accept Southern Rural Water's forecast regulatory asset base, our draft decision is to not accept Southern Rural Water's forecast depreciation. We have used Southern Rural Water's assumptions about asset lives to recalculate forecast amounts for our draft decision.

⁵⁴ Essential Services Commission, *2023 water price review: Guidance paper*, pp. 42–43.

⁵⁵ We will continue to monitor market conditions and may amend the return on equity matrix values to reflect any changes to the medium-term outlook prior to releasing our final decision. We have had regard to the return on equity adopted by interstate regulators in the following publications: Independent Pricing and Regulatory Tribunal NSW, *Final Report - Review of WaterNSW's rural bulk water prices*, 9 September 2021; Independent Pricing and Regulatory Tribunal NSW, *Final Report - Review of prices for Sydney Water*, June 2020; Essential Services Commission of South Australia, *SA Water's water and sewerage retail services: 1 July 2020 - 30 June 2024*, Price Determination, 1 July 2020; Queensland Competition Authority, *Final report - Seqwater bulk water price review 2022–26*, March 2022; Queensland Competition Authority (QCA), *Final report - Rural irrigation price review 2020–24, Part A: Overview*, January 2020; Office of the Tasmanian Economic Regulator, *Final report - Investigation into TasWater's prices and services for the period 1 July 2022 to 30 June 2026*, May 2022.

⁵⁶ Essential Services Commission, *2023 water price review: Guidance paper*, p. 42.

⁵⁷ For the period from 2022-23 to 2027-28, Southern Rural Water proposed a regulatory depreciation of \$35.0 million.

⁵⁸ Essential Services Commission, *2023 water price review: Guidance paper*, p. 39.

Our draft decision on regulatory depreciation is shown in Table 4.6 in Section 4.3.2.

4.6 Tax allowance

Our draft decision is to accept Southern Rural Water's proposed forecast of no tax allowance for the 2023–28 regulatory period.

The tax allowance is a component of the revenue requirement. Southern Rural Water has proposed no tax allowance in its revenue requirement for the 2023–28 regulatory period as it will not be in a tax paying position during the 2023–28 regulatory period.

Our draft decision is to accept the forecast as it was calculated consistently with the method required by our guidance.⁵⁹

⁵⁹ Essential Services Commission, *2023 water price review: Guidance paper*, pp. 47–48.

5. Demand, tariffs and prices

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

5.1 Demand

Our draft decision is to accept Southern Rural Water's demand forecasts.

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

Southern Rural Water's demand forecasts are set out at pages 44 to 45, 98 and 104 to 105 of its price submission and are also included in its financial model.

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

5.2 Form of price control

Our draft decision is to accept Southern Rural Water's proposed hybrid revenue cap form of price control.

Our guidance indicated we would have particular regard to whether a business proposed to continue its existing form of price control or introduce a new form of price control.⁶⁰

Southern Rural Water proposed a hybrid revenue cap form of price control as set out on page 106 of its price submission. It proposes to continue with:

- price caps for application fees, transfers and renewals
- pricing principles for recycled water charges
- revenue cap for the remainder of its annual fees and charges.

It also proposed:

- cost recovery for bulk entitlement orders (currently under a revenue cap)
- price caps for pre-application fees and site visit fees (new charges)
- cost recovery for peer review fees and public advertising fees (new charges).

⁶⁰ Essential Services Commission, *2023 water price review: Guidance paper*, p. 50.

We have reviewed Southern Rural Water’s proposal and consider it is consistent with our pricing principles.

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

- it largely reflects a continuation of current arrangements, with the changes to bulk entitlement charges allowing a more effective mechanism to recover these costs
- it provides sufficient revenue to cover the forecast efficient costs of providing services and for Southern Rural Water to deliver on any health, safety and environmental obligations
- it is otherwise consistent with the requirements of our guidance.

5.3 Tariff structures and prices

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

Southern Rural Water’s proposed tariffs are set out at pages 108 to 114 of its price submission.

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

5.3.1 Tariff structures

As outlined in our guidance, we have provided the water businesses with a large degree of discretion to decide on individual tariff structures.⁶¹ This recognises water businesses are often best placed to consider the interests of customers in designing tariffs, and that existing tariff structures have been developed over time to deal with a variety of local circumstances.

Southern Rural Water proposed to maintain its existing tariff structure with the following changes:

- introducing four new charges – pre-application fees, site visits, peer review fees and public advertising fees – to address historic under-recovery of costs associated with applications.⁶²
- modifying its bulk entitlement charges and its Latrobe Resource Management Fee
- moving its bulk entitlement charges, recreation charges, Latrobe Resource Management Fee and its charges relating to its recycled water scheme from the schedule of rural prices to the list of miscellaneous charges.

⁶¹ Essential Services Commission, *2023 water price review: Guidance paper*, p. 51.

⁶² Southern Rural Water will not apply these charges without knowledge and consent of customers.

Regarding bulk entitlement charges, Southern Rural Water proposed to remove the 5 per cent price cap that currently applies and calculate charges in accordance with the various bulk entitlement orders, which are based on a cost reimbursement model. We note Southern Rural Water's engagement findings supports this approach, with bulk entitlement holders agreeing to the removal of the cap provided Southern Rural Water advises them of intended works in accordance with the notification requirements in the bulk entitlement orders.

Gippsland Water has submitted a response to Southern Rural Water's price submission on its proposed recreational charges, seeking a review of these arrangements.⁶³

Southern Rural Water proposed to maintain its charges for recreation facilities but review the application of shared services and corporate overheads on recreation facilities, as well as the operating expenditure costs of maintaining recreation facilities. Additionally, it proposed to cap the recreational facilities charge on Gippsland Water at \$446,000 plus inflation per annum, and unless otherwise agreed, limit the annual increase in recreational facility charges to inflation.

It believes that these costs should be levied on other bulk entitlement holders who operate in this area. We note that water businesses' recreational charges are not prescribed services under the Water Industry Regulatory Order 2014. We consider most of the issues outlined in Gippsland Water's submission to be a policy matter. However, we requested Southern Rural Water to provide us information on how it allocates costs between headworks (a prescribed service) and recreational facilities (a non-prescribed service) in the Blue Rock Reservoir, Cowwarr Weir and Lake Glenmaggie areas. We reviewed Southern Rural Water's approach and consider it to be reasonable.

Our draft decision is to accept Southern Rural Water's proposal:

- to introduce four new charges (pre-application fees, site visits, peer review fees and public advertising fees) as they are in line with pricing principles and will contribute to a sustainable revenue stream
- to remove the 5 per cent price cap on bulk entitlement charges and calculate the charges in accordance with the bulk entitlement orders, as this will allow actual costs to be recovered and is based on pricing principles
- to retain the existing arrangements for recreation charges, noting its commitment to review these arrangements and to cap the charges for Gippsland Water

⁶³ Gippsland Water, submission to the Essential Services Commission on Southern Rural Water's 2023 price submission, 6 October 2022.

- to move bulk entitlement charges, recreation charges, charges related to its recycled water scheme and the Latrobe resource management fee from the schedule of rural prices to the list of miscellaneous charges as it reflects pricing principles.

5.3.2 Prices

The prices proposed by Southern Rural Water for water services are set out on pages 108 to 109 of its price submission.

Under Southern Rural Water's proposal, the following average annual customer bill impacts (excluding inflation) can be expected:

- 1.5 per cent higher for Macalister Irrigation District customers
- 1.0 per cent higher for Werribee Irrigation District customers
- 1.5 per cent higher for Latrobe bulk entitlement holders
- 1.9 per cent higher for Werribee and Maribyrnong bulk entitlement holders
- capped at inflation for Bacchus Marsh Irrigation District and Groundwater and Rivers customers.

As outlined in our guidance, we have provided Southern Rural Water with a large degree of discretion to decide on individual tariff structures.⁶⁴ This recognises that Southern Rural Water, in consultation with its customer consultative committees and customers, is 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.

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

Based on recent inflation outcomes and market expectations, the annual outcome for the March Quarter 2023 consumer price index is likely to be relatively high.⁶⁵ For the 2023–28 regulatory period, we have assumed an inflation rate of 3 per cent per year, which is significantly lower than near-term inflation expectations.

⁶⁴ Essential Services Commission 2022, *op. cit.*, p. 51

⁶⁵ The latest (February 2023) Reserve Bank of Australia Quarterly Statement on Monetary Policy forecast the consumer price index to change (over the year) fall to around 4.8 per cent by December 2023 and 3.2 per cent by December 2024.

Many of the drivers of higher inflation (such as fuel, food and travel) are not major cost items for water businesses. Some high-cost growth areas specific to the water sector such as insurance and chemicals have been accounted for in uplifts to their opening base costs for the 2023–28 regulatory period. Accordingly, it may be the case that the inflation that is added to prices in 2023-24 provides an uplift in revenue that is well above a business’s actual costs for the year. Considering this, and Southern Rural Water’s proposal for generally flat or increasing prices in real terms over the 2023–28 regulatory period, we are seeking further information from Southern Rural Water in response to our draft decision on how it intends to address the impacts of relatively high inflation on its proposed prices and customer bills for 2023-24.⁶⁶

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

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

5.3.3 Addressing the interests of low income and vulnerable customers

In making our price determination, we must have regard to whether Southern Rural Water’s prices take into account the interests of customers, including low income and vulnerable customers.⁶⁷

There is evidence that Southern Rural Water has sought to address the interests of low income and vulnerable customers because Southern Rural Water proposed to cap prices to inflation for more than 86 per cent of its customers, and prices are directly aligned with proposed expenditure. Southern Rural Water customers have indicated they prioritise profitability over affordability, and we accept that Southern Rural Water’s proposed prices will allow them to deliver on the outcomes agreed with their customers.

⁶⁶ This is relevant to clause 11(d)(ii) of the Water Industry Regulatory Order 2014 which states that when making a price determination, the commission must have regard to principles that the manner in which a regulated entity’s prices are to be calculated, determined or otherwise regulated, should provide signals about the efficient costs of providing prescribed services to customers (either collectively or to an individual customer or class of customers) while avoiding price shocks where possible.

⁶⁷ Water Industry Regulatory Order 2014 clause 11(d)(iii).

5.3.4 Unique services

Southern Rural Water has confirmed that its proposed tariffs for recycled water and miscellaneous services are calculated in accordance with the pricing principles referenced in our guidance.

5.4 Adjusting prices

Our draft decision is to accept Southern Rural Water's proposed price adjustment mechanisms.

Southern Rural Water's proposed price adjustment mechanisms are set out on pages 114 to 115 of its price submission. It is not proposing any changes to its current price adjustment mechanism.

Our draft decision is to accept Southern Rural Water's proposal to continue its existing price adjustment mechanisms as they satisfy the requirements of our guidance.

6. Financial position

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

In approving prices, we must have regard to the financial viability of the water industry.⁶⁸ We interpret the financial viability requirements under the *Essential Services Commission Act 2001* and the *Water Industry Regulatory Order (2014)* to mean that the prices we approve should provide a high level of certainty that each water business can generate sufficient cash flow to deliver on its service commitments, including financing costs arising from investments to meet service expectations.

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

⁶⁸ WIRO clause 8(b)(ii) and ESC Act s.8A(1)(b).

7. PREMO rating

PREMO is an incentive mechanism that links the return on equity used to calculate a water business’s revenue requirement to that business’s level of ambition expressed in its price submission. Our guidance required Southern Rural Water to self-assess the level of ambition of its price submission for each element of the PREMO mechanism and arrive at an overall self-rating.⁶⁹ We required Southern Rural Water to self-rate its price submission as either ‘Leading’, ‘Advanced’, ‘Standard’ or ‘Basic’, with ‘Leading’ being the most ambitious and ‘Basic’ the least.

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

We also assessed and rated Southern Rural Water’s price submission. As outlined in our guidance, the combination of Southern Rural Water’s self-rating and our rating has determined the return on equity we have adopted to calculate Southern Rural Water’s revenue requirement in our draft decision.

7.1 Our PREMO assessment of Southern Rural Water’s price submission

Our draft decision is to rate Southern Rural Water’s price submission as ‘Standard’ under PREMO, which is the same as Southern Rural Water’s self-rating.

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

Table 7.1 PREMO rating

	Overall PREMO rating	Performance	Risk	Engagement	Management	Outcomes
Southern Rural Water’s self-rating	Standard	Standard	Standard	Advanced	Standard	Advanced
Commission’s rating	Standard	Standard	Standard	Advanced	Basic	Advanced

⁶⁹ This is the first price review we have done where the rating has been based on all five elements of PREMO. In our 2018 price review, our PREMO assessment was against only four of the elements — Risk, Engagement, Management and Outcomes.

We agree with Southern Rural Water’s proposed overall PREMO self-rating of ‘Standard’. This is reflected in the return on equity we propose to approve for Southern Rural Water (see Section 4.4.2). We have formed this view after reviewing Southern Rural Water’s proposed self-rating for each of the five PREMO elements, with a summary of our assessment provided below.

7.1.1 Performance

For the 2023 price review, a business’s rating for the Performance element of PREMO is based on a combination of its overall PREMO rating at its most recent price review, and its level of performance based on achievement of outcomes (related to service targets and performance against expenditure benchmarks set at the previous price review) and customer sentiment.⁷⁰

As noted in Section 3.2, we agree with Southern Rural Water’s self-assessment that it has, overall, met its outcome commitments for the period to date.

As the commission’s survey of customer sentiment covers urban customers only, Southern Rural Water is not covered by it. Southern Rural Water’s price submission (at page 31) provided an overview of customer sentiment. These generally showed the majority of customers surveyed believed the business provided good value for service and were satisfied with the business.

Southern Rural Water’s controllable operating costs during the current regulatory period are forecast to be higher than the benchmark established at the 2018 water price review.

In 2021-22 (the last available year of audited results), its expenditure was around 8 per cent higher than the benchmark adopted at the 2018 water price review, after removing expenditure for non-prescribed storage operator charges (described in Section 4.1.1). This is around the industry average. The higher than benchmark outcome for Southern Rural Water reflects a range of factors, which we summarised in Section 4.1.1.

For the period from 2017-18 to 2021-22, Southern Rural Water’s capital expenditure (in net terms) was lower than the benchmarks adopted at the 2018 water price review. Net capital expenditure for 2022-23 is forecast to be higher. The changes relative to the benchmarks adopted in the 2018 review are mostly due to the timing of projects related to government funding.

Our draft decision is to accept Southern Rural Water’s self-rating of ‘Standard’ for the Performance element of PREMO, on the basis that we consider it met expectations for delivery against outcome commitments (noting it achieved an overall rating of ‘Advanced’ for PREMO in 2018, and could have claimed a rating of ‘Advanced’ if it considered it met performance expectations in the current period).

⁷⁰ As set out in Essential Services Commission, *2023 water price review: Guidance paper*, 26 October 2021 pp. 74-75. Guiding questions are set out on page 45.

7.1.2 Risk

The Risk element of PREMO is assessed against guiding questions focused on the appropriate allocation of risk (so that customers don't pay more than they need to), and the business's proposed guaranteed service level scheme (including that it provides incentives for the business to deliver valued services efficiently).⁷¹

In support of its self-rating of 'Standard' for the Risk element of PREMO, Southern Rural Water's price submission provided an overview of key risks and how these have been addressed in its price submission, including that its risk management approach is consistent with ISO 31000:2018 and requirements under its Statement of Obligations.

Southern Rural Water conducted a specific review for its price submission having regard to risks associated with inflows, demand, operations, construction, regulations, finances, and business risks. It did not identify any material changes in risks or approach to managing risks compared to the current 2018–23 regulatory period.

Based on the above and the material provided by Southern Rural Water in its price submission that identified key risks and their possible impacts, our draft decision accepts its proposed rating of 'Standard' for the Risk element of PREMO.

7.1.3 Engagement

The Engagement element of PREMO is assessed against guiding questions such as the form, timing, and nature of matters engaged on by the water business, and the influence of engagement on proposals. We also consider the extent to which a business has undertaken inclusive engagement, including with First Nations peoples and those experiencing vulnerability.⁷²

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

Southern Rural Water stepped up its engagement from its 2018 price review through the introduction of the independently facilitated customer reference group. This group of representative customers and the Victorian Environmental Water Holder provided a higher level of customer stewardship of the engagement program, and assurance that customer preferences were considered at every stage of the development of Southern Rural Water's price submission.

⁷¹ Essential Services Commission, 2023 water price review: Guidance paper, p. 45.

⁷² Essential Services Commission, 2023 water price review: Guidance paper, p. 45.

Southern Rural Water supported all its deliberative processes with high quality written information and presentation materials. It also received strong endorsement of the level of influence of customers on its pricing proposals with members of the customer reference group strongly endorsing the engagement outcomes, noting their direct influence on communication material, tariff reform options and pricing outcomes.

7.1.4 Management

The Management element of PREMO is assessed against guiding questions that cover matters such as the efficiency of proposed expenditure and prices, the quality of the business's submission and supporting information to justify proposals, and evidence that there is senior-level ownership and commitment to the proposals contained in the submission.⁷³

In support of its self-rating of its price submission as 'Standard' for the Management element of PREMO, as noted in Section 4.1.1, our expenditure review confirmed its proposed operating and capital expenditure as reflecting prudent and efficient forecast costs.

We consider Southern Rural Water's price submission generally provided clear justification for its proposals. However, we found Southern Rural Water's financial model (lodged with its price submission) contained a number of errors and included unexplained changes to some formulas that we embedded in the model. Corrections were needed to its financial model, with the corrections both greater in number and more complex to resolve than other businesses. These matters impeded our review process.

Our draft decision is to not accept Southern Rural Water's self-rating of its price submission as 'Standard' for the Management element of PREMO, and instead adopt a rating of 'Basic'. This reflects the importance we place on submissions that reflect our pricing models and the accuracy of information provided by water businesses.

7.1.5 Outcomes

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

- the alignment of proposed outcomes with customer priorities and expenditure forecasts
- whether the proposed outcomes are measurable
- the processes established to measure performance and report to customers.⁷⁴

As noted in Section 3.2, our preliminary view is that Southern Rural Water has provided evidence that demonstrates its outcome measures and targets were developed in consultation with its

⁷³ Essential Services Commission, 2023 water price review: Guidance paper, p. 45.

⁷⁴ Essential Services Commission, 2023 water price review: Guidance paper, p. 45.

customers, and that they are supported by customers. Its performance measures and targets were developed in response to customer feedback, tested and finalised through its customer consultative committees, customer reference group, and via customer surveys.⁷⁵

Generally, we consider Southern Rural Water's intentions are clear, and its measures and targets will provide a sound basis to track performance and delivery against each outcome, once the matters we identified in our assessment have been addressed.

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

Based on the above, our draft decision is to accept Southern Rural Water's self-rating of 'Advanced' for the Outcomes element of PREMO.

⁷⁵ Southern Rural Water, 2023 water price submission, September 2022, pp. 51 and 52.

Appendix A — Submissions received

Name or organisation	Date received
Gippsland Water	7 October 2022
Consumer Action Law Centre	30 November 2022
People for a Living Moorabool	1 December 2022
Concerned Waterways Alliance	1 December 2022
Concerned Waterways Alliance	21 December 2022

Appendix B — Commission’s consideration of legal requirements

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

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

In addition to the mandatory factors set out below, clause 11 of the WIRO requires the commission to have regard to the matters specified in the commission’s guidance.⁷⁶ We have had regard to the matters specified in our guidance in reaching our preliminary view. Our draft decision provides further information on where we have considered our guidance, and Southern Rural Water’s compliance with our guidance, in reaching our preliminary view.

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

Economic efficiency and viability matters

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

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

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

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

⁷⁶ Essential Services Commission, *2023 water price review: Guidance paper*, 26 October 2021.

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

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

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

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

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

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

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

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

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

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

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

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

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

- A 10-year trailing average approach to estimating the benchmark cost of debt (see Section 4.4.1).
- A regulatory rate of return that we consider will enable Southern Rural Water to recover borrowing costs associated with its investment in services, and generate a return on assets.⁷⁷

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

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

We have had regard to this matter in Chapter 6.

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

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

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

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

⁷⁷ The regulatory rate of return is comprised of the cost of debt and the return on equity.

- Our assessment of tariffs (Section 5.3).

Industry specific matters

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

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

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

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

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

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

Our draft decision provides for Southern Rural Water to generate a return on assets through:

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

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

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

- indicative bills paid by customers in other jurisdictions in Australia⁷⁸
- operating and capital expenditure costs per connection throughout Australia⁷⁹
- tariff structures applied by water businesses throughout Australia⁸⁰
- the regulatory rate of return set by other regulators.⁸¹

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

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

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

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

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

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

⁷⁸ Bureau of Meteorology, *National performance report 2020-21; urban water utilities, part A*, February 2022.

⁷⁹ Bureau of Meteorology, *National performance report 2020-21; urban water utilities, part A*.

⁸⁰ Includes Icon Water, Sydney Water, Hunter Water, Central Coast Council, Power and Water Corp, Urban Utilities, Unity Water, SA Water and TasWater.

⁸¹ Independent Pricing and Regulatory Tribunal NSW, *Final Report - Review of WaterNSW's rural bulk water prices*, 9 September 2021; Independent Pricing and Regulatory Tribunal NSW, *Final Report - Review of prices for Sydney Water*, June 2020; Essential Services Commission of South Australia, *SA Water's water and sewerage retail services: 1 July 2020 - 30 June 2024*, Price Determination, 1 July 2020; Queensland Competition Authority, *Final report - Seqwater bulk water price review 2022–26*, March 2022; Queensland Competition Authority (QCA), *Final report - Rural irrigation price review 2020–24, Part A: Overview*, January 2020; Office of the Tasmanian Economic Regulator, *Final report - Investigation into TasWater's prices and services for the period 1 July 2022 to 30 June 2026*, May 2022.

Customer matters

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

- Our consideration of customer engagement (Section 3.1).

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

Health, safety, environmental and social obligations

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

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

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

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

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

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

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

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

Other matters

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

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

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

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

We consider that our pricing approach helps to address market power and information asymmetries relating to the water businesses. Our PREMO water pricing approach provides incentives for a water business to provide its “best offer” to customers in its price submission. This is described in further detail in a report we released in 2016.⁸²

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

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

- Implementing a price review process so that water businesses may receive streamlined price reviews if they submit a high quality price submission. This reduces the costs of regulation for water businesses and the commission.
- Focusing our assessments of price submissions on the materiality of proposals to customer interests (including low income and vulnerable services), including in terms of price, bill and service impacts.
- Designing our guidance so we minimise the compliance costs for water businesses. Our guidance noted that much of the information required in price submissions should be readily available to water businesses as it would be relevant for other purposes such as corporate planning and project prioritisation and justification.⁸³

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

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

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

⁸² Essential Services Commission 2016, Water Pricing Framework and Approach, Implementing PREMO from 2018, October, pp. 11–13.

⁸³ Essential Services Commission, 2023 water price review: Guidance paper, p. 2.

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

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

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

- Implementing a price review process so that water businesses may receive streamlined price reviews if they submit a high quality price submission. This reduces the costs of regulation for water businesses and the commission.
- Focusing our assessments of price submissions on the materiality of proposals to customer interests (including low income and vulnerable services), including in terms of price, bill and service impacts.
- Designing our guidance so we minimise the compliance costs for water businesses. Our guidance noted that much of the information required in price submissions should be readily available to water businesses as it would be relevant for other purposes such as corporate planning and project prioritisation and justification.⁸⁴

⁸⁴ Essential Services Commission, 2023 water price review: *Guidance paper*, p. 2.