



Yarra Valley Water draft decision

2023 Water Price Review

20 December 2022



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Summary

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

This draft decision sets out our preliminary views on Yarra Valley Water's price submission.¹ Our draft decision should be read together with Yarra Valley 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 May 2023. For details of how to provide feedback, see our dedicated Engage Victoria page: <https://engage.vic.gov.au/water-price-review-2023>.

We have released an early draft decision for Yarra Valley Water

Yarra Valley Water's price submission provided clear and comprehensive information supporting its proposals. It also provided evidence that its engagement revealed the main priorities and concerns of its customers, and that it has taken this feedback into account. This enabled us to quickly assess its price submission against the legal framework.

While we intend to explore some (confined) areas further in the lead up to our final decision, we consider these do not involve matters that materially impact on customer prices or outcomes.

For these reasons, we are releasing this draft decision earlier than for most other water businesses. We have also released an early draft decision for Westernport Water. We will release draft decisions for the remaining water businesses by the end of March 2023.

Yarra Valley Water has evolved its outcomes to reflect customer priorities, including a focus on Caring for Country

Yarra Valley Water plans to deliver the following outcomes for customers:

- Safe and pleasant drinking water
- Reliable water and sewerage services
- Timely response and repair

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

- Service that meets everyone’s needs
- Saving water for the future
- Looking after our natural environment.²

These have been refined by Yarra Valley Water since its 2018 review, informed by its engagement. It will embed Caring for Country in all decisions, including its approach to delivering on its outcome commitments and targets. Service improvements are focused in areas such as investing in climate resilience including reducing carbon emissions (targeting a net zero position by 2025) and enhancing asset security, and water quality. This is in addition to investments to respond to growth in its region and maintaining best practice in customer support programs.

Yarra Valley Water’s proposal means annual water and sewerage bills will fall in 2023-24 (excluding inflation)

Based on Yarra Valley Water’s price submission and our draft decision, the typical annual water and sewerage bill for a residential owner-occupier will fall from \$1,034 currently, to \$986 in 2023-24, and \$956 in 2024-25. Bills remain steady to 2027-28 (Table A). These estimates exclude inflation (they are in \$2022-23 terms). Bills for household tenants will fall from \$504 in 2022-23 to \$480 in 2023-24 and \$466 in 2024-25. Tenant bills are then forecast to remain steady to 2027-28. Estimated annual water and sewerage bills for non-residential customers are also shown below.

The reduction in (real) customer bills partly reflects a relatively high rate of efficiency improvement compared to other businesses in our current price review, as well as forecast customer growth.

Estimated bills are likely to change following our draft decision, to reflect our updates for inflation and the cost of debt. There are also some confined areas (noted below) for further exploration that may also impact Yarra Valley Water’s revenue requirement and prices approved in our final decision and determination, which could impact estimated customer bills.

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

	Average consumption (kL p.a.)	2022-23 (current)	2023-24	2027-28
Residential – owner occupier	150	1,034	986	956
Residential – tenant	150	504	480	466
Non-residential (small)	150	1,575	1,503	1,457
Non-residential (medium)	1,000	5,644	5,386	5,222
Non-residential (large)	10,000	48,732	46,505	45,090

² Yarra Valley Water, 2023 price submission, September 2022, pp. 37–56.

Our draft decision approves a revenue requirement that is slightly lower than Yarra Valley Water’s proposal

Our draft decision is to approve a revenue requirement that will allow Yarra Valley Water to deliver on its customer service commitments, government policy, and obligations monitored by the Environment Protection Authority Victoria and the Department of Health.

Our draft decision is to approve a revenue requirement of \$4,891.0 million for Yarra Valley Water over the 5-year period starting 1 July 2023.³ This compares to the \$4,894.9 million originally proposed by Yarra Valley Water.⁴ Our draft decision reflects our review of efficient costs.

We note our draft decision is not to accept Yarra Valley Water’s proposed new customer contributions (Section 5.4), because we need to continue our review of its proposal to recover sunk costs. We are also interested in further feedback from stakeholders on its proposed transition path to higher charges. We have adopted Yarra Valley Water’s proposed forecasts for revenue from customer contributions for our draft decision (Section 4.3.2.1).

Tariff structures will generally remain the same, noting Yarra Valley Water will simplify charges for residential customers

For residential customers receiving both water and sewerage services, Yarra Valley Water proposed to combine its residential sewage disposal charge and its residential variable water charge. This was justified by Yarra Valley Water based on simplicity, and that it is supported by customers. We agree with its justification and our draft decision approves this proposal.

Our draft decision is to approve other water and sewerage tariff structures proposed by Yarra Valley Water. We note they remain unchanged and generally supported by customers.

Our draft decision is to accept Yarra Valley Water’s proposed revenue cap form of price control (Section 5.2). This means its revenue is capped subject to annual updates for demand, the cost of debt, changes in bulk charges, and any other price adjustments we approve in our price determination (Section 5.5). Yarra Valley Water currently uses a revenue cap.

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 corporation.

⁴ The difference is due to Yarra Valley Water’s incorrect treatment of rebate amounts related to the return of money to customers for not meeting performance targets, in its financial model for 2023-24.

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

Our draft decision is to rate Yarra Valley Water's price submission as 'Advanced' under the PREMO framework (Table B). This is the same as Yarra Valley Water's self-rating of its price submission.

Key factors supporting this PREMO rating include:

- sound performance against its outcome commitments in the current regulatory period, and a major project delivery record that compares favourably to other water businesses
- a strong engagement program which gives confidence that its proposals are informed by deep insights into customer priorities and concerns
- it demonstrated the ability for customers to influence its proposals, by clearly linking key proposals and initiatives such as Caring for Country, to recommendations of its Citizens' Juries
- aligning its proposed expenditure with key outcomes proposed
- a relatively high operating cost efficiency target and commitment to absorbing future cost increases should they arise, such as above-inflation labour cost growth
- recognising the possible impacts of a high inflation outlook on prices in the near term, and proposing a price path (including limits on nominal price increases) that help to manage these impacts for its customers
- relatively strong outcomes on the commission's customer perception survey
- its commitment to return funds to customers or the community where service targets are not met, demonstrating a level of accountability for underperformance that stands out compared to the other water businesses
- the overall strength of the justification for the prudence and efficiency of its forecast expenditure.

Yarra Valley Water also provided a price submission and supporting model that were of a high quality.

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. It is not an assessment of the water business itself.

Table B **PREMO rating**

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

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 May 2023.

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

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

Table C lists specific issues we are seeking feedback to inform our final decision and price determination for Yarra Valley Water.

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

Topic	Specific issue	Draft report reference
Guaranteed service levels	Yarra Valley Water's proposed guaranteed service levels, including its proposal for a new guaranteed service level and rebate focused on water quality.	Section 3.3
New customer contributions	Yarra Valley Water's proposed standard new customer contributions and transition path to higher charges.	Section 5.4

How to provide feedback and stay up to date

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

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

You can provide feedback by:

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

Taking part in a public forum

We plan to hold a public forum in late February 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 are due by 10 March 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 and/or anonymity in relation to your submission. Requesting this may affect the weight we can give to your submission.

Next steps

Activity	Indicative date
Public forum	Late February 2023
Closing date for submissions on our draft decision	10 March 2023
Release date for our final decision and price determination	Late May 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 corporations 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 corporations propose to charge customers for prescribed services from 1 July 2023.⁵ The prescribed services include retail water and sewerage services, and bulk water and sewerage services delivered by the water corporations.⁶

Yarra Valley 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 Yarra Valley Water may charge for prescribed services, or the manner in which prices are to be calculated, determined or otherwise regulated. We will also issue a final decision that explains the reasons for our price determination.

1.3 We assess prices against the WIRO and other legal requirements

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

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

⁵ The review excludes Melbourne Water, Goulburn-Murray Water, North East Water and Greater Western Water. In 2021 we approved prices for Melbourne Water to 30 June 2026 and in 2020 we approved prices for Goulburn-Murray Water to 30 June 2024. In 2018, we approved prices for North East Water to 30 June 2026. We have approved an extension to the regulatory period for Greater Western Water to 30 June 2024.

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

- the matters set out in section 33(3) of the ESC Act, which include the return on assets, relevant benchmarking and any other matters that the Essential Services Commission considers relevant
- the matters specified in our guidance⁷
- the principle that prices should be easily understood by customers and provide signals about the efficient costs of providing services, while avoiding price shocks where possible
- the principle that prices should take into account the interests of customers of the regulated entity, including low income and vulnerable customers.

Attachment 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.⁸ Table 1.1 summarises the matters we must have regard to and groups them into themes.

In October 2021, we issued guidance to Yarra Valley Water to inform its price submission. The guidance set out how we would assess Yarra Valley Water's submission against the matters we must consider under clause 11 of the WIRO. It also outlined our expectation that Yarra Valley Water would comply with certain requirements and specified information that Yarra Valley 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 Yarra Valley Water's proposed prices.⁹

If we consider the submission does not have adequate regard for the matters specified in clause 11 of the WIRO or 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.¹⁰

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

⁸ Essential Services Commission 2022, *Yarra Valley Water draft decision, 2023 Water Price Review – commission's consideration of legal requirements*, 20 December. This is located on our website at www.esc.vic.gov.au

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

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

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 corporations 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 and 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 corporations 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.

For the 2023 water price review, a water corporation'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 corporation's justification for the proposed PREMO rating, and form our own view of the appropriate rating. This process determines the PREMO rating adopted and the return on equity reflected in the revenue requirement.¹¹

1.5 Early draft decisions

We may fast-track a price submission to an early draft and final decision if it provides comprehensive and clear information in support of its proposals. We anticipate that final decisions for fast-tracked price submissions will be made in May 2023 rather than June 2023.

We may release a fast-tracked draft decision in response to a price submission if:

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

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

2. Our assessment of Yarra Valley Water's price submission

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

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

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

We found Yarra Valley Water's price submission presented clear and comprehensive information to support its proposals. Yarra Valley 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).

For these reasons, we were able to form an early view that we accept most of Yarra Valley Water's proposals for our draft decision. We intend to explore some areas further in the lead up to our final decision. However, we consider these do not involve matters that materially impact on customer prices, or the outcomes proposed by Yarra Valley Water.

If consultation on our draft decision does not result in significant further review being required, we intend to make a price determination for Yarra Valley Water in May 2023. If consultation, or our ongoing assessment, causes us to form a view that significant further review is required, we may defer our price determination for Yarra Valley Water until June 2023.

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



Yarra Valley Water must submit a response to our draft decision and provide an updated financial model by 10 March 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 Yarra Valley Water in May 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 Yarra Valley Water has committed to over the regulatory period (Chapter 3)
- establish Yarra Valley 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 Yarra Valley Water's financial position, which we have also had regard to.

Chapter 7 outlines our assessment of Yarra Valley Water's price submission under the PREMO framework.

2.2 Regulatory period

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

We are required to set the term of the regulatory period over which a water business's price determination will apply.¹² Our guidance proposed that we set a 5-year regulatory period, but also noted we were open to justified alternatives proposed in a price submission.¹³

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

¹³ For detail on the reasons for using 5 years as the default regulatory period, see: Essential Services Commission, *2023 water price review: Guidance paper*, p. 18.

Yarra Valley 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.

3. Customer outcomes

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

3.1 Customer engagement

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

We consider Yarra Valley Water’s engagement aligned with these principles in a number of ways:

- Yarra Valley Water engaged early in its planning on proposals that were informed by more than 39,000 customer interactions since the previous price review in 2018.
- It developed a wide range of engagement methods such as a citizens’ jury, willingness to pay studies, workshops and panels. It engaged deeply, providing opportunities for external stakeholders to set the context and direction of the overall engagement through co-design.
- Yarra Valley Water tailored its engagement methods to the circumstances facing its customers, including its First Nations customers and Traditional Owners who were involved in key stages of the citizens’ jury.
- It engaged using methods that were inclusive for customers more likely to experience vulnerability, including youth, customers who are vision or hearing impaired, and customers who are culturally and linguistically diverse.
- It engaged on matters that influence services and prices, such as water and the environment, water quality and reliability of services, bills and affordability, customer support and communications, and water conservation.

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

More detail on Yarra Valley Water's engagement is available in its price submission.¹⁵ A submission from the Consumer Action Law Centre noted that it was pleased to see Yarra Valley Water actively seek out the views of those communities not often captured in engagement activities.¹⁶

Actions taken by Yarra Valley Water in response to its citizens' jury recommendations provide evidence that its engagement influenced its proposals. For example, in its price submission, Yarra Valley Water proposed:

- acknowledging Traditional Owners/Custodians on its bills¹⁷
- developing a formal partnership agreement with Wurundjeri Woi Wurrung Cultural Heritage Aboriginal Corporation as the Traditional Custodian/Owner of its service area, and developing ongoing relationships and an advisory forum with Aboriginal communities to embed Caring for Country in the way it delivers all its commitments to customers¹⁸
- adapting its approach to digital meters to include accountability measures and targeted communication on the timing, cost, and benefits of their introduction¹⁹
- improving communications to help further break down barriers that exist for some customers²⁰
- stewarding water conservation initiatives to deliver permanent reductions in customers' water use.²¹

The influence of Yarra Valley 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 Yarra Valley Water has designed and delivered a high-quality engagement program and achieved strong customer and stakeholder influence on the proposals in its submission.

We consider that Yarra Valley Water's engagement was highly representative of its diverse customer base, and it used methods to ensure a deeper level of engagement, including through the co-design of its engagement process. Examples included:

- stakeholders developing the central questions that guided the deliberations of the citizens' jury

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

¹⁶ Consumer Action Law Centre, Initial Feedback: 2023-28 Water Price Review, 1 December 2022, p. 8.

¹⁷ Yarra Valley Water, 2023–28 Price Submission, September 2022, p. 41.

¹⁸ Yarra Valley Water, 2023–28 Price Submission, September 2022, p. 41.

¹⁹ Yarra Valley Water, 2023–28 Price Submission, September 2022, p. 187.

²⁰ Yarra Valley Water, 2023–28 Price Submission, September 2022, p. 12.

²¹ Yarra Valley Water, 2023–28 Price Submission, September 2022, p. 53.

- the Aboriginal Community Working Group self-determining their role and scope for their involvement in the citizens' jury process
- providing translation services (including Auslan interpreters) and arranging methods to support inclusive participation (such as mini-panels) to gain insights from people experiencing vulnerability.

We also consider that Yarra Valley Water was adaptable, ensuring its engagement considered changes in the customer environment. For example, in September 2022 it retested the results of its May 2022 willingness to pay study given subsequent changes in the cost of living and community concerns that were not present at the time of its first study.

We consider that Yarra Valley Water stepped up its engagement from an already high level in the 2018 price review and, based on the above, our draft decision is that we agree with its self-rating of 'Leading' for its price submission engagement.

See Chapter 7 for more detail on our PREMO assessment of Yarra Valley Water's price submission.

3.2 Outcomes

3.2.1 Performance against outcome commitments 2018–23

As part of our 2018 water price review, Yarra Valley Water established outcomes it would deliver to its 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 2023.²²

We consider Yarra Valley Water accounted for its annual performance in its price submission. We note, like many other water businesses, Yarra Valley Water's price submission did not include its overall rating against each outcome for the period to date. In the absence of this information, we have drawn on our 2021-22 Outcomes report for Yarra Valley Water's period to date rating.²³

Table 3.1 lists Yarra Valley Water's outcome commitments and includes its annual performance results as reported in its price submission and in our 2021-22 Outcomes report.²⁴ The information

²² Essential Services Commission, 2023 water price review: Guidance paper, 26 October 2021, p. 23.

²³ Essential Services Commission, Yarra Valley Water's outcomes performance 2021-22, October 2022.

²⁴ Yarra Valley Water, 2023 water price submission, September 2022, p. 19; Yarra Valley Water, 2023 water price submission, Appendix A, 2018–23 outcomes in review, September 2022, p. 119–140; Essential Services Commission, Yarra Valley Water's outcomes performance 2021-22, October 2022.

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
Safe drinking water	Green	Green	Green	Green	Green
Reliable water and sewerage services	Green	Amber	Amber	Green	Amber
Timely response and restoration	Green	Green	Green	Green	Green
Fair access and assistance for all	Green	Green	Green	Green	Green
Water availability and conservation	Red	Amber	Amber	Red	Red
Modern flexible service	Amber	Green	Green	Green	Green
Care for and protect the environment	Green	Green	Green	Green	Green

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

Yarra Valley Water considers it achieved 21 of its 28 annual customer outcome targets (75 per cent) over the first 4 years of the 2018–23 regulatory period, despite challenges due to the coronavirus pandemic, extreme weather events and most recently economic and geopolitical uncertainty. It also noted customer bills in 2022-23 are lower than they were in 2017-18, in both real and nominal terms.²⁵

Yarra Valley Water has failed to meet its ‘water availability and conservation’ outcome for the period to date. In its price submission, Yarra Valley Water noted that it set targets that reflect its customers’ expectations to achieve ongoing efficiencies to help save water for the future. The measure comprises the water it buys from Melbourne Water, the water its customers use, water used for firefighting, and water lost due to bursts, and system and pipe leakage. Yarra Valley Water considered it set itself ambitious targets for the period, and although it did not meet these, it did see a decrease in water use.²⁶

In its price submission, Yarra Valley Water outlined how it addressed shortfalls in performance. Although Yarra Valley Water failed to meet some targets, it has returned the equivalent of \$10.5 million to its customers through setting prices lower than approved maximum prices, and

²⁵ Yarra Valley Water, 2023 water price submission, September 2022, p. 18.

²⁶ Yarra Valley Water, 2023 water price submission, September 2022, pp. 132-133.

anticipates returning another \$1.5 million through its 2023-24 prices.²⁷ This level of accountability for underperformance stands out compared to the other water businesses and demonstrates Yarra Valley Water's commitment to providing value to its customers.

In the current regulatory period, Yarra Valley Water demonstrated ownership of its performance by promptly reporting its annual performance results prominently on the homepage of its website, and via bill inserts. We also consider its self-assessments for the four reporting years were reasonable and well explained.

Our draft decision is that we agree with Yarra Valley 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

Yarra Valley Water engaged with its customers to refine its outcome commitments for the period from 1 July 2023 to 30 June 2028. It has established six customer outcomes it proposes to deliver:

- Safe and pleasant drinking water
- Reliable water and sewerage services
- Timely response and repair
- Service that meets everyone's needs
- Saving water for the future
- Looking after our natural environment.²⁸

Informed by its engagement, it will embed Caring for Country in all decisions, including its approach to delivering on its commitments and targets.

Some of the specific targets that Yarra Valley Water has set include meeting 100 per cent of its energy requirements from renewables and achieving zero net carbon emissions by 2025, underpinned by its Climate Resilience Plan.²⁹ Summarised in its price submission, this Plan sets out Yarra Valley Water's approach to meeting its renewable energy and emissions targets, and its broader response to climate change including asset resilience and water conservation.³⁰ The Plan accounts for a proposed investment of \$134 million over the 2023–28 regulatory period, across a range of initiatives.

²⁷ Yarra Valley Water, 2023 water price submission, September 2022, p. 19.

²⁸ Yarra Valley Water, 2023 water price submission, September 2022, p. 37–56.

²⁹ The Plan is referenced and linked at page 66 of its price submission.

³⁰ Yarra Valley Water has taken into account water conservation and efficiency measures, and a long-term horizon for managing the impacts of climate change; matters noted in a submission by the Concerned Waterways Alliance (Concerned Waterways Alliance submission to the Essential Services Commission Water Price Review 2023).

Yarra Valley Water will also establish new measures for customer satisfaction with the quality of its drinking water, and invest in alternative water supplies including new recycled water plants and transfer systems (with a forecast capital cost of around \$240 million) to help it meet targets for recycled water use in designated areas.

3.2.3 Our assessment of measures and targets

Yarra Valley Water proposed a set of 17 measures and targets that it will use to report on its performance across the 6 outcomes. These are set out on pages 42 to 56 of its price submission. Performance against these measures will inform our assessment during future price reviews.

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

- be relevant to, or be a reasonable proxy for, the delivery of the outcome they represent
- be measurable
- be clearly defined and unambiguous
- be easy for customers to understand
- have performance targets listed for each year of the regulatory period.³¹

Evidence provided by Yarra Valley Water demonstrates that these measures and targets were developed in consultation with its customers, and that they are supported by its customers.³² We received a submission on Yarra Valley Water's outcomes, which stated they appear reasonable.³³

Generally, we consider Yarra Valley Water's measures and targets will provide a sound basis to track performance and delivery against each outcome. However, in our assessment we have identified that 10 of 17 measures are considered ambiguous or not clearly defined.

We will provide Yarra Valley Water with our standard Outcomes Submission Template to complete and submit with its response to this draft decision. We will work with the business to ensure the final set of measures addresses the above matters and complies with our guidance requirements.

Yarra Valley Water's proposed targets for its outcome measures suggest an overall improvement in customer value. In our preliminary view, of the 17 output targets:

- 7 indicate an increase in customer value, either improving on past performance or improving across the 2023–28 regulatory period
- 8 suggest current customer value is maintained

³¹ Essential Services Commission, 2023 water price review: Guidance paper, 26 October 2021, p. 23.

³² Yarra Valley Water, 2023 water price submission, Appendix B PREMO Assessment, September 2022, p. 172–179.

³³ Anonymous, submission to the Essential Services Commission on Yarra Valley Water's 2023 price submission, 10 October 2022.

- none indicate a decrease in customer value
- 1 is unclear in how customer value changes.

Yarra Valley Water has committed to reporting annually to customers on how it has performed against its outcome commitments. It will continue to communicate performance through established channels, including bill inserts and via the homepage on the Yarra Valley Water website. In addition, it is proposing to seek recommendations annually from its Community Advisory Group, or another similar group of customer representatives, on whether it achieved each outcome. This process will be used to inform the Yarra Valley Water board's decision on any community rebate amounts returned to customers and the community.³⁴

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

3.3 Guaranteed service levels

Our draft decision is to accept Yarra Valley Water's guaranteed service level scheme.

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

Yarra Valley Water's proposed guaranteed service levels are set out on pages 61 and 62 of its price submission as well as in additional information submitted on 30 November 2022.³⁵

For the guaranteed service levels currently in place, it proposed no changes, based on feedback from representatives of its 2017 and 2022 citizens' juries that they continue to reflect the level of service customers expect.

With the support of its customers, it has proposed a new guaranteed service level for water quality events. When water quality advisories are issued it proposes a community rebate of:

- \$5,000 for small, localised events impacting less than 50 customers
- \$10,000 for each affected postcode for advisories that affect more than 50 customers.

Yarra Valley Water advised its proposal for a new guaranteed service level and rebate focused on water quality has also been developed in consultation with South East Water, Greater Western

³⁴ Yarra Valley Water, 2023 water price submission, September 2022, p. 59.

³⁵ Yarra Valley Water, Additional information on 2023 water price submission: Water quality GSL, 30 November 2022.

Water and Melbourne Water. This is with the aim of achieving consistency for customers affected by system wide events that could impact different parts of Melbourne.

Yarra Valley Water advised it is still developing protocols for when and how these rebates are applied.

We propose to accept Yarra Valley Water's proposed guaranteed service levels, on the basis that they have been agreed with customers during its engagement. Final guaranteed service levels and rebates will be subject to our consideration of any feedback following the release of our draft decision, and further information on Yarra Valley Water's proposal for a new guaranteed service level focused on water quality and protocols for when rebates would apply.

Guaranteed service level schemes are approved in our water industry standards. Accordingly, in early 2023-24, we will update the standards to reflect the guaranteed service levels published in our final decision.

4. Revenue requirement

The revenue requirement is the forecast amount a water corporation needs to deliver on customer outcomes, government policy, and obligations monitored by technical regulators including the Environment Protection Authority Victoria and the Department of Health.³⁶ 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 Yarra Valley 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 Yarra Valley 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 approve a revenue requirement of \$4,891.0 million. This is subject to our ongoing review of Yarra Valley Water's proposed new customer contributions and revenue from customer contributions.

Yarra Valley Water proposed a revenue requirement of \$4,894.9 million over a 5-year period starting 1 July 2023. Our draft decision reflects our assessment of each element of the revenue requirement, including forecast operating and capital expenditure. Our draft decision approves a revenue requirement of \$4,891.0 million (Table 4.1). This reflects our preliminary views on the

³⁶ We met with officers of the Department of Environment, Land, Water and Planning, the Department of Health, and the Environment Protection Authority Victoria, to discuss their expectations of Yarra Valley Water in the regulatory period from 1 July 2023. We had regard to their views in arriving at our draft decision.

prudence and efficiency of proposed operating and capital expenditure, which our draft decision proposes to accept without adjustment (Sections 4.1 and 4.2).

The very minor difference (–0.08%) between our draft decision and Yarra Valley Water’s submission is accounted for by the incorrect treatment of rebate amounts (related to the return of money to customers for not meeting performance targets) included in its original pricing model and submission (which impacts ‘adjustments from last period’ in Table 4.1).

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

	2023-24	2024-25	2025-26	2026-27	2027-28	Total
Operating expenditure	709.1	700.8	701.3	689.1	686.9	3,487.1
Return on assets	141.8	133.4	134.2	135.3	136.3	680.9
Regulatory depreciation	135.7	127.3	126.3	133.3	137.4	660.0
Adjustments from last period ^a	–1.7	-	-	-	-	–1.7
Tax allowance	13.6	12.1	11.9	13.1	13.8	64.6
Draft decision – revenue requirement	998.5	973.6	973.7	970.7	974.5	4,891.0

Note: Numbers have been rounded. ^a This adjustment relates to the return of money to customers due to the non-achievement of one performance target. Yarra Valley Water initially incorrectly entered the adjustment as a positive amount in its financial model. We corrected the adjustment, which resulted in a slight reduction to the revenue requirement that it had included in its price submission and financial model for 2023-24. This change also resulted in a slight reduction in the tax allowance for 2023-24.

There are some areas we will continue to assess in the lead up to our final decision. These are:

- revenue from customer contributions (Section 4.3.2.1)
- new customer contributions (Section 5.4).

Our final decision on Yarra Valley Water’s revenue requirement will be based on the latest available information. It will also reflect our ongoing review of the matters noted above. Yarra Valley Water must also 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, Yarra Valley Water should update its price submission and provide us with an updated financial model. It also should notify us of any material changes that impact its forecast costs, revenue requirement or prices (including demand). Any updates to its submission or pricing model will be made publicly available on our website.

4.1 Operating expenditure

Our draft decision is to accept Yarra Valley Water's forecast operating expenditure.

Operating expenditure is a component of the revenue requirement. Yarra Valley Water's price submission provides detail on its forecast operating expenditure on pages 73 to 77 and 246 to 253.

We assess both:

- controllable operating expenditure – comprising all costs that can be directly or indirectly influenced by a water corporation's decisions
- non-controllable operating expenditure – comprising all costs that cannot be directly or indirectly influenced by a water corporation'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 Yarra Valley Water's expenditure forecast is available on our website.³⁷

Table 4.2 sets out our draft decision on Yarra Valley Water's forecast operating expenditure, for the purpose of establishing the revenue requirement outlined in Table 4.1.

³⁷ FTI Consulting, *Yarra Valley Water: Review of Expenditure Forecasts – 2023 Water Price Review, Fast Track Report*, December 2022..

Table 4.2 Draft decision – operating expenditure
\$ million 2022-23

	2023-24	2024-25	2025-26	2026-27	2027-28	Total
Controllable operating expenditure	161.6	160.4	161.3	161.3	162.9	807.4
Non-controllable operating expenditure	547.5	540.4	540.0	527.8	524.0	2,679.7
Bulk services ^a	500.2	494.4	495.3	484.4	481.5	2,455.7
Environmental contribution ^b	46.0	44.7	43.4	42.1	40.9	217.2
Licence fees – Essential Services Commission ^c	0.9	0.9	0.9	0.9	1.2	4.7
Licence fees – Department of Health ^c	0.3	0.3	0.3	0.3	0.3	1.6
Licence fees – Environmental Protection Authority ^c	0.1	0.1	0.1	0.1	0.1	0.5
Draft decision – operating expenditure	709.1	700.8	701.3	689.1	686.9	3,487.1

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

^b Environmental contributions are funds collected from water businesses under the *Water Industry Act 1994*. ^c Licence fees are paid to cover costs incurred by the Department of Health, the Environment Protection Authority Victoria, and the Essential Services Commission in their regulatory activities related to the water business.

Details of our assessment of Yarra Valley Water's proposal are included in Section 4.1.1 (controllable operating costs) and Section 4.1.2 (non-controllable operating costs).

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 Yarra Valley Water's price submission.

The operating expenditure that we propose to adopt for Yarra Valley Water does not represent the amount that Yarra Valley 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

Yarra Valley Water proposed a total forecast controllable operating expenditure of \$807.4 million over a 5-year regulatory period. For the reasons set out below, we propose to accept Yarra Valley Water's forecast operating expenditure for the 2023–28 regulatory period.

Yarra Valley Water's forecast controllable operating expenditure for the period from 1 July 2023 is estimated through a series of steps:

1. Establish a baseline controllable operating expenditure – the baseline comprises the efficient recurring costs from the last full year of data (2021-22) after non-controllable expenditure, one-off items are removed or normally occurring items are added in.
2. Apply a growth rate for operating expenditure for the regulatory period – assumed by Yarra Valley Water to be 0.0 per cent per year.
3. Apply an annual cost efficiency improvement rate – assumed by Yarra Valley Water to be 1.7 per cent per year.
4. Make adjustments for additional costs or cost saving expected in future years.

4.1.1.1 Baseline controllable operating expenditure

Yarra Valley Water has proposed a controllable operating expenditure baseline of \$156.1 million, after removing \$1.2 million in non-recurring operating expenditure that occurred in 2021-22. Yarra Valley Water's proposed baseline is \$5.97 million (or 4 per cent) higher than the benchmark figure of \$150.8 million of controllable operating expenditure for 2021-22 used for our 2018 price determination.

Our expenditure consultant requested substantiation of Yarra Valley Water's proposed increase to its baseline year operating expenditure benchmark.³⁸ Yarra Valley Water explained the increase was primarily driven by \$5.2 million in expenditure related to implementing and maintaining cloud-based technology. These IT system costs have previously been treated as capital expenditure but are now treated as operating expenditure.

Our expenditure consultant verified these additional costs were recurring and found Yarra Valley Water's substantiation of these costs to be reasonable. Accordingly, it recommended accepting Yarra Valley Water's proposed baseline increase with no adjustments required. We have reviewed Yarra Valley Water's proposal and advice from our expenditure consultant.

Given the above, we consider Yarra Valley Water's proposal reflects an efficient baseline cost to forecast annual operating expenditure for the purpose of our draft decision.

³⁸ FTI Consulting, *Yarra Valley Water: Review of Expenditure Forecasts – 2023 Water Price Review, Fast Track Report*, December 2022, pp. 20-21.

4.1.1.2 Efficiency improvement and growth rate

Yarra Valley Water proposed an average efficiency improvement rate on its controllable operating costs of 1.7 per cent per annum. This is a lower rate than it proposed in its 2018 price submission (an efficiency rate of 2.5 per cent per annum), but relatively high compared to other businesses in the current price review. Yarra Valley Water has proposed that through its 1.7 per cent efficiency rate, it plans to absorb approximately \$38.4 million in costs.

We note Yarra Valley Water proposes to absorb above inflation labour costs, and other cost increases if they arise due to material shortages, changes in regulatory requirements, and the costs to restore services due to any extreme weather events. It forecasts energy costs to rise from around \$27.5 million in the current regulatory period, to around \$28.4 million in the next regulatory period. We note the increase (in percentage terms) is much lower than forecast volume growth.

Yarra Valley Water has not proposed a cost growth rate on its baseline operating expenditure. Rather, it has proposed cost adjustments of \$31.9 million across the 2023–28 regulatory period to account for growth related costs. It claimed that this approach better reflects the marginal cost of growth, rather than the rate of growth in customer numbers.³⁹ This approach equates to an average cost growth rate of 1.44 per cent per annum, effectively delivering a net efficiency rate of 0.26 per cent per annum and a small decrease to Yarra Valley Water’s controllable annual baseline operating cost in each year of the regulatory period. This net efficiency rate is higher than the 0.21 per cent net efficiency rate it proposed in its 2018 price submission.

4.1.1.3 Cost adjustments

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

- \$31.9 million to service growth, which includes:
 - operation and maintenance of new assets during the period, including the Aurora and Doncaster Hill recycled water plants and the Kalkallo stormwater harvesting plant
 - provision of retail services including billing and collection activities, and support for customers experiencing financial vulnerability
 - storage and management of customer data to deliver digital services and communications for customers.
- \$31.6 million to comply with new regulatory obligations
- \$6.8 million to deliver outcomes supported by its customers, including increasing water conservation, biodiversity, and regenerative land use

³⁹ Yarra Valley Water, 2023 price submission, September 2022, p. 69.

- \$5.97 million to implement and maintain cloud-based information technology systems.

Excluding the \$31.9 million related to meeting growth, the above costs represent an additional \$44.4 million over the regulatory period, or an average of \$8.9 million per annum.

Our expenditure consultant reviewed each of the proposed forecast variations above the baseline and requested further information from Yarra Valley Water, including a further breakdown by individual cost item where required, along with documentation that supported the prudence and efficiency of each cost item.⁴⁰

Our expenditure consultant assessed each forecast variation against criteria for prudent and efficient operating expenditure and was satisfied each item was appropriately costed and supported by internal documentation, which included evidence of its prudence and efficiency. It therefore considered that Yarra Valley Water's proposed additions were reasonable and did not recommend adjusting any of the proposed costs.

We have considered the advice from our expenditure consultant, and Yarra Valley Water's proposals. We consider Yarra Valley 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. There is evidence that Yarra Valley Water has significantly tested its controllable expenditure requirements, resulting in a forecast overall decline (excluding inflation) in controllable operating expenditure per customer connection across the 2023–28 regulatory period.

4.1.2 Non-controllable operating expenditure

Our process for establishing non-controllable operating expenditure involves:

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

The values we have adopted for our draft decision are set out above in Table 4.2.

Yarra Valley Water has proposed \$2,679.7 million in non-controllable operating expenditure over the 2023–28 regulatory period. This is a decrease of \$330.5 million over the 2018–23 regulatory period, driven by a \$307.3 million decrease in external bulk charges, and a decrease of \$24.1 million due to forecast decreases in the real value of the environmental contribution.

⁴⁰ FTI Consulting, *Yarra Valley Water: Review of Expenditure Forecasts – 2023 Water Price Review, Fast Track Report*, December 2022, pp. 21-25.

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. Yarra Valley Water has followed this approach in its price submission for the first 4 years but has included a 50 per cent increase in the Essential Services Commission’s licence fee in 2027-28 in relation to the next price review. We will review these figures prior to our final decision.

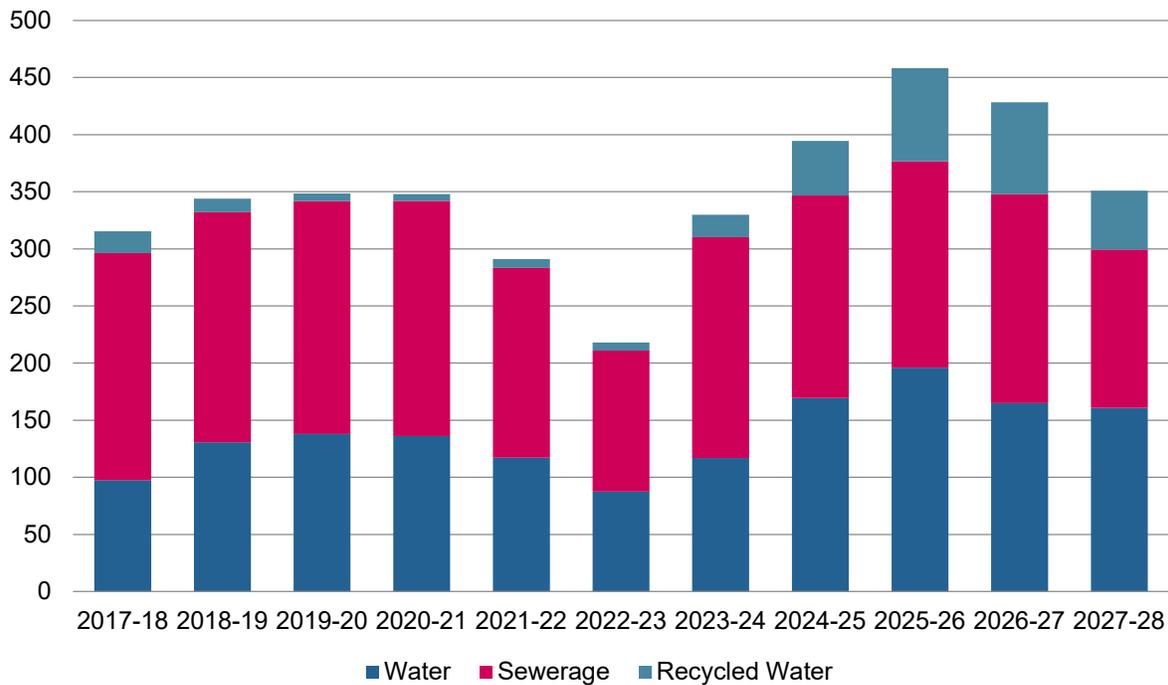
For the purpose of calculating the revenue requirement for our draft decision, we have accepted Yarra Valley Water’s proposed non-controllable operating expenditure. We have verified that Yarra Valley Water’s forecast bulk charges are consistent with Melbourne Water’s 2021 price determination and prior 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 Yarra Valley Water’s proposed forecast capital expenditure of \$1,962.0 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. Yarra Valley Water’s forecast capital expenditure and supporting information is provided at pages 77 to 85 and 180 to 245 of its price submission. Figure 4.1 shows Yarra Valley Water’s actual gross capital expenditure for 2017-18 and the first 4 years of the current 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 Yarra Valley 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 Yarra Valley 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.

Yarra Valley Water has indicated it will incur \$1,549.2 million in actual gross capital expenditure over the current regulatory period. This includes \$1,331.3 million in actual capital expenditure

⁴¹ FTI Consulting, *Yarra Valley Water: Review of Expenditure Forecasts – 2023 Water Price Review, Fast Track Report*, December 2022.

already incurred from 2018-19 to 2021-22, and \$217.9 million in forecast capital expenditure for 2022-23, in line with the benchmark approved in the 2018 price review.⁴²

Over the 2018–23 regulatory period, Yarra Valley Water is forecast to exceed its 2018 price determination benchmark of \$1,297.2 million by \$252.1 million (or 19 per cent). In net terms (that is, once any contributions or disposals are accounted for), it is forecast to exceed its 2018 determination benchmark of \$1,049.1 million by \$252.6 million (or 24 per cent).

Yarra Valley Water's price submission identified several drivers of its increased expenditure (relative to the benchmark) in the current regulatory period:

- Additional expenditure was required to expand water and sewerage infrastructure to service higher than forecast customer growth over the current period, and also to deliver some carried over projects from the 2013–18 regulatory period (\$143.2 million).
- Higher than forecast unit costs and renewal rates in the delivery of water and sewer main renewals. This was partially driven by data quality issues during the transition to a new maintenance supplier, which resulted in a lower forecast of water and sewerage interruptions than required to forecast the business's costs (\$103.8 million).
- Increased scope and rate of implementation of its digital enablement strategy (\$65.2 million). Yarra Valley Water stated the project has been assessed by Hamilton Shaw Consulting, which has determined that Yarra Valley Water's investment in this project over the current regulatory period has delivered a positive net present value in comparison to its business-as-usual capital replacement model.

We requested further information on the drivers of its higher than forecast expenditure, to inform our assessment of the Performance element of PREMO. Yarra Valley Water produced further explanatory information to justify the prudence and efficiency of this additional expenditure. Our expenditure consultant also found strong supporting information justifying Yarra Valley Water's increased capital expenditure over the current regulatory period.⁴³

As at the end of June 2022, Yarra Valley Water reported that, of the 10 major projects it proposed for the 2018–23 regulatory period, 5 were completed, 4 were on track for completion against their original timeline, and 1 had been deferred.⁴⁴

⁴² Yarra Valley Water also provided an updated forecast of \$276.2 million in capital expenditure it will incur in 2022-23. However, it will only seek to include the benchmark allowance of \$217.9 million approved in our 2018 price review in its regulatory asset base for this price review.

⁴³ FTI Consulting, *Yarra Valley Water: Review of Expenditure Forecasts – 2023 Water Price Review, Fast Track Report*, December 2022, p. 29.

⁴⁴ Essential Services Commission, *Status of Major Projects Supplement: Outcomes report 2021-22*, 18 October 2022, pp. 63-64.

4.2.2 Forecast Capital Expenditure

For the reasons set out below, our draft decision is to accept the forecast capital expenditure of \$1,962 million proposed by Yarra Valley Water for the purpose of calculating its revenue requirement:

- Yarra Valley Water's price submission provided evidence that its forecasts for capital expenditure are prudent and efficient. Its total proposed capital expenditure is \$412.8 million (26.6 per cent) higher than actual capital expenditure in the current 2018–23 period. This is mainly driven by forecast increases in the size and scope of Yarra Valley Water's top 10 projects (\$454.2 million) and customer growth (\$706.4 million, or 36 per cent of its capital program). Yarra Valley Water's renewals expenditure (\$940.2 million) will continue to be the major driver of the business's capital expenditure in the next regulatory period (47.9 per cent of its capital program).
- Our expenditure consultant requested selected documents from Yarra Valley Water as a representative sample to demonstrate its asset management processes and justification for its capital expenditure program.⁴⁵ Based on the sample of documents reviewed and Yarra Valley Water's responses to questions, our expenditure consultant found that Yarra Valley Water has a robust approach for developing project scope, the timing of works and cost estimates.
- Our expenditure consultant requested and received information on Yarra Valley Water's sustained forecast increase in capital expenditure over the next regulatory period, with a focus on renewals and growth driven expenditure, along with further information on its proposed increase in the rate of customer water meter replacements.
- Yarra Valley Water's responses provided assurance that its business cases were supported by robust planning processes. FTI Consulting noted the business cases and supporting documentation reviewed were detailed and focused, provided strong and robust justification for major projects and proposed program objectives, and were based on a strong risk-based assessment approach to prioritise and appropriately target the expenditure proposed.
- Overall, our expenditure consultant considered Yarra Valley Water's proposals were well developed and provided a high level of confidence that its forecast capital expenditure program is prudent, efficient and deliverable. FTI consulting recommended no adjustments to Yarra Valley Water's forecast capital expenditure for the next regulatory period. We agree with FTI Consulting's view as 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 appears to be achievable given Yarra Valley Water's past track record delivering its capital expenditure program. As

⁴⁵ FTI Consulting, *Yarra Valley Water: Review of Expenditure Forecasts – 2023 Water Price Review, Fast Track Report*, December 2022, pp. 27–34.

noted in Section 4.2.1 above, over the current 2018–23 regulatory period, Yarra Valley Water is expected to deliver most of its planned major projects. The only exceptions are the Sassafras (East) – community sewerage program which is now scheduled for completion in 2023-24 and the Craigieburn flow storage and distribution project which has been deferred.⁴⁶

- Yarra Valley Water has excluded an estimated \$347.3 million of speculative projects from its price submission where there is uncertainty in timing, cost, scope and benefits of capital expenditure. This equates to about 17.7 per cent of the proposed forecast capital expenditure. This approach is consistent with our guidance for managing uncertain expenditure. For example, Yarra Valley Water has excluded \$75.4 million for its digital metering pilot and roll-out and \$70.3 million for its Upper Central Creek main sewer project. Our draft decision is to accept Yarra Valley Water’s proposal for addressing uncertain capital expenditure, noting the following:
 - Yarra Valley Water will need to demonstrate the prudence and efficiency of these costs if they are indeed incurred during the 2023–28 regulatory period if seeking to include them in the regulatory asset base for the 2028–33 price review.
 - Deviations from forecasted capital expenditure during the 2023–28 regulatory period will form a key part of our assessment of the Performance element of PREMO at the next price review.

We have reviewed Yarra Valley Water’s proposals and advice from FTI consulting. We agree with FTI Consulting’s assessment and consider Yarra Valley 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 Yarra Valley Water’s proposed benchmark. The benchmark we propose to adopt is set out in Table 4.4.

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

⁴⁶ Essential Services Commission, *Status of Major Projects Supplement: Outcomes report 2021-22*, 18 October 2022, pp. 63-64.

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

4.3 Regulatory asset base

A water corporation's regulatory asset base is the value of the corporation'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 Yarra Valley Water to propose:

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

4.3.1 Closing regulatory asset base

Our draft decision is to accept Yarra Valley 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 corporation.⁵⁰

Yarra Valley Water's proposed closing asset base at 30 June 2022 is provided at page 85 of its price submission.⁵¹ Yarra Valley Water's proposed closing regulatory asset base matches its audited Regulatory Accounts information over the period 2017-18 to 2021-22.

We compared Yarra Valley 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 corporation's net capital expenditure was more than 10 per cent above the forecast, we consider the business's justification for the additional expenditure. We consider that this approach is reasonable given capital expenditure can be 'lumpy' in nature.

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.

⁴⁹ See Section 4.2 for a discussion of Yarra Valley 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.

Yarra Valley Water's net capital expenditure over the period from 2017-18 to 2021-22 was \$1,387.9 million. This is \$279.3 million or 25.2 per cent higher than the forecast used to approve maximum prices for the period from 1 July 2018. The key reasons for the higher than benchmark expenditure are outlined at page 149 of its price submission and summarised in Section 4.2.1 above.

We note Yarra Valley Water excluded around \$257 million of capital expenditure from its forecasts in 2018 for projects that were uncertain in terms of cost or timing. This approach was adopted to help ensure customers did not pay for uncertain capital expenditure, which we acknowledged as supporting its PREMO rating at the 2018 price review.

Once this is adjusted for, Yarra Valley Water's net capital expenditure is well within the 10 per cent threshold noted above. We also note that our expenditure consultant FTI Consulting found there appeared to be good information justifying the increased spending in the current regulatory period. We have considered that advice and agree with it for the purpose of our draft decision.

We consider that Yarra Valley Water calculated its closing regulatory asset base in accordance with the requirements of our guidance. For these reasons, our draft decision is to accept Yarra Valley Water's proposed closing regulatory asset base for 30 June 2022 of \$5,266.0 million.

Table 4.3 sets out our draft decision on Yarra Valley Water's closing regulatory asset base at 30 June 2022.

Table 4.3 Draft decision – closing regulatory asset base (RAB)
\$ million 2022-23

	2017-18	2018-19	2019-20	2020-21	2021-22
Opening RAB 1 July	4,416.0	4,583.7	4,766.5	4,946.5	5,132.4
Plus gross capital expenditure	315.3	343.8	348.5	348.0	290.9
Less government contributions	-	-	-	-	-
Less customer contributions	51.1	52.3	55.9	54.2	45.2
Less proceeds from disposals	1.2	1.1	0.9	0.5	3.4
Less regulatory depreciation	95.2	107.7	111.7	107.4	108.7
Closing RAB 30 June	4,583.7	4,766.5	4,946.5	5,132.4	5,266.0

Note: Numbers have been rounded.

4.3.2 Forecast regulatory asset base

Our draft decision is to accept Yarra Valley Water’s proposed forecast regulatory asset base. This is subject to any updates to its forecasts of revenue from customer contributions arising from our ongoing review of its new customer contributions.

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.

Table 4.4 sets out our draft decision on Yarra Valley 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 decision paper as follows:

- Section 4.2 (capital expenditure)
- Section 4.3.2.1 (customer contributions)
- Section 4.5 (regulatory depreciation).

Table 4.4 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	5,266.0	5,281.7	5,182.6	5,402.7	5,684.7	5,925.5
Plus gross capital expenditure	217.9	329.9	394.5	458.2	428.4	351.0
Less government contributions	-	-	-	-	-	-
Less customer contributions	40.0	46.0	45.5	48.4	52.3	50.7
Less proceeds from disposals	50.9	247.3	1.6	1.5	2.0	1.1
Less regulatory depreciation	111.3	135.7	127.3	126.3	133.3	137.4
Closing RAB 30 June	5,281.7	5,182.6	5,402.7	5,684.7	5,925.5	6,087.4

Note: Numbers have been rounded.

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.

4.3.2.1 Customer contributions

Our draft decision is to accept Yarra Valley Water's forecasts for revenue from customer contributions, subject to our further review of its proposed new customer contributions prior to our final decision.

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

New customer contributions are a key input to revenue from customer contributions. For the purposes of calculating the regulatory asset base and revenue requirement in our draft decision, we have adopted Yarra Valley Water's proposed customer contributions forecast. They appear reasonable having regard to past trends and growth forecasts. However, we note that our final decision is subject to our ongoing review of Yarra Valley Water's new customer contributions (Section 5.4).

4.4 Rate of return

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

Our guidance required Yarra Valley Water to use estimates of the cost of debt provided by the commission to estimate its revenue requirement. Yarra Valley Water used the cost of debt values we specified to calculate its revenue requirement. For this reason, as set out in Table 4.5, our draft decision is to accept the cost of debt proposed by Yarra Valley 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.

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

Table 4.5 Draft decision – cost of debt

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

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

4.4.2 Return on equity

Our draft decision is to adopt a return on equity of 4.5 per cent.

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 Yarra Valley Water’s PREMO rating. As outlined in our guidance, the return on equity we adopt depends on a water corporation’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 corporation’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

Yarra Valley Water rated its price submission as ‘Advanced’. Based on this PREMO self-rating, Yarra Valley Water proposed a return on equity of 4.5 per cent per annum. This reflects the maximum return rate allowed in our guidance for a price submission rated as ‘Advanced’.⁵⁶

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

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.

4.5 Regulatory depreciation

Our draft decision is to accept Yarra Valley Water's forecast regulatory depreciation.

Regulatory depreciation is a component of Yarra Valley Water's revenue requirement and is also an input to calculating the regulatory asset base. Yarra Valley 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 Yarra Valley Water also calculated regulatory depreciation in a manner consistent with our guidance. For these reasons, our draft decision proposes to accept Yarra Valley Water's forecast regulatory depreciation.

Our draft decision on regulatory depreciation is shown in Table 4.4 in Section 4.3.2.

4.6 Tax allowance

The tax allowance is a component of the revenue requirement. Yarra Valley Water has proposed a tax allowance of \$65.2 million in its revenue requirement for the 2023–28 regulatory period. Our draft decision is to accept a lower tax allowance of \$64.6 million reflecting the impact of changes to the revenue requirement and its treatment of rebate amounts for 2023-24.⁵⁹

⁵⁷ For the period from 2022-23 to 2027-28, Yarra Valley Water proposed a regulatory depreciation of \$771.4 million.

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

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

5. Demand, tariffs and prices

Once Yarra Valley 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 Yarra Valley Water's demand forecasts.

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

Yarra Valley Water's demand forecasts are set out at pages 93 to 104 of its price submission and are also included in its financial model.

Our draft decision is to accept Yarra Valley Water's demand forecasts for the purpose of approving maximum prices, because they were developed consistently with the requirements of our guidance, including basing demand forecasts on the latest available Victoria in Future estimates issued by the Victorian Government.⁶⁰ We note however, that since lodgement of its price submission, updated Victorian Government population and dwelling growth estimates have been made available to water businesses.

In its response to our draft decision, Yarra Valley Water must demonstrate how it has considered these updated estimates and if required, identify and justify any changes to its demand forecasts (any updates must also be included in its pricing model submitted in response to our draft decision).

5.2 Form of price control

Our draft decision is to accept Yarra Valley Water's proposed revenue cap form of price control.

Our guidance indicated we would have particular regard to whether a corporation proposed to continue its existing form of price control or introduce a new form of price control.⁶¹

⁶⁰ Yarra Valley Water's demand forecasts incorporate the proposed trade of 3,330 ML water from the Greater Yarra System with Gippsland Water from 2023-24.

⁶¹ Essential Services Commission, *2023 water price review: Guidance paper*, p. 50.

Yarra Valley Water proposed a revenue cap form of price control as set out on page 116 of its price submission. This is similar to its current approach, with some modifications to its existing revenue cap formula to allow for price smoothing. Yarra Valley Water proposed:

- an adjustment mechanism to allow for annual smoothing of nominal prices over multiple years to manage price shocks for customers that may arise from high inflation
- to cap the nominal increase in water and sewerage bills at 5 per cent per annum for 2023-24 and 2024-25
- to continue to cap annual real price increases at 2 per cent.

Our draft decision is to accept Yarra Valley Water's proposed form of price control because it:

- largely reflects a continuation of current arrangements, with some changes to reflect the near-term inflation outlook (demonstrating consideration of customer interests)
- provides sufficient revenue to cover the forecast efficient costs of providing services and for Yarra Valley Water to deliver on any health, safety and environmental obligations
- was otherwise consistent with the requirements of our guidance.

5.3 Tariff structures and prices

Our draft decision is to accept Yarra Valley Water's proposed tariff structures.

Yarra Valley Water's proposed water, sewerage and trade waste service tariff structures (and supporting justification) are set out at pages 105 to 111 of its price submission.

Our draft decision does not approve prices for each tariff. Prices will need to be updated by Yarra Valley Water to reflect our updates inflation and cost of debt estimates prior to our final decision. They may also need to be updated depending on our further review of its new customer contributions and revenue from customer contributions. 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 corporations with a large degree of discretion to decide on individual tariff structures.⁶² This recognises water corporations are often best placed to consider the interests of customers in designing tariffs, and that existing tariff structures have been developed over time to deal with a variety of local circumstances.

⁶² Essential Services Commission, *2023 water price review: Guidance paper*, p. 51.

Yarra Valley Water generally proposed to maintain its existing tariff structures, save for some changes to the structure of tariffs for residential customers.

For residential customers receiving water services only, Yarra Valley Water proposed that these customers continue to pay a fixed charge and a charge that varies with water use.⁶³

For residential customers receiving both water and sewerage services, Yarra Valley Water proposed these customers pay the fixed charge and a new higher variable charge (compared to water only customers) that incorporates the costs of disposing sewage. This change was justified by Yarra Valley Water based on increasing simplicity. Yarra Valley Water notes this change was supported during its engagement by customers and the Consumer Action Law Centre.⁶⁴ The Consumer Action Law Centre also provided a submission to us supporting Yarra Valley Water's proposal to remove sewage disposal tariffs.⁶⁵

Our draft decision is to accept Yarra Valley Water's proposal to combine its existing residential sewage disposal charge and its residential variable water tariff (for residential customers with a water and sewerage service).

In making this draft decision we note Yarra Valley Water's engagement findings support this approach, and note that our guidance considered variable sewerage tariffs for residential customers of the metropolitan water businesses were difficult for customers to understand.

Our draft decision is to also accept other water and sewerage tariff structures proposed by Yarra Valley Water because they remain unchanged and are generally supported by its customers.

Our preliminary view is that the two-part tariff structure proposed by Yarra Valley Water for its water services will promote the efficient use of services. It also sends customers a signal about the costs of their water use and is an approach that is commonly applied in other states and territories.⁶⁶ We also consider two-part tariff structures are easy to understand.

For sewerage services, we consider Yarra Valley Water's proposed fixed charge for residential customers is easy for customers to understand (consistent with its engagement findings). A

⁶³ This includes retaining its three-tier inclining block tariff for water use.

⁶⁴ The Consumer Action Law Centre supported the change subject to ensuring customers eligible for concessions still receive their full entitlements. Yarra Valley Water's price submission (p. 107) notes it has confirmed that the change will not impact concession customers' ability to claim their full concession allowance.

⁶⁵ Consumer Action Law Centre, Initial Feedback: 2023-28 Water Price Review, 30 November 2022, p. 6.

⁶⁶ Includes the tariffs of Icon Water, Sydney Water, Hunter Water, Central Coast Council, Power and Water Corp, Urban Utilities, Unity Water, SA Water and TasWater.

two-part tariff for non-residential customers sends customers signals about efficient costs.⁶⁷ We note that for recycled water, Yarra Valley Water will continue with only a variable usage charge.⁶⁸

5.3.2 Prices

The prices proposed by Yarra Valley Water for water and sewerage services are set out in Chapter 8 of its price submission (from page 105).

Under Yarra Valley Water's proposal, generally prices (excluding inflation) will be lower:

- Residential water and sewerage bills for a typical household fall by 4.5 per cent in 2023-24. These bills are forecast to fall by 3 per cent in 2024-25 and then remain steady to 2027-28. This path was proposed by Yarra Valley Water taking into account the near-term inflation outlook and cost of living pressures.
- Prices for non-residential water and sewerage services follow a similar path to residential services, with fixed and variable charges generally proposed to fall by 4.6 per cent in 2023-24 and 3 per cent in 2024-25, and then remain steady to 2027-28.

Yarra Valley Water proposes to cap any nominal increases for all water and sewerage customers at 5 per cent in 2023-24 and 2024-25.

In terms of submissions we received, one considered Yarra Valley Water's proposed prices are reasonable.⁶⁹ The Consumer Action Law Centre noted Yarra Valley Water's decreasing price path.⁷⁰ Another submission noted that Yarra Valley Water's proposed prices do not include a concession for Commonwealth Seniors Health Card holders.⁷¹ We note holders of Commonwealth Seniors Health Cards are not eligible for a water concession in Victoria. The list of cards eligible for Victoria's water and sewerage concession is published by the Department of Families, Fairness and Housing.⁷²

⁶⁷ Our reasons are outlined in our 2013 draft decisions on price review 2013-14 to 2017-18.

⁶⁸ Yarra Valley Water ceased charging a fixed charge on recycled water from 2018-19 in response to customer complaints and for consistency with South East Water, Yarra Valley Water, 2023 price submission, September 2022, p. 102.

⁶⁹ Anonymous, submission to the Essential Services Commission on Yarra Valley Water's 2023 price submission, 10 October 2022.

⁷⁰ Consumer Action Law Centre, Initial Feedback: 2023-28 Water Price Review, Essential Services Commission, 30 November 2022.

⁷¹ Anonymous, submission to the Essential Services Commission on Yarra Valley Water's 2023 price submission, 21 October 2022.

⁷² <https://services.dffh.vic.gov.au/concessions-eligibility-calculator>.

In May 2023, we intend to determine prices for Yarra Valley 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.

5.3.3 Addressing the interests of low income and vulnerable customers

In making our price determination, we must have regard to whether Yarra Valley Water took into account the interests of customers, including low income and vulnerable customers.⁷³

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

- maintaining an efficiency improvement rate greater than the industry average, helping to minimise prices and bills
- a price path that focused price reductions in the first two years of the regulatory period in consideration of the near-term inflation outlook and cost of living pressures
- new expenditure items only where there was support among self-identified vulnerable customers
- piloting a combined water audit and showerhead replacement program with a particular focus on vulnerable and higher water use customers.

As noted in Section 3.1, Yarra Valley Water's price submission was informed by engagement that was inclusive for customers more likely to experience vulnerability, including youth, customers who are vision or hearing impaired, and customers who are culturally and linguistically diverse.

5.3.4 Unique services

Yarra Valley Water has confirmed that its proposed tariffs for trade waste and miscellaneous services are calculated in accordance with the pricing principles referenced in our guidance.⁷⁴

⁷³ Water Industry Regulatory Order 2014 clause 11(d)(iii).

⁷⁴ We note some minor discrepancies between Yarra Valley Water's submission and its financial template in relation to miscellaneous service charges. We will work with Yarra Valley Water to address the discrepancies in its response to our draft decision.

5.4 New customer contributions

- Our draft decision is to not accept Yarra Valley Water's proposed standard new customer contributions. We need to continue our review of its proposal to include sunk costs (back to 2013-14) in its calculation of new customer contributions. We also invite stakeholders to comment on its approach to transitioning to higher charges.
- Our draft decision is to accept Yarra Valley Water's proposed negotiated new customer contribution framework.

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

Yarra Valley Water's proposed standard and negotiated new customer contributions are set out at pages 112 to 114 of its price submission. Yarra Valley Water proposed to:

- increase new customer contributions in the standard and special new urban growth boundary areas in real terms by 5 per cent per annum (capped at 10 per cent per annum in nominal terms by charging below the maximum price if inflation is higher than 5 per cent in any given year)
- integrate the Epping special charging area into its standard new customer contribution charge
- hold the Greenvale special charging area (negotiated) new customer contribution charges flat in nominal terms to allow its integration into the standard new customer contribution charge in a later regulatory period.

Changes in modelled costs since 2018 reflect updated capital expenditure and revenue estimates, an allocation for renewals for its community sewerage program, and the inclusion of a portion of historical (or sunk) costs (going back to 2013-14).

We have reviewed Yarra Valley Water's proposed standard new customer contributions charges and compared them to the charges calculated in its new customer contribution pricing model. We do not consider the charges are cost reflective.⁷⁵

Yarra Valley Water noted that immediately switching to the higher charges would cause an unacceptable impact on developers and its engagement considered a transition to cost reflective charges over time. In its price submission, Yarra Valley Water indicated that in its engagement, the

⁷⁵ We estimate that using the charges Yarra Valley Water proposed for the 2023–28 regulatory period, it could take around 75 years for the charges to achieve cost-reflectivity. This estimate relies on the combined water, sewerage and recycled water new customer contributions and forecast annual inflation of 2.5 per cent. It would take longer if inflation hit the 5 per cent inflation cap proposed by Yarra Valley Water.

Consumer Action Law Centre supported cost reflective charges while the Urban Development Institute of Australia did not indicate support either for or against its proposal.⁷⁶

The submission we received from the Consumer Action Law Centre noted its hope that the commission will more closely scrutinise those price submissions that do not address decreasing cross subsidies, and that it wants to see all users, particularly builders and developers, paying the full costs of their water use.⁷⁷

We will undertake a further review of Yarra Valley Water's proposed new customer contributions prior to our final decision. As part of that review, we will assess the reasonableness of Yarra Valley Water's proposed inclusion of sunk costs, including for renewals, in its proposed new customer contributions. Based on the information to date, it is unclear whether the inclusion of sunk costs, including asset renewal costs, complies with our guidance.⁷⁸ We will seek information from Yarra Valley Water to support this review.

Further, we agree that transitioning tariffs gradually to avoid price shocks is desirable. However, we consider the relatively large differential between Yarra Valley Water's proposed standard new customer contributions and its modelled price, also requires further review to determine compliance with our guidance prior to our final decision.

We note that the inclusion of sunk costs impacts the time to transition to cost reflectivity, which based on our calculations could take up to 75 years if the transition path continued as proposed by Yarra Valley Water (and based on its modelled new customer contribution charge).⁷⁹

We will seek further information from Yarra Valley Water prior to our final decision.

⁷⁶ Yarra Valley Water, 2023 water price submission, 30 September 2022, p. 113.

⁷⁷ Consumer Action Law Centre, Initial Feedback: 2023-28 Water Price Review, 30 November 2022, p. 5.

⁷⁸ The inclusion of sunk capital expenditure is not a requirement of our existing net cash flow framework to calculate new customer contribution charges. We note that very few businesses since 2013, when we commenced using our net cash flow framework, have included sunk costs in their calculation of new customer contributions. Our 2013 explanatory note regarding new customer contributions explained that these costs should only be included where they were built in anticipation of connections growth and needed to be justified as such. We stated: 'Incremental cost can include an allocation of costs of assets that the business had prudently built in expectation of future growth. If such costs are included, they should be explicitly revealed.' Essential Services Commission, *New Customer Contributions Explanatory Note*, December 2013, p. 5.

⁷⁹ If sunk costs were not included in the calculation of Yarra Valley Water's cost reflective level of new customer contributions, it may not take an estimated 75 years to transition to the cost reflective charge. Transitioning to the lower cost reflective charge (which excludes sunk costs) from the proposed charge capped at 10 per cent (nominal) may take less time and be more acceptable to customers and developers. This is because water and sewerage customers would be required to cross-subsidise the lower than cost reflective new customer contribution for a shorter length of time.

We are seeking further views from stakeholders – including customers and developers – about Yarra Valley Water’s proposed standard new customer contributions and transition path to higher charges.

We consider Yarra Valley Water’s proposed negotiated new customer contribution contracts comply with the requirements of our new customer contribution pricing principles.⁸⁰ Therefore, our draft decision is to accept Yarra Valley Water’s proposed negotiated new customer contribution framework.

5.5 Adjusting prices

Our draft decision is to accept Yarra Valley Water’s proposed price adjustment mechanisms.

Yarra Valley Water’s proposed price adjustment mechanisms are set out at page 117 of its price submission. It proposed the following price adjustment mechanisms, which are similar to those in the current regulatory period:

- A continuation of its existing uncertain and unforeseen events mechanism.
- Pass-through of several specific costs including:
 - sales and purchases of water allocations and bulk service charges, to account for differences between forecast and actual expenditure
 - annual cost of debt adjustment to reflect benchmark efficient cost of debt under a 10-year trailing average approach.
- Non-achievement of service outcomes
- Savings in financing costs arising from a deferral of top 10 projects
- Any unit rate efficiencies together with the financing costs to customers if the market reveals a reduction in the cost of the water reliability – reticulation main renewals program
- Savings due to any change in taxation status of either new customer contributions or developer gifted assets.

Our preliminary assessment is that Yarra Valley Water’s proposed price adjustment mechanisms satisfy our guidance and the Water Industry Regulatory Order 2014. The new proposed price adjustment formula enables Yarra Valley Water to smooth nominal prices each year to avoid price shocks and manage bill impacts that may arise from high inflation. Adjustment mechanisms to take into account shortfalls in performance relative to targets, and cost savings (relative to benchmarks) also demonstrate a commitment to ensuring customer prices are not higher than they need to be.

⁸⁰ Essential Services Commission, *2023 water price review: Guidance paper*, p. 58.

For these reasons, our draft decision is to accept Yarra Valley Water’s proposed price adjustment mechanisms.

6. Financial position

We have reviewed key indicators of Yarra Valley Water's financial performance and our preliminary view is that Yarra Valley 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.⁸¹ 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 corporation can generate sufficient cash flow to deliver on its service commitments, including financing costs arising from investments to meet service expectations.

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

⁸¹ 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 corporation's revenue requirement to that corporation's level of ambition expressed in its price submission.

Our guidance required Yarra Valley 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.⁸² We required Yarra Valley 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 Yarra Valley 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 Yarra Valley Water's price submission. As outlined in our guidance, the combination of Yarra Valley Water's self-rating and our rating has determined the return on equity we have adopted to calculate Yarra Valley Water's revenue requirement in our draft decision.

7.1 Our PREMO assessment of Yarra Valley Water's price submission

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

Yarra Valley 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 Yarra Valley Water's price submission.

⁸² 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.

Table 7.1 **PREMO rating**

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

We agree with Yarra Valley Water's proposed overall PREMO self-rating of 'Advanced'. This is reflected in the return on equity we propose to approve for Yarra Valley Water (see Section 4.4.2). We have formed this view after reviewing Yarra Valley 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.⁸³ As noted in Section 3.2, we agree with Yarra Valley Water's self-assessment that it has, overall, met its outcome commitments for the period to date. It also demonstrated ownership of its performance, transparently reporting to customers and returning funds to them where targets were not met.

In terms of customer perceptions, Yarra Valley Water's results on the commission's survey of customer sentiment – covering measures of overall satisfaction, value for money, trust, and reputation in the community – generally improved over the regulatory period compared to other businesses. This is summarised at pages 144 and 145 of its price submission.⁸⁴

Yarra Valley 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 \$157.3 million compared to a benchmark of \$150.1 million. As noted in Section 4.1.1, the higher than benchmark outcome mainly reflected a change to the accounting treatment of IT related expenditure. For the current

⁸³ As set out in Essential Services Commission 2021, 2023 Water Price Review: Guidance Paper, 26 October, pp. 74-75. Guiding questions are set out on page 45.

⁸⁴ The commission's customer perception survey results are available on our website. See <https://www.esc.vic.gov.au/water/sector-performance-and-reporting/how-customers-rate-their-water-business#tabs-container2>.

regulatory period, Yarra Valley Water's capital expenditure (in net terms) is forecast to be around \$253 million or 24 per cent higher than the benchmark established at the 2018 water price review.

As noted in Sections 4.1 and 4.2, we consider that the higher than benchmark expenditure by Yarra Valley Water has been appropriately justified. Its delivery of major projects (noted in Section 4.2.1) compares favourably to other water businesses. It has also returned funds to customers where it has saved on financing costs due to project delays.

Yarra Valley Water's price submission also noted two drinking water quality incidents were triggered by storms, requiring it to issue precautionary drinking water advisories. It is making improvements to its incident response and contingency plans, incorporating lessons learned from the events. And as noted in Section 3.3, Yarra Valley Water has proposed to introduce a guaranteed service level to address any water quality events.

Our draft decision is to accept Yarra Valley Water's self-rating of 'Advanced' for the Performance element of PREMO, on the basis that we consider it met expectations for delivery against outcome commitments, and achieved an overall rating of 'Advanced' for PREMO in 2018.

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).⁸⁵

In support of its self-rating of 'Advanced' for the Risk element of PREMO, Yarra Valley Water's price submission provided an overview of its corporate risk management approach and risk assessment actions undertaken for its price submission.

A key element of its approach to accepting risk on behalf of customers is its proposal to limit customer exposure to the current inflation environment by capping nominal increases in prices to 5 per cent in 2023-24 and 2024-25; the only business in our current review of 14 businesses to propose such an approach. This is in addition to other customer protections, such as:

- excluding around \$380 million from its capital expenditure forecasts due to uncertainty about project timing or costs (so customers do not pay up front for projects that may not happen)
- capping real price increases under its revenue cap to 2 per cent for variances in demand and desalination orders from benchmark assumptions
- fully passing back to customers all price decreases due to variances in demand from forecast assumptions

⁸⁵ Essential Services Commission 2021, 2023 Water Price Review: Guidance Paper, 26 October, p. 45.

- returning the net benefit of any delay for its top 10 capital expenditure projects
- adjustments to capture any unit rate efficiencies for water main renewals when arrangements are retendered during the 2023–28 regulatory period
- its commitment to return \$1.8 million per year to customers per outcome not achieved in that year.

Our draft decision is to accept Yarra Valley Water’s self-rating of ‘Advanced’ for risk, on the basis that it has provided a number of mechanisms to help ensure customers pay no more than they need to, and taken on risk on behalf of customers to provide additional protection (for example, by capping near term water and sewerage prices in nominal terms).

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.⁸⁶

Our draft decision is to accept Yarra Valley Water’s ‘Leading’ self-rating 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. Also notable was the role of stakeholders in shaping the context and direction of the engagement through co-design on key aspects of its citizens’ jury and engagement with First Nations people.

We also note its extensive effort to elevate diverse voices into its decision-making process, and that this aspect of its engagement contributed to Yarra Valley Water winning an award for its engagement on the price submission in the 2022 IAP2 Core Values Awards.

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.⁸⁷

In support of its self-rating of ‘Advanced’ for the Management element of PREMO, as noted in Section 4.1.1, Yarra Valley Water proposed one of the highest efficiency improvement rates for controllable operating expenditure over the next regulatory period (1.7 per cent). This contributes to reductions in controllable operating expenditure per water connection. Based on advice from FTI

⁸⁶ Essential Services Commission 2021, 2023 Water Price Review: Guidance Paper, 26 October, p. 45.

⁸⁷ Essential Services Commission 2021, 2023 Water Price Review: Guidance Paper, 26 October, p. 45.

Consulting, we have also tested Yarra Valley Water's assumptions for forecast operating and capital expenditure, and our preliminary view is that they reflect efficient expenditure.

We consider Yarra Valley Water's price submission provided clear justification for its proposals, and its financial model contained no substantive errors and was consistent with its written submission. Its price submission was well presented and clearly linked the outcomes of its engagement to planned outcomes and expenditure. The Yarra Valley Water Board has also attested to the accuracy of the information contained in its submission, as required by our guidance.

Accordingly, our draft decision is to accept Yarra Valley Water's self-rating of 'Advanced' for Management.

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.⁸⁸

As noted in section 3.2, our preliminary view is that we consider Yarra Valley Water has provided evidence that demonstrates its outcome measures and targets were developed in consultation with its customers, and that they are supported by customers. We consider it demonstrated a strong level of influence of its customer engagement findings and recommendations, on the Outcomes and initiatives proposed. Its submission clearly linked key proposals and initiatives such as Caring for Country, to the recommendations of its Citizens' Juries.

Further, Yarra Valley Water's proposed targets for its outcome measures suggest an overall improvement in customer value, supporting its Outcomes rating. Its submission also clearly linked the proposed Outcomes to specific projects driving its expenditure.

We consider that its approach to monitoring and reporting on performance is strong. As part of its reporting approach, it will seek recommendations annually from its Community Advisory Group, or another similar group of customer representatives, on whether it achieved each outcome. This process will be used to inform any rebate amounts returned to customers and the community.⁸⁹ We consider this demonstrates strong accountability for performance that sets it apart from other businesses.

⁸⁸ Essential Services Commission 2021, 2023 Water Price Review: Guidance Paper, 26 October, p. 45.

⁸⁹ Yarra Valley Water, 2023 water price submission, September 2022, p. 59.

Section 3.1 provides a list of actions where we consider Yarra Valley Water has demonstrated the influence of customers on its proposed Outcomes and other initiatives. This includes embedding Caring for Country in all decisions, acknowledging Traditional Owners/Custodians on bills, adapting its communications to help break down barriers that exist for some customers, and focusing on adding value through water savings initiatives and protecting the natural environment.

Overall, service improvements in line with customer preferences and reduced customer prices and bills (in real terms at least), demonstrate a commitment to improving customer value.

Accordingly, our draft decision is to accept Yarra Valley Water's self-rating of 'Advanced' for Outcomes.

Appendix A — Submissions received

Name or organisation	Date received
Anonymous	7 October 2022
Anonymous	10 October 2022
Anonymous	21 October 2022
Consumer Action Law Centre	30 November 2022
Concerned Waterways Alliance	1 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 Yarra Valley Water.⁹⁰ This paper should be read in conjunction with our draft decision, which is available at www.esc.vic.gov.au.

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.⁹¹ 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 Yarra Valley 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 Yarra Valley 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).

⁹⁰ Essential Services Commission 2022, *Yarra Valley Water draft decision, 2023 water price review*, 20 December.

⁹¹ Essential Services Commission, *2023 water price review: Guidance paper*, 26 October 2021.

- Our assessment of tariffs (Section 5.3).

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 Yarra Valley 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 corporation to retain the benefits of any cost efficiencies it generates until the end of its regulatory period. In other words, a water corporation 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 corporations 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 corporation 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 ten-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 Yarra Valley Water to recover borrowing costs associated with its investment in services, and generate a return on assets.⁹²

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 corporation can maintain an investment grade credit rating. Further, prices should enable each corporation to generate cash flow to service financing costs arising from investments to meet service expectations.

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 Yarra Valley 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.

⁹² The regulatory rate of return is comprised of the cost of debt and the return on equity.

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).

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

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

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

We have had regard to the prescribed services listed in the WIRO in making our decision. This includes adopting operating and capital expenditure benchmarks that we consider will allow Yarra Valley 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 Yarra Valley 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 Australia⁹³
- operating and capital expenditure costs per connection throughout Australia⁹⁴
- tariff structures applied by water corporations throughout Australia⁹⁵
- the regulatory rate of return set by other regulators.⁹⁶

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

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

Our pricing approach allows each water corporation 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 Yarra Valley Water’s proposals, including through submissions and public meetings.

⁹³ Bureau of Meteorology, *National performance report 2020-21; urban water utilities, part A*, February 2022

⁹⁴ Bureau of Meteorology, *National performance report 2020-21; urban water utilities, part A*.

⁹⁵ Includes Icon Water, Sydney Water, Hunter Water, Central Coast Council, Power and Water Corp, Urban Utilities, Unity Water, SA Water and TasWater.

⁹⁶ 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 Yarra Valley 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 Yarra Valley 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 corporation's engagement
- the structure of individual tariffs
- the proposed form of price control
- any changes to tariffs and how water corporations 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 Yarra Valley 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 Yarra Valley Water's prices 'take into account the interests of customers of the regulated entity, including low income and vulnerable customers'.

In considering the above factor, we had regard to the customer engagement by Yarra Valley Water and that it proposed:

- maintaining an efficiency improvement rate greater than the industry average, helping to minimise prices and bills

- a price path that focused price reductions in the first two years of the regulatory period in consideration of the near-term inflation outlook and cost of living pressures
- new expenditure items only where there was support among self-identified vulnerable customers
- piloting a combined water audit and showerhead replacement program with a particular focus on vulnerable and higher water use customers.

Yarra Valley Water's price submission was informed by engagement that was inclusive for customers more likely to experience vulnerability, including youth, customers who are vision or hearing impaired, and customers who are culturally and linguistically diverse.

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 Yarra Valley 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 Yarra Valley 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, Yarra Valley 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 corporations. Our PREMO water pricing approach provides incentives for a water corporation to provide its “best offer” to customers in its price submission. This is described in further detail in a report we released in 2016.⁹⁷

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 corporations may receive streamlined price reviews if they submit a high quality price submission. This reduces the costs of regulation for water corporations 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 corporations. Our guidance noted that much of the information required in price submissions should be readily

⁹⁷ Essential Services Commission 2016, Water Pricing Framework and Approach, Implementing PREMO from 2018, October, pp. 11–13.

available to water corporations as it would be relevant for other purposes such as corporate planning and project prioritisation and justification.⁹⁸

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 corporation’s revenue requirement
- allows water corporations to implement various forms of price control, including price caps and revenue caps
- 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 corporations may receive streamlined price reviews if they submit a high quality price submission. This reduces the costs of regulation for water corporations 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 corporations. Our guidance noted that much of the information required in price submissions should be readily available to water corporations as it would be relevant for other purposes such as corporate planning and project prioritisation and justification.⁹⁹

⁹⁸ Essential Services Commission, 2023 water price review: Guidance paper, p. 2.

⁹⁹ Essential Services Commission, 2023 water price review: *Guidance paper*, p. 2.