

Gippsland Water draft decision

2023 Water Price Review

2 March 2023



Acknowledgement

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

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

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

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Summary

Our draft decision considers Gippsland Water’s proposed prices for a 5-year period starting 1 July 2023

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



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

Gippsland Water provided us with a high-quality price submission

Gippsland 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.

As well as presenting a high-quality price submission, it has demonstrated improved value for its customers. As noted below, prices will fall (in real terms) over the 5-years from 1 July 2023, underpinned by strong operating cost control in the current regulatory period, relatively high efficiency targets for 2023–28, and management of risk on behalf of customers.

Gippsland Water has committed to delivering outcomes that reflect customer priorities, including a focus on pathways for Aboriginal people

Gippsland Water plans to deliver the following outcomes for customers:

- Be affordable and fair
- Do its job well
- Be easy to deal with
- Be involved in the community
- Be environmentally responsible
- Plan for the future.²

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

² Gippsland Water, 2023 water price submission, September 2022, p. 55.

Among the key service initiatives to deliver on its commitments, Gippsland Water will introduce SMS messages to customers in the event of a service disruption, and an app that will provide customers the ability to monitor their usage and flexibility in managing their bill payments.

It will establish new initiatives and pathways for Aboriginal people, including more opportunities for Aboriginal employment with the organisation, support for professional education and work, delivering reticulated water and drinking fountains to the culturally significant Knob Reserve, and exploring opportunities to make land it manages available for cultural use.

Customer bills will fall in real terms under Gippsland Water’s proposal

Gippsland Water’s price submission proposed a reduction in (real) prices. Based on its price submission, the typical annual water and sewerage bill for a residential owner-occupier would fall from \$1,363 currently to \$1,279 in 2023-24, and \$1,272 by 2027-28 (Table A). These estimates exclude inflation (they are in \$2022-23 terms).

Under its price submission proposal and without inflation, bills for household tenants would fall from \$366 in 2022-23 to \$344 in 2023-24, and falling to \$342 by 2027-28. Estimated annual water and sewerage bills for non-residential customers also fall in real terms. These are shown below. .

As noted below, Gippsland Water’s response to our draft decision must include an updated estimate for its proposed revenue requirement and prices, to respond to matters raised in our draft decision. Its response may affect customer bill estimates. Estimated bills will also be impacted to reflect our updates for inflation and the cost of debt, following the release of our draft decision.

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	164	\$1,363	\$1,279	\$1,272
Residential – tenant	164	\$366	\$344	\$342
Non-residential (small)	70	\$1,267	\$1,191	\$1,185
Non-residential (medium)	327	\$2,258	\$2,130	\$2,121
Non-residential (large)	600	\$3,311	\$3,128	\$3,115

Gippsland Water must update its proposed revenue requirement in response to our draft decision

The revenue requirement we approve as a benchmark for the 2023–28 regulatory period will allow Gippsland 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 adopts a slightly lower revenue requirement (\$692.5 million over the 5-year period) than that proposed by Gippsland Water in its price submission (\$694.6 million). The difference is relatively small; \$2.2 million or 0.3 per cent. The main reason for the difference is the treatment of capital expenditure in 2022-23 (Section 4.3.2).

In its price submission, Gippsland Water also included a forecast tax benchmark of zero, based on its assumption about the outcomes of an expected ruling affecting tax payable on gifted assets.³ It proposed a pass-through mechanism to allow its revenue requirement to reflect the tax that would be payable, should the change to its tax obligations not occur.

In our view, the benchmark adopted for tax should reflect the tax obligation applicable at the time, or alternatively, the business could have proposed to absorb the impact of any tax payments for customers. We have not adjusted the revenue requirement in our draft decision to reflect Gippsland Water's current tax obligations. Gippsland Water must respond to our draft decision to confirm its approach.

In its response to our draft decision, Gippsland Water must provide an updated revenue requirement and price schedule, that also takes into account updated estimates for the cost of debt and inflation, which we will advise in April 2023.

Tariff structures will generally remain the same

For water services, Gippsland Water proposed a fixed service charge and a variable component that depends on water use. For residential sewerage services, Gippsland Water proposed a fixed charge only. For non-residential sewerage services, Gippsland Water proposed a two-part tariff with a fixed service charge and a variable usage component.

Our draft decision is to approve Gippsland Water's proposed tariff structures, because this is the same as its current approach, provides customers with price certainty and means that demand risk is managed by Gippsland Water and not its customers. Our review of Gippsland Water's proposed tariff structures is set out in Section 5.3.1.

³ Gippsland Water, 2023 water price submission, September 2022, p. 162.

A key change is Gippsland Water’s proposal to reintroduce new customer contributions. This is a result of its engagement findings supporting a ‘user pays’ principle and will help to recover the costs associated with new customers connecting to its water and sewerage services. As set out in Section 5.4, our draft decision proposes to approve its proposed new customer contributions, although we seek further feedback in response to our draft decision.

Our draft decision is to accept Gippsland Water’s proposed price cap form of price control (Section 5.2). This means its maximum prices are fixed subject to updates for inflation and cost of debt, and any other price adjustments we approve in our price determination. Gippsland Water currently uses a price cap.

Our draft decision rates Gippsland Water’s price submission as ‘Advanced’ under the PREMO framework

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

Key factors supporting this PREMO rating include:

- Gippsland Water is proposing relatively large real price reductions, underpinned by efficiencies and management of risk on behalf of customers – including through excluding uncertain projects from its expenditure forecasts and adopting relatively optimistic demand projections (noting it faces downside revenue risk if demand does not meet these projections)
- Gippsland Water is performing well compared to most other businesses on its controllable operating costs in the current regulatory period, relative to benchmarks set at the 2018 price review
- recognition of the possible impacts of a high inflation outlook on prices in the near term, and a proposed price path that helps to manage these impacts for its customers
- the overall strength of the justification for the prudence and efficiency of its forecast expenditure
- a strong engagement program which gives confidence that its proposals are informed by deep insights into customer priorities and concerns
- alignment of outcome commitments with customer priorities, with improvements in a number of outcome measures and targets adding to customer value
- sound performance against its outcome commitments in the current regulatory period, and a major project delivery record that compares favourably to other water businesses.

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
Gippsland Water's self-rating	Advanced	Advanced	Leading	Leading	Advanced	Advanced
Commission's rating	Advanced	Advanced	Leading	Leading	Advanced	Advanced

Among the four draft decisions we have released so far, Gippsland Water is one of three corporations for which we propose to approve an 'Advanced' rating (Table C).

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

Leading	Advanced	Standard	Basic
	Yarra Valley Water Gippsland Water GWMWater	Westernport Water	

We invite feedback on our draft decision

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

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

- the information we have relied upon in our assessment (such as Gippsland Water's price submission):
- additional matters or issues we should consider before making our final decision
- whether our draft decision on Gippsland 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 on to inform our final decision and price determination for Gippsland Water.

Table D Specific topics we are particularly interested in stakeholder feedback on

Topic	Specific issue	Draft report reference
Guarantees service levels	Gippsland Water's proposed guaranteed service levels and rebates	Section 3.4
New customer contributions	Feedback from developers and other customers about Gippsland Water's proposed new customer contributions 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 early April 2023. Forums provide an opportunity for interested parties to discuss key features of our draft decisions. Details of our public forums will be published on the Engage Victoria website.

Provide written comments or submissions

Written comments or submissions in response to this draft decision will be due by 28 April 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	Early April 2023
Closing date for submissions on our draft decision	28 April 2023
Release date for our final decision and price determination	Late June 2023

1. Our role and approach to water pricing

1.1 We are Victoria's independent economic regulator

Our role in the water industry is based on the Water Industry Regulatory Order 2014 (WIRO), which is made under the *Water Industry Act 1994* (WI Act) and sits within the broader context of the *Essential Services Commission Act 2001* (ESC Act). Our role under the WIRO includes regulating the prices and monitoring service standards of the 18 water 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 2023.⁴ The prescribed services include retail water and sewerage services, and bulk water and sewerage services delivered by the water corporations.⁵

Gippsland 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 Gippsland 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

⁴ 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.

⁵ The prescribed services are listed at clause 7(b) of the WIRO.

- the matters set out in section 33(3) of the ESC Act, which include the return on assets, relevant benchmarking and any other matters that the ESC considers relevant
- the matters specified in our guidance⁶
- 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. Table 1.1 summarises the matters we must have regard to and groups them into themes.

In October 2021, we issued guidance to Gippsland Water to inform its price submission. The guidance set out how we would assess Gippsland Water's submission against the matters we must consider under clause 11 of the WIRO. It also outlined our expectation that Gippsland Water would comply with certain requirements and specified information that Gippsland 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 Gippsland Water's proposed prices.⁷

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.⁸

⁶ Essential Services Commission, *2023 water price review: Guidance paper*, 26 October 2021.

⁷ This is a requirement of the WIRO, clause 14(b).

⁸ 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 1994 (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 or Basic, depending on the level of ambition expressed by a water business in its price submission. Financial incentives are provided by linking the return on equity to the PREMO rating.

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

Our guidance specifies the way in which we expect water 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.⁹

⁹ In December 2022, we issued early draft decisions for Yarra Valley Water and Westernport Water.

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.¹⁰

¹⁰ Essential Services Commission, *2023 water price review: Guidance paper*, pp. 41–46.

2. Our assessment of Gippsland Water's price submission

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

- Gippsland Water's price submission
- Gippsland 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 Gippsland 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. Gippsland Water's price submission addressed each of these matters. Our preliminary assessment of these matters is provided in this draft decision.

We found Gippsland Water's price submission presented clear and comprehensive information to support its proposals. Gippsland Water also provided evidence that its engagement sought to capture the main priorities and concerns of customers, and that it has taken this feedback into account (see Section 3.1 on customer engagement). While our draft decision disagrees with the treatment of tax in its price submission, we note this has a relatively minor impact on the overall revenue requirement.

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



Gippsland Water must submit a response to our draft decision and provide an updated financial model by 21 April 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 Gippsland Water in June 2023.

2.1 Draft decision paper outline

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

- Determine the regulatory period (Section 2.2).
- Confirm the customer outcomes and service levels that Gippsland Water has committed to over the regulatory period (Chapter 3).
- Establish Gippsland 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 Gippsland Water's financial position, which we have also had regard to.

Chapter 7 outlines our assessment of Gippsland 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.¹¹ 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.¹²

Gippsland 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.

¹¹ This is a requirement of the WIRO, clause 9.

¹² For detail on the reasons for using five years as the default regulatory period, see: Essential Services Commission, *2023 water price review: Guidance paper*, p. 18.

3. Customer outcomes

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

3.1 Customer engagement

Our guidance required Gippsland Water to engage with customers to inform its price submission. Our guidance also identified principles to guide Gippsland Water’s engagement.¹³

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

- Gippsland Water engaged early and sought customer and stakeholder input when developing its engagement program, which ran between November 2020 and September 2022.
- It engaged over 3,500 customers and stakeholders using a range of online and in-person methods including surveys, stakeholder interviews, focus groups, a 3.5 day deliberative Customer Summit, and an independent Customer Reference Group.
- It used findings from each engagement stage to set the agenda for the next stage and engaged on matters that included customer expectations, issues and priorities. Complex issues relating to fairness and affordability that had a material impact on customer bills were deliberated by participants in the Customer Summit. The Customer Reference Group deliberated on the customer outcomes, measures and guaranteed service levels.
- Gippsland Water developed inclusive engagement activities to hear from customers more likely to experience vulnerability, including multicultural community members, people experiencing homelessness, and people experiencing financial difficulty. It also engaged with organisations who support and advocate for vulnerable community members.
- Its engagement was inclusive of Traditional Owners and First Nations customers through early and ongoing engagement with Gunaikurnai Land and Waters Aboriginal Corporation, and

¹³ Essential Services Commission, *2023 water price review: Guidance paper*, p. 20.

targeted engagement with Bunurong Traditional Owners, Brayakaulung Advisory Committee and Federation University's Aboriginal Education Centre.

More detail on Gippsland Water's engagement is available in its price submission.¹⁴

Actions proposed to be taken by Gippsland Water provide evidence that its engagement influenced its proposals. For example, in its price submission, Gippsland Water proposed:

- adopting all recommendations of the Customer Summit including re-introducing New Customer Contributions, re-negotiating expiring contracts with major customers to better reflect the cost of the service delivered to them, and realigning Quality Based Trade Waste tariffs with real costs to serve¹⁵
- two new customer outcomes – 'Be environmentally responsible' and 'Plan for the future' – in response to increased customer concern about environmental stewardship and responsibility¹⁶
- ten new customer experience-based output measures to align with customer priorities (for example, the inclusion of a measure to capture how effective Gippsland Water is in achieving awareness of their support services) – in response to customer feedback about ensuring people know about available support¹⁷
- additional resources that will be added to its customer care team to improve early outreach and provide tailored support – in response to feedback from its Customer Reference Group that it should increase the level of the support on offer¹⁸
- opportunities and support for Aboriginal employment and long-term careers, making land Gippsland Water manages available for cultural use, and collaborating to raise awareness and sense of pride in local Aboriginal culture – in response to its engagement with Traditional Owners¹⁹
- a decrease in the time to rectify a sewer blockage from 95 minutes to 80 minutes – in response to customer feedback about the need for timely restoration of interrupted services (and consistently outperforming 2018-23 targets).²⁰

We received a positive submission from the Consumer Action Law Centre about Gippsland Water making decisions based on its engagement. It specifically noted that Gippsland Water's

¹⁴ Gippsland Water's price submission is available on our website at www.esc.vic.gov.au.

¹⁵ Gippsland Water, 2023–28 Price Submission, September 2022, p. 166.

¹⁶ Gippsland Water, 2023–28 Price Submission, September 2022, p. 55.

¹⁷ Gippsland Water, 2023–28 Price Submission, September 2022, p. 57.

¹⁸ Gippsland Water, 2023–28 Price Submission, September 2022, p. 47.

¹⁹ Gippsland Water, 2023–28 Price Submission, September 2022, p. 49.

²⁰ Gippsland Water, 2023–28 Price Submission, September 2022, p. 58.

submission proposes a 'user pays' tariff principle in response to customer feedback, and the business has decided not to continue to investigate fixed/variable tariff changes following feedback from the Customer Reference Group (See Section 5.3 for more on tariff structures).

The influence of Gippsland 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 Gippsland Water has designed and delivered a robust and thorough engagement program and achieved strong customer and stakeholder influence on the proposals in its submission.

Customers had multiple ways of participating throughout the engagement process including through an independent Customer Reference Group that helped develop the engagement program and functioned as an independent voice on Gippsland Water's engagement process.

Gippsland Water effectively tailored its engagement program to also capture the specific needs of customers experiencing vulnerability and Traditional Owners. This is consistent with our expectations set out in our guidance. Gippsland Water's engagement with people experiencing vulnerability resulted in a high level of participation that allowed for detailed exploration of the service issues, including identifying where customers held contrasting views and expectations.

Gippsland Water was also prepared to engage on complex issues including with its large customers and did so in ways that we consider allowed full exploration of opposing perspectives and competing interests.

Further, Gippsland Water was able to achieve strong alignment between customer and stakeholder feedback and the proposals in its submission. An example of how it achieved this was its approach to identifying the topics to be discussed at the deliberative Customer Summit. Topics for the Customer Summit were developed in consultation with key decision makers to ensure they were willing to share decision-making power with customers. The result was that all recommendations from the Customer Summit were adopted.²¹

We consider that the level of customer influence Gippsland Water facilitated across the breadth of its service offerings reflected a commitment to customer participation and influence that was a step up from the engagement in its 2018 price submission.

Based on the above, our preliminary view 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 Gippsland Water's price submission.

²¹ Gippsland Water, 2023–28 Price Submission, September 2022, p. 58.

3.2 Outcomes

3.2.1 Performance against outcome commitments 2018–23

As part of our 2018 price review, Gippsland 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 Gippsland Water accounted for its annual performance for each measure in its price submission. Like many other water businesses in our current price review, Gippsland Water’s price submission was missing some of its overall ratings against outcomes for the period to date. In the absence of this information, we have drawn on Gippsland Water’s 2021-22 Outcomes report for its period to date rating.²³

Table 3.1 lists Gippsland 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 in this table informs our assessment under the Performance element of PREMO, which is discussed in Chapter 7.

For the 2018–23 regulatory period, Gippsland Water committed to 22 annual performance measures and targets across 5 outcomes. Over the first four years of the current regulatory period, Gippsland Water considers it has achieved or exceeded its targets for 66 of its 88 measures. Gippsland Water considers it has performed well, despite challenges due to the coronavirus pandemic, environmental investigations, and unprecedented new connections growth to its networks.²⁵

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

²³ Essential Services Commission, Gippsland Water’s outcomes performance 2021-22, October 2022.

²⁴ Gippsland Water, 2023 water price submission, September 2022, p. 12–14; Essential Services Commission, Gippsland Water’s outcomes performance 2021-22, October 2022. Gippsland Water’s ‘period to date’ performance was incorrectly rated outcome 3 – Be Affordable and Fair – in the 2021-22 outcomes report. It should have been rated green, not amber.

²⁵ Gippsland Water, 2023 water price submission, September 2022, p. 11–13.

Table 3.1 Business self-assessment of performance against Outcome commitments

Outcome	2018-19	2019-20	2020-21	2021-22	Period to Date ^a
1. Do Your Job Well	Green	Amber	Amber	Green	Green
2. Be Easy to Deal With	Green	Green	Green	Green	Green
3. Be Affordable and Fair	Green	Green	Green	Amber	Green
4. Prepare and Protect	Green	Green	Amber	Green	Green
5. Be Involved	Green	Green	Green	Green	Green

Note: Green = achieved target; Amber = close to achieving target; Red = failed to meet target. ^a This is Gippsland 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.

Source: Gippsland Water, 2023 water price submission, September 2022, p. 12–14; Essential Services Commission, Gippsland Water’s outcomes performance 2021-22, October 2022.

In its price submission, Gippsland Water highlighted where its performance materially outperformed its targets for the period to date. Of note, Gippsland Water has funded an average of \$63,800 per annum over the last 4 years for community projects, which is well above its \$30,000 annual target. Additionally, it noted that it remains well ahead of its targets to reduce its total carbon footprint by 24 per cent by 2025, as part of its planned pathway to becoming carbon neutral by 2030.²⁶

On the basis that Gippsland Water’s self-assessment is consistent with our reviews included in our Outcomes reporting during the current regulatory period, our draft decision is that we agree with Gippsland Water’s self-assessment that it has met its outcome commitments for the period to date.

3.2.2 Outcome commitments for 2023–28

Gippsland 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:

- Be affordable and fair
- Do your job well
- Be easy to deal with
- Be involved in the community
- Be environmentally responsible

²⁶ Gippsland Water, 2023 water price submission, September 2022, p. 15.

- Plan for the future.²⁷

Among the key initiatives to deliver on its commitments, Gippsland Water will introduce new initiatives to interact with its customers and keep them up to date about their services. This includes introducing SMS messages to customers in the event of a service disruption, and an app which will provide customers the ability to monitor their usage and flexibility in managing their bill payments. Other initiatives include increasing community support investment to \$100,000 per year. It will also ensure it is prepared for the future with higher growth and higher service levels by investigating \$268 million in its infrastructure.

As a result of its engagement with First Nations representatives, Gippsland Water will establish a new ongoing Aboriginal employment position, investigate a school-based traineeship initiative, and work with traditional owners to create long-term, meaningful employment pathways for local Aboriginal people. This includes developing an Aboriginal student scholarship program in partnership with Federation University Gippsland. It will also work with Traditional Owners to make land it currently manages available for cultural use.

3.2.3 Our assessment of measures and targets

Gippsland Water proposed a set of 19 measures and targets that it will use to report on its performance across the 6 outcomes. These are set out on pages 61 to 66 of its price submission. Performance against these measures will inform our assessment during future price reviews.

We have assessed Gippsland 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.²⁸

Gippsland Water's price submission noted these measures and targets were developed in consultation with its customers via its customer reference group, and they were supported by the customer reference group.²⁹

For some of its measures, we consider Gippsland Water's intentions are clear, and will provide a sound basis to track performance and delivery against each outcome. However, most of its

²⁷ Gippsland Water, 2023 water price submission, September 2022, p. 55.

²⁸ Essential Services Commission, 2023 water price review: Guidance paper, 26 October 2021, p. 23.

²⁹ Gippsland Water, 2023 water price submission, September 2022, p. 50.

measures were not well presented and will require reworking to meet our requirements. We identified the following matters in our assessment that need to be addressed:

- 12 of 19 measures are not measurable
- 17 of 19 measures are considered ambiguous or not clearly defined
- 1 of the 19 measures is not easy to understand.

Gippsland Water has also removed its previous measure for the number of penalties issued by the Environment Protection Authority. Gippsland Water notes it removed this measure because it considers it duplicates regulation and does not add value, and it has replaced it with measures that more accurately reflect customer value for environmental protection.³⁰

We will provide Gippsland Water with our standard Outcomes Reporting 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.

Gippsland Water's proposed targets for its outcome measures suggest customer value is maintained for most measures, with some targets indicating improved customer value. In our preliminary view, of the 19 output targets:

- 7 indicate an increase in customer value, either improving on past performance or improving across the 2023–28 regulatory period
- 10 suggest current customer value is maintained
- 1 indicates a decrease in customer value
- 1 is unclear in how customer value changes.

Gippsland Water's measure for 'planned interruptions restored within advised times' indicates a decrease in customer value. Its 2018 measure for 'number of planned interruptions going over advised times' has zero as the annual target. However for the 2023–28 period, Gippsland Water proposes to measure the percentage of planned interruptions restored within advised times, with annual targets of 98 per cent. Although its method of measuring its performance has changed, both measures track the same performance outcome. This change suggests a decrease in outcomes in this area.³¹

³⁰ Gippsland Water, 2023 water price submission, September 2022, p. 60.

³¹ Gippsland Water, 2023 water price submission, September 2022, p. 63; Essential Services Commission, Gippsland Water's outcomes performance 2021-22, October 2022.

We note some instances where Gippsland Water has set targets well below current performance levels, which suggests this is an easily achieved outcome commitment, in particular:

- Outcome 2.b of its 2018 set, 'contacts are resolved at the first point of contact', had an annual target of 88 per cent. The same measure is included in its 2023–28 set as outcome 3.c, with an increased annual target of 92 per cent. However, its actual performance average over the first 4 years of the current period is 97 per cent.
- Outcome 1.b of its 2018 set, 'average time to rectify a sewer blockage', had an annual target of 95 minutes on average. The same measure is included in its 2023–28 set as outcome 2.d, with a revised target of 80 minutes on average. However, its actual performance average over the first four years of the current period is 73.5 minutes.

Gippsland Water notes it has introduced two accountabilities should it not meet outcome commitments, in addition to its guaranteed service levels. For not meeting its annual net zero emissions target, it will plant 10,000 trees in Gippsland.³² It also notes its commitment to increasing its community support investment from \$30,000 to a minimum of \$100,000 per year and has included this as an accountability against its outcome, 'be involved in the community'.³³ While we consider this initiative demonstrates Gippsland Water's commitment to providing value to its customers, we consider this community support investment is a planned program rather than an accountability measure for shortfalls in its performance.³⁴ As such, our preliminary position is that we do not intend to report on this investment alongside other outcome commitments in our 2023–28 outcomes reporting.

In the current regulatory period, Gippsland Water reported its performance results on the main page of its website, as bill inserts, newsletters and social media posts. For the 2023–28 period, it will continue to report annually, and further involve customers in assessing its performance by sharing its assessment with its customer reference group, and via its annual customer satisfaction survey.³⁵

While Gippsland Water's proposal maintains current target levels for most of its output targets, it has proposed higher service levels for some, and its proposed outcomes appear to be supported by customers. Accordingly, we consider Gippsland Water's proposal represents improved value for customers over the 2023–28 regulatory period.

³² Gippsland Water, 2023 water price submission, September 2022, p. 56.

³³ These figures are in nominal terms, that is, they will not increase further with inflation.

³⁴ Gippsland Water, 2023 water price submission, September 2022, pp. 66 and 80.

³⁵ Gippsland Water, 2023 water price submission, September 2022, p. 73.

3.3 Service standards relating to reliability and faults

Service standards are a common set of services applicable to all Victorian consumers as required by clause 18.2 of the *Water Industry Standard – Urban Customer Service* (Urban Water Industry Standard) and clause 1.5 of the *Water Industry Standard – Rural Customer Service* (Rural Water Industry Standard). Each water business must specify its own targets against each of these service standards. These service standards and corresponding target service levels are the minimum level of service customers can expect to receive.

Gippsland Water’s service standards relating to reliability and faults can be found in its ESC Customer Service Code 2023–28 Summary document.

The service standards proposed by Gippsland Water are substantially the same as (with some wording changes to align with the updated Urban Water Industry Standard), or in some cases an improvement on, the service standards for the current regulatory period. Gippsland Water has also specified the minimum water pressure as required by the Urban Water Industry Standard.

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

The approved service standards for each business will be published in our Water Industry Standards in early 2023-24.

3.4 Guaranteed service levels

Our draft decision is to accept Gippsland Water’s proposed guaranteed service levels.

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.

Gippsland Water’s proposed guaranteed service levels are set out on pages 75 to 80 of its price submission. Gippsland Water developed and tested the outputs for its proposed outcomes and guaranteed service levels with customers throughout its engagement, including through a customer preferences survey and consultation with its Customer Reference Group. The customer preferences survey identified preferred outputs for customers and consultation with the Customer Reference Group informed what measures should have a guaranteed service level rebate associated with them if Gippsland Water failed to meet the measure of service.

Gippsland Water has proposed to maintain five of its seven existing guaranteed service levels (noting it proposed to increase the guaranteed service level payment payable for one of these five relating to the issue of a 'boil water' alert from \$5,000 to \$10,000).³⁶

In its submission, the Consumer Action Law Centre stated that it was disappointing to see Gippsland Water reduce the guaranteed service levels offered to customers.³⁷

We note that both of the guaranteed service levels Gippsland Water proposes to remove are to be replaced by community and environmental commitments that are similar in nature. For example, the current community rebate that is payable if it receives a sanction from a regulator for harm to the environment will be replaced with a commitment to plant 10,000 trees in Gippsland if it does not meet its annual net zero emissions target. This change has been proposed on the basis this better demonstrates its commitment to protecting the environment and is consistent with preferences of customers expressed through its Customer Preference Survey results. Gippsland Water also proposed to increase its investment in programs that support the wellbeing of its communities from \$30,000 each year to \$100,000 each year in the next regulatory period as part of its commitment to 'be involved in the community'.³⁸

Our draft decision is to accept Gippsland Water's proposed guaranteed service levels, on the basis that Gippsland Water is maintaining or strengthening its overall customer commitments, including but not limited to guaranteed service levels, and the changes have been agreed with customers during its engagement. Final guaranteed service levels will be subject to our consideration of any feedback following the release of our draft decision.

Guaranteed service levels 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.

³⁶ These figures are in nominal terms, that is, they will not increase further with inflation.

³⁷ Consumer Action Law Centre, Initial Feedback: 2023-28 Water Price Review, 30 November 2022, p. 8.

³⁸ These figures are in nominal terms, that is, they will not increase further with inflation.

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. 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 Gippsland 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 Gippsland 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 adopt a revenue requirement of \$692.5 million over the 2023–28 regulatory period, \$2.2 million lower than proposed by Gippsland Water in its price submission.

Gippsland Water's price submission proposed a revenue requirement of \$694.6 million over a 5-year period starting 1 July 2023. Our draft decision is to adopt a revenue requirement of \$692.5 million, reflecting an adjustment arising from our review of Gippsland Water's proposed operating expenditure (relating to additional costs proposed for regulatory consulting), and our draft decision relating to treatment of capital expenditure in 2022-23.

Gippsland Water's price submission revenue requirement included a forecast tax benchmark of zero, based on its assumption about the outcomes of an expected ruling affecting tax payable on gifted assets.³⁹ It proposed a pass-through mechanism to allow its revenue requirement to reflect

³⁹ Gippsland Water, 2023 water price submission, September 2022, p. 162.

the tax that would be payable, should the change to its tax obligations not occur. Based on its current tax obligations, Gippsland Water will be in a tax paying position from 2023-24.

In our view, the benchmark adopted for tax should reflect the tax obligation applicable at the time, or alternatively, the business should accept the risk on behalf of customers should tax ultimately be payable.

We have not adjusted the revenue requirement in our draft decision to reflect Gippsland Water's current tax obligations. Gippsland Water must respond to our draft decision to confirm its approach.

We note that Gippsland Water could choose to absorb the tax payments, thereby accepting a risk that a ruling may not eventuate that reduces its forecast tax obligations to zero. Or it could choose to recover the payments and include an adjustment mechanism to reverse the effect of this recovery if the ruling results in the tax not being payable, subsequent to the lodgement of its response to our draft decision.

In its response to our draft decision, Gippsland Water must provide an updated revenue requirement and price schedule, to also take into account updated estimates for the cost of debt and inflation, which we will advise in April 2023.

Table 4.1 Draft decision on Gippsland Water's revenue requirement
\$ million 2022-23

	2023-24	2024-25	2025-26	2026-27	2027-28	Total
Operating expenditure	89.4	90.1	91.4	92.3	91.6	454.9
Return on assets	24.7	23.7	23.3	22.9	22.6	117.2
Regulatory depreciation	21.7	22.9	24.0	25.2	26.7	120.4
Adjustments from last period	0.0	0.0	0.0	0.0	0.0	0.0
Tax allowance	0.0	0.0	0.0	0.0	0.0	0.0
Draft decision – revenue requirement	135.7	136.7	138.7	140.5	140.9	692.5

Note: Numbers have been rounded.

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, Gippsland 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 resulting updates to its submission or pricing model will be made publicly available on our website.

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

	2023-24	2024-25	2025-26	2026-27	2027-28	Total
A. Gippsland Water’s proposed revenue requirement	136.2	137.1	139.1	140.9	141.3	694.6
B. Operating Expenditure	0.0	0.0	0.0	0.0	0.0	0.0
C. Return on Assets	-0.2	-0.2	-0.2	-0.2	-0.2	-1.1
D. Regulatory Depreciation	-0.2	-0.2	-0.2	-0.2	-0.2	-1.1
E. Tax allowance	0.0	0.0	0.0	0.0	0.0	0.0
F. Draft decision – revenue requirement (A+B+C+D+E)	135.7	136.7	138.7	140.5	140.9	692.5

Notes: This table shows the differences between the amounts approved under our draft decision and what Gippsland Water proposed in its price submission. Row A shows the total revenue requirement proposed by Gippsland Water in its price submission. We have arrived at our draft decision (row F) by proposing the relevant adjustments to the components of the revenue requirement shown in rows B to E. Numbers have been rounded.

4.1 Operating expenditure

Our draft decision is to adopt an operating expenditure benchmark of \$454.9 million over the 5 years from 1 July 2023.

Operating expenditure is a component of the revenue requirement. Gippsland Water's price submission provides detail on its forecast operating expenditure from pages 104 to 123.

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 Gippsland Water's expenditure forecast is available on our website.⁴⁰

Since lodging its price submission with us, we identified that in its price submission, Gippsland Water had misclassified bulk water charges paid to Melbourne Water and Southern Rural Water as controllable operating expenditure. Gippsland Water has subsequently resubmitted a revised financial model correctly classifying these bulk water charges as non-controllable operating expenditure, which has reduced the baseline controllable operating expenditure year of 2021-22 by \$0.91 million and a reclassification of \$10.76 million from forecast controllable operating expenditure to non-controllable operating expenditure for the next regulatory period, which is reflected in Table 4.4. We accept this change because it is consistent with our definition of non-controllable operating expenditure.

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

⁴⁰ FTI Consulting, *Gippsland Water – Expenditure Review for 2023 water price review*, February 2023.

Table 4.3 Draft decision – operating expenditure

\$ million 2023-24

	2023-24	2024-25	2025-26	2026-27	2027-28	Total
Controllable operating expenditure	81.0	81.9	83.4	84.4	83.8	414.6
Non-controllable operating expenditure	8.3	8.2	8.1	7.9	7.7	40.2
Bulk services ^a	2.1	2.1	2.2	2.2	2.2	10.8
Environmental contribution ^b	5.8	5.6	5.5	5.3	5.1	27.3
Licence fees – Essential Services Commission ^c	0.1	0.1	0.1	0.1	0.1	0.6
Licence fees – Department of Health ^c	0.04	0.04	0.04	0.04	0.04	0.2
Licence fees – Environmental Protection Authority ^c	0.3	0.3	0.3	0.3	0.3	1.5
Draft decision – operating expenditure	89.4	90.1	91.4	92.3	91.6	454.9

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.

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

Details of our assessment and reasons for our proposed adjustments to Gippsland 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 Gippsland Water’s price submission.

The operating expenditure that we propose to adopt for Gippsland Water does not represent the amount that Gippsland 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.

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

	2023-24	2024-25	2025-26	2026-27	2027-28	Total
A. Gippsland Water’s proposed total operating expenditure	89.4	90.1	91.4	92.3	91.6	454.9
B. Our total proposed adjustments to controllable operating costs (B1)	-2.11	-2.13	-2.18	-2.17	-2.16	-10.8
B1 – Reclassification of bulk water charges	-2.11	-2.13	-2.18	-2.17	-2.16	-10.8
C. Our total proposed adjustments to non-controllable operating costs (C1)	2.11	2.13	2.18	2.17	2.16	10.8
C1 – Reclassification of bulk water charges	2.11	2.13	2.18	2.17	2.16	10.8
D. Draft decision – total operating expenditure (D = A + B + C)	89.4	90.1	91.4	92.3	91.6	454.9

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

4.1.1 Controllable operating expenditure

Gippsland Water proposed a total forecast controllable operating expenditure of \$425.4 million over a 5-year regulatory period. After adjusting to remove the non-controllable operating expenditure component discussed above, this becomes \$414.6 million. For the reasons set out below, we propose to accept Gippsland Water’s revised forecast controllable operating expenditure of \$414.6 million for the 2023–28 regulatory period.

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

1. Establish a controllable operating expenditure baseline – the baseline comprises the efficient recurring costs from the last full year of data (2021-22) after non-controllable expenditure, one-off items are removed or normally occurring items are added in.
2. Apply a growth rate for operating expenditure for the regulatory period – assumed by Gippsland Water to be 0.0 per cent per year.

3. Apply an annual cost efficiency improvement rate – assumed by Gippsland Water to be an average of 0.5 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

Gippsland Water had initially proposed a controllable operating expenditure baseline of \$78.7 million, after removing \$0.5 million in non-recurring operating expenditure that occurred in 2021-22. Gippsland Water's proposed baseline is \$0.8 million (or 1 per cent) lower than the benchmark figure of \$79.5 million of controllable operating expenditure for 2021-22 used for our 2018 price determination.

As discussed above, following its price submission lodgement, Gippsland Water subsequently resubmitted a revised financial model reclassifying bulk water charges paid to Southern Rural Water in 2021-22 which removed \$0.9 million of non-controllable operating expenditure from the baseline. This has resulted in a revised proposed controllable operating expenditure baseline of \$77.8 million.

Our expenditure consultant verified that the adjustments to the baseline were appropriate including non-recurring items and normally occurring items that were not represented in the baseline. As Gippsland Water's proposed baseline is below the approved benchmark for 2021-22, our expenditure consultant was satisfied that the expenditure reflects the costs incurred by a prudent business operating efficiently.

Based on our own review of Gippsland Water's proposals and advice from our expenditure consultant, we consider Gippsland Water's proposal, with our adjustments for non-controllable expenditure, reflects an efficient baseline cost to forecast annual operating expenditure for the purpose of our draft decision.

4.1.1.2 Efficiency improvement and growth rate

Gippsland Water has not proposed an operating expenditure growth rate to apply across the next regulatory period – rather, it has proposed annual cost adjustments totalling \$4.9 million across the 2023–28 regulatory period to account for growth related costs. This is the equivalent of an average growth rate of 1.2 per cent per annum. Gippsland Water submitted that this bottom-up approach was a more robust method for it to estimate growth-related expenditure and find efficiencies for this price review.⁴¹

Using this approach, Gippsland Water has effectively proposed an equivalent efficiency commitment of 1.7 per cent per annum against its cost growth allowance, or a net efficiency rate of

⁴¹ Gippsland Water, 2023 price submission, September 2022, p. 88.

0.5 per cent per annum, which is a higher net efficiency rate compared to –0.2 per cent for the current regulatory period (calculated from the current efficiency rate of 1.0 per cent per annum and cost growth rate of 1.2 per cent per annum).

Gippsland Water is one of only four water corporations proposing a net average decrease in baseline operating expenditure for the next regulatory period.

4.1.1.3 Cost adjustments

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

- \$15.74 million for business continuity and compliance with regulatory and legislative requirements
- \$7.19 million for IT investment to ensure internal systems and processes are efficient, secure and fit-for-purpose
- \$4.9 million in growth-related costs to service new growth regions and connections
- \$2.1 million in additional chemical costs which are forecasted to continue to increase in the short term
- \$2.08 million in regulatory costs to support Gippsland Water's regulatory, governance and engagement functions
- \$1.78 million in community involvement for programs that support the wellbeing of Gippsland Water's communities
- \$1.35 million for additional electricity costs as the electricity market continues to be extremely volatile.

This represents an additional \$35.1 million over the regulatory period, or an average of \$7.0 million per annum (including the \$4.9 million specifically related to meeting growth).

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

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 Gippsland Water's proposed additions were reasonable and did not recommend adjusting any of the proposed costs.

Gippsland Water's largest proposed step change is for business continuity costs (\$15.74 million) of which the majority (\$9.14 million) is allocated towards labour costs for an additional 18 employees

across the next regulatory period.⁴² This was explained by Gippsland Water as necessary due to unexpected high growth exceeding forecasts in the current regulatory period and that staff were now “stretched beyond capacity”, with further investment in staffing resources needed to meet customer expectations and maintain service levels.⁴³

Our expenditure consultant was satisfied with this explanation because Gippsland Water had robustly evaluated its workforce capacity, and taken a strategic direction to grow its internal capabilities to meet its many obligations and its customer expectations. Our expenditure consultant noted that many of the new positions effectively replace external contractors and consultants.

For the proposed \$2.08 million step change for regulatory costs, our expenditure consultant assessed this on its individual components which is comprised of \$0.98 million for dedicated internal regulatory resources for the coordination and management of the price submission as well as ongoing regulatory activities, and \$1.1 million for external consultancy costs for the 2028 price submission and Urban Water Strategy.

Our expenditure consultant considered that Gippsland Water’s proposal to develop dedicated internal regulatory resources to fill an internal capability gap was justified, and this should internalise regulatory capability and reduce the cost of external consultancies. Considering that there was a subsequent reduction in expenditure for external consultancy costs by around 20 per cent and that these costs were already removed from the 2021-22 baseline, our expenditure consultant was therefore satisfied with Gippsland Water’s explanation for this step change.

We have considered the advice from our expenditure consultant, and Gippsland Water’s proposals, and we consider Gippsland Water’s approach to forecasting its operating expenditure is consistent with the requirements of our guidance. There is evidence that Gippsland 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.

On the basis of the above, our preliminary position is that we are satisfied that its proposed forecast represents efficient controllable operating expenditure.

⁴² Gippsland Water, 2023 price submission, September 2022, p. 120.

⁴³ FTI Consulting, *Gippsland Water – Expenditure Review for 2023 water price review*, February 2023.

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 contribution⁴⁴
- adjusting the forecasts proposed by Gippsland Water where required.

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

After adjusting for misclassified bulk water charges from controllable operating expenditure to non-controllable operating expenditure as per Gippsland Water's revised financial model and discussed in Section 4.1, Gippsland Water has proposed \$40.2 million in non-controllable operating expenditure over the 2023–28 regulatory period. This is an increase of \$3.6 million over the 2018–23 regulatory period, driven mainly by an increase of \$6.3 million due to bulk water charges attributable to the purchase of a bulk water entitlement within the Greater Yarra System – Thomson River pool; balanced against a decrease of \$2.6 million due to forecast decreases in the real value of the environmental contribution.

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

We have verified that Gippsland Water's forecast bulk charges are consistent with both Melbourne Water's 2021 price determination and Southern Rural Water's proposed charges for the next regulatory period.

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.

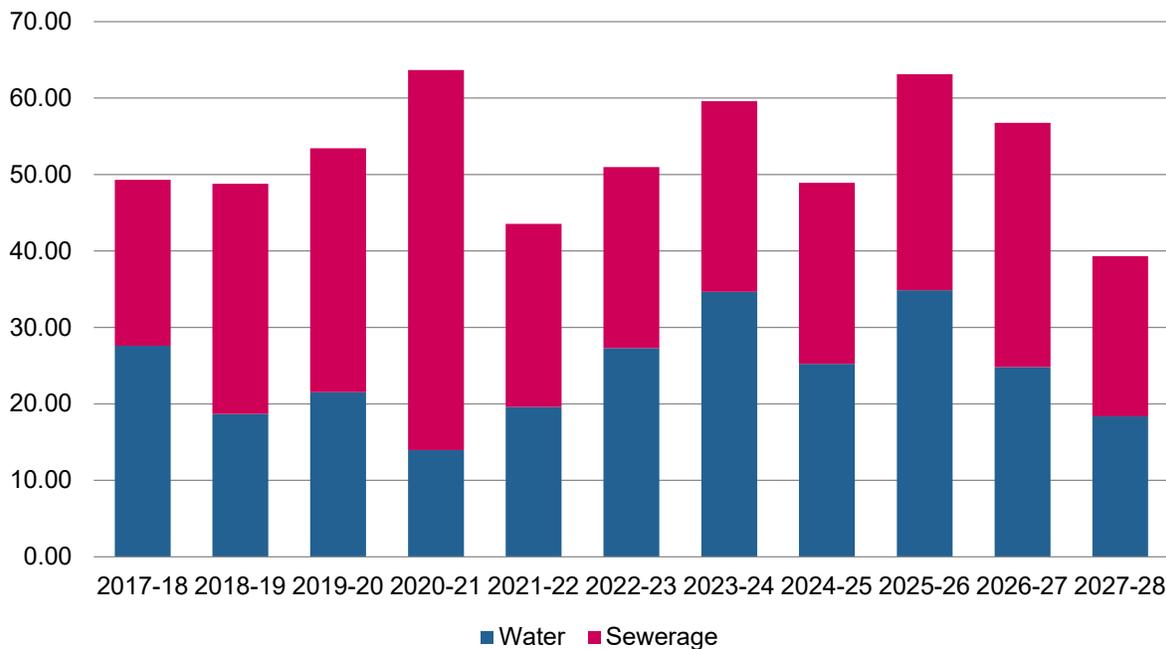
4.2 Capital expenditure

Our draft decision is to accept Gippsland Water's proposed forecast capital expenditure of \$267.7 million.

⁴⁴ Environmental contributions are funds collected from water businesses under the *Water Industry Act 1994*.

Capital expenditure is an input to estimating the regulatory asset base, which is an input to the revenue requirement. Gippsland Water’s forecast capital expenditure and supporting information is provided at pages 124 to 151 of its price submission. Figure 4.1 shows Gippsland Water’s actual gross capital expenditure for 2017-18 and the first 4 years of the current regulatory period (2018-19 to 2021-22) and forecast gross capital expenditure from 2022-23 to 2027-28. The first 5 years of actual expenditure shown in Figure 4.1 (2017-18 to 2021-22) is relevant to the calculation of the closing regulatory asset base discussed in Section 4.3.1.

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



Note: This graph shows actual figures for 2017-18 to 2021-22, and Gippsland 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 Gippsland Water’s expenditure forecast is available on our website.⁴⁵

⁴⁵ FTI Consulting, *Gippsland Water: Review of expenditure forecasts – 2023 water price review*, February 2023.

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.

Gippsland Water has indicated it will incur a total of \$260.4 million in actual gross capital expenditure over the current regulatory period, exceeding the benchmark allowance of \$233.1 million used for its 2018 price determination by \$27.3 million (or 12 per cent). This includes \$209.5 million in actual capital expenditure already incurred from 2018-19 to 2021-22, and a revised forecast of \$51.0 million for 2022-23, which is higher than the \$41.7 million benchmark approved in the 2018 price review.

When considering the 2017-18 year where Gippsland Water's actual capital expenditure of \$49.3 million was \$7.8 million above the benchmark of \$41.5 million, Gippsland Water's actual gross expenditure for the 6 years from 2017-18 to 2022-23 will be \$309.7 million, \$35.1 million (or 13 per cent) higher than the benchmark for this period.

We requested further information from Gippsland Water explaining the drivers and justifying the prudence and efficiency of its higher than forecast actual capital expenditure and referred to its most recent major capital projects report to inform our assessment of the Performance element of PREMO.

Our expenditure consultant also found strong supporting information justifying Gippsland Water's increased capital expenditure over the current regulatory period driven by unexpected cost increases.⁴⁶

Gippsland Water's price submission identified the drivers of increased capital expenditure in the current regulatory period (relative to the benchmark):

- The original cost estimate of \$35.1 million for the Drouin wastewater treatment plant upgrade has been re-estimated to \$55.5 million, mainly due to increased material costs driven by increased demand for services and coronavirus pandemic-driven supply chain issues. The project is also delayed and expected to be completed in 2022-23.
- The capital expenditure estimate of \$4.9 million proposed for shared assets and network augmentations in the 2018–23 submission was tripled to \$19.7 million due to higher than forecast new customer connections growth.

⁴⁶ FTI Consulting, *Gippsland Water: Review of Expenditure Forecasts – 2023 Water Price Review*, February 2023, pp. 32–35.

- Cost efficiencies totalling \$8 million, realised across a number of annual programs and projects, has offset the combined additional expenditure of \$35.3 million against the approved benchmark.

As at the end of June 2022, Gippsland Water reported that, of the 10 major projects proposed for the 2018–23 regulatory period, 2 were completed, 2 were on schedule and 4 are delayed (but expected to be completed in 2022-23), with the following 2 projects delayed or deferred to 2023–28.⁴⁷

- The Warragul sewer – North East branch augmentation to Sutton Street project (\$5.9 million) has been rescheduled for completion in 2023-24 without any customer impact due to slower than anticipated growth and a longer expected asset life, to enable other more critical works to proceed.
- The Saline Waste Outfall Pipeline – stages 4 and 5 upgrade (\$17.2 million) is deferred to 2025–2027 to determine the best delivery approach, in consultation with the major customer the asset is dedicated to, following the confirmation of an increased asset life expectancy. This project does not impact customer tariffs as the individual beneficiary has agreed, in principle, to provide funding.

Gippsland Water’s response to our request for additional information further clarified the drivers of its updated capital expenditure forecast of \$51.0 million for 2022-23. The projects contributing to the \$9.3 million proposed increase in capital expenditure against the benchmark for 2022-23 are:

- the escalated delivery cost of the Drouin Wastewater Treatment Plant upgrade with a forecast expenditure of \$3.7 million for 2022-23 for its delayed completion
- significant demand for \$5.3 million of brought-forward shared assets sewer expenditure above the approved benchmark for 2022-23 associated with higher than anticipated new customer connections across 2018–23.

Based on the above, our preliminary view is that the actual capital expenditure Gippsland Water has incurred from 2017-18 to 2022-23 is appropriate for the purpose of calculating its regulatory asset base (see Section 4.3.2 however, where we note our preliminary view that amounts for 2022-23 above the capital expenditure benchmark set at the 2018 price review should not be included in the calculation of its forecast regulatory asset base).

⁴⁷ Essential Services Commission, *Status of Major Projects Supplement: Outcomes report 2021–22*, 18 October 2022, pp. 11–13. Gippsland Water’s major projects are reported by the business as part of our annual outcomes reporting process, as part of its commitment to communicate the delivery of its major projects to its customers. The business’s comments are not audited by the commission.

4.2.2 Forecast Capital Expenditure

For the reasons set out below, our draft decision is to accept the forecast capital expenditure of \$267.7 million proposed by Gippsland Water for the purpose of calculating its revenue requirement:

- Gippsland Water's price submission provided evidence that its forecasts for capital expenditure are prudent and efficient. Its total proposed capital expenditure is \$267.7 million, \$7.3 million (2.8 per cent) higher than actual capital expenditure in the current 2018–23 period.
- Our expenditure consultant, FTI Consulting, requested a representative sample of its top 10 major individual projects to demonstrate its asset management processes and justification for its capital expenditure program. Based on the sample of documents reviewed, our consultant considered Gippsland Water has a reasonable approach for developing project scope, the timing of works and cost estimates. Our consultant noted Gippsland Water utilised a robust asset management framework and capital governance and approvals process.
 - Gippsland Water has forecast \$92.4 million in expenditure over the period on its top 10 major projects (34.58 per cent of its total capital expenditure forecast). Our consultant reviewed the Tyers interconnection project, the Traralgon-Morwell interconnection project and the bulk water entitlement purchase project as a representative sample of Gippsland Water's Top 10 major projects. Our consultant concluded there was sufficient planning underpinning each project that supported the prudence and efficiency of each project.
 - Gippsland Water has forecast \$175.3 million in capital expenditure to deliver its remaining capital programs and other capital projects in the next regulatory period. Gippsland Water provided additional information to our consultant on its capital expenditure programs and remaining capital projects. Our consultant considered this information provided a good level of confidence that the remaining proposed capital expenditure is prudent and efficient.
- Our consultant also considered that given Gippsland Water's progress in delivering its capital program in the current regulatory period, and a similar level of expenditure proposed in the next regulatory period, it is confident Gippsland Water will be able to deliver its forecast capital program across the 2023–28 period.
- Our preliminary view is also that the planned capital expenditure program is achievable given Gippsland Water's past track record delivering its capital expenditure program, particularly given its performance against the capital expenditure benchmarks approved in its 2018 price determination. As noted in Section 4.2.1 above, over the current 2018–23 regulatory period, Gippsland Water is expected to deliver most of its planned major projects in the current regulatory period. The only exceptions are the Warragul sewer – North East Branch augmentation to Sutton Street and the Saline waste outfall pipeline – stages 4 and 5 upgrade.

- Gippsland Water has excluded approximately \$8.2 million of expenditure associated with uncertain projects from its price submission. This expenditure is related to two projects and equates to about 3 per cent of the forecast capital expenditure. Gippsland Water stated in its price submission that these projects would have an impact of \$4.35 per customer per annum. This approach is consistent with our guidance for managing uncertain expenditure and accordingly, our draft decision is to accept Gippsland Water’s proposal for addressing uncertainty, noting the following:
 - Gippsland 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.

As discussed above, on the basis of its review, our consultant has recommended no adjustments to Gippsland Water’s forecast capital expenditure. Based on that advice, and our own review of Gippsland Water’s proposals, our preliminary view is that the prudence and efficiency of the expenditure has been justified, consistent with our guidance and with the principles in the Water Industry Regulatory Order 2014.⁴⁸

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

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

⁴⁸ Essential Services Commission, *2023 water price review: Guidance paper*, pp. 32–37.

4.3 Regulatory asset base

A water business's regulatory asset base is the value of the corporation's assets for regulatory purposes.⁴⁹ 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 Gippsland 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 Gippsland Water's proposed closing regulatory asset base of \$875.0 million at 30 June 2022.

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 2021-22.⁵⁰ This helps to ensure prices reflect the actual net expenditure of a water corporation.⁵¹

Gippsland Water's proposed closing asset base at 30 June 2022 is provided at page 160 of its price submission.⁵²

We compared Gippsland 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 before including it in the closing regulatory asset base. We consider this approach is reasonable given capital expenditure can be 'lumpy' in nature.

⁴⁹ 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.

⁵⁰ See Section 4.2 for a discussion of Gippsland Water's capital expenditure.

⁵¹ 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.

⁵² Available at www.esc.vic.gov.au.

Gippsland Water's net capital expenditure over the period from 2017-18 to 2021-22 was \$253.6 million. This is \$24.8 million or 10.9 per cent higher than the forecast used to approve maximum prices for the period from 1 July 2018. As noted in section 4.2.2, we consider Gippsland Water has justified the prudence of projects contributing to higher than forecast capital expenditure.

We consider Gippsland Water calculated its closing regulatory asset base in accordance with the requirements of our guidance. For these reasons, our draft decision is to accept Gippsland Water's proposed closing regulatory asset base for 30 June 2022 of \$875.0 million.

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

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

	2017-18	2018-19	2019-20	2020-21	2021-22
Opening RAB 1 July	726.7	752.6	781.4	814.0	854.3
Plus gross capital expenditure	49.3	48.8	53.4	63.7	43.5
Less government contributions	0.0	0.0	0.0	0.0	0.0
Less customer contributions	3.7	0.0	0.1	1.4	0.0
Less proceeds from disposals	0.5	0.5	0.3	0.7	0.6
Less regulatory depreciation	19.3	19.5	20.4	21.3	22.3
Closing RAB 30 June	752.6	781.4	814.0	854.3	875.0

Note: Numbers have been rounded.

4.3.2 Forecast regulatory asset base

Our draft decision is to not accept Gippsland Water's proposed forecast regulatory asset base.

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

Our guidance specifies that the amount reflected for 2022-23 in the forecast regulatory asset base is to be calculated based on the forecast for gross capital expenditure adopted in the 2018 price determination less any contributions (net capital expenditure).⁵³

This is intended to provide an incentive for businesses not to defer capital expenditure, noting they recover financing costs on projects included in capital expenditure benchmarks in earlier years.

As noted in Section 4.2.1, Gippsland Water has proposed to roll in a higher amount than specified in our guidance, due to two main items:

- the escalated delivery cost of the Drouin Wastewater Treatment Plant upgrade with a forecast expenditure of \$3.7 million for 2022-23 for its delayed completion
- significant demand for \$5.3 million of brought-forward shared assets sewer expenditure above the approved benchmark for 2022-23 associated with higher than anticipated new customer connections across 2018–23.

The Drouin Wastewater Treatment Plant has been impacted by higher than expected costs and delays due to the pandemic. However, Gippsland Water's prices reflected financing costs for project capital expenditure reflected in its prices from 2018-19. On that basis, our preliminary view is that Gippsland Water has not sufficiently justified allowing amounts above the 2022-23 benchmark adopted at the 2018 water price review for this project.

Also, our preliminary view is that Gippsland Water has not justified additional amounts for inclusion in its forecast regulatory asset base for 2022-23 for the bring-forward of shared assets expenditure. These costs are typically recovered through new customer contributions, noting Gippsland Water proposes to apply new customer contributions charges from 1 July 2023. To inform our final decision, we are seeking information from Gippsland Water as to why these costs are not reflected in its new customer contributions charges that it proposes to apply from 1 July 2023.

On that basis, our draft decision is to not accept Gippsland Water's proposed forecast regulatory asset base.

⁵³ 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.

Table 4.6 sets out our draft decision on Gippsland Water's forecast regulatory asset base from 1 July 2023.⁵⁴ Our assessments of the components of the forecast regulatory asset base are outlined in different sections of this draft decision paper as follows:

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

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

	2022-23	2023-24	2024-25	2025-26	2026-27	2027-28
Opening RAB 1 July	875.0	892.7	929.5	948.8	975.7	993.6
Plus gross capital expenditure	41.7	59.6	48.9	63.1	56.8	39.3
Less government contributions	0.0	0.0	0.0	0.0	0.0	0.0
Less customer contributions	0.4	0.3	6.2	11.6	13.4	9.6
Less proceeds from disposals	0.3	0.8	0.5	0.6	0.3	0.5
Less regulatory depreciation	23.4	21.7	22.9	24.0	25.2	26.7
Closing RAB 30 June	892.7	929.5	948.8	975.7	993.6	996.2

Note: Numbers have been rounded

4.3.2.1 Customer contributions

Our draft decision is to accept Gippsland Water's proposed forecast for customer contributions.

Revenue from customer contributions is deducted from gross capital expenditure so it is not included in the regulatory asset base.⁵⁵

⁵⁴ 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.

⁵⁵ Revenue from new customer contributions reflects revenue earned from new connections made to the water corporation's water, sewerage or recycled water networks.

We compared Gippsland Water’s forecast for customer contributions with past outcomes. Our preliminary view is that Gippsland Water’s forecast contributions are reasonable, having regard to past trends and its growth forecasts.

On that basis, our draft decision is to accept Gippsland Water’s forecasts for customer contributions.

4.4 Rate of return

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

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

Table 4.7 Draft decision – cost of debt

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

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

4.4.2 Return on equity

Our draft decision is to adopt a return on equity of 4.5 per cent, which reflects Gippsland Water’s PREMO self-rating.

Under our PREMO incentive mechanism, which we have applied since 2018, the return on equity we adopt to calculate the revenue requirement is linked to a business’s PREMO rating. See Chapter 7 for an explanation of PREMO and our assessment of Gippsland 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.⁵⁶ 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.⁵⁷

Gippsland Water rated its price submission as 'Advanced'. Based on this PREMO self-rating, Gippsland Water proposed a return on equity of 4.5 per cent per annum. This reflects the maximum return rate allowed in our guidance for a price submission rated as 'Advanced'.⁵⁸

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

4.5 Regulatory depreciation

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

Regulatory depreciation is a component of Gippsland Water's revenue requirement and is also an input to calculating the regulatory asset base. For its price submission, Gippsland Water forecast regulatory depreciation using a straight-line depreciation profile.⁵⁹ We noted in our guidance that we prefer this approach.⁶⁰ However, Gippsland Water will need to respond to our draft decision with an updated estimate for depreciation, noting our draft decision above on its forecast regulatory asset base (Section 4.3.2).

⁵⁶ Essential Services Commission, *2023 water price review: Guidance paper*, pp. 42–43.

⁵⁷ 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.

⁵⁸ Essential Services Commission, *2023 water price review: Guidance paper*, p. 42.

⁵⁹ For the period from 2022-23 to 2027-28, Gippsland Water proposed a regulatory depreciation of \$144.9 million.

⁶⁰ Essential Services Commission, *2023 water price review: Guidance paper*, p. 39.

4.6 Tax allowance

Our draft decision is to not accept Gippsland Water's proposed tax allowance as set out in its price submission.

The tax allowance is a component of the revenue requirement. Gippsland Water's price submission proposed a forecast tax benchmark of zero, based on its assumption about the outcomes of an expected ruling affecting tax payable on gifted assets.⁶¹

It proposed a pass-through mechanism to allow its revenue requirement to reflect the tax that would be payable, should the change to its tax obligations not occur. In our view, the benchmark adopted for tax should reflect the legal obligation applying at the time, or alternatively, the business could have proposed to accept the risk on behalf of customers should tax be payable.

We have not adjusted the revenue requirement in our draft decision to reflect Gippsland Water's current tax obligations. Gippsland Water must respond to our draft decision to confirm its approach. We note that Gippsland Water could choose to absorb the tax payments, thereby accepting the risk that a ruling may not eventuate that reduces its forecast tax obligations to zero. Or it could choose to recover the payments in some form along with including an adjustment mechanism to reverse the effect of this recovery if the ruling results in the tax being payable subsequent to the lodgement of its response to our draft decision.

⁶¹ Gippsland Water, 2023 water price submission, September 2022, p. 162.

5. Demand, tariffs and prices

Once Gippsland 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 Gippsland Water's demand forecasts.

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

Gippsland Water's demand forecasts are set out at pages 152 to 158 of its price submission and are also included in its financial model.

Our draft decision is to accept Gippsland 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 estimates issued by the Victorian Government. 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, Gippsland 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 Gippsland Water's proposed price 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.⁶²

Gippsland Water proposed a price cap form of price control as set out on page 163 of its price submission. This is the same as its current approach. Under the price cap form of price control, maximum prices for each prescribed service for the 2023–28 regulatory period are determined at the start of the regulatory period. Adjustments to account for movements in inflation (measured by

⁶² Essential Services Commission, *2023 water price review: Guidance paper*, p. 50.

the consumer price index published by the Australian Bureau of Statistics), return on assets and any approved pass-through mechanisms will be made during the regulatory period.

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

- it is the same as its current approach, which we have previously approved
- it provides its customers with price certainty
- demand risk is more efficiently managed by Gippsland Water, rather than its customers
- it was otherwise consistent with the requirements of our guidance.

5.3 Tariff structures and prices

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

Gippsland Water's proposed tariffs are set out at pages 166 to 176 of its price submission.

Our draft decision does not approve prices for each tariff. Prices will need to be updated by Gippsland Water to reflect our updates to 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 (Section 5.4). 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.⁶³ 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.

Gippsland Water proposed to maintain its existing tariff structures. For water services, it proposed a two-part tariff with a fixed service charge and a variable usage component that depends on water use. For residential sewerage services, Gippsland Water proposed a fixed service charge only. For non-residential sewerage services, Gippsland Water proposed a two-part tariff with a fixed service charge and a variable usage component.

The Consumer Action Law Centre noted Gippsland Water have proposed a 'user pays' tariff principle in response to customer feedback about equitable tariff structures, and noted caution against tariff structures that assign more weight to variable charges.⁶⁴ A different view was noted in

⁶³ Essential Services Commission, *2023 water price review: Guidance paper*, p. 51.

⁶⁴ Consumer Action Law Centre, *Initial Feedback: 2023-28 Water Price Review*, 1 December 2022, 30 November 2022, p. 5-6.

a submission (anonymous) that considered that a pricing structure that uses a large supply charge and small usage costs doesn't encourage customers to save water. A submission by the Concerned Waterways Alliance noted it fails to understand why inclining block tariffs are not adopted by all water corporations. We note that changes to these structures can impact customers in different ways – for example, they can impact on affordability for larger households.⁶⁵

We consider that water businesses are often best placed to consider the interests of customers in designing tariffs, and that existing tariff structures have been developed over time to deal with a variety of local circumstances.

Our draft decision is to accept Gippsland Water's proposed tariff structures, on the basis that they are generally a continuation of Gippsland Water's current approach and otherwise meet the criteria in our guidance, and are generally supported by its customers.⁶⁶

Our preliminary view is that the two-part tariff structure proposed by Gippsland Water for its water services will promote the efficient use of these 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.⁶⁷ We also consider two-part tariff structures are easy to understand.

For sewerage services, we consider Gippsland Water's proposed fixed charge for residential customers is easy to understand. A two-part tariff for non-residential customers sends these customers signals about efficient costs.⁶⁸

5.3.2 Prices

Under Gippsland Water's proposal, prices will generally be lower in real terms.

In response to our draft decision, Gippsland Water will need to propose updated prices to reflect our draft decision on its revenue requirement.

In May 2023, we intend to determine prices for Gippsland 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.

⁶⁵ Concerned Waterways Alliance submission to the Essential Services Commission Water Price Review 2023, 1 December 2022.

⁶⁶ Gippsland Water, 2023–28 Price Submission, September 2022, p. 52.

⁶⁷ 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.

⁶⁸ Our reasons are outlined in our 2013 draft decisions on price review 2013-14 to 2017-18.

5.3.3 Addressing the interests of low income and vulnerable customers

In making our price determination, we must have regard to whether Gippsland Water's prices take into account the interests of customers, including low income and vulnerable customers.⁶⁹

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

- to never restrict a customer's water supply due to non-payment of bills, if Gippsland Water knows the customer is in hardship
- increasing involvement in future planning for people experiencing vulnerability through representation on its Customer Reference Group and Customer Sounding Board over the next 5 years
- adding two resources to its customer care team, and upskilling more staff to reach out early and provide tailored support for customers having difficulty
- investing in more targeted hardship support awareness campaigns (in response to feedback from its Customer Reference Group about the need to increase awareness of the support it provides to people experiencing financial difficulty).

5.3.4 Unique services

Gippsland Water proposed to adjust its quality based trade waste methodology and tariffs and its miscellaneous fees and charges to make them cost reflective. These initiatives are in response to customers recommendations that prices should be affordable, fair and based on a user pays system.

Gippsland Water has confirmed that its proposed quality based trade waste methodology and tariffs, and miscellaneous fees and charges are calculated in accordance with the pricing principles referenced in our guidance.⁷⁰

The Consumer Action Law Centre noted Gippsland Water had proposed a 'user pays' tariff principle in response to customer feedback about equitable tariff structures, and also noted its concern about assigning more weight to variable charges.⁷¹

The Concerned Waterways Alliance recommended that all water businesses should spell out how their pricing mechanisms can be used to avoid pollution and harm.⁷² Gippsland Water's

⁶⁹ Water Industry Regulatory Order 2014 clause 11(d)(iii).

⁷⁰ Essential Services Commission, 2023 water price review: Guidance paper, p. 53.

⁷¹ Consumer Action Law Centre, Initial Feedback: 2023-28 Water Price Review, 1 December 2022, 30 November 2022, p. 5.

⁷² Concerned Waterways Alliance, submission to the 2023 water price review, 1 December 2022, p. 3.

quality-based trade waste charges have been put in place to incentivise trade waste customers to limit their trade waste discharges.

We remind Gippsland Water that it must comply with the pricing principles under clause 4.2 of Schedule 4 of its price determination, when entering into new or renegotiating contracts.

5.4 New customer contributions

Our draft decision is to accept Gippsland Water's proposed standard new customer contributions as set out in its price submission.

Our draft decision is to accept Gippsland Water's proposed negotiated new customer contributions.

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

Gippsland Water currently does not apply new customer contributions. It proposes to reintroduce new customer contributions from 1 July 2023.

Gippsland Water's proposed new customer contributions are set out at pages 170 to 174 of its price submission. Gippsland Water proposed using a model based on average incremental cost to estimate its system-based new customer contributions, rather than the net cash flow approach adopted by the commission.⁷³ Gippsland Water proposed separate water and sewerage new customer contributions for five different systems, ranging from \$216.05 for sewer in Morwell to \$3,814.02 for water in Warragul and Drouin.

The submission we received from the Consumer Action Law Centre noted it is pleased to see Gippsland Water remove cross-subsidies that disadvantage residential customers and that it wants to see all users, particularly builders and developers, paying the full costs of their water use.⁷⁴

Gippsland Water examined capping new customer contributions for water and sewer combined to be no greater than 3.5 per cent of the average cost of an average lot of land in that system to

⁷³ The average incremental cost approach calculates the new customer contribution charge by dividing the capital and operating cost of a growth area by the number of connections in that area. The net cash flow approach applies the incremental revenue less incremental cost to estimate the new customer contribution charge.

⁷⁴ Consumer Action Law Centre, Initial Feedback: 2023-28 Water Price Review, 30 November 2022, p. 5.

mitigate risks of developer price shock. This resulted in the Moe Newborough system being the only capped new customer contribution following feedback from developers.⁷⁵

Gippsland Water put forward several reasons for using the alternative incremental cost approach, namely, that it will address:

- the risks associated with changes in development across the towns Gippsland Water services
- a need to achieve cost reflectivity at a system level
- the lack of transparency in the rationale and calculation of existing new customer contributions.

We consider the net cash flow approach outlined in our guidance also enables water businesses to address the risks associated with changes in development, allows for system-based cost reflectivity and is transparent, and that these issues can be flexibly dealt with by applying that approach.⁷⁶

However, we have reviewed Gippsland Water's proposed new customer contributions and our preliminary view is that they meet the new customer contribution pricing principles outlined in our guidance.⁷⁷ Gippsland Water's proposed new customer contributions as set out in its price submission excludes tax liability based on Gippsland Water's assumption that it will be in a zero tax paying position pending an Australian Taxation Office decision on tax on gifted assets (Section 4.6).

For the above reasons, our draft decision is to accept Gippsland Water's proposed new customer contributions, as set out in its price submission.

We are interested in feedback from developers and customers regarding the proposed new customer contributions tariffs to inform our final decision.

Noting our draft decision on tax (Section 4.6) Gippsland Water may wish to consider the drivers of the increases in its tax payments (based on its current tax obligations) and whether these might appropriately be allocated to new customers contributions.

⁷⁵ We note that the cap is relatively immaterial at the combined water and wastewater level (that it, it is around 5 per cent below the calculated combined charge).

⁷⁶ The inclusion of sunk capital expenditure is not a requirement of our existing net cash flow framework to calculate new customer contribution charges. The inclusion of sunk costs has been cited by Gippsland Water as a reason for moving away from the net cash flow approach as it may send incorrect pricing signals to developers on the true cost of development. We note that, since 2013 when we commenced using our net cash flow framework, very few businesses have included sunk costs in their calculation of new customer contributions. Our 2013 explanatory note 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.

⁷⁷ Essential Services Commission, *2023 water price review: Guidance paper*, p. 59.

Gippsland Water has provided its negotiating framework for negotiated new customer contribution contracts. This framework is in accordance with the requirement of our new customer contribution pricing principles. For that reason, our draft decision is to accept Gippsland Water's proposed framework for negotiated new customer contributions.

5.5 Adjusting prices

Our draft decision is to not accept Gippsland Water's proposed price adjustment mechanism to account for any tax liability.

Our draft decision is to accept Gippsland Water's proposed mechanism related to cost of debt adjustments.

Gippsland Water's proposed price adjustment mechanisms are set out at pages 162 and 163 of its price submission. It proposed:

- to continue to apply cost of debt adjustments to all regulated tariffs excluding miscellaneous fees and charges and new customer contributions
- to include an annual pass-through mechanism to account for any tax liability.

Our draft decision is to not accept Gippsland Water's proposed pass-through of tax liability. This reflects our preliminary views on its tax allowance (Section 4.6)

6. Financial position

We have reviewed key indicators of Gippsland Water's financial performance and our preliminary view is that Gippsland 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.⁷⁸ 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.

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

⁷⁸ 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 Gippsland 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.⁷⁹ We required Gippsland 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 Gippsland 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 Gippsland Water's price submission. As outlined in our guidance, the combination of Gippsland Water's self-rating and our rating has determined the return on equity we have adopted to calculate Gippsland Water's revenue requirement in our draft decision.

7.1 Our PREMO assessment of Gippsland Water's price submission

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

Gippsland 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 Gippsland Water's price submission.

Table 7.1 PREMO rating

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

⁷⁹ This is the first price review we have done where the rating has been based on all five elements of PREMO. In our 2018 price review, our PREMO assessment was against only four of the elements — Risk, Engagement, Management and Outcomes.

We agree with Gippsland Water’s proposed overall PREMO self-rating of ‘Advanced’. This is reflected in the return on equity we propose to approve for Gippsland Water (see Section 4.4.2). We have formed this view after reviewing Gippsland 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.⁸⁰ As noted in Section 3.2, we agree with Gippsland Water’s self-assessment that it has overall, met its outcome commitments for the period to date.

In terms of customer perceptions, we looked at Gippsland Water’s results in the commission’s survey of customer sentiment, which covers measures of overall satisfaction, value for money, trust, and reputation in the community. While generally not ranking highly relative to other water businesses, Gippsland Water’s results generally improved over the regulatory period, and improved relative to other businesses.

In 2021-22 (the last available year of audited results), its controllable operating expenditure was \$78.7 million compared to a benchmark of \$79.5 million established during the 2018 price review. It recorded lower controllable operating costs for the 2021-22 year, which is the baseline year to forecast expenditure for the 2023–28 regulatory period. We consider this demonstrates good cost control to manage bills on behalf of customers.

As noted in Section 4.2.1, Gippsland Water has indicated it will incur a total of \$260.4 million in actual gross capital expenditure over the current regulatory period, exceeding the benchmark allowance of \$233.1 million used for its 2018 price determination by \$27.3 million (or 12 per cent). As noted earlier, our preliminary view is that the higher than benchmark expenditure by Gippsland Water has been appropriately justified.

Our draft decision is to accept Gippsland Water’s self-rating of ‘Advanced’ for the Performance element of PREMO, on the basis that we consider it:

- generally met expectations for delivery against outcome commitments with outperformance in some areas
- recorded improving results in the commission’s customer perception survey

⁸⁰ 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.

- achieved strong controllable operating cost control in the current period relative to other businesses and relative to the benchmarks adopted at the 2018 price review.

We consider these factors support its assessment that it exceeded expectations in the current period (noting it achieved an overall PREMO rating of ‘Standard’ for its price submission 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).⁸¹

In support of its self-rating of ‘Leading’ for the Risk element of PREMO, Gippsland Water’s price submission (at Chapter 4) provided an overview of its approach and ways it had managed risk on behalf of its customers.

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 through its price path, proposing relatively large reductions in real prices in 2023-24. Other ways it has managed or accepted risk on behalf of its customers include:

- adopting demand growth forecasts higher than that forecast by Victoria in Future (which means under its price cap form of price control, the business is accepting revenue risk on behalf of customers)
- in addition to proposing prudent capital expenditure, excluding two projects (totalling \$8.2 million over the 2023–28 regulatory period) from its prices, given uncertainty about delivery
- taking on more revenue risk through its guaranteed service level program, by committing to two new guaranteed service levels and to returning funds to customers where its service does not meet expectations
- adopting optimistic forecasts for negotiation of major contracts.

We also note its price submission included a comprehensive overview of the business’s approach to managing risk, including in terms of climate risk, clearly setting out how its approach has impacted on customer bills.

Our draft decision is therefore, to accept Gippsland Water’s self-rating of ‘Leading’ for risk.

⁸¹ Essential Services Commission, *2023 water price review: Guidance paper*, p. 45.

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.⁸²

Our draft decision is to accept Gippsland Water's self-rating of 'Leading' for the Engagement element of PREMO based on the overall suitability of the engagement methods to support effective participation in its engagement process, including by customers experiencing vulnerability and its Traditional Owners. We also note the complexity of the issues it was willing to engage on, particularly with its large customers and the suitability of the methods used in undertaking this engagement.

Gippsland Water showed strong commitment to the outcomes of the engagement and influence of customers, including by adopting all recommendations of its Customer Summit. It also provided evidence that participants in its engagement had a positive view of its approach. See Section 3.1 for more detail.

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.⁸³

In support of its self-rating of 'Advanced' for the Management element of PREMO (as noted in Section 4.1.1), Gippsland Water proposed one of the highest efficiency improvement rates for controllable operating expenditure over the next regulatory period. This contributes to reductions in controllable operating expenditure per water connection. Informed by advice from FTI Consulting, we have also tested Gippsland Water's assumptions for forecast operating and capital expenditure, and our preliminary view is that they reflect efficient expenditure.

We consider Gippsland 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 Gippsland Water Board has also attested to the accuracy of the information contained in its submission, as required by our guidance.

⁸² Essential Services Commission 2021, *2023 Water Price Review: Guidance Paper*, p. 45.

⁸³ Essential Services Commission 2021, *2023 Water Price Review: Guidance Paper*, p. 45.

Accordingly, our draft decision is to accept Gippsland 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.⁸⁴

As noted in Section 3.2, our preliminary view is that Gippsland 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.

Section 3.1 provides a list of actions where we consider Gippsland Water has demonstrated the influence of customers on its proposed Outcomes and other initiatives. This includes through its Customer Summit, and adopting all recommendations arising from the Summit.

While Gippsland Water's proposal maintains current target levels for most of its output targets, it has proposed higher service levels for some, and its proposed outcomes are supported by customers. This is being delivered alongside reductions in (real) prices. Accordingly, we consider Gippsland Water's proposal represents improved value for customers over the 2023–28 regulatory period.

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

⁸⁴ Essential Services Commission 2021, *2023 Water Price Review: Guidance Paper*, p. 45.

Appendix A — Submissions received

Name or organisation	Date received
Anonymous	7 October 2022
Consumer Action Law Centre	30 November 2022
Concerned Waterways Alliance	1 December 2022
Concerned Waterways Alliance	21 December 2022

Appendix B — Commission’s consideration of legal requirements

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

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

In addition to the mandatory factors set out below, clause 11 of the WIRO requires the commission to have regard to the matters specified in the commission’s guidance.⁸⁵ 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 Gippsland 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 Gippsland Water.

Economic efficiency and viability matters

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

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

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

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

⁸⁵ Essential Services Commission, *2023 water price review: Guidance paper*, 26 October 2021.

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

We consider that the delivery of outcomes which reflect customer service priorities at an efficient cost promotes efficiency in regulated entities and the water industry. Our draft decision has therefore had regard to the extent that Gippsland 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 10-year trailing average approach to estimating the benchmark cost of debt (see Section 4.4.1).
- A regulatory rate of return that we consider will enable Gippsland Water to recover borrowing costs associated with its investment in services, and generate a return on assets.⁸⁶

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 Gippsland Water has demonstrated its forecasts reflect efficient costs to deliver services valued by customers, and to deliver on relevant legislation and relevant health, safety, environmental and social obligations.

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

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

⁸⁶ The regulatory rate of return is comprised of the cost of debt and the return on equity.

- Our assessment of tariffs (Section 5.3).

Industry specific matters

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

Our pricing approach allows each water 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 Gippsland 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 Gippsland 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 Australia⁸⁷
- operating and capital expenditure costs per connection throughout Australia⁸⁸
- tariff structures applied by water corporations throughout Australia⁸⁹
- the regulatory rate of return set by other regulators.⁹⁰

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 Gippsland Water’s proposals, including through submissions and public meetings.

⁸⁷ Bureau of Meteorology, *National performance report 2020-21; urban water utilities, part A*, February 2022.

⁸⁸ Bureau of Meteorology, *National performance report 2020-21; urban water utilities, part A*.

⁸⁹ Includes Icon Water, Sydney Water, Hunter Water, Central Coast Council, Power and Water Corp, Urban Utilities, Unity Water, SA Water and TasWater.

⁹⁰ 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 Gippsland 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 Gippsland 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 Gippsland 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 Gippsland Water’s prices ‘take into account the interests of customers of the regulated entity, including low income and vulnerable customers’.

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

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

- Our consideration of customer engagement (Section 3.1)

Commission’s consideration of legal requirements

- Our consideration of outcomes (Section 3.2)
- Our consideration of guaranteed service levels (Section 3.4)
- Our consideration of tariff structures and prices (Chapter 5)

Health, safety, environmental and social obligations

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

Our draft decision proposes to approve a revenue requirement that will enable Gippsland 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 Gippsland 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, Gippsland 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 2016.⁹¹

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 available to water corporations as it would be relevant for other purposes such as corporate planning and project prioritisation and justification.⁹²

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

⁹¹ Essential Services Commission 2016, Water Pricing Framework and Approach, Implementing PREMO from 2018, October, pp. 11–13.

⁹² Essential Services Commission, 2023 water price review: Guidance paper, p. 2.

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

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

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

- Implementing a price review process so that water 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.⁹³

⁹³ Essential Services Commission, 2023 water price review: *Guidance paper*, p. 2.