



Goulburn Valley Water draft decision

2018 Water Price Review

28 March 2018



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Summary

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

This draft decision sets out our preliminary views on Goulburn Valley Water's price submission.^{1 2}

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 2018. Details on how to make a submission on our draft decision are provided in Chapter 4.

Goulburn Valley Water has committed to improve outcomes for customers

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

Some of the ways Goulburn Valley Water plans to improve outcomes for customers are by:

- reducing prices for all customer groups
- improving customer service by introducing new ways for customers to receive and provide information
- increasing access to drinking water including in some non-potable towns
- trialling changes to fixed and variable tariffs for customers who wish to have greater control of their bills.

Our draft decision proposes to approve Goulburn Valley Water's prices

Our draft decision proposes to approve a revenue requirement of \$372.6 million for Goulburn Valley Water over the five year period starting 1 July 2018.³

We note that our draft decision revenue requirement is lower than the revenue requirement we calculate based on our assessment of efficient costs. This reflects Goulburn Valley Water's

¹ Clause 16 of the Water Industry Regulatory Order 2014 requires us to issue a draft decision.

² Goulburn Valley Water's price submission is available on our website at www.esc.vic.gov.au.

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

commitment to continue to improve the efficiency of its operations to deliver the lowest prices it can to its customers. Our draft decision proposes to accept Goulburn Valley Water's proposed prices. More detail is available on page 7.

Tariff structures will remain the same, although Goulburn Valley Water will trial a new approach to setting variable tariffs

Our draft decision accepts Goulburn Valley Water's proposed tariff structures, which are the same as its current tariff structures.

For water services, Goulburn Valley Water proposed a fixed service charge and a variable component that depends on water used. For sewerage services, Goulburn Valley Water proposed a fixed charge only for residential customers and a fixed and variable charge for non-residential customers.

Goulburn Valley Water also proposed a tariff trial in Cobram and Kilmore to provide customers with the option of reduced fixed and higher variable charges to provide greater control over their bills. We propose to accept the tariff trial, the outcomes of which may inform Goulburn Valley Water's future tariff strategy.

The tariff structure discussion on page 26 provides more detail on our assessment of Goulburn Valley Water's tariff structures.

We propose to accept Goulburn Valley Water's proposed 'price cap' form of price control. 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.

Goulburn Valley Water's price submission is rated as 'Leading' under PREMO

Our draft decision is to accept Goulburn Valley Water's PREMO self-rating of its price submission as 'Leading' (Table A).

We consider Goulburn Valley Water's proposals reflect a significant improvement in the value delivered to customers. In particular, we note that Goulburn Valley Water proposes to reduce its prices from 1 July 2018 by 2 per cent per annum over the following five years; which is the largest price decline proposed by a water corporation included in our 2018 price review. This means Goulburn Valley Water would have the lowest bills in the state before the end of the five year period.

The proposed price reductions are a result of Goulburn Valley Water's very high efficiency improvement rate in relation to controllable operating expenditure (of around 3.1 per cent per annum) and its proposed efficiency dividend to return savings to customers. These outcomes put Goulburn Valley Water ahead of the rest of the sector in terms of customer value, supporting its

overall self-rating as ‘Leading’ (in particular, supporting its ‘Leading’ self-rating for the Management and Outcomes elements of PREMO).

Our PREMO rating is an assessment of the water corporation’s price submission. It is not an assessment of the water corporation itself.

Table A **PREMO Rating**

	Overall PREMO rating	Risk	Engagement	Management	Outcomes
Goulburn Valley Water’s rating	Leading	Leading	Leading	Leading	Leading
Commission’s rating	Leading	Leading	Leading	Leading	Leading

Among the 15 draft decisions we have released so far, Goulburn Valley Water is the only corporation for which we propose to approve a ‘Leading’ rating (Table B).

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

Leading	Advanced	Standard	Basic
Goulburn Valley Water	Barwon Water	Coliban Water	Wannon Water
	Central Highlands Water	East Gippsland Water	
	City West Water	Gippsland Water	
	GWMWater	Lower Murray Water (urban)	
	North East Water	Westernport Water	
	South East Water		
	Southern Rural Water		
	Yarra Valley Water		

1. Our role and approach to water pricing

We are Victoria's independent economic regulator

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

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

Our review of the prices proposed by the water corporations covers the prescribed services listed in the WIRO.⁴ The prescribed services include retail water and sewerage services, and bulk water and sewerage services delivered by the water corporations.⁵

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

We assess prices against the WIRO and other legal requirements

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

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

⁴ The review excludes Melbourne Water and Goulburn-Murray Water. In 2016 we approved prices for Melbourne Water to 30 June 2021 and for Goulburn-Murray Water to 30 June 2020.

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

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

- the matters specified in 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.

A separate document lists the specific objectives and the various matters the commission must have regard to when making a price determination and provides a guide to where the commission has done so in this draft decision.⁷

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

If we consider the price submission has adequate regard for the matters in clause 11 of the WIRO and complies with our guidance, we must approve Goulburn Valley Water's proposed prices.⁸

If we consider the submission does not have adequate regard for the matters specified in clause 11 of the WIRO or comply with our guidance, we may specify maximum prices, or the manner in which prices are to be calculated, determined or otherwise regulated.⁹

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

In 2014, the Victorian Government reviewed and revised the WIRO. The changes allowed us more flexibility to decide on the pricing approach we use in Victoria's water sector. In April 2015 we released a consultation paper to start reviewing our pricing approach.¹⁰

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

⁶ Essential Services Commission 2016, *2018 Water Price Review, Guidance paper*, November.

⁷ Essential Services Commission 2018, *Goulburn Valley Water draft decision, 2018 Water Price Review – commission's consideration of legal requirements*, 28 March. This is located on our website at www.esc.vic.gov.au

⁸ This is a requirement of the WIRO, clause 14(b).

⁹ This is provided for under the WIRO, clause 14(b)(i).

¹⁰ Essential Services Commission 2015, *Review of Water Pricing Approach, Consultation paper*, April.

In May 2016, we released a position paper setting out our proposed new pricing approach, and invited submissions.¹¹ We met with each water corporation and other interested parties to help inform their submissions. Submissions were supportive of the overall proposal, in particular the greater focus on customer engagement and value.

We finalised our new approach to water pricing in October 2016.¹²

Our new pricing approach builds on many aspects of the previous approach. We continue to use the building blocks to estimate the revenue requirement for a water corporation.¹³ Our guidance explains the building blocks and how we use it to estimate the revenue requirement.¹⁴

Among the key changes, the new approach introduces new incentives to help ensure water corporations deliver the outcomes most valued by customers. Our new PREMO framework rewards stronger customer value propositions in price submissions, and an early draft decision is available for price submissions we can assess in a short timeframe.¹⁵ The PREMO incentive is described next.

Our consultation on the pricing approach informed the guidance we issued water corporations in November 2016 to inform price submissions for the 2018 water price review.

PREMO

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

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

¹¹ Essential Services Commission 2016, *A new model for pricing services in Victoria's water sector, Position paper*, May.

¹² For more detail on the new water pricing approach see: Essential Services Commission 2016, *Water Pricing Framework and Approach: Implementing PREMO from 2018*, October.

¹³ The revenue requirement is the forecast amount that a water corporation needs to deliver on customer outcomes, government policy, and obligations monitored by technical regulators including Environment Protection Authority Victoria and the Department of Health and Human Services.

¹⁴ Essential Services Commission 2016, *Guidance Paper*, op. cit., pp. 8-9.

¹⁵ In December 2017 we issued early draft decisions for East Gippsland Water, South East Water, Westernport Water and Yarra Valley Water.

Our PREMO rating is an assessment of the water corporation's price submission. It is not an assessment of the water corporation itself.

The 2018 water price review is the first time we've applied our PREMO incentive mechanism.

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

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

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

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

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

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

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

Our guidance included a number of matters water corporations must address in their price submissions. Goulburn Valley Water's price submission addressed each of these matters. Our preliminary assessment of these matters is provided in this chapter. We intend to make a price determination for Goulburn Valley Water in June 2018.

Goulburn Valley Water must submit a response to our draft decision and provide an updated financial model by 8 May 2018 (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 Goulburn Valley Water in June 2018.

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

Regulatory period

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

Customer engagement

Our guidance required Goulburn Valley Water to engage with customers to inform its price submission.

The engagement by Goulburn Valley Water:

- took place between September 2016 and May 2017, and incorporated past customer research
- included a range of methods such as community forums, pop-up water cafes at community events, online and paper surveys, and a deliberative forum
- involved customers from all 54 of its towns, and sought feedback from a range of customer groups including plumbers, builders, land developers, and major customers
- covered topics such as prices, on-line services, water quality in non-potable towns, the balance of fixed and variable charges, hydration stations, water efficiency and emission reduction.

More detail on Goulburn Valley Water's engagement is available in its price submission.¹⁹

Evidence that Goulburn Valley Water's engagement influenced its proposals includes:

- reducing prices (below inflation) in response to feedback that customers prioritise affordability
- improving water quality in response customer support for better tasting drinking water
- introducing digital services in response to feedback that customers value real time notifications
- trialling new approaches to fixed and variable charges in response to feedback that customers would prefer greater control over their bills.

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

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

¹⁹ Goulburn Valley Water's price submission is available on our website at www.esc.vic.gov.au. See pages 6 to 26.

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

Outcomes

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

- the best prices for customers
- renewed focus on water quality and supply
- modern and thoughtful customer service
- meaningful environmental and recreational outcomes.

Goulburn Valley Water proposed measures and activities it will use to report on progress against achieving each outcome. These are set out at pages 11 to 25 of its price submission. To report on its performance Goulburn Valley Water proposes to develop an annual performance forum where they will report the progress against key activities and the results of its customer satisfaction surveys. The report will be available online and via mail-outs.

We will engage with Goulburn Valley Water to finalise the measures and targets used to assess performance against its outcomes, and how it will report this publicly. Performance against these measures will inform our assessment during future price reviews.

Guaranteed service levels

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

Goulburn Valley Water's proposed GSLs are set out on pages 36 and 37 of its price submission. It has made no changes to its existing GSLs, including its hardship GSL. It has proposed to introduce seven new GSLs to support its commitments around its tariff structure trial, water pressure, water taste, non-potable water, notification of supply events and water hydration stations.

Goulburn Valley Water developed its GSLs in consultation with its customers. On this basis, we propose to accept Goulburn Valley Water's proposed GSLs. Final GSLs will be subject to our consideration of any feedback following the release of our draft decision.

Revenue requirement

Goulburn Valley Water's price submission showed a total revenue requirement of \$391.3 million, but included two elements that served to lower the revenue required from its customers by \$14.3 million:

- using \$7.8 million of non-regulated earnings to offset its tariff revenue

Our assessment

- through an ‘efficiency dividend’ that effectively returned \$6.5 million of efficiency savings made in prior years to its customers.

Allowing for these reductions produced a revenue requirement of \$377.1 million over the five years from 1 July 2018.

However, during our review, Goulburn Valley Water identified that the amount of non-regulated earnings it had included was \$5.1 million higher than it intended. It had used the gross non-regulated revenue figure, rather than the net earnings of \$2.7 million after expenses.²¹

While the corporation could have raised its proposed customer prices as a result of the correction, it decided to maintain its commitment to the prices set out in its original price submission. Goulburn Valley Water accepted it should absorb the financial consequences of its error, rather than its customers, and proposed to increase the ‘efficiency dividend’ by \$5.1 million to effectively preserve its original reduction to the revenue requirement.

A subsequent correction to the depreciation forecast in November reduced the revenue requirement to \$390.0 million, or \$375.7 million after the \$14.3 million reduction.

However, in its price submission, Goulburn Valley Water proposed to collect tariff revenue of \$372.6 million over the five year period, lower than its original proposed revenue requirement of \$377.1 million (\$375.7 million after the correction).

Our assessment of Goulburn Valley Water’s price submission establishes a notional revenue requirement of \$377.6 million, using the building block approach outlined in our guidance (Table 2.1).

Because Goulburn Valley Water’s tariff revenue figure is lower than our calculated notional revenue requirement, our draft decision adopts Goulburn Valley Water’s figure of \$372.6 million as the revenue requirement over the five years from 1 July 2018 (Table 2.1).

Goulburn Valley Water has committed to find additional savings (or identify other initiatives) to fund the shortfall between the notional revenue requirement and the draft decision revenue requirement (equivalent to around \$5.0 million over the five years from 1 July 2018 – see Table 2.1).

We have assessed Goulburn Valley Water’s financial position (page 29), and consider our draft decision on the revenue requirement will allow Goulburn Valley Water to deliver on customer

²¹ See submission from Goulburn Valley Water on 15 November 2017, pp. 50-51, available at www.esc.vic.gov.au.

outcomes, government policy, and obligations monitored by technical regulators including Environment Protection Authority Victoria and the Department of Health and Human Services.²²

Table 2.1 Draft decision – revenue requirement

\$ million 2017-18

	2018-19	2019-20	2020-21	2021-22	2022-23	Total
Operating expenditure	47.2	46.8	46.6	46.5	45.9	233.0
Return on assets	15.5	16.2	16.9	17.4	17.9	83.8
Regulatory depreciation	11.0	11.9	12.9	14.0	13.6	63.4
Non-prescribed revenue offset of revenue requirement	-0.5	-0.5	-0.5	-0.5	-0.5	-2.7
Notional revenue requirement	73.2	74.3	75.8	77.4	76.9	377.6
Efficiencies or savings to be found by GVW	2.7	0.9	-1.3	-3.6	-3.7	-5.0
Draft decision revenue requirement	75.8	75.3	74.6	73.8	73.1	372.6

Note: Numbers have been rounded

The following sections outline our assessment of efficient costs and the notional revenue requirement. Table 2.2 shows the adjustments we made to Goulburn Valley Water’s proposed revenue requirement (as set out in its original price submission), to calculate the notional revenue requirement.

Our final decision will be based on the latest available information. Accordingly, as well as responding to our draft decision and providing an updated price schedule, Goulburn Valley Water

²² We met with officers of the Department of Environment, Land, Water and Planning, Department of Health and Human Services, and Environment Protection Authority Victoria, to discuss their expectations of [corporation name] in the regulatory period from 1 July 2018. We had regard to their views in our draft decision.

must update its revenue requirement and prices to reflect our April 2018 updates to estimates for the cost of debt and inflation.

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

Table 2.2 Adjustments to notional revenue requirement
\$ million 2017-18

	2018-19	2019-20	2020-21	2021-22	2022-23	Total
Proposed revenue requirement (excluding proposed revenue offsets*)	74.9	76.4	78.6	80.5	80.9	391.3
Operating expenditure	-1.2	-1.6	-2.2	-2.6	-2.2	-9.7
Return on assets	-0.001	-0.002	-0.002	-0.0001	0.03	0.03
Regulatory depreciation	0.03	0.03	-0.02	-0.1	-1.4	-1.4
Notional revenue requirement (excluding the proposed revenue offsets*)	73.7	74.9	76.4	77.9	77.4	380.2
Less net non-regulated revenue offsets proposed by GVW	-0.5	-0.5	-0.5	-0.5	-0.5	-2.7
Notional revenue requirement	73.2	74.3	75.8	77.4	76.9	377.6

Note: Numbers have been rounded; *revenue offsets includes two components – (i) net non-regulated revenue and (ii) efficiency dividend.

Operating expenditure

Operating expenditure is an input to the revenue requirement. Goulburn Valley Water's price submission provides detail on its forecast operating expenditure from pages 29 to 30, with a cost breakdown shown in tables A3.3 and A3.4 in its appendix.

Our assessment

We assess both:

- controllable costs – those that can be directly or indirectly influenced by a water corporation’s decisions
- non-controllable costs – those that cannot be directly or indirectly influenced by a water corporation’s decisions.

For controllable operating expenditure, our assessment process first confirms an efficient baseline, based on the last year of actual costs prior to our price review (that is, 2016-17). We then consider the forecast costs relative to this baseline, including the proposed efficiency improvement rate and forecast growth, and any proposed cost changes relative to the baseline. We engaged Deloitte Access Economics to provide expert advice to inform our assessment of controllable operating expenditure. Deloitte’s report on its assessment of Goulburn Valley Water’s expenditure forecast is available on our website.²³

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

Table 2.3 sets out our draft decision on Goulburn Valley Water’s forecast operating expenditure, for the purpose of establishing the revenue requirement (Table 2.1). Details of our assessment and reasons for our proposed adjustments to Goulburn Valley Water’s proposal follow, with a summary of our adjustments shown at Table 2.4.

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

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

²³ Deloitte Access Economics 2018, *Goulburn Valley Water – expenditure review for 2018 water price review*, February.

Table 2.3 Draft decision – operating expenditure

\$ million 2017-18

	2018-19	2019-20	2020-21	2021-22	2022-23	Total
Controllable costs	42.6	42.3	42.0	42.0	41.6	210.5
Non-controllable costs	4.6	4.6	4.5	4.5	4.4	22.5
Bulk services ^a	1.1	1.1	1.1	1.1	1.1	5.5
Environmental contribution ^b	3.4	3.3	3.2	3.2	3.1	16.3
Licence fees - ESC ^c	0.042	0.042	0.042	0.042	0.063	0.232
Licence fees - DHHS ^c	0.029	0.030	0.030	0.030	0.030	0.149
Licence fees - EPA ^c	0.086	0.086	0.086	0.086	0.086	0.429
Draft decision – operating expenditure	47.2	46.8	46.5	46.5	45.9	233.0

^a Bulk services covers the supply of bulk water and sewerage services

^b The Environmental Contribution collects funds from water corporations under the WI Act

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

Note: Numbers have been rounded

Goulburn Valley Water proposed a total forecast controllable operating expenditure of \$220.2 million over a five-year regulatory period. For the reasons set out below, we propose to reduce this by \$9.7 million to establish a benchmark controllable operating expenditure of \$210.5 million.

Baseline controllable operating expenditure:

- Goulburn Valley Water has proposed downward adjustments of \$2.46 million to its actual 2016-17 baseline year controllable operating expenditure, producing a reasonable starting point for forecast annual operating expenditure. The resultant figure of \$41.76 million is 1 per cent below the benchmark of \$42.03 million allowed for 2016-17 in the previous price determination.

Our assessment

Deloitte assessed the proposed 2016-17 baseline and recommended no adjustment.²⁴ We accept Deloitte's recommendation as we consider this reflects an efficient baseline cost to forecast annual operating expenditure.

Efficiency improvement:

- Goulburn Valley Water's proposed efficiency improvement rate on controllable operating costs is 3.1 per cent per year. This is high compared to its past performance (where it met our mandated 1 per cent efficiency rate) and is the highest of all efficiency improvement rates proposed by other water corporations in their price submissions. It significantly exceeds Goulburn Valley Water's forecast connection growth rate of 1.3 per cent per year, giving a declining annual baseline operating cost.
- Goulburn Valley Water also proposed an 'efficiency dividend' of \$1.3 million per year, to effectively return money to customers from its efficiency savings across 2013–18. Following a correction to its revenue requirement (see page 8 for details) this was increased to \$2.3 million per year. For comparison purposes, Deloitte considered this efficiency dividend (\$11.6 million in total) as an offset to the proposed \$21.72 million of additional costs above the baseline sought by Goulburn Valley Water, which is equivalent to a 1.5 per cent per year reduction in its controllable operating expenditure per connection (as shown in Figure 2.1). This places Goulburn Valley Water ahead of the average for the water industry, with the fourth largest overall reduction in controllable operating expenditure per connection.

Proposed cost changes:

- Goulburn Valley Water has sought \$21.72 million of additional operating expenditure to its annual baseline cost, spanning a number of different projects and cost allocations. Some of these included a labour component.
- While it did not include a specific cost item for labour increases, Goulburn Valley Water has effectively proposed additional labour costs of \$5.90 million embedded within the different variations above the baseline. These labour increases are mostly to cover wage increases above inflation resulting from its enterprise agreement. Deloitte's assessment of wage increases above inflation is that these should be managed by the water corporation through productivity improvements or through the growth allowance applied to the baseline, as most other water corporations have proposed.²⁵ It has recommended removing all of these additional labour costs, within the recommended adjustment for the relevant cost item. We agree with Deloitte's

²⁴ Deloitte Access Economics, op. cit., p.13.

²⁵ Deloitte Access Economics, op. cit., pp.16–18.

view as it reflects more efficient labour expenditure. We expect Goulburn Valley Water will meet its enterprise agreement requirements through the inflation and growth allowances, with any shortfall funded by efficiency or productivity improvements.

- Goulburn Valley Water proposed \$1.70 million of electricity costs above the baseline for electricity price increases. Deloitte recommended an indicative reduction of \$0.70 million as it did not agree with Goulburn Valley Water's forecasted higher electricity prices continuing beyond 2019-20 through to 2022-23.²⁶ We accept Deloitte's recommendation as we consider it reflects a more accurate forecast of efficient electricity costs during the 2018–23 regulatory period. However we do acknowledge that there is currently uncertainty in forecasting electricity prices and Goulburn Valley Water's electricity contract expires on 30 June 2018. We request that Goulburn Valley Water proposes a revised electricity forecast based on its new contract prices in response to our draft decision.
- Goulburn Valley Water proposed an additional \$4.44 million for a mechanical and electrical (M&E) preventative maintenance program and an asset maintenance program. Deloitte found that the M&E program appeared to be a significant change from operating practices and accepted Goulburn Valley Water's justification. However Deloitte considered Goulburn Valley Water did not sufficiently justify why costs for the asset management activities were above the growth-adjusted baseline. Accordingly, Deloitte recommended the removal of the \$2.48 million for the asset maintenance program. We agree Deloitte's view is consistent with the requirements of our guidance for costs above the baseline to be fully explained.
- Goulburn Valley Water forecast \$6.27 million of new operating costs from new assets. Deloitte considered that Goulburn Valley Water had not sufficiently justified why all of the proposed costs should be above the baseline and recommended an adjustment of \$4.86 million. This adjustment reflects Deloitte's view that much of the cost for these activities should be able to be funded under a growth-adjusted baseline. We agree Deloitte's view is consistent with the requirements of our guidance for new costs above the baseline to be prudent and fully explained.
- Goulburn Valley Water proposed \$3.83 million for its biosolids and alum sludge management strategy (\$0.71 million) and its digital business strategy (\$3.12 million). Deloitte reviewed these costs and recommended no adjustments. We consider this is consistent with the requirements of our guidance for costs above the baseline to be justified.
- Goulburn Valley Water proposed a number of other additional cost items totalling \$5.94 million. Deloitte accepted Goulburn Valley Water's explanations for the operational resourcing strategy and the corporate service strategy. Deloitte found that the near 50 per cent increase in costs for planning, strategy and environmental consultancies was not sufficiently justified and these costs

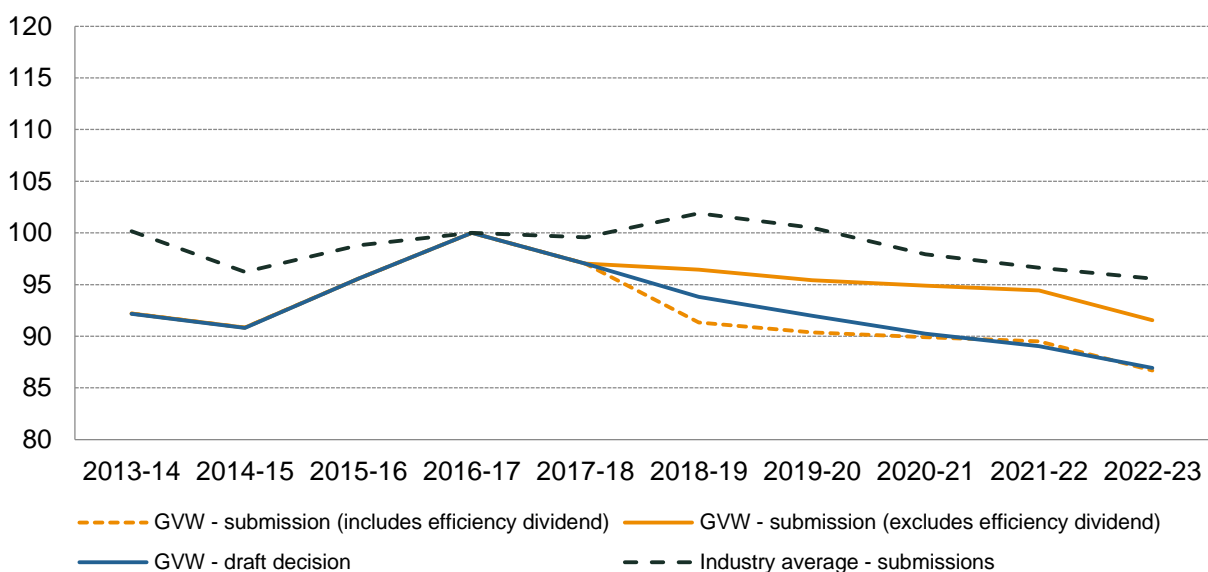
²⁶ For the reasoning behind Deloitte's recommendations, refer to pages 18 to 21 of Deloitte Access Economics' report.

should be managed within the growth-adjusted baseline. Accordingly, Deloitte recommended a \$1.64 million reduction for this third cost item. We agree Deloitte’s view is consistent with the requirements of our guidance.

We consider applying our proposed adjustment of \$9.69 million to Goulburn Valley Water’s total proposed controllable operating expenditure forecast better meets the requirements of the WIRO and the criteria for prudent and efficient expenditure outlined in our guidance.²⁷ This will bring about a greater decrease (in real terms) in controllable operating expenditure per connection relative to the baseline year and the industry average, as shown in Figure 2.1.

Figure 2.1 Controllable operating expenditure per water connection

Index: 2016-17=100



Submission – based on actual historical and forecast values provided by the water corporation in its price submission.
 Draft decision – includes any corrections or adjustments to historical and forecast values arising from our assessment.
 Industry average – drawn from the price submissions for all urban water corporations (excludes rural expenditure).

For non-controllable operating expenditure, we have adjusted Goulburn Valley Water’s forecasts where required based on the latest information received from the relevant regulatory authorities on their licence fees and the environmental contribution. The values we have adopted for our draft decision are set out in Table 2.3 above.

For the environment contribution, we have used the 2018-19 value provided by the Department of Environment, Land, Water and Planning and assumed that this will remain flat in nominal terms (decline in real terms) across the 2018–23 regulatory period.

²⁷ Essential Services Commission 2016, *Guidance paper*, op. cit., p. 31.

We have assumed the licence fees for the Department of Health and Human Services, the Environment Protection Authority Victoria and the Essential Services Commission remain flat in real terms across the period, but with a 50 per cent increase for our commission fee in 2022-23 to align with our regulatory review cycle.²⁸

We have verified Goulburn Valley Water's forecast external bulk water charges against the current price determination for Goulburn-Murray Water.

We have reduced Goulburn Valley Water's forecast non-controllable operating expenditure by \$0.03 million across the 2018–26 period, resulting from our adjustments:

- decrease our commission licence fee by \$0.01 million per year to \$0.04 million per year, and increased the value to \$0.06 million in 2022-23 (a total reduction of \$0.02 million)
- decrease the Environment Protection Authority Victoria licence fee to \$0.086 million per year (a total reduction of \$0.01 million).

Overall, non-controllable operating expenditure increases by \$0.93 million from 2017-18 to 2018-19, predominantly due to the increase in the environmental contribution from \$2.42 million to \$3.40 million.

Prior to making our final decision, we will adjust Goulburn Valley Water's forecast non-controllable operating expenditure for the latest inflation and external bulk charges data.

Table 2.4 sets out our proposed adjustments to both controllable and non-controllable operating expenditure.

²⁸ The Department of Health and Human Services and the EPA Victoria provided their latest 2016-17 licence fees for making our draft decision. We have also based our forecast on our 2016-17 commission licence fee.

Table 2.4 Adjustments to operating expenditure

\$ million 2017-18

	2018-19	2019-20	2020-21	2021-22	2022-23	Total
Proposed total operating expenditure	48.4	48.4	48.7	49.0	48.1	242.7
Electricity	0.0	0.0	-0.4	-0.3	-0.0	-0.7
Asset class plans and asset performance consultancies	-0.5	-0.6	-0.5	-0.5	-0.5	-2.5
Opex from new capex	-0.3	-0.8	-1.0	-1.3	-1.5	-4.9
Planning, strategy and environment consultancies	-0.4	-0.3	-0.3	-0.4	-0.3	-1.6
Total adjustments to controllable costs	-1.2	-1.6	-2.2	-2.5	-2.2	-9.7
Licence fees	-0.009	-0.010	-0.011	-0.012	0.008	-0.033
Total adjustments to non-controllable costs	-0.009	-0.010	-0.011	-0.012	0.008	-0.033
Draft decision - total operating expenditure	47.2	46.8	46.6	46.5	45.9	233.0

Note: Numbers have been rounded

Regulatory asset base

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

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

Our assessment

Closing regulatory asset base

We update the regulatory asset base to reflect actual gross capital expenditure, less government and customer contributions, and asset disposals for the period to 30 June 2017. This helps to ensure prices reflect the actual net expenditure of a water corporation.²⁹

Table 2.5 sets out Goulburn Valley Water's proposed regulatory asset base at 30 June 2017.

We compared Goulburn Valley Water's actual net capital expenditure for 2012-13 to 2016-17 with the forecast used to approve maximum prices for the period from 1 July 2013. We undertake a prudence and efficiency review where a water corporation's net capital expenditure is more than 10 per cent above the forecast used to approve maximum prices for the period from 1 July 2013. We believe this approach is reasonable given capital expenditure can be relatively 'lumpy' in nature.

Goulburn Valley Water's net capital expenditure was \$124.1 million, 9.3 per cent lower than the forecast. This is within the 10 per cent threshold noted above. It also calculated its closing regulatory asset base in accordance with the requirements of our guidance.

For these reasons, our draft decision accepts Goulburn Valley Water's proposed closing regulatory asset base for 30 June 2017 of \$337.9 million.

²⁹ Net capital expenditure is calculated by deducting government and customer contributions from gross capital expenditure. Customer contributions reflects revenue earned from new connections made to the water corporation's water, sewerage or recycled water networks.

Table 2.5 Closing regulatory asset base

\$ million 2017-18

	2012-13	2013-14	2014-15	2015-16	2016-17
Opening RAB 1 July	271.2	277.8	289.8	307.9	320.2
Plus gross capital expenditure	20.1	24.0	32.0	26.8	34.2
Less government contributions	1.4	0.0	0.6	0.6	1.6
Less customer contributions	1.2	1.7	2.0	1.7	2.1
Less proceeds from disposals	0.6	0.8	1.1	1.0	0.7
Less regulatory depreciation	10.3	9.5	10.2	11.1	12.0
Closing RAB 30 June	277.8	289.8	307.9	320.2	337.9

Note: Numbers have been rounded

Forecast regulatory asset base

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

Table 2.6 sets out our draft decision on Goulburn Valley Water's proposed forecast regulatory asset base from 1 July 2018.³⁰ Our assessment of the components of the forecast regulatory asset base is set out below.

³⁰ Our guidance required water corporations to provide an estimate of the components of its regulatory asset base for 2017-18. This is so we can assess the opening asset base for 1 July 2018. Our guidance noted that where the 2017-18 forecasts for net capital expenditure (gross capital expenditure less government and customer contributions) is lower than the forecast benchmark for that year in its 2013 price determination, the lower amount must be used (otherwise the 2013 determination forecast applies). The estimates for 2017-18 will be confirmed at the price review following the 2018 water price review.

Our assessment

Table 2.6 Forecast regulatory asset base
\$ million 2017-18

	2017-18	2018-19	2019-20	2020-21	2021-22	2022-23
Opening RAB 1 July	337.9	351.4	367.3	384.9	401.0	409.4
Plus gross capital expenditure	29.0	29.1	32.2	31.3	24.6	27.7
Less government contributions	0.5	0.0	0.0	0.0	0.0	0.0
Less customer contributions	1.4	1.5	1.5	1.5	1.6	1.6
Less proceeds from disposals	0.7	0.7	1.2	0.8	0.8	0.8
Less regulatory depreciation	12.8	11.0	11.9	12.9	14.0	13.6
Closing RAB 30 June	351.4	367.3	384.9	401.0	409.4	421.1

Note: Numbers have been rounded

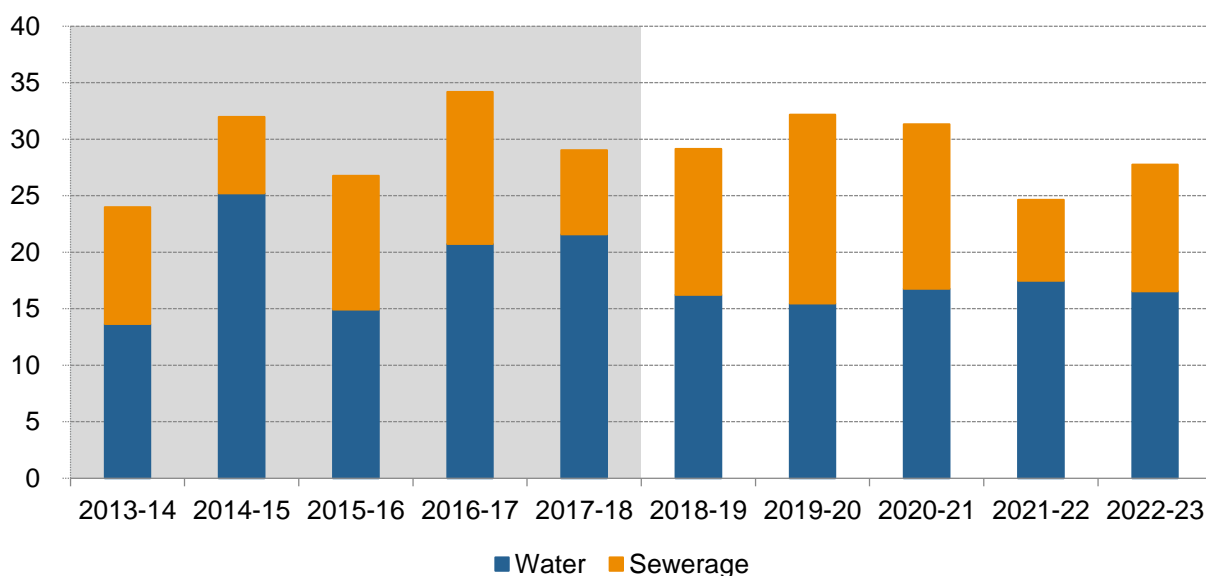
Capital expenditure

Capital expenditure is an input to estimating the regulatory asset base. Goulburn Valley Water's forecast capital expenditure and supporting information is provided at pages 31 to 33 and 45 to 46 of its price submission. This is summarised in Figure 2.2, for the current 2013–18 period, and as proposed by the water corporation for the 2018–23 period.

We engaged Deloitte Access Economics to provide expert advice to inform our assessment of capital expenditure. Deloitte's report on its assessment of Goulburn Valley Water's expenditure forecast is available on our website.³¹

³¹ Deloitte Access Economics, op. cit.

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



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

Goulburn Valley Water proposed a total gross capital expenditure of \$145.0 million over a five-year regulatory period. For the reasons set out below, we propose to accept the forecast capital expenditure proposed by Goulburn Valley Water for our draft decision on its revenue requirement:

- Goulburn Valley Water’s proposed capital expenditure for 2018–23 is consistent with its total for the current regulatory period, predominantly driven by renewals. We note Goulburn Valley Water’s capital expenditure for 2013–18 was \$145.9 million, \$17.8 million lower than the \$163.7 million benchmark allowance in its previous price determination.
- Deloitte requested selected documents from Goulburn Valley Water as a representative sample to demonstrate its asset management processes and justification for its capital expenditure program. Based on the sample of documents reviewed, these demonstrate that Goulburn Valley Water has a robust approach for developing project scope, the timing of works and cost estimates. We also note that Goulburn Valley Water is committed to achieving ISO550001:2014 certification for its asset management by 30 June 2023. Goulburn Valley Water also noted it was one of the leading corporations in the ‘small’ Australian Water Utilities category in WSAA’s 2016 benchmarking project.³²

³² Water Services Association of Australia’s Asset Management Customer Value (AMCV) benchmarking project incorporated the principles of ISO550001:2014. Refer to page 32 of Goulburn Valley Water’s price submission for its views on asset management.

- Deloitte reviewed documentation for the Bradford water treatment plant upgrade, the climate change mitigation strategy, the digital enablement strategy, and the Nathalia treated water pipeline. Deloitte also reviewed the water and sewer renewal programs.
- Deloitte did not recommend any adjustments to Goulburn Valley Water’s forecast capital expenditure based on the documentation reviewed.³³ We agree with Deloitte’s view and consider the forecast reflects prudent and efficient capital expenditure with robust justification, consistent with our guidance.
- We consider the planned capital expenditure program is achievable given Goulburn Valley Water’s management of its capital program over the current period. Of the six projects scheduled for the 2013–18 period, Goulburn Valley Water has completed two of these on time, with another being completed in 2017-18. It deferred two projects into the 2023–28 period as alternative interim options were identified. The remaining project will be completed in 2019-20 after initial optimisation work deferred the need for an upgrade at the Shepparton water treatment plant.³⁴
- We note Goulburn Valley Water has adopted a P40 cost estimate rather than the P50 basis specified in our guidance paper to capture its targeted efficiency savings for its largest projects. For all other projects Goulburn Valley Water has adopted a 10 per cent efficiency savings target. We agree with Deloitte’s view that this demonstrates a commitment to achieve efficient delivery of projects.
- Whilst it has clearly demonstrated a robust challenge to forecast capital expenditure, Goulburn Valley Water’s price submission did not specifically identify how it would manage uncertainty in timing, scope and cost from capital works. However it did note its commitment to progress several projects or programs where expenditure had not been included in prices due to uncertainty in scope and timing, and that it would seek to include significant costs incurred in the asset base at the end of the period. It did not identify the potential costs associated with these projects, or any other costs it had specifically excluded from its capital expenditure forecast. Regarding uncertain capital expenditure, we note the following:
 - Goulburn Valley Water will need to demonstrate the prudence and efficiency of any additional costs if they are indeed incurred during the 2018–23 period if seeking to include them in the regulatory asset base.
 - Variations in capital expenditure from forecast during the 2018–23 period will form a key part of our assessment of the Performance element of PREMO at the next price review.

³³ Deloitte Access Economics, op. cit., pp. 28–33.

³⁴ Essential Services Commission 2018, *Status of major projects supplement: Water performance report 2016-17*, 1 March, p. 18.

- We consider Goulburn Valley Water’s approach to forecasting its capital expenditure is consistent with our guidance and WIRO.³⁵

Our draft decision for total gross capital expenditure is to accept Goulburn Valley Water’s proposed benchmark, as set out in Table 2.6.

The benchmark that we adopt for Goulburn Valley Water does not represent the amount that the water corporation 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. Goulburn Valley Water determines how to best manage the allocation of its revenue and priority of its expenditure within a regulatory period.

Customer contributions

Revenue from customer contributions is deducted from gross capital expenditure so it is not included in the regulatory asset base.³⁶

We compared Goulburn Valley Water’s forecast for customer contributions with past outcomes, and its forecasts for growth in customer connections.³⁷ We consider Goulburn Valley Water’s forecast contributions are reasonable, having regard to past trends and its growth forecasts.

However, as we propose not to accept Goulburn Valley Water’s new customer contributions charge (outlined later), we require Goulburn Valley Water to update its customer contributions in response to this draft decision.

³⁵ Essential Services Commission 2016, *Guidance paper*, op. cit., p. 35.

³⁶ Revenue from new customer contributions reflects revenue earned from new connections made to a water corporation’s water, sewerage or recycled water networks.

³⁷ Growth in customer connections can be used as an indicator of growth in customer contributions.

Cost of debt

Our guidance required Goulburn Valley Water to use estimates of the cost of debt provided by the commission to estimate its revenue requirement. Goulburn Valley Water used the cost of debt values we specified to calculate its revenue requirement. For this reason, our draft decision accepts the cost of debt proposed by Goulburn Valley Water, as set out in Table 2.7.

Table 2.7 Trailing average cost of debt

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

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

Note: Numbers have been rounded

From 2016, we accepted a ten-year trailing average approach to estimating the benchmark cost of debt, changing from an on-the-day approach. The trailing average approach better aligns the actual cost of debt for an efficient business to the regulated benchmark, compared with an on-the-day approach.³⁸ We consider the ten year trailing average approach helps to minimise risk to water corporations and provides better incentives for long-term investment.

Return on equity – PREMO rating

Goulburn Valley Water rated its price submission as ‘Leading’. Based on its PREMO self-rating, Goulburn Valley Water proposed a rate of return on equity of 5.3 per cent per annum. This reflects the maximum return rate allowed in our guidance for a price submission rated as ‘Leading’.³⁹

The return on equity is higher than the rates approved for ‘Advanced’, ‘Standard’ and ‘Basic’ price submissions under PREMO. However, it is within the range of the rates we have set in the past, and set by other regulators in other Australian jurisdictions recently for the water industry.⁴⁰

Our draft decision accepts Goulburn Valley Water’s PREMO self-rating and proposed return on equity of 5.3 per cent per annum. Our assessment of Goulburn Valley Water’s proposed PREMO rating is set out in Chapter 3.

³⁸ For more detail on the trailing average and on the day approaches to the cost of debt, see Essential Services Commission 2016, *Water pricing framework*, op. cit., p.27.

³⁹ Essential Services Commission 2016, *Guidance paper*, op. cit., p. 49.

⁴⁰ Essential Services Commission of South Australia 2016, *SA Water regulatory determination 2016, Final determination*, June; Independent Pricing and Regulatory Tribunal 2017, *WACC biannual update*, August.

Regulatory depreciation

Regulatory depreciation is an input to calculating the regulatory asset base. Goulburn Valley Water's forecast regulatory depreciation was calculated using a straight line depreciation profile.⁴¹ We noted in our guidance that we prefer this approach.⁴² Goulburn Valley Water also calculated regulatory depreciation in a manner consistent with our guidance.

For these reasons, our draft decision proposes to accept Goulburn Valley Water's forecast regulatory depreciation.

Tax allowance

The tax allowance is an input into the revenue requirement. Goulburn Valley Water has proposed no allowance for tax in its revenue requirement. Our draft decision is to accept the forecast as it was calculated consistently with the method required by our guidance.⁴³

Demand

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

Goulburn Valley Water's demand forecasts are set out at pages 27-28 of its price submission, and are also included in its financial model. Our draft decision proposes to accept Goulburn Valley Water's demand forecasts for the purpose of approving maximum prices as we consider they were estimated in a manner that is consistent with the requirements of our guidance. This includes basing demand forecasts on the latest *Victoria In Future* population growth forecasts issued by the Victorian Government.

Form of price control

Goulburn Valley Water proposed to continue with a price cap form of price control as set out on page 38 of its price submission.

Our draft decision is to accept Goulburn Valley Water's proposed form of price control. A price cap will allow Goulburn Valley Water to recover sufficient revenue to cover the forecast efficient costs of providing services, and for it to deliver any health, safety and environmental obligations.

⁴¹ For the period from 2018-19 to 2022-23, Goulburn Valley Water proposed a regulatory depreciation of \$63.4 million.

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

⁴³ Essential Services Commission 2016, *Guidance paper*, op. cit., pp. 50-51.

A price cap also provides customers with price certainty, and means a water corporation is managing demand risk on behalf of its customers. We consider demand risk is more efficiently managed by a water corporation, rather than its customers.⁴⁴

Tariff structures

Goulburn Valley Water's proposed tariffs are set out at page 38 of its price submission. Goulburn Valley Water proposed a two per cent per annum price decrease over the next five years.

As outlined in our guidance, we have provided the water corporations with a large degree of discretion to decide on individual tariff structures. 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.

Tariff structures

Goulburn Valley Water proposed to maintain its existing tariff structures:

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

For the townships of Cobram and Kilmore, Goulburn Valley Water proposed a trial tariff structure from 1 July 2019 for three years. As part of the trial, customers will be provided the option of selecting a tariff structure with lower fixed charges or continuing with the existing two-part tariff structure. Customers in these towns were supportive of a trial to reduce their water fixed charge and increase the variable component to allow greater control over their bills.

Two-part tariffs

We consider the two-part structure proposed by Goulburn Valley Water for its residential, non-residential water service tariffs will promote efficient use of services. The two-part structure for water tariffs sends customers a signal about costs of their water use, and is an approach that is commonly applied in other states and territories. We also consider two-part tariff structures are easy to understand.

⁴⁴ We note our determinations will allow water corporations flexibility to apply to change from a price cap to a weighted average price cap or tariff basket within a regulatory period.

On the trial tariff structure for Cobram and Kilmore, we note Goulburn Valley Water gained customer support for this through its engagement program, and we propose to approve the tariff trial.

For sewerage tariffs, we consider a fixed charge only for residential customers and a two-part tariff for non-residential tariffs sends customers signals about the efficient costs.⁴⁵

Price and bill levels

Submissions by Gerald Mallon and the Consumer Action Law Centre highlighted the impact price changes may have on some customers, particularly those with low or fixed incomes.⁴⁶

We note Goulburn Valley Water proposed a two per cent per annum price decrease, and they already have amongst the lowest bills in the state (and nationally). We also note that Goulburn Valley Water is committed to its customer hardship fund and alternative payment options to support customers and provide assistance to those in financial distress.

Unique services

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

Draft decision

For the reasons set out above, our draft decision approves Goulburn Valley Water's proposed tariff structures as set out at pages 38 of its price submission.

Prior to our final decision and price determination, Goulburn Valley Water must submit:

- updated prices to reflect our draft decision on the revenue requirement
- our updates to cost of debt and inflation estimates, which we will provide in late April 2018.

Adjusting prices

Goulburn Valley Water proposed to maintain the current price adjustment mechanisms as set out on page 34 of its price submission. It proposed:

- to continue with its existing uncertain and unforeseen events mechanism⁴⁷

⁴⁵ Our reasons are outlined in our 2013 draft decisions on price review 2012-13 to 2017-18.

⁴⁶ Gerald Mallon 2017, *Submission*, 7 November; Consumer Action Law Centre 2017, *Initial Feedback: 2018 Water Price Review*, 15 November.

- to accept a cost of debt adjustment mechanism determined by the commission

Our draft decision accepts Goulburn Valley Water's proposal to continue the existing uncertain and unforeseen events mechanism. We noted in our guidance that we propose that the mechanism continues in its current form.

Goulburn Valley Water has not included adjustments to reflect movements in the cost of debt, as set out in our guidance. In response to our queries, Goulburn Valley Water outlined that it will work with the commission on a revised price adjustment formula that includes movements in the cost of debt.

New customer contributions

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

Goulburn Valley Water's proposed charges for new customer contributions are set out at page 38 of its price submission. Goulburn Valley Water proposed a one-off small increase to the standard water new customer contribution charge by 0.6 per cent per year until 2022-23.

The increase proposed by Goulburn Valley Water is relatively small, however the supporting model provided to us by Goulburn Valley Water included some assumptions that were not in line with the business's financial template. For this reason we are unable to accept the proposed increase to Goulburn Valley Water's standard water new customer contribution charge, in our draft decision.⁴⁸

Goulburn Valley Water must respond to this draft decision with an updated model supporting its proposed increase; otherwise we propose to approve the continuation of the existing standard water charge, in our final decision and price determination.

For negotiated new customer contributions, Goulburn Valley Water proposes to continue to calculate a charge in accordance with the requirements of our NCC pricing principles.⁴⁹ Our draft

⁴⁷ Goulburn Valley Water confirmed with us that it intends to continue with the existing mechanism.

⁴⁸ Our review included assessment of Goulburn Valley Water's modelling of incremental costs and incremental revenue.

⁴⁹ Essential Services Commission 2016, *Guidance paper*, op. cit., p. 62.

decision proposes to accept Goulburn Valley Water's proposed calculation of negotiated charges in line with the NCC principles.

Financial position

In approving prices, we must have regard to the financial viability of the water industry.⁵⁰ We interpret the financial viability requirements under the *Essential Services Commission Act 2001* (Vic) 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 service commitments, including financing costs arising from investments to meet service expectations.

Goulburn Valley Water's price submission and the supporting financial model provided estimates for key indicators of financial performance. These estimates were based on Goulburn Valley Water's assumptions about revenue and expenditure. Our draft decision proposes adjustments to revenue and expenditure. We have reviewed the key indicators of financial performance based on our draft decision. Under our draft decision, we consider Goulburn Valley Water will generate sufficient cash flow to deliver on service commitments, including financing costs arising from investments to meet service expectations.

⁵⁰ WIRO clause 8(b)(ii) and ESC Act s.8A(1)(b).

3. PREMO rating

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

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

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

In Chapter 2, we noted our draft decision is to accept Goulburn Valley Water's proposed return on equity of 5.3 per cent, based on the justification provided for the level of ambition in its price submission. Below, we set out our preliminary assessment of Goulburn Valley Water's proposed PREMO rating.

Our review of Goulburn Valley Water's PREMO self-rating

Goulburn Valley Water's proposed PREMO rating, and our draft decision is summarised below.

Table 3.1 PREMO Rating

	Overall PREMO rating	Risk	Engagement	Management	Outcomes
Goulburn Valley Water's rating	Leading	Leading	Leading	Leading	Leading
Commission's rating	Leading	Leading	Leading	Leading	Leading

We agree with Goulburn Valley Water's proposed overall PREMO self-rating of 'Leading'. This is reflected in the return on equity we propose to approve for Goulburn Valley Water at page 23.

We consider Goulburn Valley Water's proposals reflect a significant improvement in the value delivered to customers. In particular, Goulburn Valley Water proposes to improve services, at the same time reducing its prices from 1 July 2018 by 2 per cent per annum over the following five years; which is the largest price decline proposed by a water corporation included in our price

review.⁵¹ This means Goulburn Valley Water would have the lowest bills in the state before the end of the five year period.

The proposed price reductions are a result of Goulburn Valley Water's very high efficiency improvement rate in relation to controllable operating expenditure (of around 3.1 per cent per annum), and its proposal to deliver further efficiency savings to customers. These outcomes put Goulburn Valley Water ahead of the rest of the sector in terms of customer value, supporting its overall self-rating as 'Leading' (in particular, supporting its 'Leading' self-rating for the Management and Outcomes elements of PREMO).

Other reasons we agree with Goulburn Valley Water's self-ratings include:

- Goulburn Valley Water's engagement was inclusive and tailored to suit its circumstances. Goulburn Valley Water engaged across all 54 towns within its service area, involving one quarter of its staff. Its approach included discussions with customers at water cafes at each town and surveys. It tested these results at a 'Mini-Public', a deliberative style forum whose members were representative of its customer base. In our view this range of methods was effective in providing customers an opportunity to participate, and was well suited to the issues discussed.
- The results of Goulburn Valley Water's engagement had an influence on its proposals. For example, it has initiated a trial tariff (involving a higher variable water tariff) in some towns in response to customer feedback that they would like much more control over bills. The results of the trial will be used to inform any future broader rollout of the tariff (Goulburn Valley Water has proposed to credit the bill of each customer if it fails to initiate the trial by its target date).
- The influence of engagement is also evident in the corporation's commitments to improve water quality in some towns, and introduce new forms of electronic communication with its customers.
- Goulburn Valley Water's acceptance of greater risk is demonstrated by the introduction of a number of new guaranteed service levels. The new GSLs increase the corporation's revenue at risk, providing an incentive and financial consequence should it not deliver on outcomes identified as priority areas by customers through its engagement program. In addition, Goulburn Valley Water's adoption of a P40 cost estimate for major capital projects will result in the corporation bearing greater risk from cost overruns when compared to the P50 approach outlined in our guidance paper.
- Goulburn Valley Water has committed to improving a number of service targets, including in relation to the reliability of supply, and time taken to rectify service interruptions.

⁵¹ Essential Services Commission 2018, *Water performance report 2016-17: Performance of Victorian urban water and sewerage businesses*, 1 March.

Our review of Goulburn Valley Water's proposed PREMO ratings took into account the correction made by the corporation during our review (to its treatment of non-regulated revenue in our financial model). While the impact of the incorrect entries could have resulted in higher prices, Goulburn Valley Water decided to absorb the revenue shortfall arising from the error.

This, in effect, added to the efficiency targets adopted by Goulburn Valley Water. It also demonstrates the acceptance of risk by Goulburn Valley Water, with the corporation unsure of how it will find the additional efficiencies to offset the impact of the correction.

We have made a reduction to Goulburn Valley Water's operating expenditure forecast to reflect our views on efficient costs. However, this reduction has had no impact on prices, because Goulburn Valley Water proposed a revenue requirement lower than our model allows. We also note that the review of proposed capital expenditure did not identify any reductions, which reflects the corporation's leading approach to absorbing risk and commitment to lowering costs and prices.

4. We invite feedback on our draft decision

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

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

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

How to provide feedback:

Attend a public forum

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

Provide written comments or submissions

Written comments or submissions in response to this draft decision will be due in early May 2018.

We require submissions by this date so 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 our website at www.esc.vic.gov.au/waterpricereview.

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

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

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

We invite feedback

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

Next steps

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

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

APPENDIX A – submissions received

Name or organisation	Date received
Environment Protection Authority Victoria	12 December 2017
Consumer Action Law Centre	15 November 2017
Mr G Mallon	7 November 2017