

# South Gippsland Water final decision

2018 Water Price Review

19 June 2018

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# Summary

## **We have made a final decision on South Gippsland Water's prices**

In September 2017, South Gippsland Water provided a submission to us proposing prices it intends to charge from 1 July 2018. In April 2018, we released our draft decision on its price submission.<sup>1</sup> The draft decision set out our preliminary views on South Gippsland Water's proposals. Following the release of our draft decision, we invited interested parties to make further submissions. We also held a public meeting in April 2018. In addition to a response from South Gippsland Water, we received three written submissions on our draft decision, which are available on our website. A list of these submissions is included in Appendix A.

After considering feedback, we have made a price determination for South Gippsland Water.<sup>2</sup> The price determination sets out the maximum prices South Gippsland Water may charge for prescribed services (or the manner in which its prices are to be calculated, determined, or otherwise regulated). This final decision paper sets out our supporting reasons and analysis for the price determination.

Where our final decision on a particular aspect is unchanged from our draft decision, we have not detailed the supporting reasons in our final decision. Rather, we have noted that our final decision accepts the reasons and position we reached in the draft decision.

Where we have reached a different decision to that proposed in our draft decision, or where new information required our consideration, we have set out our reasons in full in this final decision. This final decision should be read in conjunction with our draft decision.

## **Our final decision approves maximum prices that increase by inflation only, over a two year period from 1 July 2018**

In its price submission, South Gippsland Water originally proposed an average price increase of around 20 to 25 per cent over the five years from 1 July 2018. Our draft decision instead proposed to approve a maximum price increase of around 10 per cent over two years from 1 July 2018. The lower prices in our draft decision were mainly a result of correcting errors in South Gippsland Water's original submission and additional savings we identified during our review. The shorter

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<sup>1</sup> Clause 16 of the Water Industry Regulatory Order 2014 requires us to issue a draft decision. South Gippsland Water's price submission and our draft decision are available at [www.esc.vic.gov.au/waterpricereview](http://www.esc.vic.gov.au/waterpricereview).

<sup>2</sup> Before the commencement of a regulatory period, clause 10 of the Water Industry Regulatory Order 2014 requires us to make a price determination which determines the maximum prices a water corporation may charge, or the manner in which its prices are to be calculated, determined or otherwise regulated during the regulatory period. See Essential Services Commission 2018, *South Gippsland Water Determination: 1 July 2018 – 30 June 2020*, June.

regulatory period proposed in our draft decision reflected our view that South Gippsland Water's price submission did not meet the standards required by our guidance.<sup>3</sup>

In its response to our draft decision, South Gippsland Water accepted our draft decision to approve a two year regulatory period. However, South Gippsland Water proposed that its maximum prices increase by inflation only in each year, lower than the maximum provided for in our draft decision.

It proposed the lower prices after further considering the impact of higher prices on residential tenants, and high water users. This included customer feedback received at the public forum we held in April 2018, following the release of our draft decision. At this forum, concerns were raised about the impact of proposed price increases on tenants and customers with a low income.

South Gippsland Water's response to our draft decision noted that it could not sustain price increases limited to inflation for more than two years without substantial pricing relief or a material transformation to the business that improves economies of scale. However, it committed to undertake a review of the business during the two year period, to address affordability issues to inform its next price submission while providing for the long term financial sustainability of the business.

Our final decision approves South Gippsland Water's revised proposal to limit annual price changes to inflation over the two years from 1 July 2018. These prices result in forecast revenue that is lower than the maximum revenue requirement we calculate using our usual approach (based on an assessment of efficient costs). We consider the prices approved will provide the corporation with sufficient cash flow to deliver on its service commitments and remain financially viable.

### **Customer bills will remain steady**

A summary of approved maximum prices for major services delivered by South Gippsland Water is set out on page 23. The estimated typical bills for residential customer groups under our final decision are provided in Table A. Under South Gippsland Water's proposal and our final decision, bills for residential customers will remain steady (in constant price \$2018-19 terms).

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<sup>3</sup> Our draft decision noted the insufficient and inadequate information provided by South Gippsland Water in its price submission and in response to our information requests.

**Table A**      **Estimated typical water and sewerage bills**  
\$ 2018-19

Customer group	Average consumption (kL p.a.)	2017-18 annual bill	2018-19 annual bill	2019-20 annual bill
Residential (Owner occupier)	118	\$996	\$996	\$996
Residential (Tenant)	118	\$215	\$215	\$215

Note: Numbers have been rounded

### **Tariff structures are the same**

Our final decision approves South Gippsland Water’s proposed tariff structures, which reflect a continuation of its current approach.

For water services, we have approved South Gippsland Water’s proposal for a fixed service charge and a variable component that depends on water use. For residential sewerage services, we have approved South Gippsland Water’s proposal for a fixed charge only. For non-residential sewerage services we have approved a fixed service charge and volumetric cistern fees.

Our final decision also approves South Gippsland Water’s proposed price cap form of price control. This means its maximum prices are fixed subject to updates for inflation, and any other price adjustments we approve in our price determination. South Gippsland Water currently uses a price cap. For more detail on tariffs and the form of price control, see pages 21 to 23.

### **We have not assigned South Gippsland Water’s price submission a PREMO rating**

Our draft decision did not assign an overall PREMO rating to South Gippsland Water’s price submission. Among other things, this reflected our view that South Gippsland Water’s price submission did not comply with the requirements of our guidance.

South Gippsland Water did not comment on this in its response to our draft decision.

Our final decision is therefore consistent with our draft decision – we have not assigned South Gippsland Water an overall PREMO rating for the two year period. Our rating for each component of PREMO, along with our reasoning, is set out in our draft decision.

South Gippsland Water and Western Water are the only businesses for which we have not assigned a PREMO price submission rating (Table B).

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

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

Leading	Advanced	Standard	Basic	Not rated
Goulburn Valley Water	Barwon Water	East Gippsland Water	Wannon Water	South Gippsland Water
	Central Highlands Water	Gippsland Water		Western Water *
	City West Water	Lower Murray Water (urban)		
	Coliban Water	Westernport Water		
	GWMWater			
	North East Water			
	South East Water			
	Southern Rural Water			
	Yarra Valley Water			

\* We have not assessed Western Water under PREMO, as prior to lodging its price submission it notified us of its intention to target a short-term pricing outcome rather than the overall value for money outcome expected under PREMO. Western Water adopted this approach to provide time for it to undertake a review to inform longer-term prices.



# 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.<sup>4</sup> The prescribed services include retail water and sewerage services, and bulk water and sewerage services delivered by the water corporations.<sup>5</sup>

Our task is to assess price submissions by water corporations against the legal framework that governs our role, and make a price determination that takes effect from 1 July 2018. We make a price determination after issuing a draft decision, and considering feedback from interested parties.

The price determination specifies the maximum prices a water corporation 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 sets out the supporting 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 making a price determination, 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

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<sup>4</sup> 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.

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

- the matters specified in our guidance<sup>6</sup>
- 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.

Our consideration of legal requirements 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 we have done so for our final decision for South Gippsland Water.<sup>7</sup>

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

If we consider the price submission has adequate regard for the matters in clause 11 of the WIRO and complies with our guidance, we must approve South Gippsland Water's proposed prices.<sup>8</sup>

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.<sup>9</sup>

The power for water corporations to impose fees is set out in the *Water Act 1989 (Vic)* (Water Act). Provisions in the Water Act also govern the manner in which water corporations may impose fees, and it is for each water corporation to ensure that it complies with them.<sup>10</sup>

## **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.<sup>11</sup>

<sup>6</sup> Essential Services Commission 2016, *2018 Water Price Review: Guidance paper*, November.

<sup>7</sup> Essential Services Commission 2018, *South Gippsland Water final decision, 2018 Water Price Review – commission's consideration of legal requirements*, 19 June. This is available at [www.esc.vic.gov.au/waterpricereview](http://www.esc.vic.gov.au/waterpricereview).

<sup>8</sup> This is a requirement of the WIRO, clause 14(b).

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

<sup>10</sup> See Part 13, Division 5 of the *Water Act 1989 (Vic)*.

<sup>11</sup> Essential Services Commission 2015, *Review of Water Pricing Approach: Consultation paper*, April.

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.

In May 2016, we released a position paper setting out our proposed new pricing approach, and invited submissions.<sup>12</sup> 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.<sup>13</sup>

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.<sup>14</sup> Our guidance explains the building blocks and how we use it to estimate the revenue requirement.<sup>15</sup>

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.<sup>16</sup> 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.

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<sup>12</sup> Essential Services Commission 2016, *A new model for pricing services in Victoria's water sector: Position paper*, May.

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

<sup>14</sup> 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.

<sup>15</sup> Essential Services Commission 2016, *Guidance paper*, op. cit., pp. 8–9.

<sup>16</sup> In December 2017 we issued early draft decisions for East Gippsland Water, South East Water, Westernport Water and Yarra Valley Water.

The 2018 water price review is the first time we've applied our PREMO incentive mechanism. A water corporation's ambition in terms of delivering customer value is being assessed against four elements of PREMO – Risk, Engagement, Management and Outcomes.<sup>17</sup>

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.<sup>18</sup>

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<sup>17</sup> The Performance element of PREMO will be assessed at the review following the 2018 water price review.

<sup>18</sup> The PREMO process is described in: Essential Services Commission 2016, *Guidance paper*, op. cit., pp. 44–49.

## 2. Our assessment of South Gippsland Water's price submission

We have made our price determination for South Gippsland Water after considering: South Gippsland Water's price submission, its responses to our queries and our draft decision, and written submissions from interested parties. A list of submissions responding to our draft decision is provided in Appendix A. We also held a public meeting in April on our draft decision to receive feedback.

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

Our guidance included a number of matters water corporations must address in their price submissions. Our final decision on each of these matters is set out below.

### Regulatory period

South Gippsland Water's price submission proposed a five year regulatory period from 1 July 2018. Our draft decision proposed to adopt a two year regulatory period. This reflected our concern about the quality of information and data provided by South Gippsland Water in its price submission, and in its responses to our information requests. Our draft decision considered that it would not be appropriate for us to approve a regulatory period of more than two years.<sup>19</sup>

In response to our draft decision, Consumer Action Law Centre (CALC) recommended the regulatory period should be the same for all water corporations, unless there are special circumstances.<sup>20</sup> It noted South Gippsland Water was an example of a special circumstance.

In its response to our draft decision, South Gippsland Water did not directly address our preliminary views on its regulatory period. We note however, that its response stated 'given that the price determination will be for two years the corporation has committed that prices will be held at the 2017–18 prices plus inflation until the next pricing determination.'<sup>21</sup>

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<sup>19</sup> We note there is a precedent – the commission shortened the regulatory period for Melbourne Water in its 2013 price review. See: Essential Services Commission 2013, *Price review 2013: greater metropolitan water businesses, Final decision*, June, p. xviii.

<sup>20</sup> Consumer Action Law Centre 2018, *Submission on standard draft decisions: 2018 Water Price Review*, 8 May, p. 10.

<sup>21</sup> South Gippsland Water 2018, *Response to Price Review 2018: South Gippsland Water Draft Determination*, 10 May, p. 1.

No other new information was presented in submissions that caused us to change the views in our draft decision on South Gippsland Water's regulatory period.

Our final decision is to approve a two year regulatory period from 1 July 2018 to 30 June 2020 for South Gippsland Water.

## **Customer engagement**

Our guidance required South Gippsland Water to engage with customers to inform its price submission.

The engagement by South Gippsland Water:

- took place between June 2016 and September 2017
- used a range of methods including surveys, interviews, deliberative workshops and forums
- sought views from an advisory group of community members appointed by South Gippsland Water, as well as special interest groups, and community groups
- covered topics such as prices, service levels, hardship support and protecting the environment.

More detail on South Gippsland Water's engagement is available in its price submission.<sup>22</sup> More detail on our review of South Gippsland Water's engagement is provided in our draft decision.

CALC suggested we could play a greater role to promote best practice customer engagement and identify areas for improvement.<sup>23</sup> We note that following our price review, we will continue to work with water corporations to promote best practice customer engagement.

## **Outcomes**

The outcomes South Gippsland Water proposes to deliver over its regulatory period are:

- partnering with community, local government and business to plan for future years
- be reliable, minimise unplanned interruptions to services and communicate well with customers
- provide safe clean drinking water for the benefit of customers and communities
- provide a safe wastewater service that contributes to the health and liveability of communities and environment
- be environmentally responsible, sustainable and adapt to a future impacted by climate variability
- treat all customers and community with honesty, respect and strive to balance affordability, value for money and fairness.

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<sup>22</sup> South Gippsland Water's price submission is available on our website at [www.esc.vic.gov.au](http://www.esc.vic.gov.au). See pages 7 to 13.

<sup>23</sup> Consumer Action Law Centre 2018, op. cit., p. 4.

In early 2018-19, we will engage with South Gippsland Water to understand how it will measure its performance against these outcomes in the two year regulatory period, and how this will inform our assessment during future price reviews as part of the Performance element of PREMO assessments.

CALC commented on the need for additional funding for regional water corporations to strengthen existing hardship programs or adopt new practices to assist vulnerable customers.<sup>24</sup> CALC cited our 2013 price review where we provided an additional allowance for metropolitan water corporations to expend existing hardship programs or introduce new hardship programs.

We have not adopted CALC's recommendation in our final decision. We note that the additional allowance in our 2013 price review was provided in recognition of the large one-off price increases approved for the metropolitan corporations during the review.<sup>25</sup> Further, water corporations already allocate funds to programs aimed to deliver payment options and hardship support required by our customer service codes. South Gippsland Water has responded to its customers' views on affordability by maintaining its current level of support to customers in financial hardship and by proposing prices consistent with flat bills for residential customers.

## Service Standards

South Gippsland Water also provided a list of service standards relating to reliability and attending faults that it will include in its customer charter. These service standards and South Gippsland Water's targets until June 2020 are set out in Appendix B.

CALC has noted a range of ambitions by water corporations when it comes to proposed service standards and that water corporations should be encouraged to 'improve service standards over time'.<sup>26</sup> We note that South Gippsland Water proposed standards for reliability and attending faults that are in line with past years.

We accept there are arguments for maintaining or decreasing service levels over time particularly where engagement identifies customers are satisfied with the existing level of service or do not support increasing expenditure to deliver improved service. We expect South Gippsland Water to continue to consider customer preferences when forming future service targets.

Approved service standards relating to reliability and attending faults are set out in Appendix B and form part of the manner in which South Gippsland Water's services are regulated.

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<sup>24</sup> *ibid.*, p. 3.

<sup>25</sup> The increase in prices approved in 2013 for metropolitan Melbourne was around 20 to 25 per cent. We note for most water corporations in our 2018 price review, generally prices are remaining relatively steady, or falling.

<sup>26</sup> Consumer Action Law Centre, *op. cit.*, p. 6.

## 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. We expect water corporations to include GSLs in its customer charter.

South Gippsland Water's proposed GSLs are set out on pages 41 and 42 of its price submission. It has made no changes to the hardship GSL, and revised some of its existing GSLs. In our draft decision we provided an overview of South Gippsland Water's proposed GSLs.

CALC supported GSL payments increasing over time.<sup>27</sup> We note South Gippsland Water has proposed to increase payment amounts for two of its existing GSLs.

South Gippsland Water's proposed GSLs were reviewed in consultation with its pricing submission advisory panel to reflect the aspects of service delivery most important to customers. For the reasons set out above, our final decision approves South Gippsland Water's proposed GSLs.

South Gippsland Water's GSLs are set out in Appendix C to this final decision.

South Gippsland Water's commitment to GSL payments should these service levels not be met, forms part of the manner in which South Gippsland Water's services are regulated.

## Revenue requirement

The revenue requirement is the forecast amount a water corporation needs to deliver on customer outcomes, government policy, and obligations monitored by technical regulators including Environment Protection Authority Victoria and the Department of Health and Human Services.<sup>28</sup> Along with forecast demand, it is an input to calculating prices.

Our draft decision proposed to approve a revenue requirement for South Gippsland Water of \$59.8 million over the two years from 1 July 2018. This was \$4.0 million or 6.3 per cent lower than proposed by South Gippsland Water in its price submission, for the same period.

Our final decision approves a revenue requirement of \$55.7 million, calculated based on South Gippsland Water's response to our draft decision which proposed to limit price changes for the two years from 1 July 2018 to inflation (below the price increase provided for in our draft decision).

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<sup>27</sup> *ibid.*, p. 1.

<sup>28</sup> 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 South Gippsland Water in the regulatory period from 1 July 2018. We had regard to their views in our draft and final decisions.



This is lower than the 'notional' revenue requirement of \$59.5 million we calculated based on our usual building block approach (Table 2.1). The difference between the final decision revenue requirement and the notional revenue requirement is the revenue foregone by South Gippsland Water (\$3.8 million). South Gippsland Water will not be able to recover this foregone revenue via customer prices, in future regulatory periods.

We consider our final decision approves prices that will enable South Gippsland Water to remain financially viable (see page 25), and enable it to deliver on customer outcomes, government policy, and obligations.

Table 2.2 identifies the revenue requirement approved in our draft decision, and the adjustments we made to arrive at the notional figure for our final decision. The adjustments are described later in this chapter.

**Table 2.1 Final decision – Revenue requirement**  
\$ million 2017-18

	2018-19	2019-20	Total
Operating expenditure	19.7	19.8	39.5
Return on assets	5.8	6.2	12.0
Regulatory depreciation	4.0	4.3	8.3
Non-prescribed revenue offset of notional revenue requirement	-0.2	-0.2	-0.4
Tax allowance	0.0	0.0	0.0
<b>Notional revenue requirement</b>	<b>29.3</b>	<b>30.1</b>	<b>59.5</b>
Forgone revenue	-1.6	-2.1	-3.8
<b>Final decision revenue requirement</b>	<b>27.7</b>	<b>28.0</b>	<b>55.7</b>

Note: Numbers have been rounded

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

	2018-19	2019-20	Total
<b>Draft decision – revenue requirement</b>	<b>29.5</b>	<b>30.4</b>	<b>59.8</b>
Operating expenditure	-0.03	-0.1	-0.1
Return on assets	-0.1	-0.1	-0.2
Regulatory depreciation	-0.004	-0.03	-0.04
<b>Total adjustments</b>	<b>-0.1</b>	<b>-0.2</b>	<b>-0.4</b>
<b>Final decision – notional revenue requirement</b>	<b>29.3</b>	<b>30.1</b>	<b>59.5</b>

Note: Numbers have been rounded

## Operating expenditure

Operating expenditure is an input to the notional revenue requirement. Our draft decision proposed a \$35.9 million benchmark for South Gippsland Water’s forecast controllable operating costs for the 2018–20 period.<sup>29</sup> This was \$2.7 million lower than proposed by South Gippsland Water, and we set out our assessment approach and reasoning for our allowances in our draft decision (pages 10 to 21). In summary:

- We established a baseline controllable operating expenditure that reflected an efficient benchmark.
- We allowed \$1.11 million of additional costs above the baseline for electricity, stakeholder collaboration, biosolids management, ecological risk assessments, and the new Lance Creek connection.
- We considered the remaining \$2.72 million of costs were not prudent and efficient for the 2018–20 period. We removed costs for increased maintenance, labour increases above inflation, new obligations we considered were actually ongoing and already represented in the baseline, and IT improvements. We also considered costs for customer support programs were better classified as revenue not collected rather than operating costs.

<sup>29</sup> Controllable costs are those that can be directly or indirectly influenced by a water corporation’s decisions.

Our draft decision also requested an updated forecast for electricity costs based on new contract prices, given the electricity contract was currently under negotiation.

We forecasted \$3.68 million for South Gippsland Water's non-controllable operating costs for the 2018–20 period.<sup>30</sup> We noted in our draft decision that we would update this forecast for the latest inflation and external bulk charges data.

South Gippsland Water's response to our draft decision accepted the commission's adjustments to its price submission proposal, and provided updated forecasts for controllable operating expenditure based on the latest information for payroll tax and electricity prices:

- The 2018-19 Victorian budget cut the payroll tax from 3.65 per cent to 2.425 per cent for regional corporations from 1 July 2018. As a result, South Gippsland Water has advised a reduction of \$0.20 million across the 2018–20 period. This is consistent with our draft decision requirement to be provided with updated forecasts if there is a change in legislation or government policy, and we have reduced the forecast accordingly.
- South Gippsland Water provided an updated electricity forecast of \$0.39 million above the baseline for 2018–20, an increase of \$0.09 million from its price submission forecast for the two years.<sup>31</sup> We accept South Gippsland Water's revised electricity forecast as it is based on actual contract prices and better reflects efficient expenditure.

CALC's submission to our draft decision supported our approach of adjusting forecast electricity costs and limiting wage increases in operating expenditure above the baseline.<sup>32</sup> No other new considerations were presented in submissions received following the draft decision that caused us to change our views on controllable operating expenditure.

Accordingly, our final decision for controllable operating expenditure adopts a \$0.11 million reduction from our draft decision for 2018–20.

For non-controllable operating expenditure, we have revised our draft decision forecasts where required based on the latest March 2018 inflation and external bulk charges information. We have

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<sup>30</sup> Non-controllable costs are those that cannot be directly or indirectly influenced by a water corporation's decisions.

<sup>31</sup> We requested our expenditure consultant, Deloitte Access Economics, to review the updated electricity price forecasts and compare against the information received for our draft decision. Deloitte did not recommend any adjustments for our final decision.

<sup>32</sup> Consumer Action Law Centre, *op. cit.*

revised our forecast environmental contribution from our draft decision, and made no changes to forecast licence fees or external bulk charges.<sup>33</sup>

Based on the latest inflation data, we have revised the forecast 2018-19 environmental contribution from \$1.20 million to \$1.21 million, which results in a total increase of \$0.01 million across the 2018–20 period.

Accordingly, we have increased our draft decision forecast for South Gippsland Water’s non-controllable operating expenditure by \$0.01 million to \$3.69 million across the 2018–20 period.

Table 2.3 sets out our adjustments from our draft decision for controllable and non-controllable operating expenditure. Table 2.4 sets out the benchmark operating expenditure we have adopted for our final decision.

**Table 2.3 Adjustments to operating expenditure**  
\$ million 2017-18

	2018-19	2019-20	Total
<b>Draft decision – total operating expenditure</b>	<b>19.8</b>	<b>19.8</b>	<b>39.6</b>
Electricity	0.07	0.02	0.09
Payroll tax	-0.10	-0.10	-0.20
<b>Total adjustments to controllable costs</b>	<b>-0.03</b>	<b>-0.08</b>	<b>-0.11</b>
Environmental contribution	0.005	0.005	0.009
<b>Total adjustments to non-controllable costs</b>	<b>0.005</b>	<b>0.005</b>	<b>0.009</b>
<b>Final decision – total operating expenditure</b>	<b>19.7</b>	<b>19.8</b>	<b>39.5</b>

Note: Numbers have been rounded

We have adopted the benchmark for operating expenditure set out in Table 2.4 for the purpose of making our final decision on South Gippsland Water’s revenue requirement (Table 2.1). We

<sup>33</sup> For the environmental 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 2018–20 regulatory period.

consider our final decision for South Gippsland Water’s forecast operating expenditure is consistent with the requirements of the Water Industry Regulatory Order 2014 (WIRO) and the criteria for prudent and efficient expenditure outlined in our guidance.<sup>34</sup>

**Table 2.4 Final decision – operating expenditure**

\$ million 2017-18

	2018-19	2019-20	Total
<b>Controllable costs</b>	<b>17.9</b>	<b>17.9</b>	<b>35.8</b>
<b>Non-controllable costs</b>	<b>1.9</b>	<b>1.8</b>	<b>3.7</b>
Bulk services <sup>a</sup>	0.6	0.6	1.2
Environmental contribution <sup>b</sup>	1.2	1.2	2.4
Licence fees – ESC <sup>c</sup>	0.016	0.016	0.033
Licence fees – DHHS <sup>c</sup>	0.010	0.010	0.020
Licence fees – EPA <sup>c</sup>	0.048	0.048	0.095
Other	0.0	0.0	0.0
<b>Final decision – total operating expenditure</b>	<b>19.7</b>	<b>19.8</b>	<b>39.5</b>

<sup>a</sup> Bulk services covers the supply of bulk water and sewerage services

<sup>b</sup> The Environmental Contribution collects funds from water corporations under the *Water Industry Act 1994* (Vic)

<sup>c</sup> Licence 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

The benchmark operating expenditure that we have adopted for South Gippsland Water does not represent the amount that South Gippsland 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 and to provide services over the regulatory period.

<sup>34</sup> Essential Services Commission 2016, *Guidance paper*, op. cit., p. 31.

## 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 South Gippsland Water to propose its:

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

### Closing regulatory asset base

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

Our draft decision proposed to approve a closing regulatory asset base for 30 June 2017 of \$144.7 million. We proposed to approve this amount as South Gippsland Water's actual net capital expenditure was 3.4 per cent lower than the forecast used to approve maximum prices for the period from 1 July 2013.<sup>35 36</sup> South Gippsland Water also calculated its closing regulatory asset base in accordance with the requirements of our guidance.

No other new considerations were raised in submissions on our draft decision that affected our assessment of the closing regulatory asset base. Our final decision approves a closing regulatory asset base at 30 June 2017 of \$144.7 million. The calculations are provided at Table 2.5.

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<sup>35</sup> Net capital expenditure is calculated by deducting government and customer contributions from gross capital expenditure.

<sup>36</sup> We take a risk-based approach to including past capital expenditure in the regulatory asset base. We undertake a prudence and efficiency review where a water corporation has exceeded its net capital expenditure forecasts by more than 10 per cent. We believe this approach is reasonable given capital expenditure can be relatively 'lumpy' in nature.

**Table 2.5 Final decision – Closing regulatory asset base**  
\$ million 2017-18

	2012-13	2013-14	2014-15	2015-16	2016-17
Opening RAB 1 July	112.2	117.3	126.3	141.7	147.0
Plus gross capital expenditure	10.1	13.5	20.4	10.8	8.2
Less government contributions	0.0	0.0	0.0	0.0	5.6
Less customer contributions	0.5	0.4	0.7	0.3	0.7
Less proceeds from disposals	0.6	0.4	0.6	1.3	0.3
Less regulatory depreciation	3.9	3.6	3.7	3.8	3.9
<b>Closing RAB 30 June</b>	<b>117.3</b>	<b>126.3</b>	<b>141.7</b>	<b>147.0</b>	<b>144.7</b>

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 final decision on South Gippsland Water's forecast regulatory asset base from 1 July 2018.<sup>37</sup> Since our draft decision we have updated the forecast regulatory asset base to reflect updated estimates for customer contributions (see page 17). Compared with our draft decision, this lowered the forecast regulatory asset base by around \$0.4 million by 2019-20.

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<sup>37</sup> Our guidance required water corporations to provide an estimate of the components of its regulatory asset base for 2017-18. This is so we can assess the opening asset base for 1 July 2018. Our guidance noted that where the 2017-18 forecasts for net capital expenditure (gross capital expenditure less government and customer contributions) is lower than the forecast benchmark for that year in its 2013 price determination, the lower amount must be used. The estimates for 2017-18 will be confirmed at the price review following the 2018 water price review.

**Table 2.6 Final decision – Forecast regulatory asset base**  
\$ million 2017-18

	2017-18	2018-19	2019-20
Opening RAB 1 July	144.7	147.6	161.9
Plus gross capital expenditure	32.8	19.5	16.6
Less government contributions	24.5	0.0	0.0
Less customer contributions	0.6	0.8	0.8
Less proceeds from disposals	0.5	0.5	0.5
Less regulatory depreciation	4.2	4.0	4.3
<b>Closing RAB 30 June</b>	<b>147.6</b>	<b>161.9</b>	<b>172.9</b>

Note: Numbers have been rounded

### Capital expenditure

Capital expenditure is an input to estimating the regulatory asset base. In our draft decision (pages 24 to 29), we proposed a gross capital expenditure forecast of \$36.2 million for South Gippsland Water for the 2018–20 period. The reasons for this were:

- South Gippsland Water’s capital forecast for the two year period would be more robust than for the later years. We removed \$0.88 million for the Water Reticulation Renewal Allocation as there was not sufficient evidence to justify the increase in the renewals program from the level in prior years. We noted our other \$7.83 million of proposed reductions would only apply to years beyond the 2018–20 period, which will be addressed in South Gippsland Water’s next price submission.
- We considered the planned capital expenditure program for 2018–20 is achievable, given South Gippsland Water’s past track record delivering its capital expenditure program.
- South Gippsland Water had an appropriate approach for managing expenditure associated with uncertain projects.

South Gippsland Water’s response to our draft decision accepted the commission’s adjustments to its price submission proposal for gross capital expenditure. South Gippsland Water also updated its top 10 major capital projects to exclude two projects that do not occur in the 2018–20 period but



that were included in its price submission. This update has no impact on the forecast gross capital expenditure proposed in our draft decision. It has replaced:

- Leongatha raw water transfer main renewal
- Fish Creek treated water distribution main renewal

with its next two largest projects for 2018–20:

- Sewer system expansion (Foster) mains
- Wonthaggi low level basin liner and cover renewal.

No other new considerations were presented in submissions received following the draft decision that caused us to change our views on gross capital expenditure.

Accordingly, we have adopted the gross capital expenditure benchmark proposed in our draft decision for the purpose of making our final decision on South Gippsland Water’s forecast regulatory asset base (Table 2.6) and its revenue requirement (Table 2.1). We consider this benchmark is consistent with our guidance and WIRO principles.<sup>38</sup>

The benchmark that we adopt for South Gippsland 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. South Gippsland Water determines how to best manage the allocation of its revenue and priority of its expenditure within a regulatory period.

In our draft decision, we accepted South Gippsland Water’s approach for addressing uncertain capital expenditure. We reiterate that South Gippsland Water will need to demonstrate the prudence and efficiency of additional costs incurred during the 2018–20 period if seeking to include them in the regulatory asset base.

### **Customer contributions**

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

Our draft decision required South Gippsland Water to submit updated forecast revenue from customer contributions.

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<sup>38</sup> Essential Services Commission 2016, *Guidance Paper*, op. cit., p. 35; WIRO clause 8(b)

We compared South Gippsland Water's updated forecast for customer contributions with past outcomes, and its forecasts for growth in customer connections.<sup>39</sup> We consider South Gippsland Water's forecast contributions are reasonable, having regard to past trends and its growth forecasts.

No other new considerations were presented in submissions received following the draft decision which caused us to change our views on revenue from customer contributions.

For the reasons set out above, our final decision accepts the benchmark revenue from customer contributions as set out at Table 2.6.

## **Cost of debt**

In our draft decision we proposed to approve the cost of debt proposed by South Gippsland Water as it used the cost of debt values we specified in our guidance to calculate its revenue requirement. We also noted that we will update the value of the estimated cost of debt for 2017-18 with our calculation of the actual cost, applying the method outlined in our guidance.<sup>40</sup>

CALC recommends that we set the benchmark cost of debt at five per cent or around one per cent lower than the amount allowed in our draft decision (6.05 per cent per annum in nominal terms).<sup>41</sup> CALC submits that government owned water corporations carry less risk than private corporations and as such, the allowed cost of debt and the return on equity should be lowered compared with the rates allowed in our draft decision. These recommendations are based on a report prepared by CME for CALC.<sup>42</sup>

A submission by the Water Services Association of Australia (WSAA) addressed CALC's submission.<sup>43</sup> Among other things, WSAA's submission noted that competitive neutrality principles have been embedded in government policy, including in Victoria via the Financial Accommodation Levy. As a result, water corporations face a cost of debt that reflects the commercial cost of debt.

In keeping with government policy, the approach we take to the cost of debt is to adopt a benchmark rate that applies to all water corporations. The benchmark reflects our estimate of the

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<sup>39</sup> Growth in customer connections can be used as an indicator of growth in customer contributions.

<sup>40</sup> We received data on the actual trailing average cost of debt for 2017-18 from Treasury Corporation Victoria in April 2018 and we updated the 2017-18 estimates for our final decision.

<sup>41</sup> Consumer Action Law Centre, *op. cit.*, p. 8.

<sup>42</sup> *ibid.*

<sup>43</sup> Water Services Association of Australia 2018, *Submission*, May.

efficient financing costs for a privately owned business facing a similar degree of economic risk to a regulated water corporation. We consider this is consistent with the requirements of the WIRO.<sup>44</sup>

In our view, adopting the approach recommended by CALC would mean a benchmark efficient water corporation may not have a reasonable opportunity to recover their debt costs.

A more detailed response to the issues raised by CALC is set out at Appendix D.

Our final decision adopts the benchmark cost of debt as set out in Table 2.7.

**Table 2.7 Final decision – 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%	4.5%

Note: Numbers have been rounded

## Return on equity – PREMO rating

Our draft decision proposed to adopt a rate for the return on equity of 3.9 per cent. This was lower than the 4.5 per cent proposed by South Gippsland Water, and reflected our preliminary review of South Gippsland Water’s PREMO self-rating. The range of possible outcomes for the return on equity is set out in the PREMO matrix included in our guidance.<sup>45</sup>

South Gippsland Water’s response to our draft decision incorporated a rate for the return on equity of 3.9 per cent, consistent with our draft decision.

CALC recommended a one per cent reduction to each return on equity value in the PREMO matrix.<sup>46</sup> CALC’s recommendation is based on the findings of a report prepared by CME. The main reason CME proposed the reduction is due to comparisons with returns allowed for UK water entities, and that government owned water corporations carry less risk than private corporations.

The most relevant comparisons for the return on equity are other economic regulators in Australia. We note the rate for the return on equity (and the regulatory rate of return, comprising the cost of debt and the return on equity) approved in our draft decision are similar to rates recently estimated

<sup>44</sup> Including, in particular, the requirements that our decision have regard to: the promotion of efficiency in regulated industries and the financial viability of the regulated water industry (cl 8(b)(ii) WIRO); efficiency in the industry and incentives for long term investment (s 8A(1)(a) ESC Act); and consistency in regulation between States and on a national basis (s 8A(1)(f) ESC Act).

<sup>45</sup> Essential Services Commission 2016, *Guidance paper*, op. cit., p. 49.

<sup>46</sup> Consumer Action Law Centre, op. cit., p. 8.

by other Australian regulators of the water sector.<sup>47</sup> We also consider the allowed return on equity should not be adjusted to reflect government ownership, as the exposure of a water corporation to market risk will not be materially affected by government ownership.

A more detailed response to the issues raised by CALC is set out at Appendix D.

We consider our approach to the return on equity is consistent with our requirements under the WIRO, and in particular, that our estimate provides water corporations with an incentive to invest efficiently, and that our approach has regard to the financial viability of the water industry.

Our final decision approves a rate for the return on equity of 3.9 per cent per annum, reflecting our views above, and our final decision on South Gippsland Water's PREMO rating (Chapter 3).

## **Regulatory depreciation**

Regulatory depreciation is an input to calculating the regulatory asset base. Our draft decision proposed to accept South Gippsland Water's forecast regulatory depreciation, as it was calculated in a manner consistent with the requirements of our guidance.<sup>48</sup>

Our final decision on regulatory depreciation is slightly lower than our draft decision; this is due to the correct allocation of the draft decision capital expenditure cuts to the relevant projects and programs.

No new considerations for depreciation were raised in submissions on our draft decision.

For the reasons set out above, our final decision confirms our draft decision.

The forecasts for regulatory depreciation adopted for our final decision on the notional revenue requirement is set out in Table 2.1.

## **Tax allowance**

The tax allowance is an input into the revenue requirement. Our draft decision accepted South Gippsland Water's forecasts for zero tax in its revenue requirement, as it was calculated consistently with the method required by our guidance.<sup>49</sup> No other new considerations were presented in submissions received following the draft decision which caused us to change our views on the tax allowance.

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<sup>47</sup> Essential Services Commission of South Australia 2016, *SA Water regulatory determination 2016*, Final Determination, June; Independent Pricing and Regulatory Tribunal 2017, *WACC biannual update*, February.

<sup>48</sup> Essential Services Commission 2016, *Guidance paper*, op. cit., p. 42.

<sup>49</sup> *ibid.*, pp. 50-51.

For the reasons set out above, our final decision adopts South Gippsland Water's tax forecasts, as set out in Table 2.1 in our calculation of the notional revenue requirement.

## **Demand**

In our draft decision, we considered South Gippsland Water's demand forecasts were not consistent with the requirements of our guidance as:

- some of South Gippsland Water's forecasts were not arithmetically accurate, or did not appropriately reflect the forecasting method adopted by the corporation
- some of South Gippsland Water's forecasts were not consistent with historical trends
- assumptions used by South Gippsland Water on price elasticity were incorrectly applied.

In response to our draft decision, South Gippsland Water provided updated demand forecasts. We have reviewed these updated forecasts and consider they comply with the requirements of our guidance, including that connections forecasts are based on the latest Victoria In Future estimates.

For the reasons set out above, our final decision accepts South Gippsland Water's demand forecasts. South Gippsland Water's price determination includes the benchmark demand forecasts adopted for our final decision.

## **Form of price control**

Our draft decision accepted South Gippsland Water's proposal to retain a price cap form of price control. We considered that a price cap provides customers with price certainty, and means a water corporation is managing demand risk on behalf of its customers. We also noted that we consider demand risk is more efficiently managed by a water corporation, rather than its customers.

No other new considerations on the form of price control were raised in response to our draft decision.

For the reasons set out above, our final decision approves South Gippsland Water's proposed price cap form of price control.<sup>50</sup>

## **Tariff structures and prices**

Our draft decision did not approve South Gippsland Water's proposed tariffs (as set out in its price submission) as we considered they did not comply with the requirements of our guidance or the

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<sup>50</sup> We note our determinations 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.

WIRO. In particular, South Gippsland Water's price submission proposed a relatively large increase in the residential variable water charge (of 18.8 per cent in 2018-19). We considered an increase of 18.8 per cent in the first year represents a price shock, which is exacerbated for tenants (who only pay the variable charge) and low income and vulnerable customers.

In response to our draft decision, South Gippsland Water proposed to retain existing tariff structures including:

- For residential and non-residential water services, a two-part tariff with a fixed service charge and a variable usage component.
- For residential sewerage services, a fixed charge only.
- For non-residential sewerage services, a fixed access fee and volumetric cistern fees.

It also proposed to increase prices by inflation only for the next two years; including for the residential variable water charge noted above. It proposed the lower prices after further considering the impact of higher prices on residential tenants, and high water users. This included customer feedback received at the public forum we held in April 2018 following the release of the draft decision. At this forum, concerns were raised about the impact of proposed price increases on tenants and customers with a low income.

We consider a two-part structure for water services will promote efficient use. It also provides customers a signal about their water use costs, and is an approach that is commonly applied in other states and territories.<sup>51</sup> We also consider two-part tariff structures are easy to understand.

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

South Gippsland Water proposes to calculate tariffs for recycled water, trade waste and miscellaneous services in accordance with the pricing principles referenced in our guidance. These pricing principles promote cost reflectivity of tariffs.

In a submission responding to our draft decision, CALC raised concern about the impact of large price increases on low income and vulnerable customers.<sup>52</sup> We note South Gippsland Water's response to our draft decision proposes to increase prices by inflation only.

For the reasons set out above, our final decision approves South Gippsland Water's proposed tariffs. Our price determination for South Gippsland Water sets out the maximum prices it may charge for the two year period from 1 July 2018 (or the manner in which its prices are to be

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<sup>51</sup> Includes the tariffs of Icon Water, Sydney Water, Hunter Water, Gosford City Council, Wyong Shire Council, Power and Water Corp, Urban Utilities, Unity Water, SA Water and TasWater.

<sup>52</sup> Consumer Action Law Centre, op. cit., pp. 3 and 5.

calculated, determined, or otherwise regulated). Approved maximum prices for water and sewerage services applying to most residential and non-residential customers are set out at Tables 2.8 and 2.9.<sup>53</sup>

**Table 2.8** Final decision – water prices  
\$ 2018-19

	2018-19	2019-20
<b>Residential</b>		
Variable (\$/kL)	1.8240	1.8240
Fixed (\$/year)	306.00	306.00
<b>Non-residential</b>		
Variable (\$/kL)	1.8240	1.8240
Fixed (\$/year)	306.00	306.00

Note: Numbers have been rounded

**Table 2.9** Final decision – sewerage charges  
\$ 2018-19

	2018-19	2019-20
<b>Residential</b>		
Fixed (\$/year)	474.90	474.90
<b>Non-residential</b>		
Fixed (\$/year)	474.90	474.90

Note: Numbers have been rounded

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<sup>53</sup> On 23 May 2018 (after our consultation period had closed on our draft decision for South Gippsland Water), we received a submission from Kingspan Environmental and Urban Water Cycle Solutions under our consultation process for Western Water's draft decision. We have considered the views raised in the submission for our final decision and price determination for South Gippsland Water. Our response to the submission is set out in our final decision paper for Western Water.

## Adjusting prices

Our draft decision approved the continuation of South Gippsland Water's existing uncertain and unforeseen events mechanism. We approved the mechanisms on the basis that they are consistent with efficiency objectives, and reflect a continuation of current arrangements.<sup>54</sup>

We also developed price adjustment formulas that allow prices to adjust for changes in the cost of debt.

No other new considerations were presented in submissions received following the draft decision which caused us to change views on price adjustment mechanisms.

Our final decision approves South Gippsland Water's uncertain and unforeseen events mechanism and updated price adjustment mechanisms.

## 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 corporations and developers to negotiate a site-specific arrangement.

Our draft decision required South Gippsland Water to resubmit its new customer contribution charges in response to our draft decision.

In its response to our draft decision South Gippsland Water proposed that existing unique sewerage charges applying to pressurised sewerage systems in Poowong, Loch, Nyora and Alberton be abolished.<sup>55</sup> In areas serviced by pressurised sewerage systems, South Gippsland Water proposed that a negotiated contribution charge would apply in addition to the standard sewerage new customer contribution charge. The negotiated charge would recover the additional asset costs associated with pressurised sewerage systems.

South Gippsland Water did not propose any changes to its existing standard water and standard sewerage charges in its response to our draft decision. South Gippsland Water stated that its standard new customer contribution charges and negotiated charges are calculated in line with the new customer contribution pricing principles.

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<sup>54</sup> WIRO clauses 8(b)(i)(ii) and (iii).

<sup>55</sup> South Gippsland Water's response to our draft decision is available on our website.



No other new considerations were presented in submissions received following the draft decision which caused us to change our views on new customer contributions charges.

Our final decision accepts the continuation of South Gippsland Water's existing standard water and sewerage new customer contribution charges at existing levels (plus inflation), as they are calculated in accordance with our new customer contribution pricing principles.<sup>56</sup>

Our final decision also accepts South Gippsland Water's method of calculating negotiated contribution charges in line with our new customer contribution pricing principles.

Our price determination for South Gippsland Water sets out the approved new customer contribution charges for the two year period from 1 July 2018 (or the manner in which its prices are to be calculated, determined, or otherwise regulated).

South Gippsland Water should update and publish any development servicing plans and negotiation protocols to assist developers understand the underlying assumptions of its new customer contribution charges.<sup>57</sup> Having this information easily accessible would be particularly helpful for developers given South Gippsland Water's shift to negotiated charges for pressurised sewerage connections.

## Financial position

In approving prices, we must have regard to the financial viability of the water industry.<sup>58</sup> 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 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.

Our guidance set out key indicators of forecast financial performance. We have reviewed forecasts for these key indicators based on our final decision on South Gippsland Water's prices. We have also taken into account its response to our draft decision, which proposed prices that were below the amount provided for in our draft decision.

We have assessed that, under our final decision, South Gippsland Water will generate sufficient cash flow to deliver on service commitments, including financing costs arising from investments to

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<sup>56</sup> Essential Services Commission 2016, *Guidance paper*, op. cit., p. 62.

<sup>57</sup> Essential Services Commission 2013, *New Customer Contributions: Explanatory Note*, December, pp. 9-11.

<sup>58</sup> WIRO clause 8(b)(ii) and ESC Act section 8A(1)(b).

meet service expectations. We do not consider that the revenue foregone by South Gippsland Water (noted on page 8) will negatively impact its financial viability.

### 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 final decision is to approve a return on equity of 3.9 per cent, based on our assessment of South Gippsland Water's PREMO rating.

#### Our review of South Gippsland Water's PREMO rating

South Gippsland Water's proposed PREMO rating, and our draft and final decision are summarised below (Table 3.1).

**Table 3.1** PREMO Rating

	Overall PREMO rating	Risk	Engagement	Management	Outcomes
South Gippsland Water's rating	<b>Standard</b>	Standard	Advanced	Standard	Standard
Commission's draft decision rating	<b>Not rated</b>	Basic	Standard	Not rated	Standard
Commission's final decision rating	<b>Not rated</b>	Basic	Standard	Not rated	Standard

Our draft decision did not assign an overall PREMO rating to South Gippsland Water's price submission. Among other things, this reflected our view that South Gippsland Water's price submission did not comply with the requirements of our guidance.

South Gippsland Water did not comment on this in its response to our draft decision.

Our final decision is therefore consistent with our draft decision – we have not assigned South Gippsland Water an overall PREMO rating for the two year period. Our reasoning is set out in our draft decision.

## Appendix A – submissions received on draft decision

Name or organisation	Date received
Kingspan Environmental and Urban Water Cycle Solutions	23 May 2018
Water Services Association of Australia	15 May 2018
Consumer Action Law Centre	8 May 2018

## Appendix B – approved service standards

We have approved the following standards and conditions of service and supply and associated targets for South Gippsland Water.

### South Gippsland Water's approved service standards

Service Standard	2018-19	2019-20
<b>Water</b>		
Number of customers experiencing more than 5 unplanned water supply interruptions in the year (number)	0	0
Average time taken to attend bursts and leaks (priority 1) (minutes)	30	30
Average time taken to attend bursts and leaks (priority 2) (minutes)	35	35
Average time taken to attend bursts and leaks (priority 3) (minutes)	500	500
Average duration of unplanned water supply interruptions (minutes)	100	100
Average duration of planned water supply interruptions (minutes)	240	240
<b>Sewerage</b>		
Customers receiving more than 3 sewer blockages in the year (number)	0	0
Average time to attend sewer spills and blockages (minutes)	30	30
Average time to rectify a sewer blockage (minutes)	120	120
Spills contained within 5 hours (per cent)	100	100

Note: Numbers have been rounded

## Appendix C – approved GSL schemes

We have approved the following service level obligations and corresponding amounts of payment for failure to attain the stated obligation as the guaranteed service level (GSL) scheme for South Gippsland Water.

In accordance with clause 13 of our Customer Service Code: Urban Water Businesses, South Gippsland Water must ensure that any payment is made to a customer as soon as practical after a customer becomes entitled to the GSL payment.

South Gippsland Water is not required to make a payment where the failure to meet the service level is due to the action or inaction of the customer or a third party. For the avoidance of doubt, third party does not include any person or firm acting on behalf of South Gippsland Water.

### South Gippsland Water's approved GSL scheme

Approved service level obligation	Approved payment (\$)
Unplanned water interruptions restored within five hours	100
Unplanned sewer service interruptions rectified within 5 hours	100
Sewage spill within a customer's house	1000
Payment difficulty information disclosure	300

## Appendix D – rate of return

A submission from the Consumer Action Law Centre (CALC) recommended we set the benchmark cost of debt at five per cent or around one per cent lower than the amount allowed in our draft decision (6.05 per cent per annum in nominal terms). It also recommended that we reduce each of the equity values in the PREMO matrix by one per cent. CALC submits that government owned water corporations carry less risk than private corporations, and as such, the allowed cost of debt and the return on equity should be lowered, compared with the rates allowed in our draft decision.<sup>59</sup> These recommendations are based on a report prepared by CME for CALC.<sup>60</sup>

Victoria's water corporations are subject to the competitive neutrality measures the Victorian government agreed to implement as part of the national competition policy agreement and related reforms.<sup>61</sup> This includes ensuring that borrowing costs reflect an estimate of a water corporation's standalone risk profile and credit rating. We note that:

- Victoria's water corporations do not access debt capital markets directly, but rather, their debt is managed by the state government treasury corporation, through the issuance of government bonds. While the treasury corporation may have access to lower debt funding costs due to government's higher credit rating, the water corporation's borrowing costs do not reflect this. Rather, the water corporations borrow from the state treasury corporation at rates consistent with the risk inherent in the businesses as reflected in their stand-alone credit rating.
- The difference between the government's borrowing costs and the costs faced by water corporations represents consideration for state taxpayers accepting the corporations' credit risk. This is achieved via the Financial Accommodation Levy (FAL), which seeks to ensure the borrowing cost faced by each water corporation reflects the nature of their businesses, not the tax powers of government. If state-owned service providers accessed debt markets directly, then they would face debt financing interest rates that reflected their stand-alone credit ratings.

In keeping with these policy parameters, the approach we take to the cost of debt is to adopt a benchmark rate that applies to all water corporations. The benchmark reflects our estimate of the efficient financing costs for a privately owned business facing a similar degree of economic risk to

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<sup>59</sup> Consumer Action Law Centre, op. cit.

<sup>60</sup> *ibid.*, Appendix A.

<sup>61</sup> We note the Water Services Association of Australia supports application of competitive neutrality principles, see Water Services Association of Australia 2016, *Submission to the Essential Services Commission: A new model for pricing services in Victoria's water sector*, July, p. 11.



a regulated water corporation. We consider this is consistent with the requirements of the Water Industry Regulatory Order 2014 (WIRO).<sup>62</sup>

Adopting the approach recommended by CALC would mean the allowed rate for the cost of debt may be lower than the rate faced by a benchmark efficient water corporation. As well as being inconsistent with government policy that water corporations pay an estimate of a commercial equivalent borrowing rate, it would also be inconsistent with the WIRO's viability and efficiency objectives. Our approach is also similar to that adopted by other Australian economic regulators.

CALC's submission also recommended a one per cent reduction to each return on equity value in the PREMO matrix.<sup>63</sup> CME proposed the reduction mainly based on comparisons with the return allowed for UK water entities, and its view that government-owned water corporations carry less risk than comparable privately owned businesses.

We believe the most relevant comparisons for the return on equity are other economic regulators in Australia. We note the rate for the return on equity (and the overall regulatory rate of return, comprising the cost of debt and the return on equity) approved in our draft decision are within the range of rates estimated by other Australian-based regulators.<sup>64</sup>

Also, our current view is that the allowed return on equity should not be adjusted to reflect government ownership. In deriving the values for the return on equity in the PREMO matrix, we had regard to the return on equity we had allowed in the past, and the incentives for water corporations to provide high quality price submissions in the interests of their customers.

CME also argues for a reduction in return on equity to reflect the prevailing revenue cap form of price control. This reflects that a revenue cap provides a water corporation with greater revenue certainty than other forms of price control, such as a price cap. We note however, that only one urban water corporation in Victoria (Yarra Valley Water) has a revenue cap form of price control. As well, a revenue cap does not necessarily change the level of systematic risk faced by a water corporation. For example, it is possible that a water corporation operating under a revenue cap is more exposed to cost risks than corporation operating under a price cap.<sup>65</sup>

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<sup>62</sup> Including, in particular, the requirements that our decision have regard to: the promotion of efficiency in regulated industries and the financial viability of the regulated water industry (cl 8(b)(ii) WIRO); efficiency in the industry and incentives for long term investment (s 8A(1)(a) ESC Act); and consistency in regulation between States and on a national basis (s 8A(1)(f) ESC Act).

<sup>63</sup> Consumer Action Law Centre, *op. cit.*

<sup>64</sup> Essential Services Commission of South Australia, *op. cit.*; Independent Pricing and Regulatory Tribunal 2017, *WACC biannual update*, August.

<sup>65</sup> For example, increases in water demand can lead to increased costs for a water corporation, which would not be matched by an increase in revenue, under a revenue cap. By contrast, under a price cap increases in water demand would also lead to an increase in revenue.

While our final decision has not agreed with CALC's recommendations, we will re-consider its arguments as part of any future review of the PREMO framework.