

15 December 2022



Westernport Water: Review of expenditure forecasts

2023 Water Price Review
Fast Track Report

FINAL REPORT

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Glossary

Term	Definition
AUD	Australian dollar
ESC	Essential Services Commission
FTE	Full time equivalent
FTI Consulting	FTI Consulting (Australia) Pty Ltd
PREMO	Performance, Risk, Engagement, Management and Outcome
PS4	Price Submission for the fourth regulatory period (2017-18 to 2022-23)
PS5	Price Submission for the fifth regulatory period (2023-24 to 2027-28)
WIRO	Water Industry Regulatory Order
WSAA	Water Services Association of Australia

Executive Summary

FTI Consulting has been engaged by the Essential Services Commission (the Commission) to undertake an independent expert review of 14 Victorian water businesses' forecast (controllable) operating and capital expenditure for the 1 July 2023 to 30 June 2028 (PS5) regulatory period.

The Commission is required to assess the water businesses' proposals against a legal framework set out in the *Water Industry Regulatory Order 2014* and the Commission's PREMO pricing framework. We have assessed Westernport Water's forecast operating and capital expenditure based on the guidelines contained in the Commission's *2023 Water Price Review: Guidance Paper*.

This report sets out our views as to whether Westernport Water's forecasts of capital expenditure and controllable operating expenditure over the regulatory period can be reasonably assessed to be prudent and efficient.

Forecast controllable operating expenditure

Westernport Water has proposed an average net increase in controllable operating expenditure (growth less efficiency factor) of 0.45 per cent per year for the regulatory period. When comparing this net result against other water businesses, Westernport Water is ninth out of 13 urban water businesses subject to this review.

Westernport Water's forecast operating expenditure reflects:

- baseline 2021-22 expenditure of \$16.38 million, which is \$1.56 million (or 10.5 per cent) above the benchmark allowance approved by the Commission in the previous price review
- total step changes to the baseline of \$4.4 million across the regulatory period
- an average growth factor in operating expenditure of 1.95 per cent per year and an efficiency factor of 1.50 per cent per year.

Based on Westernport Water's PS5 proposal and the further information and discussions to date, we have formed the view that the forecast controllable operating expenditure is consistent with a prudent business that operates efficiently and does not require any further adjustments. This reflects our assessment that:

- the key drivers of the overspend against the baseline appear reasonable, and the baseline does not appear to include any items that are non-recurring
- the proposed step changes are reasonable and supported by a sound rationale
- it is not reasonable to expect that these step changes could be absorbed by the business given the net growth factor of 0.45 per cent per year.

As a result, we have not proposed any adjustments to Westernport Water's forecast controllable operating expenditure for the PS5 regulatory period.

Forecast capital expenditure

Westernport Water has forecast capital expenditure of \$42.3 million for the PS5 regulatory period. This represents an increase on both the capital expenditure benchmark for the PS5 period included in the Commission's PS4 determination (21 per cent) and actual capital expenditure undertaken over the PS4 regulatory period (29 per cent).

Westernport Water's pricing submission provides a detailed breakdown of its forecast capital expenditure for the PS5 regulatory period. The further information provided to us by Westernport Water in relation to the key issues of further investigation provides a reasonable level of confidence that the proposed capital expenditure program is consistent with the actions of a prudent business operating efficiently. The forecast capital expenditure is justified, robust and is capable of being delivered by Westernport Water in the PS5 period.

As a result, we do not recommend any adjustments to Westernport Water's forecast capital expenditure for the PS5 regulatory period.

1. INTRODUCTION

1.1. Purpose of this report

The Essential Services Commission (the Commission) is reviewing submissions from 14 Victorian water businesses setting out their proposed prices, revenue requirement and key service outcomes to apply to water and sewerage services commencing in 1 July 2023 through to 30 June 2028 (referred to in this report as the PS5 regulatory period).¹ Each of the Victorian water businesses, including Westernport Water, submitted their proposals to the Commission for assessment on 30 September 2022.

FTI Consulting has been engaged to undertake an independent expert review of the water businesses' forecast operating expenditure and capital expenditure for the PS5 regulatory period. The scope of our review of operating expenditure is limited to controllable operating expenditure.

This report sets out our independent expert view of the prudence and efficiency of Westernport Water's capital expenditure and controllable operating expenditure forecasts for the PS5 regulatory period, in accordance with the requirements of the regulatory framework.

1.2. Context and challenges facing Victorian water businesses

The environment faced by most Victorian water business over the last few years has been significantly more challenging than envisaged in 2018 when the Commission approved the expenditure forecasts used to set water prices for the 1 July 2018 to 30 June 2023 (PS4) regulatory period.

The COVID-19 pandemic has been one of the unforeseen events that has impacted the Victorian water businesses' expenditure in several ways, including:

- requiring additional water and wastewater monitoring and treatment
- increasing customer hardship due to cost-of-living pressures
- disrupting business operations, including the ability to carry out maintenance activities and higher rates of staff absenteeism
- changing work practices, including social distancing and hygiene requirements as well as transitioning to enable staff to work from home

¹ The 14 water businesses include Barwon Water, Central Highlands Water, Coliban Water, East Gippsland Water, Gippsland Water, Goulburn Valley Water, GWMWater, Lower Murray Water, South East Water, South Gippsland Water, Southern Rural Water, Wannon Water, Westernport Water and Yarra Valley Water.

- disrupting supply chains, putting pressure on the availability and cost of inputs
- increasing migration from Melbourne to regional areas.²

These impacts have affected each water business's actual and forecast expenditure in different ways. Some water businesses have faced new costs or cost pressures, while others have enjoyed cost savings.

The effects of the COVID-19 pandemic continue to be felt nearly three years later. Some of these impacts are moderating as Victoria (and the rest of the country) adapts to a new phase of living with the pandemic. However, there is the potential for other more permanent changes, including changes to work practices and greater migration of people from major cities to regional areas. At the time of this review, the longer-term implications remain unclear.

There are other events and changes that were unforeseen (or at least unable to be fully anticipated) as part of the Commission's previous water price review. These include:

- the continued impacts of climate change on the frequency and severity of major weather events, including drought, bushfires and floods
- the continued evolution in climate change and environmental policy, including emission reduction strategies and targets, and associated compliance and reporting obligations
- a continued hardening of the insurance market, which also (at least partly) reflects the impacts of major climate-related events domestically and globally
- a ramping up of the need to do more to mitigate cyber security risks, including mandated obligations.

These issues and challenges *do not* imply or support a premise that:

- water businesses should continue to increase their operating and capital expenditure, and hence water and sewerage prices
- there should be lower expectations in terms of the need to drive efficiency savings in the longer term for the benefit of customers
- businesses should avoid responsibility for managing the risk of cost increases and/or passing more of those risks on to customers.

It further underlines the importance of scrutinising increases in expenditure, as well as proposed step changes, to ensure that they remain consistent with the actions of a prudent

² For example, refer: <https://population.gov.au/sites/population.gov.au/files/2021-09/the-impacts-of-covid-on-migration-between-cities-and-regions.pdf>, accessed 1 December 2022.

business operating efficiently, including in how it responds to the uncertainties and challenges in its operating environment. It also does not alter the standards that should be reasonably expected of businesses in supporting and justifying any increases in expenditure for the next regulatory period, including being able to provide adequate supporting documentation (such as Board-approved policies or strategies and business cases).

1.3. Water industry regulatory framework

The water businesses' proposals are being assessed against a legal framework set out in the *Water Industry Regulatory Order 2014 (WIRO)*³ and the Commission's PREMO framework for approving prices.⁴

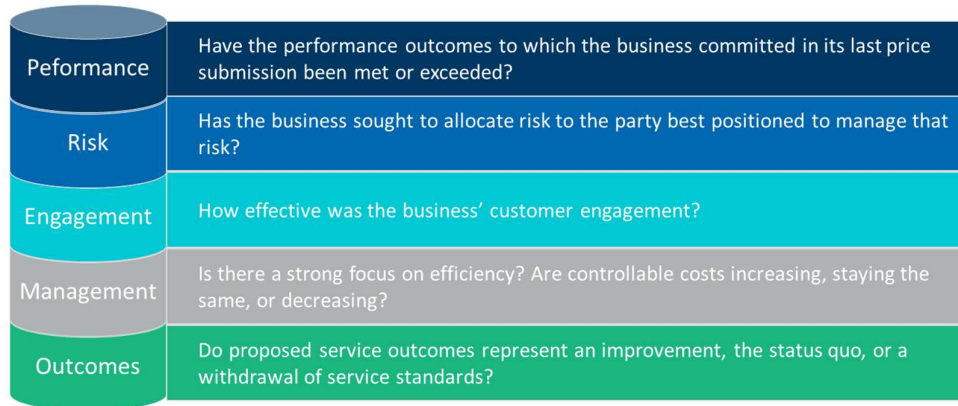
The Commission's regulatory framework places an emphasis on efficient delivery of services. Assessing the prudence and efficiency of a water business's expenditure forecasts is fundamental to achieving this objective.

In 2018, the Commission introduced a new approach called PREMO to regulate the prices charged to Victorian water businesses. As Figure 1.1 describes, the PREMO approach contains both new and conventional elements related to price, risk, engagement, management and outcomes. PREMO provides water businesses with incentives to put forward their best offer to customers and deliver the outcomes its customers value most and to deliver these as efficiently as possible.

³ The Water Industry Regulatory Order 2014 (WIRO) sits within the broader context of the *Water Industry Act 1994 (Vic)* and the *Essential Services Commission Act 2001 (Vic)*.

⁴ Essential Services Commission 2016, *Water Pricing Framework and Approach: Implementing PREMO from 2018*, October.

Figure 1.1: The Commission’s PREMO framework



More conventional elements of PREMO include the retention of the building block approach, which provides reasonable certainty that prudent and efficient costs can be recovered. This includes an expenditure review to determine whether a water business’s proposed capital and operating expenditure forecasts are consistent with the requirements of the regulatory framework.

Under the PREMO framework, each submission is expected to reflect the water business’s best offer to its customer base. Submissions may be fast tracked through the assessment process based on several factors. Some water business proposals may require a more detailed review of their proposed expenditure while others may only require a review of some elements of their proposed expenditure (for example, specific items where expenditure is increasing).

The *2023 Water Price Review: Guidance Paper* (the Guidance Paper) explains the Commission’s methodology and approach to assessing water businesses’ price submissions and making a price determination and sets out the information each business is required to provide in its price submission.⁵ The Guidance Paper also identifies the governing criteria for each component of the building block methodology, including forecast operating and capital expenditure.

This review is the second review under PREMO for these businesses. The Commission also expects price submissions to demonstrate how water businesses are building on their previous proposals to deliver value to their customers.

⁵ Essential Services Commission 2021, *2023 Water Price Review: Guidance paper*, 26 October.

1.4. Methodology and approach

The scope of our assessments is limited to examining water business's forecast controllable operating expenditure and capital expenditure over the PS5 regulatory period. It does not include examining decisions about whether to fast track a water business's PS5 submission, nor does it involve assessing other elements of the PREMO framework such as past performance or engagement.

Our methodology for assessing Westernport Water's capital and operating expenditure forecasts for the next regulatory period is consistent with the Commission's Guidance Paper. In summary, the scope of our review includes:

- for forecast operating expenditure, our assessment focuses on controllable expenditure only. We have assessed proposals using the base-step-trend approach as set out in the Commission's Guidance Paper and is consistent with the basis on which each water business has submitted information as part of their price review model templates
- for forecast capital expenditure, our assessment focuses on the Top 10 major projects and major capital expenditure programs that comprise a significant proportion of the water business's total capital expenditure forecast.

Further detail about our assessment framework as it has been applied is set out in Section 3 (Operating expenditure assessment) and Section 4 (Capital expenditure assessment).

Our process has involved several steps:

- an initial review of PS5 price submissions, financial model templates and associated documentation
- comparison of each of the water business's proposed capital and operating expenditure proposals, including assumptions adopted in relation to growth trends, efficiency factors, and comparison of actual and proposed expenditure
- a Stage 1 (preliminary) assessment workshop undertaken with Commission staff identifying the key issues to be explored in our more detailed review
- visits and/or online discussions with each of the water businesses on key issues related to their proposal
- further review and analysis of further information or explanations provided.

1.5. Structure of this report

The structure of this report is as follows:

- Chapter 2 provides a high-level summary of the Westernport Water’s expenditure proposal
- Chapter 3 sets out our assessment of Westernport Water’s operating expenditure proposals
- Chapter 4 sets out our assessment of Westernport Water’s capital expenditure proposals.

Consistent with the Commission’s guidance paper and the price review model completed by businesses, all forecasts are expressed in dollars as 1 January 2023.

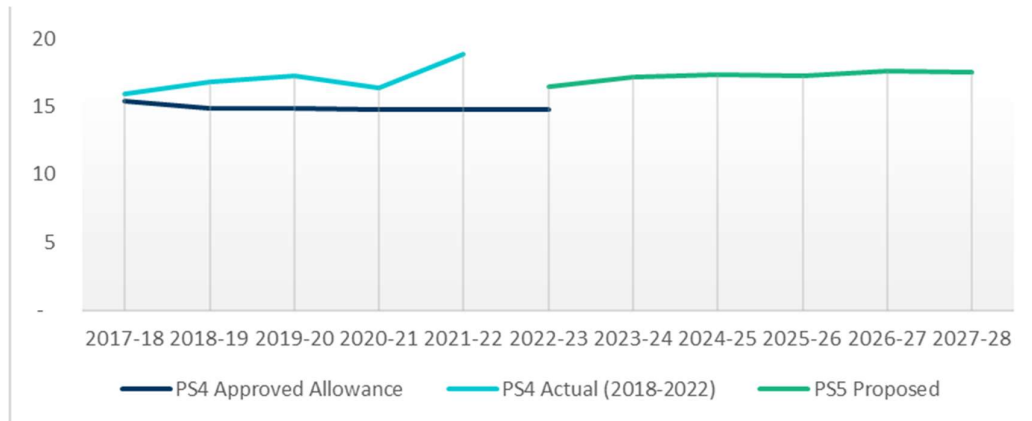
2. SUMMARY OF EXPENDITURE PROPOSAL

2.1. Forecast controllable operating expenditure

For the current PS4 regulatory period, the Commission approved a total controllable operating expenditure benchmark allowance for Westernport Water of \$74.17 million (in \$ 1 January 2023).⁶

For the first four years of the PS4 regulatory period, Westernport Water's actual operating expenditure was \$9.96 million (16.8 per cent) above the benchmark allowance approved by the Commission for those four years.

Figure 2.1: Westernport Water's actual and forecast controllable operating expenditure by year (in \$m, 1 January 2023)



'PS4 Approved Allowance' relates to the approved operating expenditure benchmark allowance for 2017-18 to 2022-23.

Source: Westernport Water, WPW_2023 Price Review Model, 26 October 2022; Essential Services Commission 2018, Westernport Water Determination Price Review Model: 1 July 2018 – 30 June 2023, 29 May.

Westernport Water's baseline 2021-22 controllable operating expenditure is \$16.38 million, which is \$1.56 million (or 10.5 per cent) above the benchmark allowance approved by the Commission in the last price review.

⁶ Essential Services Commission 2018, Westernport Water Determination: 1 July 2018 – 30 June 2023, 29 May.

Westernport Water has proposed a step change increase to the baseline of \$4.4 million across the PS5 regulatory period, comprising:

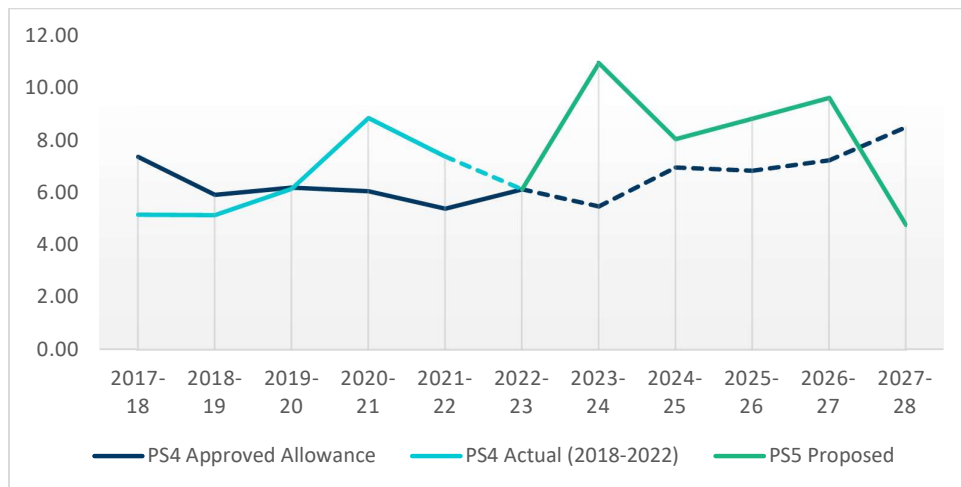
- \$1.38 million of additional employee costs
- \$3.02 million of additional costs associated with new capital projects.

Westernport Water has forecast an average growth factor for operating expenditure of 1.95 per cent per year and an efficiency factor of 1.5 per cent per year over the PS5 regulatory period.

2.2. Forecast capital expenditure

Westernport Water has forecast capital expenditure of \$42.3 million for the PS5 regulatory period. This represents an increase on both the capital expenditure benchmark for the PS5 period included in the Commission’s PS4 determination (21 per cent) and actual capital expenditure undertaken over the PS4 regulatory period (29 per cent), as shown in Figure 2.2.

Figure 2.2: Westernport Water’s actual and forecast capital expenditure by year (in \$m, 1 January 2023)



'PS4 Approved Allowance' relates to the approved capital expenditure benchmark allowance for 2017-18 to 2022-23, and their 2018 forecast for 2023-24 to 2027-28.

Source: Westernport Water, WPW_2023 Price Review Model, 26 October 2022; Essential Services Commission 2018, Westernport Water Determination Price Review Model: 1 July 2018 – 30 June 2023, 29 May.

The key drivers, projects and programs are well linked to customer outcomes and engagement results as defined in the submission and supporting documentation, and include:

- renewals (43 per cent of the program)
- growth (28 per cent of the program)
- 10 major projects (\$17.4 million)
- 10 major programs (\$17.56 million).

Westernport Water’s Top 10 capital expenditure projects, shown in Table 2.1, account for 41 per cent of its proposed capital expenditure for the PS5 regulatory period.

Table 2.1: Westernport Water’s Top 10 capital expenditure projects (in \$ 1 January 2023)

Major capital expenditure project	Proposed cost (\$ million)
Recycled Water Wetland Storage	4.34
Water Quality Continuous Improvement Program	2.10
Bio-Gas Waste to Energy	1.88
Renewable Energy Generation	1.56
Wastewater Systems Future	1.51
Cowes Wastewater Treatment Plant Upgrade – Stage 3	1.35
Asset Management Information System Upgrade	1.30
Treatment Plant Energy Efficiency Project	1.28
Sustainable Reuse and Afforestation	1.13
King Road Wastewater Treatment Plant Pump Station Upgrade	0.99

Source: Westernport Water 2022, Price Submission 2023-28, 30 September.

3. OPERATING EXPENDITURE ASSESSMENT

3.1. Overview of assessment approach

The Commission's Guidance Paper notes the requirement that forecast operating expenditure is:

... operating expenditure which would be incurred by a prudent service provider acting efficiently to achieve the lowest cost of delivering on service outcomes over the regulatory period, taking into account a long-term planning horizon (prudent and efficient forecast operating expenditure).⁷

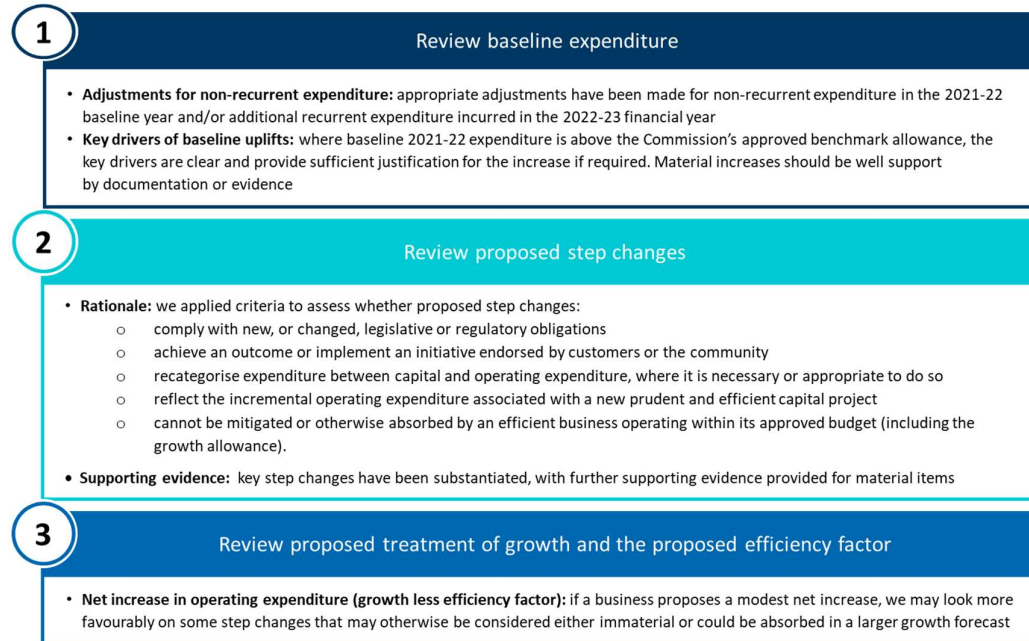
The Commission has asked us to provide an independent expert view on whether Westernport Water's forecast controllable operating expenditure is prudent and efficient having regard to the base-step-trend approach and assessment criteria set out in its Guidance Paper.

We have assessed whether forecast controllable operating expenditure is consistent with the actions of a prudent business acting efficiently, including if:

- the established 2021-22 controllable operating expenditure baseline has been appropriately adjusted for any one-off expenditure items and efficiency commitments
- operating costs reflect reasonable cost efficiency/productivity assumptions applied to the 2021-22 baseline operating expenditure, having regard to industry trends
- changes in operating costs are consistent with the timing of major capital projects
- operating costs can fulfil the business's obligations and meet customer service expectations as efficiently as possible
- any forecast divergence from historical trends in operating expenditure can be readily explained, for example, by changes in obligations imposed by government, including technical, regulatory and customer service expectations.

⁷ Essential Services Commission (2021). 2023 Water Price Review: Guidance Paper, 26 October (August 2022 Amendment), p. 28.

The key steps in our approach were as follows.



In assessing proposed increases in expenditure, including step changes, we have had regard to each business's approach to allowing for growth and efficiency, and the resulting net growth factor for the PS5 regulatory period. For example, some businesses have proposed more ambitious efficiency targets (resulting in negative net growth in expenditure over the PS5 regulatory period) and/or have sought to recognise economies of scale in allowing for growth.

This is a relevant factor in considering the business's ability to absorb cost increases, including proposed step changes, which has required us to apply judgement in assessing the reasonableness of the business's proposals.

3.1.1. Key operating expenditure drivers across water businesses

We have identified several areas of operating expenditure that are common across water businesses. This includes four key areas summarised in Table 3.1.

We have not sought to directly benchmark these costs across the water businesses as the requirements of each business will vary, although these comparisons do further assist in identifying those businesses that might be looking at material increases in expenditure. Instead, we have sought to apply the same level of rigour in analysing this expenditure

across businesses, particularly where increases are material (for example, are material increases in IT expenditure supported by evidence, such as an IT strategy or business case).

Table 3.1: Common operating expenditure issues

Expenditure category	What we have examined
Electricity	<p>The application of the Schneider electricity price forecasts, which was commissioned by the businesses to enable reference to a consistent methodology and forecast estimates.</p> <p>The approach to meeting the Victorian water sector’s commitment to the State Government to source 100 per cent of their energy requirements from renewables by 2025, recognising that each business’s approach will reflect its own circumstances and operating environment (this can also include capital projects).</p>
Labour	<p>The rationale for any material growth in employee numbers.</p> <p>Remuneration increases, having regard to each organisation’s Enterprise Agreement (EA) as well as conditions in labour markets, with several regional businesses citing challenges in attracting and maintaining people with the right skills. Some businesses have also referred to the Victorian Government’s 2022 PEER review of executive remuneration.</p>
IT	<p>Software as a Service (Saas), with all businesses either having transitioned, or are in the process of transitioning, to cloud-based services. This has also resulted in expenditure that would have been classified as capital expenditure now treated as operating expenditure.</p> <p>Cyber security, which is an important issue for all water businesses as well as utilities and other corporations more generally. This includes compliance with new obligations.</p>
Insurance	<p>All businesses facing material increases in insurance costs in the hardening market, which has also been impacted by major climate-related events domestically and globally.</p>

The following sections summarise our assessment of Westernport Water’s forecast controllable operating expenditure for the PS5 regulatory period.

3.2. Assessment of the baseline

After adjusting for non-recurring items, Westernport Water’s adjusted controllable operating expenditure in 2021-22 was \$16.38 million. This represents an increase in actual expenditure of \$1.56 million or 10.5 per cent compared to the \$14.83 million benchmark allowance approved by the Commission as part of the last price review.

We have assessed the reasonableness of Westernport Water’s baseline operating expenditure by verifying that:

- any overspend against the benchmark allowance is consistent with what is required by a prudent business operating efficiently

- the forecast operating expenditure does not include any items that are non-recurring.

Westernport Water's PS5 submission explained that the overspend in its baseline operating expenditure against the benchmark allowance is attributed to the following key drivers:

- **Growth** – residential connections are 2.5 per cent above the forecast reflected in the approved benchmark allowance for the current regulatory period, and non-residential connections are 7 per cent below the level forecast. The increase in residential connections has led to a higher volume of customer transactions, and hence the need to employ an additional customer service team member and an additional meter reader.
- **Demand** – water consumption was 10 per cent greater than the forecast reflected in the approved benchmark allowance for the current regulatory period, resulting in additional treatment costs.
- **Compliance** – new or amended obligations introduced during the current regulatory period resulted in an increase in contractor and consultancy costs. An increased focus on cyber security also increased IT expenditure to ensure that controls and mitigations are tested and effective.
- **Staffing costs** – Westernport Water has paid staff at the higher end of the salary bands to attract and retain employees with the appropriate skills and experience. The assumption used to set prices for the current regulatory period was at the mid-point of each salary band.
- **COVID-19** – several additional costs were incurred that were associated with adapting to the changing operating environment due to COVID-19.

While Westernport Water's submission included this explanation of key drivers, it did not separately quantify these drivers. While noting that a number of these drivers are common to other businesses, we sought a further breakdown of these costs from Westernport Water given the materiality of the overspend relative to the 2021-22 approved benchmark allowance (that is, a 10.5 per cent increase). Table 3.2 sets out the further detail provided by Westernport Water.

Table 3.2: Overspend of operating expenditure against the benchmark allowance in 2021-22 by driver (in \$ 1 January 2023)

Driver	Overspend \$'000
Growth	160.2
Demand	232.9
Compliance	414.5
Staffing costs	347.4
Other	409.2
Total	1,564.2

Source: Email from General Manager, Corporate & Customer, Pricing Submission Information Request – Westernport Water, 26 October 2022.

We sought further explanation from Westernport Water regarding the increase in compliance costs (\$414 500), particularly the quantum that was attributable to new or amended obligations and for cyber security. The further information provided by Westernport Water indicated that:

- \$140 000 was attributable to additional costs required to meet increasing cyber security risks
- \$164 000 was attributable to meeting expanded requirements for existing obligations
- \$110 000 was attributable to new obligations introduced during the regulatory period.

After reviewing the explanation in Westernport Water’s price submission, as well as the further information provided, we have been able to confirm that there is a clear rationale for the cost increases and that they are consistent with a prudent business acting efficiently. We can also confirm that these costs are recurrent.

We therefore do not propose to make any further adjustments to Westernport Water’s proposed baseline and it does not appear to include any items that are non-recurring.

3.3. Assessment of the step changes

Westernport Water has proposed a step change increase to its baseline 2021-22 operating expenditure of \$4.40 million across the next regulatory period, comprising additional employee costs and additional costs associated with new capital projects.

We assessed the reasonableness of these step changes having regard to whether they:

- comply with new, or changed, legislative or regulatory obligations
- achieve an outcome or implement an initiative that is endorsed by customers or broadly meets accepted changes in community expectations
- recategorise expenditure between capital and operating expenditure, where the business can demonstrate that it is necessary or appropriate to do so
- reflect the incremental operating expenditure associated with a new prudent and efficient capital project
- cannot be mitigated or otherwise absorbed by an efficient business operating within its approved budget (including the growth allowance).

In its PS5 submission, Westernport Water explained the key drivers of these step changes as follows:

- Employee costs (\$1.38 million) – the 2021-22 baseline year experienced a vacancy rate of 6 per cent compared to the typical rate of 3 per cent (which was the rate assumed in the Commission’s approved 2021-22 benchmark allowance). These vacant positions were largely for key personnel in the engineering and maintenance team that were subsequently filled in September 2022. There is also a reduction of 0.4 FTE in the 2025-26 year as the planned efficiencies in the People and Culture team are realised through improvements to the HR information system.
- New capital projects (\$3.02 million) – this relates to incremental expenditure largely attributable to preventative maintenance, IT related licence fees and additional initiatives. Westernport Water provided extensive detail regarding these costs in its price submission.⁸

For the second step change category, we found that the detailed information regarding capital-related costs provided sufficient evidence on the prudence and efficiency of these costs based on our step change criteria. The information provided by Westernport Water set out the customer outcomes that each additional cost item related to, as well as a breakdown of the forecast costs per year of the PS5 regulatory period.

We sought further detail from Westernport Water on the employee costs. The following is a summary of the further explanation provided by Westernport Water.

As noted above, the approved operating expenditure benchmark allowance was based on a forecast that assumed a 3 per cent vacancy rate. However, the actual vacancy rate in 2021-22 was 6 per cent due to the resignation of a general manager and an increase in vacancies across the assets and engineering teams.

⁸ Westernport Water, PS5 price submission 2023-28, p. 87.

This also means that the higher vacancy rate could have resulted in lower actual employee costs in that year – that is, Westernport Water was not paying salaries for the additional 3 per cent of positions that were vacant. However, this saving was outweighed by the increase in salaries resulting from the decision to pay some staff at the upper end of the salary band (rather than the mid-point assumed in the forecast), as outlined in section 3.2 above.

Given actual baseline year expenditure reflects a 6 per cent vacancy rate, refilling those vacant positions back to the typical rate of 3 per cent results in a step change.

The second driver of the employee cost step change is that the business has added:

- a new temporary 0.4 FTE position to focus on the Gender Equality Action Plan, which ends in 2025
- a new ongoing compliance role (1 FTE) focused on climate change action, in line with the Minister for Water’s Statement of Obligations (Emission Reduction).

Westernport Water also indicated that in real dollars, the part of the step change that can be attributed to salary costs will reduce each year of the PS5 regulatory period because the approved wage growth provided for in the Enterprise Agreement (2.5 per cent years 1-3 and 2 per cent years 4-5) is less than the forecast consumer price index of more than 3 per cent.

Based on this information, we are satisfied that Westernport Water’s step change in employee costs reflects our step change criteria.

While Westernport Water’s net growth factor of 0.5 per cent per year in assessing whether its proposed step changes should be absorbed by the business rather than approved as a step change to baseline operating expenditure. We have concluded that these costs are sufficiently material to warrant an increase to baseline operating expenditure for the PS5 regulatory period.

Overall, based on the information provided by Westernport Water, we have been able to confirm that:

- there is a clear rationale for the step changes and that they are consistent with a prudent business acting efficiently, having regard to our step change criteria
- they are sufficiently material to allow these increases to baseline operating expenditure rather than assume that they should be absorbed by the net growth factor.

3.4. Forecast growth and efficiency factors

Westernport Water is forecasting average growth in operating expenditure of 1.95 per cent per year and an efficiency factor of 1.5 per cent per year over the PS5 regulatory period. This results in a net increase in operating expenditure over the PS5 regulatory period of 0.45 per cent per year. When comparing this net result against other water businesses, Westernport Water is ninth out of 13 urban water businesses subject to this review (see Table 3.3).

Table 3.3: Net average increase in operating expenditure per year by urban water business

Water business	Net average annual increase
South East Water	-0.9%
GWMWater	-0.8%
Wannon Water	-0.3%
Gippsland Water	-0.2%
Yarra Valley Water	-0.2%
Lower Murray Water (Urban)	0.0%
Barwon Water	0.1%
South Gippsland Water	0.2%
Westernport Water	0.5%
Coliban Water	0.5%
East Gippsland Water	0.7%
Goulburn Valley Water	1.1%
Central Highlands Water	1.2%

Source: Calculated from pricing models submitted by each of the Victorian water businesses to the Commission, 30 September 2022.

3.5. Summary of operating expenditure assessment

Based on Westernport Water's PS5 submission, discussions with the business and the further information it provided, the adjusted operating expenditure in 2021-22 is consistent with a prudent business that operates efficiently and does not require any further adjustments. This reflects our view that:

- the key drivers of the overspend against the baseline appear reasonable, and the baseline does not appear to include any items that are non-recurring
- the proposed step changes are reasonable and supported by a sound rationale
- it is not reasonable to expect that these step changes could be absorbed by the business given the net growth factor of 0.45 per cent per year.

As a result, we do not propose any adjustments to Westernport Water's forecast controllable operating expenditure for the PS5 regulatory period.

4. CAPITAL EXPENDITURE ASSESSMENT

4.1. Overview of assessment approach

The Commission's Guidance Paper states that forecast capital expenditure is:

.... capital expenditure that would be incurred by a prudent service provider acting efficiently to achieve the lowest cost of delivering service outcomes, taking into account a long-term planning horizon (prudent and efficient forecast capital expenditure).⁹

We have assessed Westernport Water's proposed capital expenditure program against the criteria set out in Figure 4.1.

Figure 4.1: Criteria used to assess forecast capital expenditure

Assessment of capital program
<ul style="list-style-type: none">• Link to customer service outcomes, regulatory obligations and risk management• Comparison of forecast and actual capital expenditure• Reliability of cost estimation• Deliverability of capital program
Assessment of major capital projects and programs
<ul style="list-style-type: none">• Major capital projects and programs are clearly justified• Proposed delivery solution is reasonable

Having regard to these criteria, we have also considered whether any adjustments to the proposed expenditure forecast would be considered appropriate, material and justified.

We have assessed Westernport Water's forecast capital expenditure for the PS5 regulatory period focusing primarily on a review of how asset management, capital planning and prioritisation processes have been applied. We have also reviewed key supporting documentation for a sample on the Top 10 capital expenditure projects which account for around 41 per cent of its forecast capital expenditure for the PS5 regulatory period.

⁹ Essential Services Commission 2021, 2023 water price review, Guidance paper, 26 October, p. 33.

Our assessment is based on a review of the information contained in Westernport Water's PS5 submission and responses to additional information requests we raised based on the above criteria.

Although Westernport Water's submission supporting its proposed capital expenditure program was strong overall, with good context and justification in relation to the forecast expenditure increase and associated drivers, we requested additional information to further test the justification for the forecast increase in capital expenditure for the PS5 regulatory period compared to PS4 regulatory period. The information requested related to the following issues:

- **Business cases:** whether Westernport Water had prepared any finalised business cases (as business cases provided were preliminary), in which it considered alternative options, and the level of confidence that the preferred option would be considered efficient.
- **Recycled water and wetland storage business case:** clarifying the key driver for this project and consideration of other options, the Environment Protection Authority (EPA) licence requirements that realistically could be breached, further background to the growth estimates used affecting timing for increased flows to treatment plants, confidence with the growth predictions that influence inflows, whether any scenario assessment planning been undertaken (such as alternative higher and lower growth rates) and information comparing the assumed growth compared to actuals in previous years.
- **Unspecified renewals:** clarifying how much unspecified renewals contributes to overall expenditure, understanding the difference between PS4 and PS5 unspecified renewals expenditure.
- **Odour and corrosion program:** confirming the level of confidence in the timing of this project and whether this expenditure could be deferred into the PS6 period.
- **Customer priorities:** including whether customers were asked if they supported increased expenditure in recycled water and wetland construction.
- **Renewable energy:** including whether options were considered to purchasing renewable energy credits as opposed to investing in renewable energy infrastructure – and how they compared, and that corresponding operating expenditure savings are assumed.

Westernport Water responded promptly with all requested additional information and documentation, including detailed documentation setting out the capital planning processes used to develop the program, relevant reports, asset renewal and management plans and strategies as well as major project and program business cases.

4.2. Assessment of overall capital program

Westernport Water is currently forecasting that it will deliver all Top 10 projects in the current PS4 regulatory period together with the balance of its capital program at a spend of \$33.8 million. This represents a \$4.2 million (14 per cent) increase to the PS4 approved benchmark allowance of \$29.66 million.

Westernport Water has forecast capital expenditure of \$42.3 million for the PS5 regulatory period, which represents an increase of 21 per cent over actual/forecast expenditure in PS4 and a 35 per cent increase compared to the PS5 forecast included in its PS4 submission.

The major areas contributing to these relative increases in the capital program relate primarily to:

- increased network capacity to service forecast demand and growth
- sustaining existing performance levels via targeted renewal activity
- investments in renewable energy.

The documents and information submitted by Westernport Water provide good support and reasonable explanations for the increased spend in the PS4 regulatory period.

4.2.1. Link to customer outcomes and obligations

The key drivers, projects and programs appear to be well linked to customer outcomes and engagement results, and include:

- renewals (43 per cent of the program)
- growth (28 per cent of the program)
- 10 major projects (\$17.4 million)
- 10 major programs (\$17.56 million).

The supporting strategy and business case documents reviewed provide strong justification for the projects and programs that underpin the overall capital expenditure program and forecast. They also provide insight into how each element of the program supports Westernport Water's four key customer expectations:

- affordable products and services for everyone
- maintenance of existing service levels
- further improvement in drinking water quality
- accelerated investment to respond to climate change.

4.3. Process of developing overall capital expenditure program

Westernport Water uses a capital works planning and prioritisation process based on guidelines set by the Water Services Association of Australia (WSAA). The prioritisation process is also aligned to Westernport Water's Project Management Framework, and has been designed to ensure that:

- project submissions are justified as both prudent and efficient and are prepared in a consistent and comparable manner
- projects are prioritised having regard to their contribution to customer outcomes and the level of additional risk taken on by Westernport Water if deferred
- define a robust and deliverable capital program.

Good evidence was provided showing that the associated frameworks and processes have been applied in developing the PS5 capital expenditure program, with significant executive team and Board oversight.

4.4. Approach to cost estimation

Westernport Water's approaches to cost estimation appear to provide an appropriate basis for developing the budget estimates for its PS5 capital expenditure program. Westernport Water advised that its business cases and base cost estimates for all major projects have been independently reviewed by external consultants and it has undertaken probability modelling of contingencies to assess the P50/P90 outcome costs depending on the complexity of the project. These approaches to cost estimation used by Westernport Water appear to provide a robust and appropriate basis for developing the budget estimates for its PS5 capital expenditure program.

4.5. Deliverability of capital program

We are satisfied that Westernport Water has the appropriate capacity to deliver the capital program for the PS5 regulatory period given its relatively minor complexity and scope given that it:

- has completed seven of the Top 10 projects for the PS4 regulatory period, and the remaining three projects are on track to be completed by 30 June 2023
- has a project management structure in place and internal project management resources to deliver its proposed capital expenditure program
- draws on a consultant panel for concept designs, detailed designs and tender preparation as required to assist in project planning and delivery of the capital program.

These factors provide a good level of confidence that robust arrangements will be ready and in place to support implementation of the proposed program

4.6. Assessment of major projects and programs

4.6.1. Major projects and programs

We requested from Westernport Water business cases for each of the capital projects in its PS5 submission, as well as information to support the increased unspecified (unplanned) renewal spend programs.

Westernport Water provided 'preliminary' business cases for five of the Top 10 projects and an Unspecified Asset Renewal Strategy. These preliminary business cases did not include any detailed analysis of options other than a 'do nothing' option.

We undertook a further detailed review of the business case for Westernport Water's largest capital expenditure item associated with the Recycled Water Project. Our focus was on understanding Westernport Water's rationale and assessment of the most prudent and efficient option. Westernport Water provided responses addressing most of our initial concerns, including details of how the preferred options in the preliminary business cases had been chosen. Westernport Water advised that the preferred options that have been provided in each 'preliminary' business case have resulted from independent reviews, master plans, or renewal/growth requirements.¹⁰

To support this claim, Westernport Water provided the Master Plan for the King Road wastewater treatment plant prepared in 2015 by CMP consulting group. This Master Plan presented detailed options justifying the Recycled Water Project and construction of the 60ML storage, being the largest project proposed in this submission.

A detailed review of the Unspecified Asset Renewal Strategy could potentially provide some savings in the future. While this strategy proposes a 50 per cent increase in unspecified renewals for the PS6 period, in dollar terms, this increase is modest. A detailed review of the methodology is therefore not considered necessary at this time.

Total renewals comprise 43 per cent of proposed capital spend, and while the unspecified renewals category is proposed to increase by 16 per cent (\$800 000) over the PS4 period, overall renewals expenditure is expected to be 5 per cent lower than the expected total actual expenditure for the PS4 regulatory period.

¹⁰ Email responding to FTI Consulting queries, General Manager, Corporate & Customer, 3 November 2022.

Westernport Water provided detailed responses to all remaining questions raised, which provided sufficient confidence for us to assess the proposed expenditure. Although the timing and scope of some of the business cases could be further explored in greater detail, the quantum and impact of any associated changes are not expected to be material. As such, the review focus was on larger items such as the Recycled Water Project and renewals.

Our review has provided confidence in Westernport Water's management of its capital expenditure and the analysis conducted prior to undertaking capital projects. The robustness of this program is also demonstrated by the fact that rather than allocating expenditure in each year of the PS5 regulatory period for items such as watermain renewals (as typically recurring expenditure) Westernport Water instead investigates cohorts of watermain failures and then packages projects to gain a better market response.

In summary, the review of the information provided by Westernport Water has provided us with sufficient confidence that its forecast capital expenditure for the PS5 regulatory period is consistent with a prudent business operating efficiently.

4.7. Summary of capital expenditure assessment

Westernport Water's pricing submission provides a detailed breakdown of its forecast capital expenditure for the PS5 regulatory period. The capital forecast submission is well developed and provides, along with the additional information reviewed, a high level of confidence that the proposed capital expenditure program is appropriate, prudent and robust, and can be delivered.

The further information provided to us by Westernport Water in relation to the key issues of further investigation provides a reasonable level of confidence that the proposed capital expenditure program is consistent with the actions of a prudent business operating efficiently. As a result, we do not recommend any adjustments to the forecast capital expenditure for the PS5 regulatory period.

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