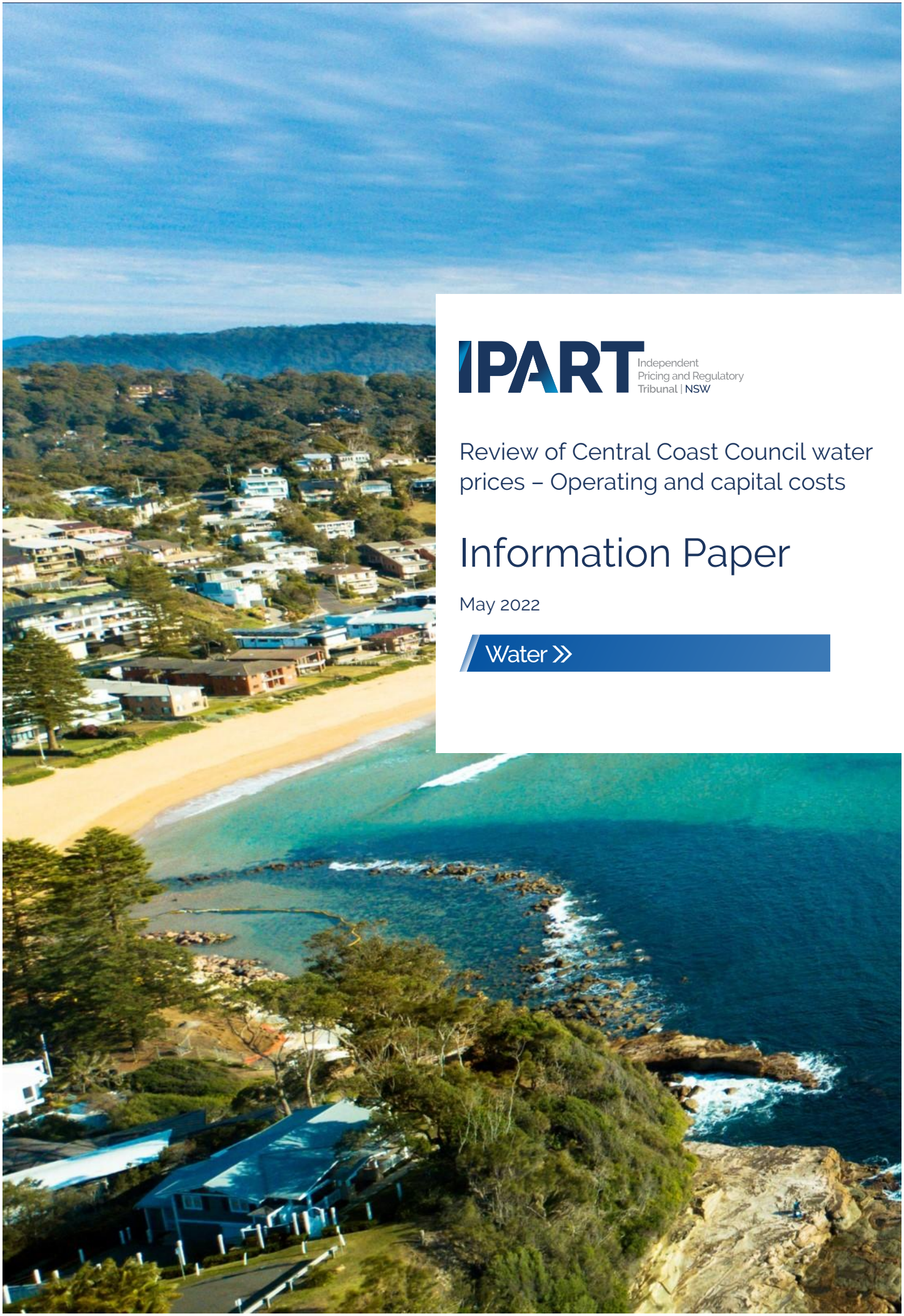

IPART Independent Pricing and Regulatory Tribunal | NSW

Review of Central Coast Council water prices – Operating and capital costs

Information Paper

May 2022

Water »

Tribunal Members

The Tribunal members for this review are:

Carmel Donnelly PSM, Chair
Deborah Cope
Sandra Gamble

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The Independent Pricing and Regulatory Tribunal (IPART)

Further information on IPART can be obtained from IPART's website.

Acknowledgment of Country

IPART acknowledges the Traditional Custodians of the lands where we work and live. We pay respect to Elders, past, present and emerging.

We recognise the unique cultural and spiritual relationship and celebrate the contributions of First Nations peoples.

Contents

1 CCC Water needs to spend more to improve services

IPART sets the maximum prices Central Coast Council can charge its customers for the water, wastewater and other services provided by it as a Water Supply Authority.

IPART also sets the maximum percentage by which Central Coast Council may increase its general income each year through the local government rate peg or special variations.

To ensure it is clear which of Central Coast Council's responsibilities IPART is referring to, throughout this report:

- we refer to the Central Coast Council's functions as a Water Supply Authority under the *Water Management Act 2000* as '**CCC Water**'
- we refer to the Central Coast Council's local government functions under the *Local Government Act 1993* as '**the council**'.

Further information is available in our *Technical Paper – Regulatory background*.

We have reviewed CCC Water's prices for its water-related services and made decisions on the maximum prices CCC Water can charge over the 4 years from 1 July 2022 to 30 June 2026.[a] Our review only considers prices and costs related to CCC Water. It does not consider those related to the council's general activities for which it charges local government rates, levies and other charges.[b]

We consider our prices will allow CCC Water to deliver good quality water and improve services to the community – now and in the future. This information paper focuses on operating and capital costs.

In providing water, wastewater and stormwater services, CCC Water incurs 2 types of costs:

- operating costs, which are the day-to-day expenses involved in running its business and maintaining the infrastructure and equipment it uses to provide services (e.g. staff wages, electricity, contractors)
- capital costs, which are the investments it makes to buy, build and renew the infrastructure and equipment it uses to provide services (e.g. water mains and pipelines, wastewater treatment plants, IT systems).

[a] As part of our review we must consider certain matters under the *IPART Act 1992* (NSW) – detailed information is available in our *Technical Paper – Regulatory background*.

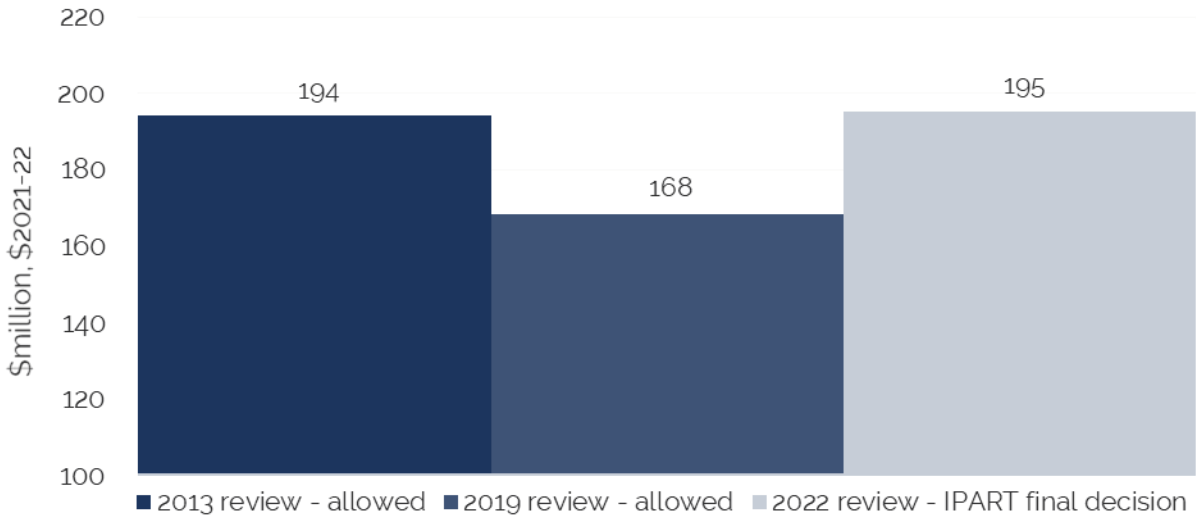
[b] IPART can also review increases to the council's income from rates, but this is a separate review through the special variation process.

We assessed how much of each type of cost CCC Water should need to incur to provide services that meet customers' expectations if it managed its business with minimum wasted effort and expense. Our decisions on these costs, which we call the efficient costs, determines how much operating and capital costs CCC Water will be able to recover through prices over the 2022 determination period. We aim to set the efficient costs so that they are no more and no less than necessary, to ensure CCC Water has an incentive to improve how it manages its business, and enough revenue to provide services of acceptable quality.

To make these decisions, we reviewed CCC Water's proposed operating and capital expenditure over the next 4 years, as well as its actual capital expenditure since 2018-19. To assist us, we asked independent consultants to assess CCC Water's historical and proposed costs, and to compare these costs with those of other water utilities.

Overall, we decided that CCC Water's efficient costs for the 2022 determination period are $195 million per year, on average, over the next 4 years. This is 16% higher than the costs we used to set prices in our last review in 2019, 7% lower than CCC Water proposed, and similar to the former Gosford and Wyong councils' combined costs used to set prices in our 2013 reviews.[1] We consider CCC Water needs to increase spending to ensure it can provide services of acceptable quality, but also has opportunities to improve how it manages its business so it can provide better services to customers in the long run.

Figure 1.1 Average annual cost of providing services ($million, $2021-22)



Our decisions are:

6. To set CCC Water's operating expenditure allowance at $483.7 million over 4 years as shown in Table 3.1 in our *Information Paper – Operating and capital costs*.

7. To set the efficient level of past capital expenditure since 2018-19 to be included in the Regulatory Asset Base as set out in Table 3.2 in our *Information Paper – Operating and capital costs*.

8. To set CCC Water's efficient level of capital expenditure to be included in the Regulatory Asset Base for the 2022 determination period at $297.4 million, as shown in Table 3.3 in our *Information Paper – Operating and capital costs*.

A complete list of all our decisions and recommendations is included in our *Final Report Summary*.

2 CCC Water proposed significant cost increases

CCC Water proposed to increase its operating and capital costs by around $41 million per year, over the next 4 years to improve its water, wastewater and stormwater services to meet service standards. This includes providing good quality drinking water, supplying safe and reliable services, and planning for growth. It proposed to increase its operating costs by around 35%, and its capital costs by 10%, compared to the levels we set at our last review of prices in 2019.

2.1 Proposed increase to operating costs

CCC Water proposed operating costs of $524.1 million over the next 4 years. This is around 35% higher per annum than the operating costs we used to set prices in 2019.

CCC Water's proposed operating costs are based on how much it spent in 2019-20. It considers that this expenditure reflects its typical annual costs, whereas more recent years' costs are not representative. This is because the council announced it was in serious financial difficulties in October 2020 and the NSW Government has since appointed an administrator to temporarily run the council.[2] Due to the financial difficulties, CCC Water had to reduce its costs substantially for the rest of 2020-21, and 2021-22.

To calculate its proposed operating costs, CCC Water adjusted its 2019-20 costs to account for proposed changes in activities over the 2022 determination period. Its proposed increases in costs are mainly driven by water and wastewater activities, including:

- planning and delivery activities to improve customer communications, water resilience, asset management and strategic planning
- network operations and maintenance activities to maintain and service its infrastructure (e.g. dams, treatment plants and pipes) to make sure it remains usable
- headworks and treatment activities to support its treatment plants and improve bushfire and catchment management.

CCC Water also proposed increased expenditure on existing stormwater drainage activities, and to transfer around $15.5 million over the next 4 years in stormwater-related environmental management costs currently funded through local government rates to the Water Supply Authority.[3]

2.2 Proposed increase to capital costs

CCC Water proposed capital costs of $313.0 million over the next 4 years.[4] This is around 10% higher per annum than the capital costs we used to set prices in in 2019.

CCC Water stated in its proposal that it had to substantially reduce capital works over the 2019 determination period, partly as a result of the financial issues facing the council. As a result, it is close to and exceeding, in many instances, its regulated requirements and breaching mandatory standards in a range of areas. This will continue without the proposed increase in capital costs.[5]

CCC Water's proposed capital works program over the next 4 years comprises:

- $160.4 million of spending on wastewater services. This includes capital works at the Charmhaven, Bateau Bay, Kincumber and Gwandalan wastewater treatment plants to manage growth and ensure asset and service reliability (around $41 million)
- $116.1 million of spending on water services. This includes a major upgrade of the Mardi water treatment plant to manage water quality risks and restore the plant to its full treatment capacity ($34 million)
- $36.4 million on stormwater services.[6]

3 We assessed CCC Water's proposed costs

To decide whether CCC Water's proposed costs are reasonable we asked independent consultants to review:

- CCC Water's proposed operating costs for cost saving opportunities, compare the level of proposed operating costs to those of similar water utilities in Australia, and make recommendations on an efficient level of operating costs for the next 4 years
- CCC Water's actual capital costs from 2018-19 to 2021-22 to determine whether CCC Water spent more than it needed to
- a subset of CCC Water's proposed capital projects and provide advice on whether these projects are necessary, and their proposed costs are no higher than they need to be. We then asked the consultants to use the findings from its review of these projects to make recommendations on an efficient level of capital costs for the next 4 years.

The consultants' final report can be found on our website.

While we set the overall amount of money CCC Water can collect through the prices its customers pay, it is up to CCC Water to decide how it ultimately spends this money. We decided the efficient amount of operating costs for the next 4 years, but it is up to CCC Water to allocate this money between its cost categories. Similarly, while we assessed a subset of CCC Water's proposed capital projects to help us form a view about the efficient amount of capital costs, CCC Water is not required to adjust its spending on these projects in line with our assessment. Rather we expect it to regularly re-evaluate its priorities and consult with the community on whether the proposed projects will deliver the level of service that customers expect, at a reasonable cost.

Our *Information Paper – Improving performance* discusses our recommendations that ensure CCC Water's spending meets the community's expectations.

3.1 We set operating costs 8% lower than CCC Water's proposal

To help us assess CCC Water's proposed operating costs, we engaged Frontier Economics (Frontier) to review CCC Water's proposal for cost saving opportunities and compare CCC Water's proposal against operating costs of similar water utilities in Australia.

Our draft decision was to set CCC Water's operating costs at $477.7 million over the next 4 years. This was $46.4 million (9%) lower than what CCC Water proposed.

We considered all stakeholder submissions to the Draft Report, Frontier's final expenditure review findings and changes in economic conditions prior to making our final decision.

Our final decision is to set CCC Water's operating costs at $483.7 million over the next 4 years. This is 8% lower than CCC Water's proposal but 24% higher than the operating costs we used to set prices in the last review.

Our decision is based on our findings that:

CCC Water's proposal includes double counting of water resilience activities and the transfer of stormwater costs

There are opportunities for additional cost reductions as well as ongoing productivity improvements

Benchmarking analysis shows that CCC Water's proposed costs are higher compared to those of a reasonably efficient water business

These findings are discussed in detail in the sections below.

We identified opportunities for cost savings in CCC Water's proposal

Frontier reviewed CCC Water's proposed operating costs for its water, wastewater and stormwater services, and identified opportunities for CCC Water to reduce the proposed operating costs by around $54 million (10%) over the next 4 years. This is based on:

- removing $4.7 million of double counting related to CCC Water's proposal to increase spending on water resilience activities[7]
- not accepting CCC Water's proposal to transfer $15.5 million of stormwater costs currently funded through local government rates to the Water Supply Authority.[8] Our decision on stormwater costs is discussed in our *Information Paper – Funding stormwater services*
- adjusting for $33.3 million of efficiencies in CCC Water's proposal. Frontier recommended a reduction of 5.0% per year to capture cost savings it identified in CCC Water's proposal.[c] Frontier also applied a further reduction of 0.7% per year, based on IPART's expectations for continuous improvements in productivity.[d, 9]

[c] Frontier applied a reduction of 5.0% per year to account for potential cost savings in CCC Water's proposal. This is based on its review of CCC Water's proposal, business cases, interviews with staff, as well as findings from its review of CCC Water's systems and processes, which flagged areas for improvement in CCC Water's asset management, procurement and cost estimation practices.

[d] Based on IPART's standard method for determining the continuing efficiency factor.

CCC Water's proposed costs are higher than our estimates for a reasonably efficient water business

Frontier also found that most (around 95%) of CCC Water's proposed increases are from changes in activities to target performance to meet existing obligations (including the appropriate maintenance of assets) and service standards. This suggests that the method CCC Water used to derive the base level of costs for its operating cost forecasts may not be appropriate.[10]

As a result, Frontier also used a base-step-trend approach to estimate what CCC Water's operating costs should be over the next 4 years. This involved looking at the operating costs of similar water utilities in Australia. Frontier's base-step-trend approach is explained in Box 1.

Box 1 Frontier's assessment of proposed operating costs

Frontier's base-step-trend approach is separated into 3 steps.

Derive a base expenditure range using benchmarking

Frontier used benchmarking to estimate a range for CCC Water's efficient operating expenditure. It drew on data for 27 'Major' and 'Large' water utilities across Australia from the National Performance Report (NPR) over the period from 2009 to 2019 to determine what a 'reasonably efficient' water business of CCC Water's size would need to deliver water and wastewater services. As the NPR data does not include costs related to stormwater services, Frontier applied the ratio of CCC Water's stormwater to water and wastewater operating expenditure from 2013-14 to the economic benchmarking results to derive efficient stormwater costs.[a]

Identifying genuine step changes

Frontier found that most of CCC Water's proposed changes in activities relate to existing obligations and are implicitly included in its base expenditure range. In Frontier's view, genuine step changes are increases required for meeting new regulatory requirements, addressing major changes in external factors and/or meeting efficient operating and capital expenditure trade-offs.

Frontier identified 4 genuine step changes that reflect new regulatory requirements or emerging risks for CCC Water and allowed additional costs for these.

Incorporating trend factors

Frontier then adjusted its base expenditure forecasts for increases due to growth using forecast customer connections, and the cost of inputs using a combination of forecast Wage Price Index and Consumer Price Index. We also asked it to apply reductions of 0.7% per year to account for expected productivity gains over the next 4 years.

a. By using the ratio of stormwater to water and wastewater operating costs from 2013-14, Frontier has implicitly excluded the stormwater costs CCC Water proposed to transfer from local government rates to the Water Supply Authority. This is consistent with our decision on stormwater costs, which is discussed in our *Information Paper – Funding stormwater services*.

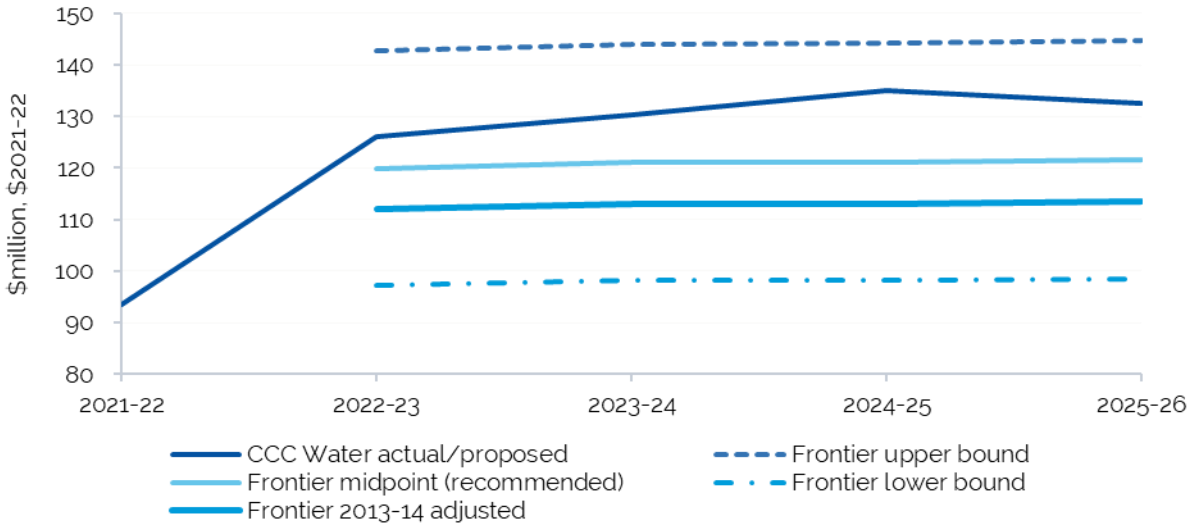
Source: Frontier Economics and Mott MacDonald, *Central Coast Council Water Expenditure Review – Final Report for IPART*, April 2022, pp 23-27 & 66-69.

This analysis resulted in a range for the efficient operating costs from around $98 million to around $144 million per year.[11] This range is relatively wide due to the uncertainty associated with data and forecasts. Frontier recommended using the midpoint of the range to set the efficient level of operating costs for the next 4 years.[12] This is slightly higher than the results of adjusting CCC Water's proposal for double counting, the transfer of stormwater costs and efficiency opportunities.

To sense-check the results from the base-step-trend approach, Frontier compared the recommended midpoint to the former Gosford and Wyong councils' combined actual operating costs in 2013-14, and found that the recommended midpoint is around 7% higher.[13] Frontier considers the adjusted 2013-14 figure provides a reasonable estimate of CCC Water's efficient and sustainable operating expenditure because there was no evidence of concerns with the former councils' performance and service standards at that time.

Figure 3.1 compares CCC Water's proposal and the results of Frontier's analysis, including the recommended midpoint for efficient operating costs, the upper and lower bounds of the expenditure range, and the adjusted 2013-14 figure Frontier used as a sense-check.

Figure 3.1 Efficient range for expenditure ($million, $2021-22)



Source: Email to IPART, Frontier Economics, 3 March 2022 and IPART calculations.

Stakeholders questioned spending on particular cost categories

Stakeholder submissions to our Draft Report questioned CCC Water's forecast operating costs for specific categories such as:

- labour, including executive salaries, redundancy and hiring costs[14]
- consultancies, particularly CCC Water's use of consultants to assist with the preparation of its pricing proposal[15]
- the allocation of corporate overheads between the council and CCC Water.[16]

One stakeholder argued that cost cutting measures should be undertaken before increasing prices.[17]

CCC Water did not agree with the approach used to set operating costs

In CCC Water's response to IPART's Draft Report, it accepted our findings that its proposal included double counting for water resilience activities.[18] However, it raised concerns about the approach taken by Frontier to estimate operating costs, particularly the reliance on benchmarking. It considered that the top-down benchmarking approach used by Frontier discounts the bottom-up approach and individual business cases it prepared to justify cost increases for specific activities.[19]

CCC Water also expressed concerns about the use of the adjusted 2013-14 figure as a sense-check because:

- the base year of 2013-14 is not representative of the current organisation as the former councils were not amalgamated, and the structure of teams and operating models were different
- the year-on-year increases used by Frontier to escalate these costs to the 2022 determination period are lower than increases experienced by other organisations such as Hunter Water.[20]

CCC Water's response to IPART's Draft Report also included a proposal to defer some of the operating costs for water and wastewater from years 1 and 2 of the 2022 determination period to years 3 and 4 due to challenges in resourcing and procurement in the current economic environment. It proposed lower operating costs in years 1 and 2 offset by higher operating costs in years 3 and 4 compared to our draft decision, with the total amount over the 4 years being the same.[21]

CCC Water also proposed a 'moderated' proposal for stormwater operating costs, which involved the transfer of some costs associated with activities currently funded through local government rates. Under this proposal, the council would continue to fund the activities CCC Water had proposed to transfer to the Water Supply Authority in its September 2021 pricing proposal, though the amount of funding would progressively reduce over the 2022 determination period, with costs being fully funded through CCC Water's stormwater prices by year 4 of the determination period (i.e. 2025-26).[22]

CCC Water needs to spend more to meet regulatory obligations and deliver better services to customers

Our decision is to accept Frontier's recommended midpoint and set efficient operating costs at $483.7 million over the next 4 years. This is $6 million (1%) higher than our draft decision due to an increase in forecast inflation for 2021-22 between our draft and final reports.[e]

Under our decision, the operating costs CCC Water could recover through prices would be 24% higher than in the 2019 review period.[f] In our view, this increase is necessary so that CCC Water can deliver services that meet existing obligations and customers' expectations.

[e] We have used the Refinitiv mean consensus forecast of Australian CPI for the 12 months to the June quarter 2022.
[f] On an annual basis.

Our decision on efficient operating costs over the 2022 determination period is set out in Table 3.1.

Table 3.1 Decision on efficient operating expenditure for the 2022 determination period ($million, $2021-22)

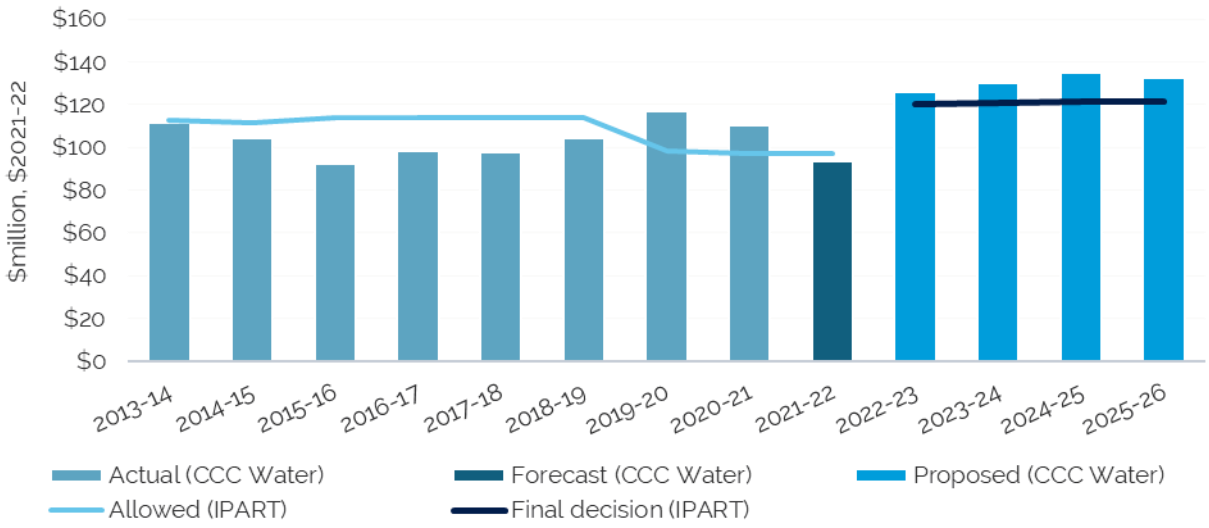
	2022-23	2023-24	2024-25	2025-26	Total
Water	58.9	59.4	59.5	59.8	237.6
Wastewater	50.3	50.8	50.8	50.9	202.9
Stormwater	10.7	10.8	10.8	10.9	43.1
Total	**120.0**	**121.0**	**121.2**	**121.6**	**483.7**

Note: The figures presented in Table 3.1 are slightly higher than those presented in Frontier and Mott MacDonald's expenditure review final report due to an update in forecast inflation for 2021-22 (from 2.9% to 4.2%).

Source: Frontier Economics and Mott MacDonald, *Central Coast Council Water Expenditure Review – Final Report for IPART*, April 2022, p 25 and IPART calculations.

Figure 3.2 shows our decision on CCC Water's efficient operating costs over the next 4 years compared to its proposal. It also shows its actual operating costs and the level of operating costs we used to set prices from 2013-14 to 2021-22.

Figure 3.2 Decision on efficient operating costs compared to historical and proposed costs ($million, $2021-22)



Note: This figure shows CCC Water's actual spending over 2013-14 to 2020-21, its forecast spending for 2021-22, and its proposed spending from 2022-23 to 2025-26. It also shows the amount of operating costs IPART included in prices from 2013-14 to 2021-22, and the amount we will include over the next 4 years based on our final decision.

We have not accepted CCC Water's proposed 35% increase in operating costs as Frontier's review found that there is scope for cost savings such as reflecting flow-on effects from upfront operating expenditure to drive efficiencies.[g, 23] We have also maintained our decision not to accept the transfer of stormwater costs currently funded through local government rates to the Water Supply Authority.

Our decision is based on Frontier's recommendation on efficient operating costs, which is derived from a base-step-trend approach with the base level of costs informed by economic benchmarking. This means that Frontier did not undertake detailed bottom-up assessments of all of CCC Water's proposed increases in specific activities. We agree with Frontier's assessment that most of CCC Water's proposed increases in specific activities should be included in the base level of costs, and relying on the individual business cases to determine efficient operating costs would likely lead to some double counting.[h, 24] As a result, we maintain that the benchmark is the best basis to set prices given the uncertainty in CCC Water's cost estimates.

We acknowledge that CCC Water's operating model has changed post amalgamation. While we have referred to Frontier's adjusted 2013-14 figures as a sense-check, we have not used these to set operating costs for the next 4 years. Further, we do not consider CCC Water's argument that Hunter Water has experienced higher annual increases in operating costs over this period is relevant, as Frontier's escalation rate incorporates the main driver of operating costs – the change in customer connections – rather than the changes in operating costs for a different water utility.[25]

We have set operating costs for the next 4 years at our best estimate of what a reasonably efficient water utility would need to deliver water-related services of an acceptable quality and meet its regulatory obligations. This is informed by the performance of water utilities across Australia from 2009 to 2019. We consider this approach ensures that customers will pay no more than what is needed.

Our allowance for water is similar to CCC Water's proposal, and although we have reduced the allowance for wastewater, we consider the amount we have allowed is sufficient and will enable CCC Water to undertake an appropriate level of maintenance of its assets. The reduction in the stormwater allowance compared to CCC Water's proposal is mainly due to our decision not to accept the transfer of costs currently funded through local government rates to the Water Supply Authority.

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g Frontier identified flow-on effects in forecast operating costs as one example of where cost savings may exist. CCC Water's proposed increase in operating costs includes costs associated with transitioning from a reactive to proactive maintenance regime. However, CCC Water's forecasts did not include any corresponding decreases in spending required on reactive maintenance (e.g. overtime costs) that would likely result from a more proactive approach.

h Most of CCC Water's proposed increases in specific activities relate to expenditure required to meet existing obligations.

Frontier considers it is highly likely that at least some of the costs of these activities are already included in the base level of operating costs proposed by CCC Water, and it would be virtually impossible to determine the extent of double counting if we adopt the detailed bottom-up approach CCC Water requested.

Implementing further cost-cutting measures may exacerbate CCC Water's current service issues and may not be in the long-term interest of its customers. However, we expect CCC Water to make productivity improvements over the next 4 years and have included this in the operating costs we allowed. CCC Water has also indicated that proposed spending to transition from reactive to proactive maintenance in the 2022 determination period should deliver labour cost savings in the next review period.[26]

Stakeholder submissions to our Draft Report questioned costs for particular expenditure categories, such as labour, consultancies, and corporate overheads. Our decision to use a top-down approach means that we have not established efficient levels of expenditure for individual cost categories.[i, 27]

While we set the amount CCC Water can collect through prices over the next 4 years, we do not approve budgets for individual cost categories. We consider that it is up to CCC Water to decide how to allocate spending between different categories and manage its budget to respond to changes in circumstances, including variations between forecast and actual operating costs driven by shifts in the economic environment.

We also note that our decision on efficient operating costs is not a budget that CCC Water is constrained to. Rather it is the amount of efficient costs we consider customers should pay for through prices. CCC Water is not prevented from spending more than this, however, it will not be able to recover from customers any additional operating costs it incurs above the amount we have included in our final prices.

3.2 We set capital costs for the 2019 period at CCC Water's expected actual costs

A regulated entity's actual capital expenditure can vary from its proposed (forecast) expenditure for a range of reasons. For example, the cost of a project might change following new developments, some projects may not go ahead, or there may be unforeseen delays in implementing them. For this reason, at each price review, we assess CCC Water's actual capital spending over the current determination period and compare it to the forecast we used to set prices at our last review. This allows us to adjust the forecast expenditure that we included in its regulatory asset base (RAB) at the last review, so that it reflects the level of its actual capital expenditure that we consider was reasonable and in line with what it needed to spend.

For this price review, CCC Water submitted that it expects its actual capital expenditure for the 2019 determination period will be $205.6 million.[j] This is approximately $1.9 million (0.9%) more than we included in the RAB when setting prices in 2019.[28]

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[i] As part of the expenditure review, Frontier compared a sample of CCC Water's wages and salaries to industry standards and found that its rates of pay are not out of line with industry standards. Frontier also assessed CCC Water's cost allocation methodology for corporate overheads and determined that it is reasonable, though cost-reflectivity may be improved.

[j] This is based on actuals for 2019-20 and 2020-21, and forecasts for 2021-22. The total for the 2019 determination period is based on nominal values.

To help us assess the efficiency of this expenditure, we asked an independent consultant, Mott MacDonald, to assess CCC Water's spending and advise us on whether it was no higher than necessary. Mott MacDonald found that CCC Water's spending was largely reasonable but recommended a downward adjustment of $6.9 million to forecast capital costs for 2021-22, to account for delays in projects continuing into the 2022 determination period.[29]

Table 3.2 summarises our decision on the efficient level of capital costs to be included in the RAB over the period from 2018-19 to 2021-22.

Table 3.2 Decision on efficient capital expenditure from 2018-19 to 2021-22 ($million, $nominal)

	2018-19	2019-20	2020-21	2021-22[a]
Water	17.6	32.0	41.5	23.8
Wastewater	15.5	22.5	17.2	34.7
Stormwater	9.8	9.6	6.2	11.4
Total	**42.9**	**64.0**	**64.8**	**69.8**

a. Figures for 2021-22 are forecasts.

Source: Frontier Economics and Mott MacDonald, *Central Coast Council Water Expenditure Review – Final Report for IPART*, April 2022, pp 16-21 and IPART calculations.

3.3 We set capital costs for the 2022 period 5% lower than CCC Water proposed

To help us assess CCC Water's proposed capital costs for the 2022 determination period, we asked Mott MacDonald to review the key business systems and processes which drive the proposed costs to determine whether they represent good industry practice. We also asked Mott MacDonald to examine 10 of CCC Water's proposed capital projects to provide advice on whether they are needed, and the proposed costs are no higher than necessary. Mott MacDonald was then required to recommend an efficient level of capital costs for the next 4 years based on all of its findings.

After considering the outcomes of Mott MacDonald's review, we have decided to set CCC Water's capital costs at $297.4 million over the next 4 years. This is 5% lower than CCC Water's proposal, 5% higher than the capital costs we used to set prices in the last review, and consistent with our draft decision.

Our decision is based on our findings that:

Some proposed capital projects would benefit from further investigations and may be delivered at lower cost

CCC Water can lower the overall cost of its proposed capital program through better planning, project and infrastructure management

We expect CCC Water to lower its capital costs over time through ongoing productivity improvements

These findings are discussed in detail in the sections below.

CCC Water's business systems and processes are still maturing

As part of our review of CCC Water's costs, we asked the consultants to provide advice on whether its systems and processes reflect good planning, decision making and infrastructure management practices. We think this is important because the maturity of key systems and processes influence whether expenditure plans are likely to be efficient and in the long-term interest of customers.

The consultants noted that CCC Water is moving towards good industry practices to ensure that the customer requirements are met in a collaborative and efficient manner. However, CCC Water's business systems and processes are still maturing, meaning that the drivers of its cost proposal for the next 4 years are not yet fully evidence-based and robust.[30] As a result, there is scope for reductions in amount of capital costs proposed by CCC Water for the next 4 years.

CCC Water can lower the overall cost of its proposed capital program

Mott MacDonald's review focused on 10 individual projects, totalling $116.3 million over the 2022 determination period. These represent around 37% of CCC Water's proposed capital works program.[31] The review covered:

- 3 water projects, including $33.6 million for a major upgrade of the Mardi water treatment plant and $15.8 million for a region-wide water mains asset renewal program
- 5 wastewater projects, including $16.3 million for a major augmentation of the Charmhaven wastewater treatment plant and $11.8 million for a sewer mains asset renewal program
- 2 stormwater projects.[32]

Mott MacDonald found that CCC Water has demonstrated the need for investment for the 10 capital projects it reviewed. However, because the majority of these are at an early stage, Mott MacDonald could not definitively state that CCC Water's proposal for each project represents the best option and least cost. It recommended a number of specific adjustments to these projects based on issues it identified around CCC Water's project planning and risk assessment processes.[33]

Further, Mott MacDonald considered that the issues it identified are systemic and would impact on the efficiency of CCC Water's entire capital works program. As a result, it also recommended efficiency adjustments to the unsampled portion of capital expenditure. These adjustments were determined by categorising the systemic issues into 3 groups and estimating the potential cost savings that would result from addressing issues in each group. However, Mott MacDonald noted that making improvements is a gradual process and that the full cost savings cannot be achieved from Day 1 of the new determination period. As a result, it incorporated only half of the indicative cost savings in its recommendations on efficient capital costs.[34]

It then applied an ongoing reduction of 0.7% per year to reflect IPART's expectation that CCC Water should continue to become more productive over time.[k, 35]

These cost savings, in addition to the specific adjustments for the 10 capital projects reviewed in detail, resulted in a recommended efficient capital costs expenditure range of $291 million to $303 million over the next 4 years.[36]

Stakeholders commented on the necessity and funding of capital projects

In response to our Draft Report:

- one stakeholder asked us to reconsider the efficiency of CCC Water's planned capital projects because there appeared to be a preference for big projects, without an appropriate assessment of broader options.[37]
- several stakeholders did not support the construction of a permanent desalination plant at Toukley, which is described in the council's Draft Water Security Plan. This was mainly due to concerns about high construction costs, expensive ongoing running costs, and potential adverse impacts on the environment[38]
- two stakeholders considered that some projects should be funded through alternative means including developer contributions and grants from the Government.[39]

CCC Water requested a shift in expenditure from wastewater to water

CCC Water's submission to the Draft Report argued for higher capital costs for water compared to our draft decision. CCC Water considers that an increase in the capital allowance for water is necessary to ensure it has enough money to undertake essential projects including the major upgrade of the Mardi water treatment plant.[40]

[k] Based on IPART's standard method for determining the continuing efficiency factor.

CCC Water proposed that an increase in the capital allowance for water can be offset by an equal decrease in the capital allowance for wastewater and stated that this reallocation would not compromise its ability to deliver all high-risk and critical works on both water and wastewater assets.[41]

CCC Water also requested that we revise the profiles of the annual allowances to better align with what it believes it needs to deliver each year.[42]

We established an overall amount of efficient capital costs but have not made judgements on individual projects

Our decision is to set efficient capital costs at $297.4 million over the next 4 years. Under this decision, the level of costs CCC Water could recover through prices will be 5% higher than in the 2019 review period.[l]

Although our final decision on total efficient capital costs is consistent with our draft decision, we have made changes to the allowances for water, wastewater and stormwater. These changes reflect new information provided by CCC Water on essential projects, updated project timeframes, and findings in our consultants' final report.

While CCC Water has demonstrated the need for investment for the subset of capital projects assessed by our consultants, there are opportunities to reduce costs due to systemic issues with CCC Water's project planning and risk assessment processes. This includes room for improvement in how it investigates different options to solve problems and exploration of incremental solutions to achieve desired outcomes.[43] We have applied efficiency adjustments to CCC Water's proposed capital costs to account for these systemic issues.

In response to our Draft Report, one stakeholder expressed concerns about capital projects related to growth.[44] We note that new infrastructure required as a result of growth is funded by developer contributions. These are upfront charges that water utilities levy on developers to recover part of the infrastructure costs of providing water, wastewater and/or stormwater infrastructure to new developments. We also note that CCC Water has secured funding from the NSW Government for select capital projects such as water and wastewater infrastructure upgrades within the Gosford CBD aimed at addressing growth.[45]

Stakeholders also expressed concerns about capital expenditure on a desalination plant over the next 4 years through submissions to the Draft Report and at our April 2022 public hearing.[46] CCC Water has indicated that planning, design and construction costs associated with a desalination plant have not been included in its proposed costs for the next 4 years, and the council's Water Security Plan shows that such a project is still years away from the delivery and commissioning stages.[47] As such, desalination costs are not included in the prices we have set for the next 4 years.

[l] On an annual basis.

However, while we decide the overall amount of efficient capital costs included in prices, we do not approve particular programs or projects for CCC Water to undertake. This is because we consider it is CCC Water's responsibility to consult with its community, determine its spending priorities, and adjust these from time to time as required.

We will reassess capital expenditure over the 2022 determination period at our next price review to ensure CCC Water's capital investments over this period provide value for money to customers. This also means that if CCC Water makes additional capital investments over the 2022 determination period which were not included in its pricing proposal, and we determine these to be necessary and efficient, we would include the costs of those projects in the prices we set at our next review.[m] Further information on how capital costs are included in the prices we set is available in our *Technical Paper – How we set the revenue level*.

Our decision on efficient capital costs over the 2022 determination period is set out in Table 3.3.

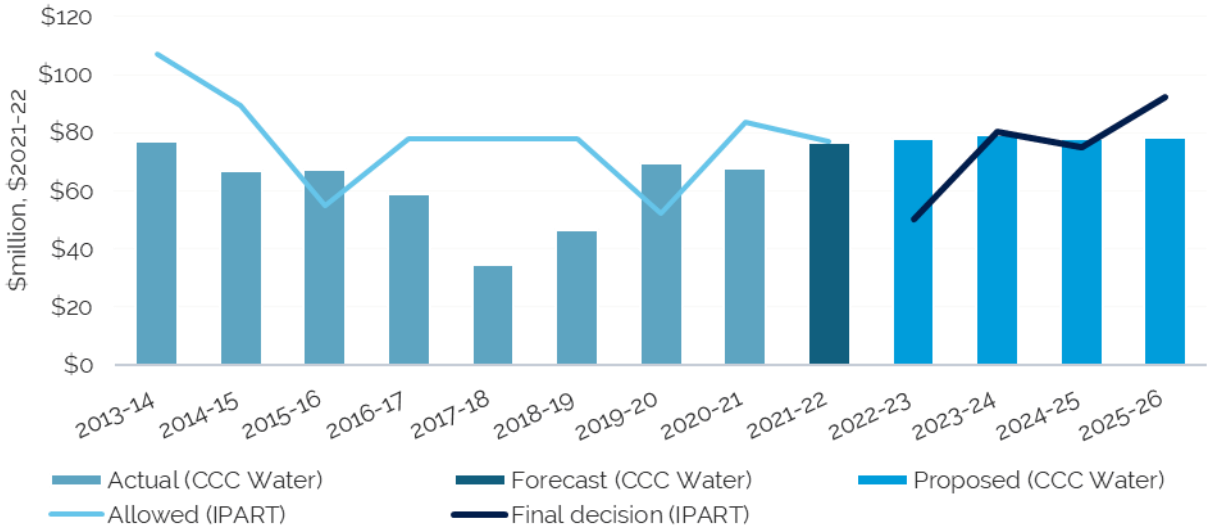
Table 3.3 Decision on efficient capital expenditure for the 2022 determination period ($million, $2021-22)

	2022-23	2023-24	2024-25	2025-26	Total
Water	12.3	41.1	24.2	27.7	105.3
Wastewater	30.4	30.4	42.5	55.7	159.0
Stormwater	7.7	8.7	8.2	8.7	33.1
Total	**50.4**	**80.2**	**74.8**	**92.1**	**297.4**

Figure 3.3 shows our decision on CCC Water's efficient capital costs over the next 4 years compared to its proposal. It also shows its actual capital costs and the level of capital costs we used to set prices from 2013-14 to 2021-22.

[m] These capital costs are generally spread over the expected life of the project.

Figure 3.3 Decision on efficient capital costs compared to historical and proposed costs ($million, $2021-22)



Note: This figure shows CCC Water's actual spending over 2013-14 to 2020-21, its forecast spending for 2021-22, and its proposed spending from 2022-23 to 2025-26. It also shows the amount of capital costs IPART included in prices from 2013-14 to 2021-22, and the amount we will include over the next 4 years based on our final decision.

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[19] CCC Water, submission to IPART's Draft Report for the 2021-22 CCC Water price review, April 2022, p 49.
[20] CCC Water, submission to IPART's Draft Report for the 2021-22 CCC Water price review, April 2022, p 15.
[21] CCC Water, submission to IPART's Draft Report for the 2021-22 CCC Water price review, April 2022, pp 39-42.
[22] CCC Water, submission to IPART's Draft Report for the 2021-22 CCC Water price review, April 2022, pp 50 & 59.
[23] Frontier Economics and Mott MacDonald, *Central Coast Council Water Expenditure Review – Final Report for IPART*, April 2022, p 90.
[24] Frontier Economics and Mott MacDonald, *Central Coast Council Water Expenditure Review – Final Report for IPART*, April 2022, p 68.
[25] Frontier Economics and Mott MacDonald, *Central Coast Council Water Expenditure Review – Final Report for IPART*, April 2022, pp 69-70.
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[29] Frontier Economics and Mott MacDonald, *Central Coast Council Water Expenditure Review – Final Report for IPART*, April 2022, pp 16-21, 199 & 247.
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[35] Frontier Economics and Mott MacDonald, *Central Coast Council Water Expenditure Review – Final Report for IPART*, April 2022, pp 120-121.
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[41] CCC Water, submission to IPART's Draft Report for the 2021-22 CCC Water price review, April 2022, p 13.
[42] CCC Water, submission to IPART's Draft Report for the 2021-22 CCC Water price review, April 2022, p 13.
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