

Response to submissions on consultation paper to inform guidance

Organisation	Issue	Substantive point being made in submission	ESC Response
Melbourne Water	Approach to regulation	<p>Melbourne Water believes there is scope for improving the Commission’s application of the building block methodology to commence a transition to lighter handed regulation. This could include, for example:</p> <ul style="list-style-type: none"> • For operating expenditure reviews: confine review to those elements of Melbourne Water’s proposal that differ from previous proposals (e.g. trends in cost items that have already been subject to extensive scrutiny). • For capital expenditure reviews: limit assessment to aspects of capital expenditure that have not been subject to previous consideration (e.g. for major capital projects that have already been scrutinised by the Commission and by the Shareholder). 	<p>We adopt a light handed approach when assessing the prices proposed by a water business via the building block methodology.</p> <p>A recent report noted that the Commission’s 2013 water price review was the lowest cost (measured in terms of costs incurred by the regulator) of all major water price reviews recently undertaken by Australian regulators.¹ The report also noted that the timeframes taken by the Commission to complete a review compared well against other regulators.</p> <p>For the purpose of approving prices, the Commission has an obligation (under the Water Industry Regulatory Order) to assess the efficiency of expenditure proposed by a water business. Nevertheless, our approach seeks to focus effort on major reasons for changes in expenditure. For example, our scrutiny of proposed capital expenditure is based on an assessment of major projects (as opposed to assessing every project proposed by a business).</p> <p>Our guidance requests only detailed justification in Melbourne Water’s price submission for proposals</p>

¹ Deloitte 2014, *Comparison of water regulatory approaches*, April.

Organisation	Issue	Substantive point being made in submission	ESC Response
			<p>which differ from the current approach. This is consistent with light handed regulation.</p> <p>Under the propose-respond model mandated by the Water Industry Regulatory Order, the nature of the Commission's review is heavily determined by the content of a water business's price submission.</p>
Melbourne Water	Expenditure review and efficiency hurdle	Melbourne Water questions whether a review based on both the productivity hurdle and reviewing individual categories of operating expenditure is consistent with light handed regulation.	<p>The combination of an expenditure review and an efficiency (or productivity) hurdle is consistent with the requirements in the WIRO for the Commission to provide a regulated business with incentives to deliver services efficiently, and pursue efficiency improvements (clause 8(b)(iii)).</p> <p>Our approach to assessing operating expenditure supports a light handed approach. The Commission applies an efficiency hurdle to the operating expenditure required to deliver unchanged levels of service, rather than seeking detailed justification for past cost levels. We then focus our review on areas where a business forecasts strong cost growth, and assess the reasonableness of the forecasts.</p>

Organisation	Issue	Substantive point being made in submission	ESC Response
Melbourne Water	Weighted average cost of capital (WACC)	<p>Melbourne Water notes recent decisions and reviews by other regulators have led to some significant changes in the approach to determining an appropriate rate of return for regulated businesses, including water businesses.</p> <p>The Commission should re-consider the parameters it uses to calculate the WACC, including:</p> <ul style="list-style-type: none"> • Market Risk Premium (MRP) • Beta • Cost of equity • Cost of Debt • Gamma 	<p>The estimates we have used for the MRP, beta, gamma and the cost of debt and equity are within reasonable bounds for water businesses (having regard to recent regulatory decisions). Our 2013 decision on the WACC was very close to the rate decided by other regulators at the time.</p> <p>We are open however, to re-considering our approach to estimating the cost of debt and will explore this further with Melbourne Water in the course of the price review.</p> <p>Our guidance paper notes a range of information requirements that would be needed in Melbourne Water's price submission, if it proposes to argue for a change to our approach to estimating the cost of debt.</p>
Melbourne Water	Financial viability	<p>All aspects of the regulatory allowances should be subjected to the financeability test. If some elements of the regulatory decision are excluded, the test may provide a misleading view of the actual financial position of the business.</p> <p>Exclusion from the test of any regulatory decision that defers cashflows, or spreads the same present value of cashflows over a longer period, is likely to make the financial position of the regulated business look more sustainable than it actually is.</p>	<p>The intention of the financial viability test is to identify a point at which the Commission may intervene in prices to support the financial viability of a business. Under the current industry and regulatory framework, there is minimal risk of Melbourne Water being financially unviable.</p> <p>We disagree with the premise of Melbourne Water's submission that the Commission excludes elements of the regulatory decision in conducting our financial viability test. All aspects of a regulatory decision are reflected in the</p>

Organisation	Issue	Substantive point being made in submission	ESC Response
			<p>Commission's financial viability test.</p> <p>In response to the example posed by Melbourne Water regarding the spreading of cashflows, the Commission's approach would ensure that Melbourne Water would be no worse (or better) off under such a scenario.</p> <p>For pricing purposes, any spreading of cashflow recovery is assumed to result in higher borrowing and finance charges (in the near term). Approved prices would reflect these additional finance charges in full. The higher finance charges are then reflected in the Commission's financial viability test through higher gearing, lower cash flow and lower interest cover (all other things being equal).</p> <p>Thus, our guidance on the manner in which we will undertake our financial viability assessment of Melbourne Water has not changed on the approach outlined in our consultation paper.</p>
Melbourne Water	Use of statutory profit to inform financial viability assessments	Melbourne Water is of the view that a measure of overall statutory profit or an equivalent measure remains one of the indicators that should guide the overall estimation of financial viability.	<p>While the four indicators noted in our guidance paper form the basis of our financial viability test, the Commission will have regard to other information such as statutory accounts when assessing the financial position of Melbourne Water.</p> <p>We will not place the same weight on statutory profit as an indicator of financial viability, however</p>

Organisation	Issue	Substantive point being made in submission	ESC Response
			<p>(compared with the four indicators noted in our guidance paper).</p> <p>A paper prepared for the Commission noted that the significance of depreciation values and the selection of the useful life of assets has a significant impact on the reliability and comparability of reported statutory profits.² We are not aware of other regulators using statutory profit as a major indicator in financial viability tests.</p>
Yarra Valley Water	Price shock	For Melbourne Water's price review, Yarra Valley Water is not expecting any price shocks. We believe that price shocks need to be avoided and, if necessary, transition arrangements put in place.	<p>We agree with Yarra Valley Water that price shocks should be avoided where possible (and transition plans put in place where price shocks cannot be avoided).</p> <p>The Commission's guidance notes that for the purposes of Melbourne Water's price review, we have defined a price shock as an increase in any tariff of more than 10 per cent in any year.</p> <p>Note that a proposed increase of more than 10 per cent may be still allowed by the Commission; however, typically, strong justification would be needed and a transition plan would need to be in place for affected customers.</p>

² Centre for Water Policy and Management La Trobe University 2014, Review of the Statutory Asset Values of Victorian Water Businesses, January, p 5.

Organisation	Issue	Substantive point being made in submission	ESC Response
Yarra Valley Water	Benchmarking	Interested in the use of benchmarking or bottom up scrutiny of expenditure proposals to review Melbourne Water's proposed prices.	<p>The Commission agrees that benchmarking information will be beneficial to our review of Melbourne Water's proposed expenditure. We may undertake a benchmarking review of Melbourne Water's proposed expenditure.</p> <p>Further, our expectation is that any internal benchmarking work undertaken by Melbourne Water (or by another party at Melbourne Water's request) will be made available to the Commission during the price review.</p>
Yarra Valley Water	Timeline	<p>The final determination needs to be finalised by end May 2016 rather than 15 June 2016 (as noted in the Commission's consultation paper) to enable implementation of new prices for our customers. The planned dates for the Commission's draft decision and submission of Melbourne Water's final price submission should be brought forward by three weeks to 19 February 2016 and 15 October 2015 respectively.</p>	<p>The Commission's guidance has a revised due date for Melbourne Water's price submission of 30 October 2015. We have also moved forward the date for our final decision on Melbourne Water's prices to 1 June 2016.</p> <p>In the event that Melbourne Water's approved prices result in change to the prices of the retail water businesses, we consider that this will better allow the retail water businesses to implement new prices.</p>
Yarra Valley Water	Timing of future price reviews	A two-year gap should remain for future price reviews to enable more scope for engagement between retail water businesses and Melbourne Water.	We agree that staggering price reviews such that Melbourne Water's review precedes that of the retail businesses is beneficial – mainly to allow greater scope for the retail businesses to test Melbourne Water's assumptions and proposals. The Commission will monitor engagement by the

Organisation	Issue	Substantive point being made in submission	ESC Response
			retailers during this review to inform our future approach.