INNOVATION
CO-OPERATION
SUSTAINABILITY

Suite 1, Level 6, 2 Collins Street, Melbourne, Victoria 3000
Tel: (03) 9639 8868 Fax: (03) 9639 8860
Email: vicwater@vicwater.org.au Web: www.vicwater.org.au
ABN: 46 541 210 712 Inc Reg No. A0016320F

VICTORIAN WATER
INDUSTRY ASSOCIATION INC.

29 July 2016

Water Team
Essential Services Commission
Level 37, 2 Lonsdale Street
MELBOURNE VIC 3000
water@esc.vic.gov.au

Re: Review of water pricing approach – Position Paper

Thank you for the opportunity to provide a response to the Review of water pricing approach Position Paper. VicWater is the peak body of the Victorian water industry with its membership constituted by Victoria's statutory water corporations. Those corporations are responsible for the provision of urban water and wastewater services, rural water supply including irrigation and related drainage services. The comments in this VicWater submission represent the majority of views received from our members. We note that a number of water corporations will be making separate submissions highlighting issues specific to their business and this is encouraged by VicWater.

Highlights of VicWater's June 2015 submission

VicWater proposed a number of principles for the new approach to water pricing as a part the June 2015 submission. These principles are the product of the significant time that was spent considering the economic regulation of the water industry during 2013-14 as well as reviewing the most recent regulatory pricing process with members.

Fundamentally, VicWater supports approaches which seek to recover the efficient costs of water corporations, which provide incentives and encourages innovation for improved performance, can be easily understood by customers, ensures customer's interests are protected, services are sustainable and protects the financial viability of water corporations. Furthermore, the pricing approach should not be unduly affected by uncontrollable externalities or structural differences, for example some approaches may favour water corporations that experience high population growth or have centralised infrastructure and low cost water sources.

These principles were well-summarised by the ESC in the Position Paper Appendix. Water corporations continue to be very happy with their engagement with ESC during this review process.

Water corporation feedback on the proposed model – new interest rate calculation

Water corporations support the decision to adopt a trailing average approach to calculating the cost of debt. The previous 'on-the-day' approach fixed the cost of debt for a pricing period and exposed water corporations' balance sheets to the impact of interest rate movements.

A main benefit of the trailing average approach, compared with the on-the-day approach, is that it allows for a cost of debt that better reflects the actual financing costs incurred by a business (accounting for the maturity profile of the business's debt portfolio). This is a significant improvement from the previous method of determining a benchmark cost of debt within the WACC.

Determining the level of ambition and the self-assessment framework

A defining element of the proposed model is that water corporations will decide on a level of 'ambition' for their pricing submission that will determine return on capital. The ESC will then either validate the water corporation's self-assessment, or penalise it with a lower return than would have been the case had the water business 'accurately' assessed its level of ambition.

By using this approach, the ESC is attempting to create an incentive for water businesses to honestly self-assess the ambition and quality of their own price proposals before submitting them to the regulator. This is a laudable objective, however it presupposes that any difference between a water corporation's self-assessment and the ESC's assessment can only be attributed to the water corporations making a dishonest ambit claim.

The need to punish water corporations that fail to 'accurately' self-asses and magnitude of the punishment should to be carefully considered. Instead of the 0.2% reduction in the approved rate of return (suggested in the Position Paper), the ESC could consider an alternative penalty. The ESC could also consider removing this penalty entirely during the first price assessment under the new model while both parties learn how this incentive would work in practice.

For any water corporations that receives a penalty rate reduction under the proposed framework, rather than the scenario envisaged by the ESC on page 67 of the Position Paper:

> *The water business is questioned by the Department of Treasury and Finance as to why it has forfeited its opportunity to earn a higher rate of return. Had it been more honest in its self-assessment.*

VicWater envisages disgruntlement, disputes and distraction from focusing on the delivery of services to customers.

Dispute resolution

Water corporations have previously observed the need to develop appropriate mechanisms for water corporations to challenge or appeal pricing determinations. This will be of particular importance should the ESC proceed with punishing water corporations that self-assess at a higher level of ambition than the ESC's assessment.

VicWater is aware of the provisions under the *Essential Services Commission Act* (s 55), for a water businesses to appeal a determination made by the Commission. Although private sector entities regulated by the ESC have made frequent use of these provisions, it is not appropriate for government-owned water corporations to do the same (for one part of the government to, in effect, litigate another part of the government).

VicWater reiterates its support for the development of a separate mechanism to allow determinations to be appealed, as a part of the new water pricing approach.

Consultation and engagement

Water corporations overwhelmingly support the greater emphasis on community consultation and engagement outlined in the Position Paper. On April 15 VicWater hosted an Executive Forum on Customer and Community Engagement. The Forum included presentations from ESC, DELWP and an IAP2-accedited facilitator. City of Melbourne also presented a case study on the community consultation to develop their most recent 10 year financial plan.

The Position Paper correctly notes that there is a vast array of publicly available information on customer engagement. This information is usually summarised as 'principles' to guide the development of customer consultation and engagement strategies. Examples of documents that feature 'principles' for customer consultation and engagement include the VAGO guide, IAP2 and the ESC position paper.

Nevertheless, there remains a degree of uncertainty regarding exactly how these principles should apply to specific water industry scenarios. This uncertainty is visible in two phrases within the Position Paper:

> *"The form of customer engagement undertaken by a water business should be tailored to suit the content of consultation, and to the circumstances facing the water business and its customers"* (p24).
>
> *"The more expansive the engagement program (that is, the bigger the triangle), the more likely a business will earn higher returns and face less intrusive scrutiny by the Commission of their price submissions"* (p29)

The first phrase appears to recognise that a spectrum of consultation scenarios are encountered by water corporations and they will require differing approaches. Whereas the second phrase implies that bigger is better.

Water corporations believe that tailoring customer engagement to suit circumstances means that some scenarios require a comprehensive approach to consultation and other scenarios do not.

Another source of uncertainty is how to accommodate the potentially different wishes of various customer groups within a homogenous pricing structure. This is a particular issue for rural water corporations that cover a broad geographic area. Although strategies are already in place to manage these potential issues, it is unclear how the ESC would view the trade-offs involved under the new pricing approach.

Rather than allowing any uncertainty to persist, at a minimum, water corporations and the ESC should be in broad understanding regarding expectations for which scenarios require a comprehensive consultation approach, and which do not. And how existing approaches would be evaluated under the new framework. If there are different expectations, between the ESC, Water Minister and water corporations, these need to be illuminated and resolved prior to pricing submissions being made.

Demand models

Previous VicWater submissions on economic regulation have raised the importance of demand forecasts to price submission. The ESC acknowledges that demand forecasting is inherently uncertain. Water corporations agree. Accurate demand forecasting must combine estimates of population growth, with household consumption patterns that can vary significantly from year to year depending on rainfall. The model proposed to decide on the demand forecasts to be used to estimate prices has garnered significant interest from water corporations.

Water corporations wish to avoid the disputes over demand forecasts that occurred in the previous price submission process and were characterised by expensive and time consuming debates between competing consultants. With this in mind, the ESC's suggestion that it "would adopt the water business's demand forecast and proposed prices subject to minimal scrutiny of the underlying assumptions" and be "very unlikely to engage in modelling its own demand forecasts" is welcome.

The challenge for water corporations arise from the fact that water corporation costs have a higher fixed component, whereas customer prices have a higher variable component. Above or below forecast demand can, depending on the circumstances, result in higher or lower revenue than was anticipated, and also affect the water corporation's operational costs. In response, customers are asked to fund a risk premium (buffer) against unforeseen demand fluctuations. With prices progressively corrected for actual consumption after the fact.

Whilst it is prudent to include a mechanism to restrict excessive risk transfer to customers by adopting unnecessarily larger risk premium. The need for a risk premium is not disputed and its prudent size depends on individual circumstances. A revenue/price cap may be effective provided the caps are not aggressively set so as to undermine the recovery of the efficient costs of water corporations' delivery of water and wastewater services under variable circumstances.

Some details of the operation of the autonomous demand models require further discussion and clarification during the next phase of this review.

- The proposal to 'bid in' risk premiums competitively, be ranked by the ESC and have those ranking contribute to the PREMO assessment would advantage water corporations that have more predictable demand profiles and linear water supply costs. Water corporations with less predictable demand profiles, or with higher cost marginal water supply options may be disadvantaged under this approach.
- The Position Paper does not describe the technique behind the imposition of the revenue cap. If the role of the revenue cap is to limit total revenue for a period, and revenue earned exceeds the cap, how will the adjustment mechanism apply?
- The revenue cap should also allow for alternative responses by the business. For example, a prudent response to significant demand growth may be capital expenditure rather than reimbursement.
- The proposed mechanism by which prices are corrected for actual consumption shortly after it eventuates may lead to significant annual price swings in volumetric tariffs. Past customer feedback has indicated a strong preference for "no price shocks" and smooth price changes.
- It might be worthwhile to separate the components of demand, for example to provide more latitude for the climate-dependent component of the demand forecast.
- An alternative approach may be utilise a trailing average approach to demand forecasting (per connection) similar to the approach proposed for interest rate calculation. Most water corporations will assess usage patterns and risks of supply variability in line with the Government's proposed Urban Water Strategy Guidelines. Consistency with these guidelines, together with a trailing average parameter could provide confidence that buffers are not unnecessarily large.
- The proposed approach will become an important consideration for water corporations seeking to grow new, regulated revenue through innovation or initiative. The requirement to 'cash out' any benefit in the short term, even if it requires capital investment or increases future system capacity, may act as a dis-incentive. An alternative solution may be to allow additional revenue to go towards paying down debt, potentially a more balanced, inter-generational reward for the effort.

Performance monitoring

The performance monitoring framework will be key component of the new pricing approach. The Position Paper identifies a challenge for the performance monitoring framework to inform the process by determining how:

> *"the cost of equity established at the start of a pricing period (is adjusted) depending on how well a business performs against the outcome commitments in its price submission."*

The ESC does not express a view regarding how the incentive framework should be designed to encourage water businesses, during a regulatory period, to outperform the commitments made in their price submissions. VicWater offers to establish a dedicated working group to address these challenges in partnership with the ESC.