



Essential Services Commission

Water Pricing Approach – Position Paper

Barwon Water response

Response Date: 29 July 2016

Barwon Water response: Water Pricing Approach – Position Paper

Executive Summary

Barwon Water would like to thank the ESC for the opportunity to comment on the May 2016 'A new model for pricing services in Victoria's water sector' position paper. We would also like to acknowledge the ESC's efforts in meeting with Barwon Water and Wannon Water in Geelong on the 19th July to discuss and clarify areas of the position paper. For transparency, Barwon Water has included comments clarified at this meeting in this response.

The below response is structured to follow the position paper and to address each section individually. Key principles and comments made by the ESC are highlighted for each section and Barwon Water's subsequent comments and position is provided.

Barwon Water supports the ESC's position of early, broad and meaningful stakeholder engagement. Identifying outcomes that are most valued by customers and the community and building a Price Submission that focuses on the delivery of these is a refreshing and economically efficient way of looking at Price Submissions.

Barwon Water notes that early clarity and guidance from the ESC is needed on a number of principles identified in this paper, so that businesses can undertake the engagement and financial modelling required to achieve the desired results of stakeholders, businesses and the ESC. Barwon Water is also concerned that a number of principles could result in price and revenue uncertainty over the regulatory period, leading to dissatisfied stakeholders following completion of the consultation period.

It should be noted that the ESC addressed a number of Barwon Water's comments made in this response at its presentation in Geelong on the 19th of July. Barwon Water is expecting that the ESC will provide more clarity on a number of new proposals in its position paper prior to releasing the 2018 Price Submission Guidance Paper in November 2016.

Barwon Water is looking forward to receiving a final Guidance Paper from the ESC that addresses the issues raised.

Barwon Water response

Customer engagement

Form of customer engagement

ESC Principle 1: *The form of customer engagement undertaken by a water business should be tailored to suit the content of consultation and the circumstances facing the water business and its customers.*

Barwon Water supports the ESC in its proposal to tailor customer consultation to the needs of customers and unique uncontrollable external circumstances facing businesses.

Barwon Water would expect the ESC to assess the merit of any engagement exercise relative to the topic at hand and the preference of customers about what and how they want to be engaged in relation to that topic. In terms of the “customer engagement diagram” shown in Figures 5.1 and 5.2 of the position paper, a bigger triangle is not necessarily better – indeed, it is likely that different triangles could be drawn for the different topics discussed with customers which would result in different triangle sizes depending on the level of consultation for the topic.

ESC Principle 2: *A water business must provide customers with appropriate instruction and information, given the purpose, form and the content of the customer consultation.*

Barwon Water supports an open transparent bilateral approach to customer consultation.

Informing and educating customers about the range of issues on which water businesses need to engage will be the most important but also the most difficult aspect of engagement. Providing objective facts will minimise the impact of misinformation and biases that may be prevalent among participants. Given the limited timeframes, it is crucial that water businesses have very few uncertainties about the new water pricing approach so that engagement can be based on accurate and current information.

Barwon Water position: *Greater clarity from the ESC about the requirements and treatments of inputs for the Price Submission will enable businesses to effectively achieve Principle 2.*

Content of customer engagement

ESC principle 3: *A water business’s customer engagement should give priority to matters that have a significant influence on the services provided and prices charged by the business.*

Barwon water supports the notion that outcomes valued most by customers should be prioritised during consultation and Price Submission proposals.

To this point, Barwon Water completed an initial engagement exercise (Test Phase) in June to confirm the content on which, and the methods by which, customers would like to be more fully engaged during the development of the 2018 Price Submission. Barwon Water will shortly embark upon a more comprehensive engagement exercise (Main Phase) to engage more deeply with customers on those issues that are critical to the development of the 2018 Price Submission, based on the outcomes from the Test Phase.

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Timing of customer engagement

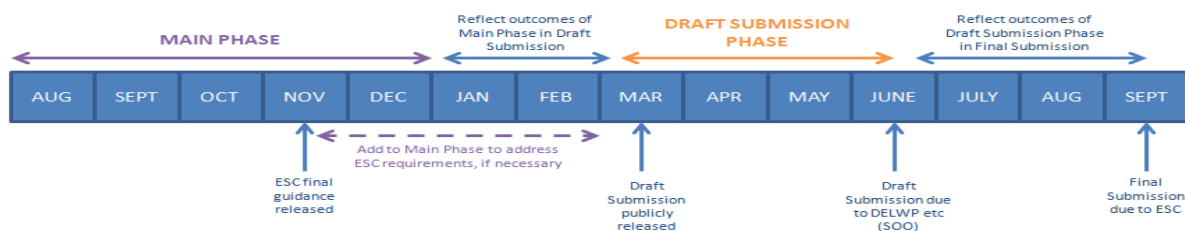
ESC principle 4: A water business should start customer engagement early in its planning. The engagement should be ongoing, to keep testing proposals with customers.

Barwon Water already engages with its customers on many different topics, in many different ways. However, it will be necessary to test and refine specific concepts and proposals with customers to help inform development of the 2018 Price Submission. Barwon Water cannot wait until the ESC releases its Guidance Paper in November 2016 before commencing this engagement, for the reasons outlined below. As such, Barwon Water will be engaging with customers despite uncertainty about a number of variables for the price submission and financial model.

Clause 2.2.2 of the Statement of Obligations (SoO) issued to Barwon Water by the Minister for Water requires that a draft Price Submission be submitted to the Minister for Water and other regulatory agencies no less than three months prior to lodging the final submission with the ESC. This means that water businesses will need to complete draft Price Submissions by June 2017, given the final Price Submission due date of September 2017 to the ESC.

As shown in Image 1, Barwon Water proposes to allow a period of public consideration and comment on its draft submission prior to its lodgement to the Minister for Water (Draft Submission Phase). This is considered necessary to allow customers the opportunity to provide feedback on how engagement outcomes from the Main Phase are proposed to be incorporated into the 2018 Price Submission. Working backwards from this date, allowing at least three months to reflect outcomes from the Draft Submission Phase; undertake the Draft Submission Phase; and reflect outcomes of the Main Phase and the ESC guidance paper; means that the Main Phase will need to be completed by the end of 2016 (see Image 1).

Image 1 – Price Submission timeframes



Given the above timeframes, the December/January holiday period may pose difficulties in engaging with a large/diverse enough sample of stakeholders necessary for meaningful consultation. This means that consultation may need to begin even earlier as indicated in Image 1.

Barwon Water position: Greater clarity from the ESC about Price Submission requirements will enable businesses to begin robust and meaningful engagement early to meet necessary timeframes.

Demonstration of customer engagement

ESC principle 5: A water business should demonstrate in its price submission how it has taken into account the views of its customers.

Barwon Water agrees that Price Submissions should demonstrate adequate customer support. However, water businesses need to have a level of understanding about the level of customer feedback that the ESC expects to be incorporated in Price Submissions in terms of PREMO assessment criteria in evaluating levels of ambition.

Barwon Water position: The ESC should provide criteria on which it will assess whether businesses have incorporated a sufficient level of customer feedback into Price Submissions.

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A new incentive framework

Building on existing incentives

ESC comment: Approach that allows the cost of equity to change within a pricing period depending on how a business performs against service commitments made in its price submission.

More detail surrounding the practical mechanisms and assessment criteria for this mechanism is required.

The proposed framework would result in even greater price uncertainty for customers and revenue uncertainty for water businesses, especially given the proposed trailing average cost of debt approach discussed below. It is difficult enough to craft communications material currently to explain the consumer price index and annual price path movements when explaining to customers how their tariffs and bills will change from one year to another.

In addition, any changes to prices within the period may distort willingness to pay propositions developed with customers during the engagement phase.

It may be beneficial to defer full implementation of the proposed to the 2023 regulatory period once businesses, the ESC, other regulatory agencies and stakeholders become familiar with the other new aspects of the regulatory framework.

Barwon Water position: The ESC should consider the option of a ‘true-up’ approach at the start of the next regulatory period, rather than through the period, to minimise price uncertainty to customers and revenue uncertainty for businesses.

New model, new incentives

ESC comment: Model pillars for consultation with interested parties.

Barwon Water supports the consultation pillars highlighted by the ESC in principle, taking into account the comments below.

ESC comment: Returns allowed for each water business will vary depending on the ambitiousness of the business’s proposed outcomes in its price submission dependent on: customer engagement proposed service outcomes, cost efficiencies and absorption of risk on behalf of customers.

The possibility of the return on equity changing post engagement potentially results in businesses giving different willingness to pay examples in the engagement process than what is approved in the final determination.

Clear PREMO criteria of how ambition levels will be determined will not only reduce stakeholder and business price and revenue uncertainty, but also reduce the regulatory burden for the ESC because businesses will have a process to clearly link their proposals to assessment criteria.

Barwon Water position: The ESC should release clear PREMO assessment criteria of how it will decide the level of ambition for each water business.

The “PREMO model”

ESC comment: Price submission will first be rated by the business and then by the ESC according to PREMO (**P**erformance, **R**isk, **E**ngagement, **M**anagement, **O**utcomes) criteria which will indicate the business’s level of ambition.

Barwon Water response to ESC Pricing Framework Review

Barwon Water considers the decrease in allowable return on equity when the ESC deems a business to be 'too ambitious' relative to the self-assessment undertaken by the business are too severe. Given the 2018 regulatory period will be the first time the new pricing framework has been employed, an asymmetry of information will exist when each business assesses its own performance compared to the ESC assessing each business' performance relative to each other. The penalties for incorrect self-assessment could potentially result in a significant financial risk to businesses which, in the absence of clear criteria about how the ESC will make its assessment, could encourage businesses to be conservative in their own self-assessments. This would undermine the intent of the incentive matrix. Perhaps the extent of 'punishment' could be smoothed/staged based on the PREMO assessment criteria, with lesser penalties in place for the 2018 regulatory period relative to the 2023 regulatory period and beyond.

In addition, assessments to downgrade businesses return on equity allowance should be done with an overlay of financial health indicators to ensure the changes do not result in a business experiencing financial stress.

Barwon Water also notes that a formalised requirement for Boards to attest to the Price Submission may result in increased expenditure on consultancies to check all aspects of the document.

Barwon Water position: *Similar to the previous position, the ESC should release clear PREMO assessment criteria of how it will decide the level of ambition for each water business.*

ESC comment: *The cost of equity for a price submission with the lowest level of ambition would be set at a level no lower than the benchmark real cost of debt, and possibly higher.*

Barwon Water supports setting the lowest level of return of equity at a level no lower than the real benchmark cost of debt.

Cost of debt

ESC comment: *We propose to establish the cost of debt using a 10 year trailing average approach of past interest rates, updated annually to include the latest interest rate. Prices are adjusted during a pricing period in line with the interest rate.*

Barwon Water supports the adoption of a 10 year trailing average approach to establish the cost of debt.

However, a formula with all input assumptions would assist businesses to begin financial scenario modelling. As noted above, this is particularly relevant if robust and meaningful stakeholder engagement is to be conducted. For example:

$$WACC_{(real)} = (0.6CoD_{y(nominal)} + 0.4RoE_{y(nominal)}) - CPI_y$$

Where $CoD_{y(nominal)}$ is nominal 10 year trailing average cost of debt based on RBA BBB credit rating market rates, and TCV BBB credit rating rates for the Global Financial Crisis (GFC) years 2008/09 to 2011/12 of the year in question..

Where $RoE_{y(nominal)}$ is the nominal Return on Equity based on the approved level of ambition of the year in question.

CPI_y is the inflation rate of the year in question.

In addition, rounding down of the WACC calculation in the ESC financial pricing model can result in a material amount of revenue under-recovery.

Barwon Water response to ESC Pricing Framework Review

Barwon Water position: *The ESC should clearly define the WACC calculation including all input parameters of calculating the cost of debt prior to releasing the Guidance Paper.*

The ESC should remove rounding down in the ESC financial pricing model WACC calculations.

Adjusting returns during the pricing period

ESC comment: *Intra-period adjustments might be warranted in two instances:*

- *if the Commission's final decision downgrades the level of ambition, the business may have its cost of equity upgraded during the period if its performance in delivering outputs and managing costs outstrips expectations.*
- *the ESC might consider revisiting its final after two or three years if the business is performing well below the claims made in its price submission.*

Adjusting the WACC by changing the cost of equity during the regulatory period would result in price uncertainty for customers and increases complexity in explaining annual changes in tariffs, which is difficult to explain to customers currently when CPI is included.

It may be more effective to 'true-up' any revisions to the return on equity into the following regulatory period to minimise the regulatory burden and maximise customer price certainty.

Barwon Water position: *To either not implement this mechanism in the 2018 regulatory period due to the overall unfamiliarity of the framework to all parties, or to consider a 'true-up' approach in the following regulatory period.*

Flexibility mechanisms

Proposed changes to performance reporting

ESC comment: *Improvements to our performance reporting framework:*

- *Our annual performance reporting will give greater prominence to business performance against outcomes, rather than focusing on inputs.*
- *We will require businesses to self-report to customers on how well they performed against service commitments agreed with customers.*

Barwon Water supports increased focus to be given to performance outcomes and self reporting based on agreed service commitments.

Clarity from the ESC is welcome regarding its expectation of the treatment of the current, very network focused, service standards and targets. It would also be desirable for the ESC to provide guidance on the acceptability of significant changes to the current service standards, should this be an outcome following customer engagement.

The guaranteed service level scheme

ESC comment: *Businesses to review the number, nature of, and the rebate amounts that will apply in the event of a breach of a GSL. The rebate amounts should be reviewed in consultation with customers given the changes in prices since 2013, and to ensure they continue to provide incentives for a water business to make efficient investment decisions.*

Barwon Water supports the revaluation of GSL indicators in collaboration with its customers.

It is expected that effective customer engagement will result in closer alignment between GSLs and service standards given that both should reflect areas of service mostly valued by customers and the community.

Barwon Water response to ESC Pricing Framework Review

A new flexible price review process

ESC comment: *'Fast-tracking' of well justified pricing submissions that are evidence-based, supported through customer consultation and with enough evidence of the robustness of its cost and demand estimates to gain regulatory approval earlier and with less regulatory scrutiny.*

The extent of review required for a business reflects the quality of the price submission, past performance, and benchmarking of forecast spending against other businesses.

Barwon Water supports the fast-tracking mechanism for water businesses who prepare a well justified and competitive cost proposition Price Submission.

Barwon Water position: *Criteria used to determine who is fast-tracked should be available and transparent to minimise asymmetry of information.*

Autonomy in demand forecasting

ESC comment: *The Commission would adopt the water business's demand forecast and proposed prices subject to minimal scrutiny of the underlying assumptions. Unlike in past price reviews, the Commission would be very unlikely to engage in modelling its own demand forecasts. (However:)*

- *Up to the water business's forecast level of demand, a price cap form of control would apply based on the prices submitted by the water business.*
- *Beyond the water business's forecast level of demand, a revenue cap would apply.*

Barwon Water supports the ESC's intent of encouraging businesses to provide, what they can predict with the most reliable information available at the time, the truest demand forecasts for the regulatory period.

However, higher demand due to exceptionally dry conditions as was experienced through the 2015/16 summer period can result in higher than forecast operating expenditure. This includes increased electricity, water carting (potentially), treatment and transfer costs.

The result of this would be that businesses in regions with standby water sources that are marginally more expensive would be disadvantaged by this approach as they would require a higher 'buffer' to avoid detrimental effects of a revenue cap combined with higher operating expenses.

Price uncertainty for customers would also occur due to prices changing as a result of the revenue cap.

Barwon Water position: *Consideration should be given to include a minimum buffer level so that businesses are not disadvantaged for servicing in areas of higher marginal source costs.*