Essential Services Commission

Lower Murray Water final decision – urban services: 2018 Water Price Review – Commission's consideration of legal requirements

19 June 2018

Clause 11 of the Water Industry Regulatory Order 2014 (WIRO) specifies the mandatory factors we must have regard to when making a price determination. The WIRO covers matters that are included in the *Water Industry Act 1994* (Vic) (WI Act) and the *Essential Services Commission Act 2001* (Vic) (ESC Act).

Below, we describe how we apply the mandatory factors and where we have done so in our final decision for Lower Murray Water.[1] This paper should be read in conjunction with our final decision, which is available at www.esc.vic.gov.au.

In addition to the mandatory factors set out below, clause 11 of the WIRO requires the commission to have regard to the matters specified in the commission's guidance.[2] Our draft and final decisions provide further information on where we have considered our guidance, and Lower Murray Water's compliance with our guidance, in making our price determination.[3]

Note: all page numbers referenced below refer to our final decision for Lower Murray Water.

[1] Essential Services Commission 2018, *Lower Murray Water final decision – urban services:2018 Water Price Review*, 19 June

[2] Essential Services Commission 2016, *2018 Water Price Review, Guidance paper*, November.

[3] Essential Services Commission 2018, *Lower Murray Water draft decision, 2018 Water Price Review*, 28 March; Essential Services Commission 2018, *Lower Murray Water Determination – urban services: 1 July 2018 – 30 June 2023*, June.

Economic efficiency and viability matters

WIRO clause 8(b)(i) requires us to have regard to the 'promotion of efficient use of prescribed services by customers'.

We consider that the efficient use of prescribed services by customers is promoted when a tariff is applied to customers benefiting from the service covered by the tariff, and tariffs send appropriate signals about efficient costs.

The following sections of our final decision involved consideration of this factor:

- Our consideration of customer engagement (page 6).
- Our assessment of the revenue requirement (pages 9 to 10).
- Our assessment of efficient operating expenditure (pages 10 to 14) and capital expenditure (pages 17 to 18).
- Our assessment of tariffs (pages 22 to 24).

WIRO clause 8(b)(ii) requires us to have regard to the 'promotion of efficiency in regulated entities as well as efficiency in, and financial viability of, the regulated water industry'.

We consider that the delivery of outcomes which reflect customer service priorities at an efficient cost promotes efficiency in regulated entities and the water industry. Our final decision has therefore had regard to the extent that Lower Murray Water has demonstrated its proposed outcomes reflect customer service priorities, and whether its tariffs and forecast costs reflect efficient levels of expenditure.

The following sections of our final decision involved consideration of this factor:

- Our consideration of customer engagement (page 6).
- Our assessment of the revenue requirement (pages 9 to 10).
- Our assessment of efficient operating expenditure (pages 10 to 14) and capital expenditure (pages 17 to 18).
- Our assessment of tariffs (pages 22 to 24).
- Our assessment of financial viability (pages 26 to 27).

WIRO clause 8(b)(iii) requires us to have regard to the 'provision to regulated entities of incentives to pursue efficiency improvements'.

We consider that the delivery of outcomes which reflect customer service priorities at an efficient cost provides regulated entities incentives to pursue efficiency improvements. The following sections of our final decision involved consideration of this factor:

- Our consideration of customer engagement (page 6).

- Our consideration of outcomes (pages 6 to 7).
- Our assessment of the revenue requirement (pages 9 to 10).
- Our assessment of efficient operating expenditure (pages 10 to 14) and capital expenditure (pages 17 to 18).
- Our assessment of tariffs (pages 22 to 24).

Additionally, our pricing approach allows a water corporation to retain the benefits of any cost efficiencies it generates until the end of its regulatory period. In other words, a water corporation has an incentive to outperform the operating and capital expenditure benchmarks we accept for the purpose of estimating its revenue requirement and prices. This is consistent with providing incentives for water corporations to pursue efficiency improvements.

ESC Act section 8A(1)(a) requires us to have regard to 'efficiency in the industry and incentives for long term investment'.

We consider that adopting forecasts of efficient expenditure that reflect the service priorities of the customers of each water corporation promotes efficiency in the water industry.

The following sections of our final decision involved consideration of this factor:

- Our consideration of customer engagement (page 6).
- Our consideration of outcomes (pages 6 to 7).
- Our assessment of the revenue requirement (pages 9 to 10).
- Our assessment of efficient operating expenditure (pages 10 to 14) and capital expenditure (pages 17 to 18).
- Our assessment of tariffs (pages 22 to 24).

We have had regard to incentives for long term investment by adopting:

- A ten year trailing average approach to estimating the benchmark cost of debt (pages 18 to 19).
- A regulatory rate of return that we consider will enable Lower Murray Water to recover borrowing costs associated with its investment in services, and generate a return on assets.[4]

[4] The regulatory rate of return is comprised of the cost of debt and the return on equity.

ESC Act section 8A(1)(b) requires us to have regard to the 'financial viability of the industry'.

We consider that the financial viability of the industry is secured by approving prices that provide a high degree of certainty that each water corporation can generate cash flow to service financing costs arising from investments to meet service expectations.

We have had regard to this matter on pages 26 to 27.

ESC Act section 33(3)(b) requires us to have regard to the 'efficient costs of producing or supplying regulated goods or services and of complying with relevant legislation and relevant health, safety, environmental and social legislation applying to the regulated industry'.

In preparing our final decision, we have had regard to the extent Lower Murray Water has demonstrated its forecasts reflect efficient costs to deliver services valued by customers, and to deliver on relevant legislation and relevant health, safety, environmental and social obligations.

The following sections of our final decision involved consideration of this factor:

- Our consideration of customer engagement (page 6).
- Our assessment of the revenue requirement (pages 9 to 10).
- Our assessment of efficient operating expenditure (pages 10 to 14) and capital expenditure (pages 17 to 18).
- Our assessment of tariffs (pages 22 to 24).

Industry specific matters

ESC Act section 33(3)(a) requires us to have regard to the 'particular circumstances of the regulated industry and the prescribed goods and services for which the determination is being made'.

Our pricing approach allows each water corporation to propose outcomes, tariff structures and expenditure that reflect its particular circumstances. We consider that taking into account the particular circumstances of each water corporation is consistent with taking into account the particular circumstances of the water industry.

The following sections of our final decision involved consideration of this factor:

- Our consideration of customer engagement (page 6).
- Our consideration of outcomes (pages 6 to 7).

- Our assessment of the revenue requirement (pages 9 to 10).
- Our assessment of efficient operating expenditure (pages 10 to 14) and capital expenditure (pages 17 to 18).
- Our assessment of tariffs (pages 22 to 24).

We have had regard to the prescribed services listed in the WIRO in making our decision. This includes adopting operating and capital expenditure benchmarks that we consider will allow Lower Murray Water to deliver services that are covered by the prescribed services listed in the WIRO.

ESC Act section 33(3)(c) requires us to have regard to the 'return on assets in the regulated industry'.

Our final decision provides for Lower Murray Water to generate a return on assets through:

- Our consideration of the regulatory asset base (pages 14 to 17).
- Our consideration of the cost of debt (pages 18 to 19).
- Our consideration of the return on equity (page 20).

ESC Act Section 33(3)(d) requires us to have regard to 'any relevant interstate and international benchmarks for prices, costs and return on assets in comparable industries'.

In assessing costs, prices and return on assets we have had regard to relevant interstate benchmarks:

- indicative bills paid by customers in other jurisdictions in Australia[5]
- operating and capital expenditure costs per connection throughout Australia[6]
- tariff structures applied by water corporations throughout Australia[7]
- the regulatory rate of return set by other regulators.[8]

We are not aware of any international benchmarks that are relevant to our decision.

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[5] Bureau of Meteorology 2018, *National performance report 2016-17; urban water utilities, part A*, Melbourne.

[6] ibid.

[7] Includes Icon Water, Sydney Water, Hunter Water, Gosford City Council, Wyong Shire Council, Power and Water Corp, Urban Utilities, Unity Water, SA Water and TasWater.

[8] Essential Services Commission of South Australia 2016, *SA Water regulatory determination 2016*, *Final determination*, June; Independent Pricing and Regulatory Tribunal 2017, *WACC biannual update*, August.

WI Act section 4C(b) requires us to 'ensure that regulatory decision making and regulatory processes have regard to any differences between the operating environments of regulated entities'.

Our pricing approach allows each water corporation to propose outcomes, a revenue requirement, expenditure and tariffs that reflect its particular circumstances and operating environment.

The following sections of our final decision involved consideration of this factor:

- Our consideration of customer engagement (page 6).
- Our consideration of outcomes (pages 6 to 7).
- Our assessment of the revenue requirement (pages 9 to 10).
- Our assessment of efficient operating expenditure (pages 10 to 14) and capital expenditure (pages 17 to 18).
- Our assessment of tariffs (pages 22 to 24).

Our price review also considers the views of stakeholders affected by Lower Murray Water's proposals, including through submissions and public meetings.

Customer matters

ESC Act section 8(1) requires us to have regard to the fact that the 'objective of the Commission is to promote the long term interests of Victorian consumers'.

We consider that promoting efficiency in delivering outcomes that align to service priorities of customers is consistent with promoting the long term interests of Victorian consumers.

The following sections of our final decision involved consideration of this factor:

- Our consideration of customer engagement (page 6).
- Our consideration of outcomes (pages 6 to 7).
- Our assessment of the revenue requirement (pages 9 to 10).
- Our assessment of efficient operating expenditure (pages 10 to 14) and capital expenditure (pages 17 to 18).
- Our assessment of tariffs (pages 22 to 24).

ESC Act Section 8(2) requires us to 'have regard to the price, quality and reliability of essential services' in seeking to achieve the objective in section 8(1) of the ESC Act.

We consider that promoting efficiency in delivering outcomes that align to service priorities of customers, and allowing businesses to meet regulatory and policy obligations is consistent with this objective.

In terms of prices, the following sections of our final decision involved consideration of this factor:

- Our consideration of the revenue requirement (pages 9 to 10).
- Our assessment of efficient operating expenditure (pages 10 to 14) and capital expenditure (pages 17 to 18).
- Our consideration of demand (page 21).
- Our consideration of tariffs (pages 22 to 24).

In terms of the quality and reliability of services, the following sections of our final decision involved consideration of this factor:

- Our consideration of customer engagement (page 6).
- Our consideration of outcomes (pages 6 to 7).

WIRO Clause 11(d)(i) requires us to have regard to whether Lower Murray Water's prices 'enable customers or potential customers of the regulated entity to easily understand prices charged by the regulated entity for prescribed services or the manner in which such prices are calculated, determined or otherwise regulated'.

We consider that the following matters are relevant when considering whether Lower Murray Water's prices enable customers or potential customers to easily understand prices, or the manner in which prices are calculated, determined or otherwise regulated:

- feedback from customers during a water corporation's engagement
- the structure of individual tariffs
- the proposed form of price control
- any changes to tariffs and how water corporations explain them to customers.

The following sections of our final decision involved consideration of this factor:

- Our consideration of the form of price control and tariffs (pages 21 to 24).

WIRO Clause 11(d)(ii) requires us to have regard to whether Lower Murray Water's prices 'provide signals about the efficient costs of providing prescribed services to customers while avoiding price shocks where possible'.

We consider prices can provide signals about efficient costs when a tariff is applied to customers benefiting from the service covered by the tariff, and tariffs send appropriate signals about efficient costs.

The following sections of our final decision involved consideration of this factor:

- Our consideration of customer engagement (page 6).
- Our assessment of the revenue requirement (pages 9 to 10).
- Our assessment of efficient operating expenditure (pages 10 to 14) and capital expenditure (pages 17 to 18).
- Our assessment of tariffs (pages 22 to 24).

WIRO Clause 11(d)(iii) requires us to have regard to whether Lower Murray Water's prices 'take into account the interests of customers of the regulated entity, including low income and vulnerable customers'.

In considering the above factor, we had regard to:

- the customer engagement by Lower Murray Water, noting that affordability was one of the major priorities identified by its customers. Lower Murray Water has proposed a reduction in average prices, which results in indicative bills reducing for most residential customers, including tenants (page v).
- Lower Murray Water offers a range of payment options and advice for customers experiencing difficulty paying bills. We consider these options and advice provide avenues for low income and vulnerable customers to seek assistance.

Health, safety, environmental and social obligations

ESC Act Section 8A(1)(d) requires us to have regard to 'the relevant health, safety, environmental and social legislation applying to the industry'.

Our final decision approves a revenue requirement that will enable Lower Murray Water to deliver the outcomes valued by customers, and on its legal and regulatory obligations.

The following sections of our final decision involved consideration of this factor:

- Our assessment of the revenue requirement (pages 9 to 10).

- Our assessment of efficient operating expenditure (pages 10 to 14) and capital expenditure (pages 17 to 18).
- Our assessment of the form of price control (pages 21 to 22).

WI Act section 4C(c) requires us to 'ensure that regulatory decision making has regard to the health, safety, environmental sustainability (including water conservation) and social obligations of regulated entities'.

Our final decision approves a revenue requirement that will enable Lower Murray Water to deliver the outcomes valued by customers, and on its health, safety, environmental sustainability and social obligations.

The following sections of our final decision involved consideration of this factor:

- Our assessment of the revenue requirement (pages 9 to 10).
- Our assessment of efficient operating expenditure (pages 10 to 14) and capital expenditure (pages 17 to 18).
- Our assessment of tariffs (pages 22 to 24).

Other matters

ESC Act section 8A(1)(c) requires us to have regard to 'the degree of, and scope for, competition within the industry, including countervailing market power and information asymmetries'.

In relation to the above, Lower Murray Water does not face any competition in the delivery of its prescribed services within its region. Our final decision takes this into account through our consideration of forecast efficient costs, and considering the service priorities of customers as revealed through a business's customer engagement.

The following sections of our final decision involved consideration of this factor:

- Our assessment of engagement (page 6)
- Our assessment of outcomes (pages 6 to 7)
- Our assessment of efficient operating expenditure (pages 10 to 14) and capital expenditure (pages 17 to 18).

We consider that our pricing approach helps to address market power and information asymmetries relating to the water corporations. Our new PREMO water pricing approach provides incentives for a water corporation to provide its "best offer" to customers in its price submission. This is described in further detail in a report we released in 2016.[9]

ESC Act section 8A(1)(e) requires us to have regard to the 'benefits and costs of regulation (including externalities and gains from competition and efficiency) for: (i) consumers and users of products or services (including low income and vulnerable consumers); and (ii) regulated entities'.

We have had regard to benefits and costs of regulation by:

- Focusing our assessments of price submissions on the materiality of proposals to customer interests (including low income and vulnerable services), including in terms of price, bill and service impacts.
- Designing our guidance so we minimise the compliance costs for water corporations. Our guidance noted that much of the information required in price submissions should be readily available to water corporations as it would be relevant for other purposes such as corporate planning and project prioritisation and justification.[10]

A benchmarking study found that the cost of the commission's price reviews in the past has been lower than those of regulators in other Australian jurisdictions (after being normalised for revenue covered by price decisions).[11] Our 2013 water price review reduced the revenue requirement of the water industry by $1.3 billion compared to the water corporations' original proposals, resulting in savings to water consumers, including low income and vulnerable consumers.

ESC Act section 8A(1)(f) requires us to have regard to 'consistency in regulation between States and on a national basis'.

Similar to other state and national regulators, our economic regulatory approach:

- uses the building block method to estimate a water corporation's revenue requirement

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[9] Essential Services Commission 2016, *Water Pricing Framework and Approach, Implementing PREMO from 2018*, October, pp. 11-13.

[10] Essential Services Commission 2016, *Guidance paper*, op. cit., p.2.

[11] Essential Services Commission 2014, *Information paper for the Independent Review of the Economic Regulatory Framework*, April.

- allows water corporations to implement various forms of price control, including price caps and revenue caps
- allows for consultation with key stakeholders during a price review, including through the release of a final decision.

WI Act section 4C(a) requires us to 'ensure that the costs of regulation do not exceed the benefits'.

We have sought to ensure that the costs of regulation do not exceed the benefits by:

- Implementing a price review process so that water corporations may receive streamlined price reviews if they submit a high quality price submission (page 3). This reduces the costs of regulation for water corporations and the commission.
- Focusing our assessments of price submissions on the materiality of proposals to customer interests (including low income and vulnerable services), including in terms of price, bill and service impacts.
- Designing our guidance so we minimise the compliance costs for water corporations. Our guidance noted that much of the information required in price submissions should be readily available to water corporations as it would be relevant for other purposes such as corporate planning and project prioritisation and justification.[12]

A benchmarking study found that the cost of the commission's price reviews in the past has been lower than those of regulators in other Australian jurisdictions (after being normalised for revenue covered by price decisions).[13] Our 2013 water price review reduced the revenue requirement of the water industry by $1.3 billion compared to the water corporations' original proposals, resulting in savings to water consumers, including low income and vulnerable consumers.[14]

[12] Essential Services Commission 2016, *Guidance paper*, op. cit., p.2.

[13] Essential Services Commission 2014, *Information paper,* op. cit.

[14] Essential Services Commission 2016, *Guidance paper*, op. cit., p.2.