



WATER SERVICES
ASSOCIATION OF AUSTRALIA



Submission to the Essential Services Commission

A new model for pricing services in
Victoria's water sector

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1.0 Key points

- The ESC's existing regulatory framework meets many of the principles of good economic regulation including:
 - Having a clear objective of meeting the long term interests of consumers
 - Requiring financial viability tests to be part of the framework
 - A merits review process
- The new framework can build on these strong foundations
- WSAA supports the ESC's proposal to enshrine the utility–customer relationship at the heart of the regulatory framework and to hold utilities accountable for the outcomes they provide to customers
- The proposal contains a wholly novel method of determining the return on equity, which embodies a new incentive framework
- In developing this new method for the return on equity WSAA suggests that the ESC
 - Provide clear guidance to utilities about its expectations under the framework, at least until the framework becomes established
 - Seek to avoid semantic uncertainty surrounding the new terms in the framework
 - Develops objective assessment criteria for each water business's price submission, rather than adopting a relative ranking process
 - Does not lose sight of the need to maintain the long term financial viability of water businesses
 - Implements a competitively neutral regime that could apply regardless of ownership.

2.0 Introduction

WSAA welcomes the opportunity to respond to the Essential Service Commission's (ESC's) Position Paper, *A new model for pricing services in Victoria*. The ESC's proposed approach represents a step change in the regulation of urban water in Australia. If adopted, over time it is likely to affect the regulation of urban water nationally.

One theme in WSAA's work over the past three years has been advocating for improvements to the economic regulation of the urban water industry. Better regulation is required to enable utilities to provide greater value to customers now and in the future. In August 2014 WSAA released *Improving the economic regulation of urban water*, a report WSAA commissioned from Frontier economics. The Report evaluated current regulation against the principles of a best practice model. In November 2015 the Commonwealth Treasurer, The Hon Scott Morrison MP launched WSAA's collaborative paper with Infrastructure Partnerships Australia on urban water reform, *Doing the urgent as well as the important*. The paper identifies the reforms that are necessary now to safeguard the sector's strong performance in the future.

Economic regulation has played an important role in the water industry's development. It needs to evolve to meet future challenges, primarily to meet the long term needs of customers. In addition, greater certainty and predictability would be necessary to attract more private investment in urban water.

Water utilities occupy a privileged place as the suppliers of essential services. They are required to balance commercial, social and environmental drivers while in most cases being monopoly suppliers. Economic regulation provides protection and assurance to customers and places discipline on utilities to demonstrate that they are efficient. Against this background, the ESC's position paper is an important development. WSAA strongly supports the paper's central proposition – to put the customer at the centre of the regulatory framework.

This submission set out how the ESC's proposals sit against the criteria for best practice identified in WSAA's previous work and notes the areas that will require further development as the ESC moves into the implementation phase.

3.0 Best practice economic regulation

Like the ESC’s position paper, this submission assumes some familiarity with economic regulation of the water sector and the approach of the ESC. All of WSAA’s previous work is available on its website.

Arising from our previous work on economic regulation WSAA distilled the essential elements of best practice economic regulation and priorities for reform (Table 1). Published in 2014 these principles remain equally as relevant today for assessing regulatory frameworks. At the time we said that the findings were neither surprising nor controversial, but highlighted that no one jurisdiction has it completely right. Some jurisdictions meet most elements of a best practice model, but no jurisdiction meets them all.

Since 2014 we have witnessed around the world an even greater emphasis on customer engagement and ensuring customer preferences and values drive regulatory outcomes. WSAA fully supports this emphasis.

Table 1 Economic regulation reform priorities

Establishing regulation which is independent from Governments	This is necessary to ensure regulators are free from undue influence that could compromise regulatory outcomes. It is also important that regulators can determine prices rather than just recommend.
Setting clear objectives for regulators to act in the long term interests of customers	Lack of clarity in objectives leads to inconsistency in decision making and lack of accountability.
Strong and transparent customer engagement within the regulatory framework	Utilities need to better understand customer needs and what drives customer value. It is critical that this understanding is part of the regulatory process.
Establishing incentives for productivity and innovation	Productivity and innovation are necessary for utilities to drive further efficiency gains. In addition, future efficiency and innovation will be driven in part by greater private involvement in the water industry and by adopting new business models.
Assessment of financial viability to protect the long term interests of customers	The sector needs to be financially sustainable to maintain service levels over the longer term. Regulators need to incorporate financial viability metrics into the price determination process.
Merits review and appeal mechanisms for utilities and other stakeholders	These are essential to ensure accountability of regulators for their decisions and are a precondition for further private involvement.

Source: WSAA Position statement on economic regulation, November 2014
(available here: <https://www.wsaa.asn.au/publication/position-statement-improving-economic-regulation>)

4.0 Evaluating the ESC's proposal

4.1 Building on strong foundations

Before commenting directly on the ESC's proposal it should be emphasised that the ESC's existing pricing approach contains many elements of a sound model set out in Table 1. This is partly attributable to the way it operates, but is also attributable to the way it has been established. For example:

- It has a clear objective – Section 8 of the *Essential Services Commission Act 2001* (the Act) specifies that the objective of the Commission is to promote the long term interests of Victorian consumers.
- The Act also requires the Commission to have regard to the financial viability of the industry.
- The ESC's decisions are subject to a merits review process (although it had not been used).

In addition, like most regulatory approaches, the ESC uses a building blocks model to determine the efficient level of revenue. The model is well understood and it proposes to continue to use it under the proposed new framework.

As we said during the ESC's public consultation to develop the new framework, it is important to build on these strong foundations rather than to start with clean sheet of paper.

4.2 Reframing the customer utility relationship

The essence of the new model is absolute clarity in the framework about the responsibility for water customers. As Ron Ben David said in his Chairman's overview:

Our framework will pivot the businesses attention squarely towards their customers. There will be no successful outcomes for the businesses if they do not understand the concerns, priorities and preferences of their customers.

In relation to autonomy he added that:

The boards of water businesses are too often left confused by the Commission's role in light of the duties vested in them. There should be no such confusion. The Boards and their management teams are solely responsible for the outcomes they deliver.

WSAA agrees that utilities should own the customer relationship and be accountable to customers and regulators for delivering outcomes. Regulators in Australia and abroad are attempting to enshrine greater customer involvement in price reviews. Yet to date they do not have the clarity proposed by the ESC. While well intentioned, some regulator-led customer reference groups and other customer review mechanisms have the potential to blur the essential relationship between the customer and the utility rather than enhance it.

Regulators will never have as much information about customers as utilities. And when they attempt to capture the same amount of information – for example that necessary to set individual prices for all services – it creates a significant regulatory burden for utilities and sub optimal outcomes for customers.

In the ESC's proposed model the role of the regulator becomes to assess how well the utility has engaged with customers and how well they have taken their views into account when developing business plans.

The ESC proposes two new elements to implement the new model: a set of customer engagement principles and a new incentive framework.

4.3 Customer engagement principles

The ESC's five customer engagement principles from the position paper are as follows:

1. 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.
2. A water business must provide customers with appropriate instruction and information, given the purpose, form and the content of the customer consultation.
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.
4. A water business should start customer engagement early in its planning. The engagement should be ongoing, to keep testing proposals with customers.
5. A water business should demonstrate in its price submission how it has taken into account the views of its customers.

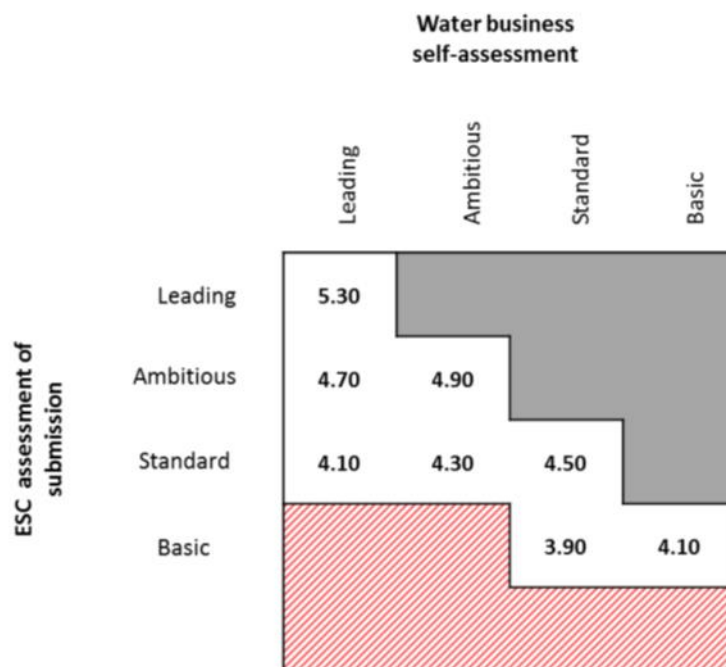
Taken together they provide a strong platform for utilities to build upon. They align with the direction the Australian industry is moving, and could place utilities at the forefront of customer engagement internationally.

4.4 The new incentive framework

The ESC is proposing a wholly new and novel incentive framework. The proposal links a utility's financial return to the ESC's assessment of the quality of customer engagement and how well customer values had been incorporated into the pricing submission.

Specifically a business' return on equity would be determined by the quality and ambition of its business plan. The 'reward' matrix in the position paper is reproduced in Figure 1.

Figure 1 The ESC’s proposed real cost of equity matrix



As shown in the Figure 1, a utility’s return will be based on the interplay of

- the water utility’s assessment of its level of ambition in its business plan and pricing proposal; and
- the ESC’s assessment of the level of ambition and the quality of the proposal.

The lower bound return for a basic submission will approximate the cost of debt whereas the return for a leading plan is higher to reward that greater level of risk and engagement.

The framework is intended to inject some laudable incentives into the regulatory regime. Chief among these are:

- the incentive to be ambitious in delivering customer value;
- the incentive to make an honest assessment and not attempt to game the system. A different ranking by the utility and the regulator will lead to return penalty.

However, the new incentive framework is likely to be the most controversial element of the new approach and generate the most discussion in response to the position paper. It may also be the most difficult to implement. This level of discussion is natural when a new regime is proposed. WSAA considers, however, that this discussion and indeed our own comments on the workability of this new incentive framework, should not overshadow the central element of the position paper, which is to enshrine the utility customer relationship at the heart of the regulatory regime.

That said we would like to raise a number of issues and questions with the approach for the ESC to consider:

- the level of guidance necessary
- avoiding semantic uncertainty
- the need to factor in financial viability (financeability)
- using absolute rather than relative assessments
- ensuring the new framework is ownership-neutral.

4.5 Level of guidance provided to utilities

The ESC will need to determine how much guidance it provides to utilities on its expectations for each element of the submission. More specifically it will need to specify the criteria that will be used to determine which category the submission will fall in to.

On the one hand the ESC does not want to constrain or determine how utilities engage with their customers. This is consistent with the intent of the new regime for the utility to be responsible for all aspects of the customer relationship. On the other hand, regulatory certainty is an important principle, and this mechanism would introduce a range of new and untested concepts. After discussion with its members WSAA believes clear guidance on the ESC's expectations will need to be provided — at least for the first round of the regulatory cycle.

4.6 Avoid semantic uncertainty

Following on from the issue of guidance, the ESC will need to ensure that the regulatory process does not reduce to semantic arguments on the meaning of the different ratings. On the material presented in the matrix it may be hard to avoid such discussions given the level of financial and reputation importance attached to each category.

Indeed the categories themselves could be refined further. For example, is 'leading' the right category for the highest rating. It implies a relative assessment of merit rather than an objective assessment of the quality of the utilities plans to meet customer needs. How many utilities could be 'leading'? Would 'excellence' be a better term for the highest rating. Or drawing on the academic rating system of pass, credit, distinction and high distinction, would 'highly' ambitious be a better term?

4.7 Use of an absolute standard rather than relative comparison

In a similar vein, in Victoria 19 utilities will be submitting price submissions. It would be tempting for the ESC to rank of submissions and apply a bell curve. WSAA's considers this approach could be a mistake. Each submission should be considered on its merits. If the ESC receives many submissions which are objectively 'ambitious' or 'leading' it should not attempt to spread the rankings across the spectrum upgrading some and downgrading others based on relative assessments.

To do so could promote a bidding war among utilities that is unrelated to the intent of delivering high levels of customer value over time.

4.8 Avoid short-termism in the regulatory cycle

Following from the previous point the ESC would need to guard against rewarding short termism in price submissions if it is to represent the long term interests of consumers. For

example, it should not encourage overly aggressive reductions in capital programs or too high a level of ‘sweating the assets’. Water infrastructure has longer average asset lives than other infrastructure sectors. A board and management team that was encouraged by the regulatory system to adopt an overly ambitious approach to its business plan in order to win one round of the regulatory cycle may not be around to bear the consequences of the need to spend significantly more in two or three regulatory cycles’ time.

A related point is the need to recognise that utilities come from different starting points and different levels of efficiency. If a utility has already undergone aggressive efficiency savings, it may be more difficult to demonstrate it is ambitious than one which is further back in the reform path. It would not appear to be the intent of the model to penalise past reform efforts.

4.9 Financeability remains an issue

As set out in WSAA’s principles of good regulation for water, financial viability testing is a critical component of the regulatory framework. WSAA has drawn attention to the need for water businesses to be financially to deliver services now and in the future, in the face of the deteriorating balance sheets for some utilities.

The ESC is one of the few jurisdictions in Australia which is required to have regard to the financial viability of water utilities.

Notwithstanding the ESC’s framework for testing for financial viability it is an area that we consider is underdeveloped within the regulatory regime. Regulators in Australia have typically viewed financial viability issues arising only because of short term anomalies in a utility’s cash flows. By contrast WSAA has previously argued that the role of financeability is an essential check to ensure the building block model and the regulatory framework is delivering sufficient long term revenue to allow utilities to renew and maintain assets.

Financial viability has received little attention in the position paper. Under the new proposed framework, financial viability will be important in at least two circumstances. First it will be important to setting the lower boundary for the return on equity under the incentive framework. But it will also be important as an overall cross check on the financial outcomes provided by the determination.

For example, our understanding of the Commission's proposed Autonomous Demand Model, is that a Victorian water business would face a price cap if demand is below forecast (revenue shortfall) and a revenue cap if demand exceeds the forecast. Businesses therefore could face significant financial downside where water demand is below forecast levels.

Financial viability testing is necessary to ensure that there is not a systemic shortfall in revenue under such an arrangement. Of course this issue could also be dealt with at its source by allowing utilities to put forward their own price setting arrangements supported by engagement with their customers.

Overall, it will never be possible or desirable to reduce the regulatory framework to a mechanistic process. Regulators will always need to exercise a degree of discretion. Testing for financial viability is one mechanism to ensure that such discretion is exercised appropriately.



4.10 Ownership-neutral regulation

Across Australia, but particularly in NSW prompted by the *Water Industry Competition Act* (WIC Act), we are seeing the entry of private players into the water market. For example, the Sydney Desalination Plant is privately owned, has its own licence under the WIC act and is regulated by the Independent Pricing and Regulation Tribunal in the same way it regulates publicly owned utilities.

The trend to greater private participation is likely to continue.

Regardless of whether there are private players in the Victorian market now or in the future, a test for any regulatory regime is whether it provides the certainty and consistency that would be workable for all types of market participants. For economic regulation this means that there should not be one set of rules for public utilities and one set of rules for private utilities. As in industries such as electricity and gas, regulation should apply consistently regardless of ownership. As the framework is refined the ESC should consider whether it will meet this test.



5.0 Contact Details

WSAA welcomes the opportunity to discuss this submission further. If there are any details you wish to follow up on please contact:

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