

Our ref: 09/070/033
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*Certified to best practice standards
ISO 9001 / 14001 and AS/NZS 4801*

17 June 2015

Dr Ron Ben-David
Chairperson
Essential Services Commission
Level 37
2 Lonsdale Street
MELBOURNE VIC 3000

Dear Dr Ben-David 

Water Pricing Approach Review

Thank you for the opportunity to contribute to the Water Pricing Approach Review and the Consultation Paper that has been prepared.

With the recent changes to the Water Industry Regulatory Order the Essential Services Commission (ESC) has greater flexibility in defining the approach to Price Determinations. This presents some opportunities for the Commission in resetting a framework that is well understood, is expedient and ensures that customers receive water and wastewater services that are valued and are provided in the most cost and resource efficient way.

The Consultation Paper provides good insight into the various approaches presently in use in Australia and to a lesser extent internationally. More specifically the paper gives good insight into matters that the Commission and Water Businesses need to give regard to from three perspectives; economic efficiency and viability, industry and business specific issues and customer issues. These issues are well presented and we note that there will be further consultation that expands on the detail.

Through the processes of the Fairer Water Bills the current framework was challenged in a manner that suggested the current framework did not provide the best value outcome to customers. The ESC responded by identifying the extent that the Commission was constrained by the WIRO in how it established prices. GWMWater made representation to the Preliminary Advice from the Independent Reviewer and believes that the responses to the Independent Reviewer remain valid in the context of the current consultation.

The Building Block Approach has served the industry well in a period that, since the start of independent price regulation, has seen significant investment and been aimed at securing water supplies and improving service standards particularly in relation to water quality and environmental outcomes. The ability to trace the history

of investment decisions and the underlying objective of these investments is powerful in explaining pricing decisions. The Building Block also has the benefit of being well understood and, given the timeframes, a big effort in re-educating the industry if there is to be a departure from the use of the Building Block Approach.

The other opportunity presented by the GWMWater submission was the opportunity to streamline the price setting process. This is particularly the case where water businesses are able to demonstrate strong customer engagement in the development of expenditure proposals and pricing policies. GWMWater believe that it has robust engagement processes and this has been evidenced by the projects such as the Wimmera Mallee Pipeline and pricing policies such as those for recreational water.

Please find enclosed the paper presented to the Independent Reviewer and we look forward to expanding on any issues in future consultation papers that are to be prepared as part of the Water Pricing Approach Review.

Yours sincerely

A handwritten signature in black ink, appearing to read 'Mark Williams', with a stylized flourish at the end.

Mark Williams
Managing Director

Encl.



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16 June 2014

Economic Regulation Framework Review Secretariat
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Preliminary Advice from the Independent Reviewer

Thank you for the opportunity to comment on the Preliminary Advice from the Independent Reviewer – Economic regulation, governance and efficiency in the Victorian Water Sector.

The review is timely as we approach ten years of independent price and service regulation of the Victorian Water Industry. The ten year period has coincided with an unprecedented period of investment in Victoria to secure water supply as a consequence of the millennium drought and in many cases this investment has been coupled with investments to restore the environment of our water ways. In the case of GWMWater, the predominant investment has been the Wimmera Mallee Pipeline but substantial investments have also been undertaken in this period to improve water quality and environmental performance.

Without debating the underlying principles of the regulatory framework, the concepts have served GWMWater well as the pricing decisions would have been much more difficult in the period before independent price and service regulation. The previous decade without independent price and service regulation was symbolised by a partial recapitalisation of the water industry that was aimed at improving industry compliance with regulatory standards that coincided with the delivery of a global 18% customer benefit, followed by a three year price freeze. At the end of the price freeze, there was a three month delay in pricing approvals by government that gave rise to a significant interruption to water businesses in the issuing of customer water accounts.

In preparing the GWMWater Fairer Water Bills submission, GWMWater was able to retrace the performance of the investments made since independent price and service regulation commenced relative to the underlying business planning assumptions. The Wimmera Mallee Pipeline investment was substantially funded by government(s) to restore health to stressed rivers and waterways that had been excessively harvested to supply water in an inefficient water delivery system from both a cost and water resource perspective. GWMWater's investment had the objective of secure consumptive water supply and additional water to meet the growth aspirations of the region as well as achieving some social objectives in relation to recreation water.

Given the need for significant tranches of investment required in water from time to time, any pricing decisions need to be framed in the context of the long run marginal cost of supply. Long term price stability becomes a fundamental principle in framing pricing decisions of infrastructure intensive utilities. The funding model for the Wimmera Mallee Pipeline was underpinned by the affordability constraints of customers and of the project to GWMWater. The analysis was undertaken at a whole of business level that took into account all expectations of GWMWater in future regulatory periods..

The elements of the proposed regulatory framework as introduced by the independent reviewer do not provide sufficient detail for GWMWater to respond in any detail. What is acknowledged is a need to ensure there is sufficient incentive to drive cost and water resource efficiency to ensure maximum customer and shareholder value is derived from the industry.

The Essential Services Commission has acknowledged the shortcomings of the current regulatory framework. Most of the issues have their origins in the requirements of the Water Industry Regulatory Order (WIRO). We would encourage greater consideration of the issues raised by the ESC to achieve the best possible regulatory model for the water industry moving forward.

A price regulation model that provides a revenue price cap with little flexibility for price reset, provides perverse incentive for water businesses to be very conservative in their representation of cost. The upper limiting basis of price does not restrict water businesses ability to set prices at levels below the level approved by the ESC.

The GWMWater Board is strongly committed to its role of maximising customer and shareholder value. This objective formed the basis of Water Plan 3 and was reiterated in its Fairer Water Bills Initiative submission. In framing Water Plan 3 the GWMWater Board set a productivity target of 4% but given the risk context of the planning outlook priced for 2% to avoid the risk of requiring a price reset. This went beyond the 1% productivity mandated by the ESC.

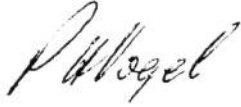
In setting the 4% productivity target, the GWMWater Board had an objective of reducing borrowings from any efficiency opportunities. The GWMWater Board also had an objective of sharing any benefit with customers if the sale of growth water achieved through the construction of the Wimmera Mallee Pipeline exceeded planning assumptions as represented in Water Plan 3 / Fairer Water Bills Submission.

GWMWater welcome the review but believe that the greatest requirement is to ensure the mechanisms for delivering customer and shareholder value are framed to strengthen the role of the Board in driving and delivering efficiency on behalf of the shareholder and the customer.

We look forward to continuing to work with the OLV and its advisors to get the best possible regulatory and shareholder oversight model for the Victorian water industry. This will ensure that we can continue to deliver water and wastewater services in the most cost and resource effective manner to all Victorians and in our case the communities of the Wimmera and Mallee.

Should you require any further detail about the GWMWater submission this should be directed in the first instance to the Managing Director, Mark Williams.

Yours sincerely

A handwritten signature in black ink, appearing to read 'P. Vogel', written in a cursive style.

Peter Vogel
Chairman OAM

1. What do you think the primary objective of economic regulation of Victoria's publicly owned water corporations should be?

The primary objective of economic regulation of the Victorian Water industry is to ensure that customers are provided with water and wastewater services at prices that reflect the most cost and resource efficient method of providing the service given the underlying service standards required of water businesses.

This objective needs to be achieved in a manner consistent with the commercial objectives of the shareholder as outlined in any regulatory instruments established to facilitate the regulation of the sector.

2. The key components of the recommended model are the reform path, efficiency path, price path and transparency arrangements. Are these sufficient to deliver improved efficiencies and performance against agreed service standards?

It is not considered that the model advocated by the Preliminary Advice provides sufficient detail as to how the regulatory model will work to comment specifically.

Any model needs to provide incentive for the regulator and water businesses to pursue efficiencies to maximise customer and shareholder value. This process can be presently facilitated through the annual Corporate Plan which from time to time will be more rigorous when the Corporate Plan (or any related document or process) is underpinned by a 'pricing determination' where there would be greater scrutiny of the cost base and more importantly the investment outlook.

The ESC in their submission(s) has provided insight to the constraints posed by the Water Industry Regulatory Order (WIRO) to achieve the best outcomes for customers. Greater consideration of the issues raised by the ESC need to be reflected in any proposed model for the water industry moving forward.

The proposed establishment of a water performance unit needs to be clarified in the context of the governing role of the Board. The current performance monitoring framework requires the preparation of a quarterly performance report to monitor performance against the annual corporate plan. This performance monitoring framework can be applied more 'vigilantly' to achieve the shareholder/regulatory oversight that is considered necessary to better 'empower' the active shareholder that is being contemplated in the preliminary advice.

Almost all water businesses in Victoria presently use the same finance system and this system could be adapted to extract the performance information considered necessary to provide a central repository of performance information across the sector.

The GWMWater Board has as one of its objectives, delivering the best possible value to customers as well as repaying the significant borrowings undertaken to fund the Wimmera Mallee Pipeline. In doing so, it has adopted a 4% productivity target since completing the construction of the Wimmera Mallee Pipeline project. The 4.3% target that has been agreed through the efficiency review of the Fairer Water Bills Initiative is not materially different from the 4% adopted by the Board. Such a process of negotiating an agreed productivity efficiency

target can and should form the basis of an agreed business outlook to support the determination of water and wastewater prices.

- 3. To what extent do you think a move from a cost-based approach to a price-based approach to regulating water prices in Victoria will provide improved incentives, financial sustainability for Victorian water corporations, and reduced costs for water corporations and their customers?**

A price based approach to regulating water prices will potentially create some issues for a regionally based water business such as GWMWater. There are some intrinsic cost differences for GWMWater that provides considerable 'community service obligations'.

A cost based approach with an agreed efficiency goal is considered to be the most appropriate method of establishing agreed commercial outcomes that can in turn be applied to determine a price path.

- 4. Will the proposed measures for clearer objectives and roles for water corporations recommended in this Preliminary Advice deliver better performance of Victoria's water corporations? Are there any ways in which these objectives and roles should be further clarified?**

The preliminary advice suggests that the proposed Letter of Expectations will provide greater clarity of expectation.

The scope the Letter of Expectation is not significantly different from the Statement of Obligations. It may be that the Letter of Expectations will be more prescriptive and possibly tailored to individual water businesses.

The Water Plan is presently an articulation of the organisation objectives given the competing objectives of the different regulatory agencies. For Boards to undertake an assessment of the trade-offs, they need to apply sophisticated risk based decision assessments to establish the relative priority of the requirements of different regulators.

The Water Plan requires Boards to establish risk trade-offs of competing obligations. If it becomes prescriptive in the Letter of Expectations this responsibility shifts to the Minister for Water.

- 5. Are there any other barriers to water corporations achieving their performance expectations that should be addressed?**

The overall framework is presently heavily burdened by conformance and this tends to outweigh water business focus on performance.

Any model needs to be administratively expedient to ensure that water businesses can achieve a more appropriate balance in pursuing performance and efficiency when we presently have a significant focus on conformance.