



10 December 2015

Marcus Crudden
Acting Director, Water
Essential Services Commission
Level 37, 2 Lonsdale Street
MELBOURNE, VIC, 3000

Dear Marcus,

Submission to Potential Water Pricing Approach- Water Plan 4

Thank you for the opportunity to submit a response to the potential water pricing approach for Water Plan 4. Our response is based on information gained through our attendance at the ESC pricing conference and the support of ideas from various papers distributed as part of the consultation process.

The timing of the review is important given the changing context of the regulatory operating environment in the last two financial years which has seen a focus on price reductions. In this context, North East Water (NEW) currently operate in a CPI minus 0.6% environment with strong customer service standards and financial viability metrics. North East Water have the third cheapest average water bill in Victoria at \$911 as highlighted in the ESC's 2013-14 Water Performance Report.

Streamlining Regulation

NEW support the notion raised in the Synergies paper "*An alternate model for Victorian water businesses*", utilising a lighter handed approach to regulation under the Type 1 and Type 2 arrangements, however we believe the building block approach should still be maintained under this model utilising a mechanism for fast tracking the assessment of proposals that seek price paths within an acceptable range, as opposed to the CPI minus X methodology. As highlighted by KPMG's paper *Application of the UK's RIIIO reforms to the Victorian water sector – July 2015*, Ofgem, the regulator of Great Britain's energy sector moved away from the RPI-X model as it was unable to deliver the innovation and research and development requirements due to the focus on cost reducing incentives for innovation.

North East Water also support the notion of “earned autonomy” raised in the Synergies paper where businesses that have appropriate management systems and procedures in place and have a proven track record can be rewarded with a “less intrusive” form of regulation.

Customer Engagement Processes

The Synergies approach proposes a number of eligibility criteria for Type 1 to be met including Service Outcomes, Business Processes, Regulatory Track Record, Transparency and Customer Engagement. The earned autonomy model assumes best practice customer engagement processes or more specifically “*high quality process for customer engagement and feedback to business practices and evidence of positive customer perceptions and experiences*”. There is however little guidance in relation to how this will be achieved. Whilst we understand that in general terms, the ESC wants a greater role for customers in shaping the price submission, we are unsure how this will change for a business with existing strong customer input. For an engagement process to be more empowering than the past it would follow that the regulator would need to forgo their role in the consultation process to increase the legitimacy of decisions made at a local level as opposed to the one size fits all approach.

The fast track approach has been tested in Great Britain and we note that in the electricity distribution network that 4 out of 14 businesses were fast tracked and 2 out of 20 water businesses in England and Wales received enhanced status. In both these cases customer engagement was not necessarily seen as a critical element or the key feature in the determination of who was fast tracked. According to the paper “*Customer engagement methodologies in water price setting: experience in England, Wales and Scotland, and possible application to Victoria*” by Stephen Littlechild and Bruce Mountain, it is noted that the strong focus on engagement and balancing the need to keep customer bills affordable while also investing in the environment and service improvements was the key measure that resulted in businesses being fast tracked.

If greater customer participation is desired to make the submission process more successful then significantly more resources will be required and a widening of representation to include those familiar with the concerns of industrial and commercial customers and greater technical knowledge in relation to tariff strategies will be required. This is a significant challenge for a small urban Corporation to attract the appropriate skills and knowledge from their existing customer base. We would encourage the option of a review of current customer engagement strategies to increase the likely regulatory acceptance of the engagement outcomes prior to the commencement of the consultation process to avoid unnecessary work.

Direct Negotiation Model

North East Water would be interested in how the direct negotiation model could form part of the regulatory submission in relation to the fast track model. We understand direct negotiation as being an agreement between the Water Corporation and its customers covering some or all of the price and service levels with the role of the regulator facilitating and approving the final agreement.

Due to the diversity of the Victorian water industry in relation to scale, scope and profit status, any proposed arrangements for direct negotiation would need to be scalable as highlighted by *Frontier Economics* in a report prepared for Wessex Water, July 2015, being the **nature of negotiation** – ranging from informal to negotiated settlement, **scope**

of the negotiation – ranging from a few elements of the plan (tariff structures, service targets) to whole of plan, and **role of the regulator** ranging from full detailed review in parallel to only intervening if negotiations fail. This approach would be consistent with the varying customer service approaches and requirements of different size Corporation's.

The direct negotiation model has also highlighted the importance of setting out the role of other regulators such as DH and the EPA and their impact and part in relation to any negotiations. (ie are they part of the customer consultative group?).

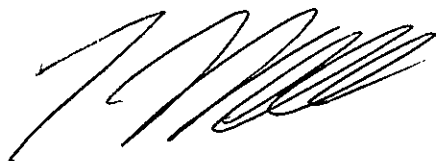
Recently, the ESC has set out its expectations in relation to the role of customer engagement in the Victorian local government sector in its "*A Blueprint for Change*" September 2015 and in relation to community engagement has provided a descriptive tool (based on the IAP2 Public Participation Spectrum) describing the Commission's expectations without prescribing how that engagement is to be conducted. We would consider this or a similar inclusion a helpful addition from a Water Industry guidance paper perspective.

Cost of Capital

We note from the paper prepared by CME "*Regulatory arrangements for the cost of capital and tax in the regulation of Victorian water companies: issues and ideas*" a number of different approaches can be used to determine the return on equity and the cost of debt which are combined in the current regulatory environment to set the Weighted Average Cost of Capital (WACC). To this end North East Water are comfortable with the regulator setting the cost of capital however we would recommend that this be set on a 5 year rolling basis as actual costs of debt have fluctuated significantly at the commencement of and during previous regulatory periods. This would be a more reasonable customer outcome than the current set and forget method.

Please contact me on 02 60 220 594 or cheiner@newater.com.au if you have any questions in relation to our submission.

Yours sincerely



Craig Heiner
Managing Director
North East Water