



Coliban Water's proposed form of price control

October 2013

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COLIBAN WATER'S PROPOSED FORM OF PRICE CONTROL

Final decision

October 2013

CONTENTS

1	BACKGROUND	1
2	THE COMMISSION'S JUNE 2013 FINAL DECISION	2
3	COLIBAN WATER'S SEPTEMBER 2013 PROPOSAL	4
4	THE COMMISSION'S ASSESSMENT	5
	APPENDIX A	11
	APPENDIX B	14

1 BACKGROUND

The Commission's June 2013 *Price Review 2013: Regional Urban Water Businesses — final decision*, did not approve Coliban Water's proposal for a demand adjusted revenue cap form of price control. The Commission's final decision required Coliban Water to resubmit a form of price control proposal for our assessment. Coliban Water submitted its proposal on 16 September 2013 and additional information on 25 September 2013.

The Water Industry Regulatory Order (WIRO) provides water businesses with the flexibility to propose prices, or the manner in which prices are calculated or otherwise determined. The form of price control for a water business is the high level structure that is adopted for price limits. Water businesses can propose pricing formulas, price caps or pricing principles, which are the different forms of price control. The various price controls have advantages and disadvantages in terms of risk sharing between businesses and their customers, price certainty, and flexibility to adjust prices to reflect changing circumstances.¹

When considering an appropriate form of price control, businesses and the Commission weigh up factors including the nature and magnitude of any uncertainties, the potential impacts of unforeseen events on businesses' finances, customer preferences and potential customer impacts.

¹ For additional information on the different forms of price control, see Essential Services Commission 2013, *Price Review 2013: Regional Urban Water Businesses — final decision*, June. Chapter 9.

2 THE COMMISSION'S JUNE 2013 FINAL DECISION

In the 2013 Water Price Review final decision, the Commission decided not to approve Coliban Water's proposal for a demand adjusted revenue form of price control as set out in its September 2012 Water Plan. In its Water Plan, Coliban Water stated that a demand adjusted revenue cap is similar to a revenue cap and would enable the business to ensure its revenues and costs remain in alignment and minimise under and over recovery of revenues compared to costs. Price adjustments would be linked to changes in demand.

As set out in our June 2013 final decision, the Commission had two main concerns about Coliban Water's Water Plan proposal:

- The additional complexity of the proposed form of price control may not contribute significantly to achieving Coliban Water's objective of risk sharing. The Commission considered that the business may be able to achieve its objectives through a revenue cap with a rebalancing constraint, which would be both simpler and more transparent.
- The proposal and resulting changes in prices may be too complicated to communicate effectively to customers. The Commission has previously emphasised the importance of customer understanding of tariffs, and it was concerned the proposed form of price control may lead to customer confusion.

For these reasons, in the final decision the Commission decided:

- to apply a price cap for Coliban Water for the first year of the regulatory period (2013–14)
- to require Coliban Water to resubmit a form of control proposal within 90 days of the Commission's final decision
- to make a separate decision on Coliban Water's form of control to apply from the second and subsequent years of Coliban Water's regulatory period (that is, to 2017–18)
- in the absence of a resubmission, a price cap form of price control would continue.²

² Essential Services Commission 2013, Price Review 2013: Regional Urban Water Businesses — final decision, June. p. 112.

3 COLIBAN WATER'S SEPTEMBER 2013 PROPOSAL

On 16 September 2013, Coliban Water submitted a proposal for its form of price control in response to the Commission's June 2013 final decision (appendix A). Coliban Water also provided additional information in response to queries from the Commission (appendix B). Both documents are also available on our website: www.esc.vic.gov.au

Coliban Water proposed to apply a price cap hybrid form of price control. This means that price caps would apply unless Coliban Water applies for a tariff basket. A tariff basket allows a business flexibility to change tariffs within a regulatory period. However, in any given year, the weighted average price change across all the business tariffs must not exceed an approved overall percentage price for that year of the regulatory period. Coliban Water stated a price cap hybrid form of price control will help Coliban Water to manage uncertainty by allowing for any reasonable rebalancing of tariffs that can be justified during the regulatory period.

Coliban Water noted that the hybrid price control will apply to all of Coliban Water's services, and it plans on using the same price adjustment mechanism approved by the Commission for use by other businesses (for example, Barwon Water). It stated that price caps will apply for the 2013–14 financial year.

Coliban Water also stated that they will:

- consult with customers before it submits any proposal for a tariff basket
- provide evidence of customer consultation (including customer consultative committees)
- provide a statement about customer impacts and how the business would address those impacts.

4 THE COMMISSION'S ASSESSMENT

The Commission uses criteria to determine whether the proposed form of control meets the WIRO requirements. Specifically, the form of price control should:

- provide incentives to align price structures with underlying costs — High cost services should have higher prices, while low cost services should have lower prices. Aligning costs and prices is important for efficient investment and water service use.
- manage and allocate demand and supply risks efficiently — The choice of form of control should reflect demand and supply risks and how they affect revenue. Water businesses should consider aligning activities with relatively higher risk with the forms of control that can mitigate that risk.
- minimise administrative complexity, cost and intrusiveness — Administratively simple forms of control are easier for customers to understand and result in lower costs for the water industry.

The Commission has previously decided that a hybrid price cap form of price control (as applied for by Coliban Water) is consistent with WIRO requirements.³ Subject to appropriate customer consultation and protection, the hybrid allows for flexibility in pricing arrangements that can support tariff reform and facilitate the adjustment of prices in response to changes in underlying costs.

Coliban Water's form of price control proposal is consistent with the requirements of the Statement of Obligations and the WIRO. The Commission therefore approves Coliban Water's proposal for a hybrid price cap form of price control. Coliban Water may apply to the Commission for approval to move to a tariff basket at the time of an annual price review within the regulatory period subject to it providing the Commission with evidence of consultation with customers, the impacts of the change on customers and how it would address those impacts. Upon applying for a tariff basket, Coliban Water will also be required to provide the Commission with a proposed rebalancing constraint that will limit the impact of price adjustments to customer categories. Price caps will continue to apply for 2013-14.

³ Essential Services Commission 2013, Price Review 2013: Regional Urban Water Businesses — final decision, June. p. 108.

To give effect to this decision, the Commission proposes to amend Coliban Water's price determination by replacing the current "No clause" at clause 3 with the following:

3. Amendment of Schedule 2

(a) Amendment

- (i) *Coliban Water* may apply to the Commission in accordance with this clause 3 for the amendment of the prescribed price movements and/or price components included in Schedule 2 for the following **regulatory year** t (the **relevant regulatory year**) and all subsequent **regulatory years** remaining in the **regulatory period** (the **revised tariff schedule**).
- (ii) The average price movement for the **relevant regulatory year** and for each subsequent **regulatory year** in the **regulatory period** determined in accordance with the **revised tariff schedule** must not exceed the average price movement that would otherwise have applied under this Determination as calculated in accordance with the following formula.

$$\frac{\sum_{i=1}^n \sum_{j=1}^m p_t^{ij} q_{t-2}^{ij}}{\sum_{i=1}^n \sum_{j=1}^m p_{t-1}^{ij} q_{t-2}^{ij}} \geq \frac{\sum_{i=1}^n \sum_{j=1}^m ap_t^{ij} q_{t-2}^{ij}}{\sum_{i=1}^n \sum_{j=1}^m p_{t-1}^{ij} q_{t-2}^{ij}}, i = 1, \dots, n; j = 1 \dots m$$

where *Coliban Water* has n tariff categories, which each have up to m tariff components, and where, for each **regulatory year** t for which the calculation is undertaken:

p_{t-1}^{ij} is the tariff charged in **regulatory year** $t-1$ for component j of tariff i

p^{ij} is the proposed tariff for component i of

- t tariff i determined in accordance with Schedule 2 where the *revised tariff schedule* is not applied
- ap t ij is the proposed tariff for component j of tariff i determined in accordance with Schedule 2 where the *revised tariff schedule* is applied
- q $t - 2$ ij is the quantity of component j of tariff i that was sold in *regulatory year* $t-2$, or, if an actual quantity is not available, either an estimate of the quantity of component j of tariff i that would have been sold in *regulatory year* $t-2$ or a forecast of the quantity of component j of tariff i that is expected to be sold in *regulatory year* $t-2$

(b) Amendment procedure

- (i) An application by *Coliban Water* under this clause 3 must be received by the Commission at least 80 *business days* prior to the commencement of the *relevant regulatory year* and must be accompanied by the following information:
- (A) (1) a clearly articulated new tariff strategy that is consistent with the regulatory principles in clause 14(i)(a) of the *WIRO* (the *revised tariff strategy*);
or
- (2) an explanation of how the *revised tariff schedule* is consistent with the tariff strategy for *Coliban Water* approved by the Commission in connection with this Determination, (*the relevant tariff strategy*);
- (B) a *revised tariff schedule* that specifies proposed prices for the *relevant regulatory year* and prescribed price movements for each

subsequent *regulatory year* in the *regulatory period* that is consistent with the *relevant tariff strategy*;

- (C) a statement setting out evidence demonstrating that *Coliban Water* has provided information to its customers explaining the *revised tariff schedule* and how it relates to the *relevant tariff strategy* and has consulted effectively with its customers on the *revised tariff strategy* (if clause 3(b)(i)(A)(1) applies) and the *revised tariff schedule*;
 - (D) a statement setting out the customer impacts resulting from the *revised tariff schedule* and actions proposed by *Coliban Water* to address these customer impacts; and
 - (E) an explanation of the calculation of the relevant quantities “ q_{t-2}^{ij} ”.
- (ii) The Commission may approve the *revised tariff schedule* submitted by *Coliban Water* under this clause 3 if it is satisfied that:
- (A) *Coliban Water* has complied with clause 3(b)(i)(A);
 - (B) the price movements calculated in accordance with the *revised tariff schedule* comply with the requirements of clause 3(a)(ii);
 - (C) the *revised tariff schedule* is consistent with the *relevant tariff strategy*;
 - (D) *Coliban Water* has consulted effectively with its customers on the *revised tariff strategy* (if clause 3(b)(i)(A)(1) applies) and the *revised tariff schedule*;

- (E) *Coliban Water* has effectively addressed customer impacts resulting from the *revised tariff schedule*; and
 - (F) the basis for calculating the relevant quantities “ q_{t-2}^{ij} ” is reasonable.
- (iii) In determining whether it will approve the *revised tariff schedule*, the Commission may request *Coliban Water* to provide any additional information specified by the Commission and/or to resubmit any of the matters in clause 3(b)(i)(A)-(E).
 - (iv) The Commission will be deemed to have not approved a *revised tariff schedule* if it has not provided notice to *Coliban Water* within 40 *business days* from the date of its receipt of *Coliban Water’s* application under this clause 3.

OTHER CONSIDERATIONS

The proposed form of price control is unchanged from the one in our final decision therefore no consultation was required by Coliban Water. However, this current decision – while it allows Coliban Water to apply for a tariff basket – would require consultation before an application to the Commission was made.

This decision does not affect Coliban Water’s approved 2013-14 prices, price paths or any other aspect of Coliban Water’s price determination made on 12 June 2013.

FINAL DECISION

The Commission has approved a hybrid form of price control, whereby:

- it has approved price caps for Coliban Water and
- Coliban Water may apply to the Commission for approval to move to a tariff basket at the time of an annual price review within the period.

Where it proposes to transfer to a tariff basket form of price control, Coliban Water must:

- consult with customers before proposing the tariff basket
- provide evidence to the Commission of customer consultation
- provide the Commission a statement about customer impacts and how the business would address those impacts
- provide a rebalancing constraint.

The hybrid form of price control of Coliban Water will be effective as of 1 January 2014.

APPENDIX A



Your ref.

Our ref.

Contact:

Jarra O'Shea

16 September 2013

Dr Ron Ben-David
Chair, Essential Services Commission
Level 37, 2 Lonsdale St
MELBOURNE VIC 3000

Dear Dr Ben-David

Re: Coliban Water's preferred form of price control

We acknowledge the Commission's consideration of our proposed "Demand Adjusted Revenue Cap" in the lead up to the Final Decision. We also acknowledge the concerns raised in the Final Decision regarding the perceptions of complexity of this form of price control, and we appreciate the opportunity to "resubmit a form of control proposal within 90 days".

In the long term, Coliban Water remains committed to a form of price control that is cost reflective and sends appropriate price signals to customers about the cost of water. However, Coliban Water acknowledges that successfully establishing, developing and prosecuting such a form of price control will take additional time and this could not have been completed in the three months since the Final Decision.

The corporation considers that Price Caps as a form of price control limits flexibility in managing price and revenue risk. Furthermore, Coliban Water is concerned about the adverse financial consequences that would result from a Revenue Cap price control mechanism, particularly as this would diminish the incentive for the corporation to sustainably maximise the provision of water across our region.

Accordingly, Coliban Water is applying for a "Price Cap Hybrid" form of price control.

Coliban Water has recently implemented a number of measures to assist financial sustainability and manage financial risk:

- Price correction applying from 2013-14
- Having a single variable price replace inclining block tariffs for residential customers
- Discontinuation of sewer volumetric charges for most non-residential customers
- Repatriating "core" business services instead of outsourcing
- Reduction in reliance on consultants
- Re-contracting operating and maintenance services through a contestable and open tendering process to provide enhanced value

The Final Decision notes that Price Cap Hybrid price control will "help businesses manage uncertainty by allowing any reasonable rebalancing of tariffs that can be



justified during the regulatory period," and the corporation endeavours to exceed Final Decision benchmarks over the coming regulatory period.

Coliban Water considers the benefits of a revenue cap do not exceed the drawbacks, including expenditure volatility and diminished incentives to provide water and serve customers. However, it is the corporation's intention to strategically engage with the Commission, DEPI and other stakeholders on the benefits of a more dynamic and cost reflective form of price control, for implementation in the next regulatory period commencing 1 July 2018.

We look forward to discussing this with you and your team. If you have any queries about this correspondence, please contact Jarrah O'Shea, Manager Economics and Pricing.

Yours faithfully

A handwritten signature in black ink, appearing to read "Jeff Rigby".

Jeff Rigby
Managing Director

APPENDIX B

Your ref.

Our ref.

Contact: Jarrah O'Shea

25 September 2013

Mr Jason Fitts
Manager, Water
Essential Services Commission
Level 37, 2 Lonsdale St
MELBOURNE VIC 3000

Jason
Dear Mr Fitts,

Re: Coliban Water's preferred form of price control – additional information

In response to your correspondence of 17 September, please note the following:

1. The form of price control we are applying for is the "price cap hybrid", as defined in your final decision. That is, price caps will apply unless Coliban Water seeks to apply for a tariff basket style adjustment "*limiting average annual price increases across the range of tariffs to the average increase under a tariff basket.*" (ESC 2013, *Price Review 2013: Regional Urban Water Businesses — final decision*, June). To avoid confusion, we accept the price caps for the 2013-14 financial year as approved in the final decision. We acknowledge the requirements of the final decision:
 - a. To consult with customers before proposing the tariff basket
 - b. To provide evidence of customer consultation (including customer consultative committees) and
 - c. To provide a statement about customer impacts and how the business would address those impacts.
2. The hybrid price control will apply to all of Coliban Water's services.
3. The formula we intend on applying is the same formula that applied to Coliban Water throughout the 2008-2013 regulatory period, and the same as applies to the majority of regional water corporations in their 2013 Determinations.

We would welcome the opportunity to further discuss our proposed price control with your team.

Yours faithfully,



Jarrah O'Shea
Manager Economics and Pricing