



Alternative approaches for establishing a water entity's revenue requirement

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Rob Francis, Frontier Economics Europe

Context for study

Objectives for regulation

- Promote efficiency
- Better outcomes for customers
- Proportionate system of regulation

Aim of this study

- How regulatory approach can be adapted to deliver these objectives
- Draw upon experience and developments in UK and elsewhere

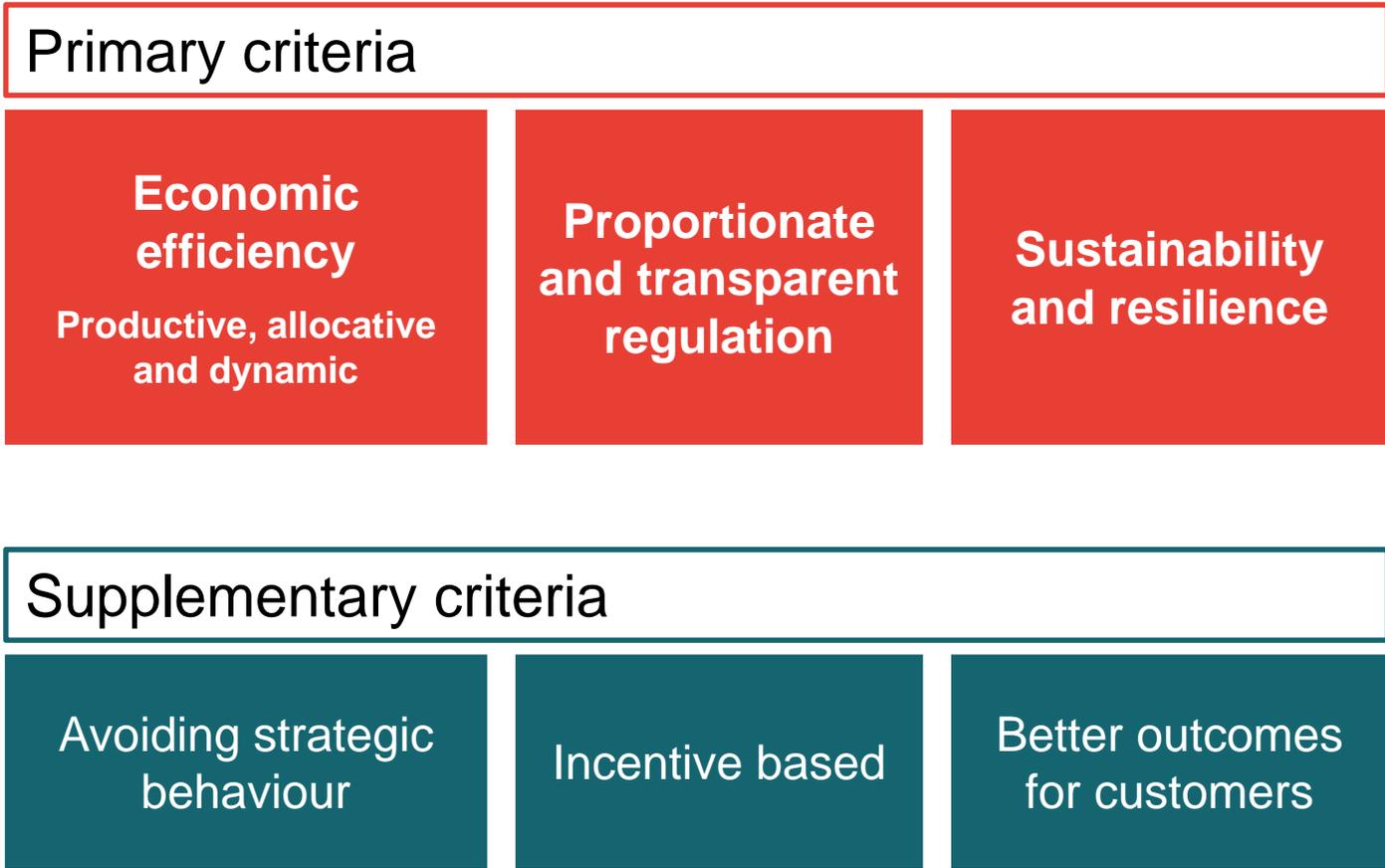
Output from study

- Options for reform and criteria for assessment
- High level recommendations that are a starting point for discussion

Approach to the study

- 1 Develop set of assessment criteria
- 2 Identify set of regulatory options: methods and tools
- 3 Develop a number of regulatory reform packages: based on combining methods and tools
- 4 Evaluate the packages against the assessment criteria
- 5 Implementation issues and recommendations

Assessment criteria



Regulatory options: methods and tools

Primary methods describe the overall methodology for setting revenue

Forward looking regulation

Ex ante controls

- Rate of return
- Earning sharing
- Price cap (CPI-X)
- LRIC based control
- Benchmarking / Yardstick

Pricing rules

- Access pricing
- Pegged tariffs
- Default tariffs / safeguard tariffs

Backward looking regulation

Ex post methods

- Non-discrimination
- Disclosure requirements
- Price monitoring

Increasing contestability and decreasing market power

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- ~~Disclosure requirements~~
- Price monitoring

Shortlisted methods – focus on ex ante controls

Regulatory options: methods and tools

Secondary tools are specific design options to be applied to the methods

Form of the control

- Separate price controls
- Price cap / revenue cap
- Length of price control
- FCM / OCM

Approach to the review

- Risk-based review
- Customer engagement / negotiated settlement

Cost assessment

- Benchmarking
- Totex
- Menus and sharing mechanisms

Performance & innovation incentives

- Outcome delivery incentives (ODIs)
- Innovation funding

Reform option packages

Five combinations of primary methods and selected regulatory tools

Primary methods	Secondary tools
1 Earning sharing	Outcome incentives Longer price control Customer engagement
2 Price cap – Option A	Outcome incentives Customer engagement Cost benchmarking
3 Price cap – Option B	Outcome incentives Customer engagement Cost benchmarking Separate retail controls Risk based review
4 LRIC	Cost benchmarking Longer price control
5 Benchmarked / pegged tariffs	Outcome incentives Longer price control Customer engagement

Evaluation of reform options against criteria

Primary method	Earning sharing	Price cap (A)	Price cap (B)	LRIC	Benchmarked prices
Secondary tools	ODIs, engagement, longer control	ODIs, engagement, benchmarking	ODIs, engagement, benchmarking, separate retail, risk based review	Benchmarking, longer control, separate controls	ODIs, engagement
Economic efficiency					
Proportionality & transparency					
Long-term sustainability					
Supplementary criteria					
Application to Victoria water sector	Simple approach more suited to smaller utilities	Suitable for all utilities	Suitable for all – separate retail for metropolitan only	Best suited to Melbourne Water	Can be applied to all

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- Price cap options are appropriate models for regulation
- Balance efficiency incentives, sustainability and proportionate regulation
- Option B includes further tools to promote customer outcomes

Implementation issues

Information requirements

- Financial, operating and performance data
- Manage regulatory burden through consistency and focus on data that is relevant to the business itself

Benchmarking

- Criteria: accuracy, incentives, transparent, low admin costs
- Simple comparisons and unit cost methods are more relevant than statistical benchmarking models

Customer engagement

- Type of engagement – customer panel, surveys
- Scope of the customer engagement
- How the customer views are used in the controls

Summary of recommendations

General recommendations

- Consider enhanced price cap approach
- Develop benchmarking and cost comparison methods
- Consider formalised framework for local customer engagement
- Engage with business and customers on additional outcome incentives
- Consider framework for sharing outperformance to strengthen incentives

Specific recommendations

- Consider separate price caps in metropolitan areas
- Proportionate implementation of price cap method for smaller regional businesses
- Consider scope for 'risk based review' in future controls – with minimal scrutiny for high quality business plans



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FRONTIER ECONOMICS EUROPE LTD.
BRUSSELS | COLOGNE | LONDON | MADRID

Frontier Economics Ltd, 71 High Holborn, London, WC1V 6DA
Tel. +44 (0)20 7031 7000 Fax. +44 (0)20 7031 7001 www.frontier-economics.com