



GENERATING IDEAS ON THE PRICING APPROACH FOR VICTORIA'S WATER SECTOR

Summary of papers prepared for the
Essential Services Commission

July 2015

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INTRODUCTION

The Essential Services Commission (the Commission) is undertaking a review of our pricing approach for the Victorian water sector. In April 2015, we published a consultation paper setting out the background, objectives and process for the review.¹

Our objective is to identify and implement the approach (or approaches) that will produce the best outcomes for Victorian customers; that is, that services are delivered at the lowest sustainable price while meeting all quality and reliability standards.

Currently, the review is focusing on generating new ideas in terms of our future pricing approach. Many of the submissions responding to our consultation paper put forward ideas for exploration. The submissions are available on our website.

To assist in the ideas generation process, the Commission also engaged a number of independent regulatory experts to provide their views on alternative pricing approaches. We didn't seek to limit the authors' discretion in the ideas put forward. The views expressed in the papers are those of the authors alone. Over the remainder of 2015, the Commission will be testing the ideas raised in submissions responding to our consultation paper and in the papers prepared by these regulatory experts. We will also remain open to any further ideas that interested parties may wish to contribute.

The Commission is holding a number of upcoming events to facilitate this process. These include workshops with interested parties in August, and a conference on pricing approaches in November 2015. Further details on the conference will be forthcoming.

This paper presents an overview of the five papers prepared by the regulatory experts (these can be found on our website at www.esc.vic.gov.au).²

¹ Essential Services Commission 2015, *Review of Water Pricing Approach, Consultation Paper*, April.

² An additional paper prepared by Bruce Mountain (CME) and Stephen Littlechild focusing on customer engagement will be released separately in August 2015.

STREAMLINING THE PRICING APPROACH

PAPER BY SYNERGIES ECONOMIC CONSULTING

The paper by Synergies Economic Consulting was prepared by Euan Morton and Dr Martin Van Buren. Mr Morton and Dr Van Buren bring strong local regulatory expertise to our review process, drawing on their background providing advice in the regulated energy, transport and water sectors.

Synergies has proposed a pricing approach under which businesses meeting certain conditions would be subject to light handed price regulation.

For example, if a business proposes price changes below a threshold specified by the Commission and the business demonstrates strong customer input, its price submission may be fast tracked and subject to less scrutiny by the Commission. Further, these businesses would also be provided an opportunity to secure an ongoing light handed price and service monitoring regime, avoiding regular price reviews.

Other businesses would be subject to more detailed price reviews (such as via the current building blocks methodology) and closer oversight by the Commission.

The proposed approach could lead to lower costs of regulation for water businesses and the Commission, provide greater incentives for businesses to innovate and operate cost-effectively, and help to ensure that services and prices better reflect customer views and needs (via a greater focus on customer engagement).

Key issues that would need to be explored prior to implementing Synergies' proposed approach includes eligibility criteria for fast tracking price submissions and securing an ongoing light handed form of price and service monitoring regime.

Synergies' full paper is available [here](#).

PRICING BY FUNCTION IN THE SUPPLY CHAIN

PAPER BY SAPERE RESEARCH GROUP

We sought advice from Kieran Murray, Director and Chairman of Sapere Research Group, in order to draw on his knowledge of regulatory frameworks in New Zealand. Dr Richard Tooth, Director at Sapere, also contributed significantly to the paper. Mr Tooth has made a number of contributions to debate on water pricing and tariffs.

Sapere recommends unbundling the water and sewerage value chain for pricing purposes. Sapere identify four discrete sections of the value chain:

- Bulk water – functions involved in the supply of water up to the point of treatment.
- Water treatment and distribution.
- Wastewater treatment and distribution.
- Retailing – including billing, customer management and related functions.

For bulk water, Sapere recommends that the Commission continue to use the building block approach to estimating a water business's revenue allowance. However, it recommends greater transparency and scrutiny of the costs and benefits of major investments in bulk water supply infrastructure.

For other parts of the value chain, Sapere recommends simplification of the pricing approach. They recommend the Commission establish a default revenue or price path, based on relatively simple cost benchmarks (similar to the approach that has been used in New Zealand energy pricing). A water business could opt for the default price path or seek a customised price path that would be developed using the building block. Sapere also recommends that water-usage prices be set to the marginal cost of supply.

Sapere's full paper is available [here](#).

APPLICATION OF UK RIIO FRAMEWORK TO VICTORIA'S WATER INDUSTRY

PAPER BY KPMG

The Commission sought advice from Alistair Buchanan, Chair of the Power and Utilities Practice KPMG (UK), on possible changes to our pricing approach informed by his experience implementing the RIIO framework to network energy prices in Great Britain. Mr Buchanan was CEO of Ofgem during the development and implementation of RIIO. Duncan Michie, Director Economics and Regulation KPMG UK, and Tim White, Associate Director KPMG, also contributed to the paper.

KPMG's paper proposes a number of changes to the Commission's pricing approach, informed by recent reforms to energy network prices in Great Britain via the RIIO framework. RIIO stands for Revenue set to deliver strong Incentives, Innovation and Outputs, and is the new regulatory framework for energy networks in Great Britain.

RIIO retains the use of the building block model to estimate a business's revenue allowance and prices. However, compared with the previous pricing approach, RIIO includes a number of changes aimed at enhancing customer value. For example, RIIO places greater emphasis on customer engagement by businesses in developing their price submissions. It also mandates a longer regulatory period (eight years, compared with five previously) to provide greater transparency on future prices, and includes an innovation fund that businesses can access to undertake research and development.

KPMG's proposed changes to the pricing approach for Victoria's water sector include:

- Enhancing customer involvement in pricing, including through the establishment of customer challenge panels by water businesses.

- Strengthening incentives for innovation by water business, including through competitively based access to an innovation fund.
- Developing protocols that allow for fast tracking of well-argued price submissions, thereby helping to minimise regulatory burden.
- Greater use of industry benchmarking to establish prices.
- Expanding the existing guaranteed service level scheme to provide greater incentives for businesses to deliver quality services to customers (including by increasing the penalties or rewards provided to businesses via the scheme).

KPMG's argues that these and other reforms will help the Commission to better promote customer value. Key issues requiring exploration include the nature and role of the benchmarks to be used to establish prices, and the assessment criteria for fast tracking price submissions.

KPMG's full paper is available [here](#).

APPROACHES FOR ESTABLISHING THE REVENUE REQUIREMENT

PAPER BY FRONTIER ECONOMICS

The Commission asked Frontier Economics (UK) to evaluate and propose alternative pricing approaches for Victoria's water businesses, drawing on its experience in the UK water sector. Frontier's paper was prepared by Janet Wright, Rob Francis and Annabelle Ong. All have considerable experience in the development and implementation of economic regulatory frameworks in the water sector in the UK.

Frontier's paper considers a range of options for the regulation of Victoria's water utilities. It considers primary methods for establishing revenue requirements and prices, and a number of secondary tools or regulatory options that can be applied to the primary methods to refine the outcomes without necessarily changing the fundamental approach. Five 'reform packages' are identified and further evaluated.

Frontier recommends developing an enhanced price cap approach based on the current building blocks methodology, which will deliver greater efficiency and long term sustainability. Any new approach should consider:

- Greater use of benchmarking and efficiency setting by the regulator.
- A clear framework for stronger customer engagement with appropriate outcome incentives, as well as the sharing of financial outperformance between customers and the shareholder.
- Separate price controls for different parts of the value chain.
- A risk-based review to earn a lighter-handed regulatory approach for high performing businesses.

Frontier's full paper is available at [here](#).

IDEAS ON THE COST OF CAPITAL AND TAX FOR WATER BUSINESSES

PAPER BY CME

We sought advice from CME on ideas to refine our approach to the cost of capital and tax for water businesses. The CME paper was prepared by Bruce Mountain, Paul Szuster and Professor Stephen Littlechild. Mr Mountain is well known in the Australian community of regulatory economists. Professor Littlechild is renowned for his pioneering work on price cap regulation and his subsequent work as the inaugural Director General of Electricity Supply at the UK Office of Electricity Regulation. Mr Szuster is an engineer and regulatory analyst.

CME's paper considers the cost of capital and tax benchmark setting arrangements in the context of government ownership of Victoria's water businesses. The cost of capital and tax are inputs to the calculation of prices water businesses charge their customers under the building block model.

CME's main ideas for change relate to the setting of the cost of equity and debt within the building block model. On the cost of equity, CME suggests the Commission place lesser emphasis on estimating the cost of equity via adherence to rigid formulas, to giving greater consideration to a wider range of issues, including tax paid by water businesses to the Victorian Government.

On the cost of debt, CME considers whether an approach adopted in the UK, where some regulated businesses have been allowed to recover their cost of debt plus a margin between 50 and 100 basis points, would better satisfy the Commission's objectives to promote the long-term interests of Victorian consumers (noting this would effectively lower the amount businesses are allowed to recover from customers for the cost of debt).

CME's paper also explores issues related to dividends paid by water businesses to government and pricing.

CME's full paper is available at [here](#).

FURTHER INFORMATION

For more information on the papers, or in relation to the Commission's review of its pricing approach for Victoria's water sector, contact either:

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