



29 July 2016

Water Team – Pricing Approach Review
Essential Services Commission
Level 37, 2 Lonsdale Street
Melbourne VIC 300

By Email: water@esc.vic.gov.au

Dear Sir/Mdm,

RE: Submission to the ESC Water Pricing Approach Review

We thank the Essential Services Commission for the opportunity to provide comment on the position paper, *A New Model for Pricing Services in Victoria's Water Sector*, published in May 2016.

The Commission has developed an ambitious new pricing approach which evidently draws on a number of recent regulatory innovations and seeks to address many of the practical shortcomings in existing models of regulation. We are broadly supportive of the new framework, which has made a significant effort to ensure consumers are at the centre of water businesses' price submissions. While we recognise the proposed approach is a high level outline of the new approach, we would ask the Commission to consider a number of questions/concerns in subsequent iterations of the pricing framework.

The Consumer Utilities Advocacy Centre Ltd (CUAC) is a specialist consumer organisation established in 2002 to represent Victorian energy and water consumers in policy and regulatory processes. As Australia's only consumer organisation focused specifically on the energy and water sectors, CUAC has developed an in-depth knowledge of the interests, experiences and needs of energy and water consumers.

CUAC's advocacy maintains a focus on the principles of affordability, accessibility, fairness, and empowerment through information and education. We believe that consumer interests – particularly those of low income, disadvantaged and rural and regional consumers – must be a primary consideration in the development and implementation of energy and water policy and in service provision. CUAC supports informed consumer participation in energy and water markets.

Consumer Action Law Centre (CALC) is an independent, not-for profit consumer organisation based in Melbourne. We work to advance fairness in consumer markets, particularly for disadvantaged and vulnerable consumers, through financial counselling, legal advice and representation, and policy work and campaigns. Delivering assistance services to Victorian consumers, we have a national reach through our deep expertise in consumer law and policy and direct knowledge of the consumer experience of modern markets.

The Victorian Council of Social Service (VCOSS) is the peak body of the social and community sector in Victoria. VCOSS members reflect the diversity of the sector and include large charities, peak organisations, small community services, advocacy groups, and individuals interested in social policy. In addition to supporting the sector, VCOSS represents the interests of vulnerable and disadvantaged Victorians in policy debates and advocates for the development of a sustainable, fair and equitable society.

Consumer engagement and consultation

In our view, the Commission has made a significant effort to ensure that meaningful and effective consumer engagement plays a significant role in the new proposed Water Pricing approach. We welcome this approach, particularly the Commission's inclusion of the International Association for Public Participation Australasia's IAP2 Public Participation Spectrum framework as the primary assessment tool in the proposed PREMO model for measuring engagement with customers.

We would ask the Commission to outline the existing consumer engagement expertise the ESC has in-house—or the in-house expertise to be obtained—to provide the regulator with the ability to effectively assess business's consumer engagement process. Given the design of the proposed framework, particularly the proposal for water businesses to decide their own engagement processes, in-house expertise will be essential for the Commission to determine whether each water business has effectively consulted with its customers and accurately incorporated their preferences into its proposal. Without expert insight into the issues of customer consultation, the regulator may fail to appreciate how customer preferences might have been selectively garnered or that customers may have been inadequately equipped to provide input on technical matters or provide answers on complex willingness to pay trade-off questions. A lack of consumer consultation expertise could be particularly problematic if the Commission deemed a price submission worthy of 'fast tracking', leading to even less scrutiny from the regulator.

The Commission should consider what resources might be required to ensure those customers engaged in a consultation processes are adequately equipped to negotiate complex matters—in particular, access to independent information and expertise. This is particularly important where a business intends to empower its customers to set the direction of its price submission, given the information asymmetry that exists between a business and its customer. Without independently verified information and advice, customers engaged in these processes may themselves become "captured" by a water business's strategic agenda. Verifying how customers' views have been considered—and whether customers are able to effectively negotiate with their water business—is a challenge that has been raised in literature about negotiated settlement.¹

¹ Bruce Mountain, 'A Summary of Evidence and Thinking on Negotiated Settlements', March 2013, 4.

A further concern is the question of how water businesses will manage cognitive biases, complexity, and differing preferences between customer segments when engaging with their customers on technical questions. Independent information and expertise might be delivered through the Commission itself, through body such a centralised ‘customer advocates’ advice centre’ as suggested by Stephen Littlechild and Bruce Mountain, or through another institution or source.² We also suggest the Commission consider how the provision of this information would be funded, given the scarce resources currently available in the community sector.

We would also ask the Commission to consider the tension in the framework between customer consultation and the approved return on equity. A water business might develop a price submission which, according to the framework would be deemed “leading”, if it empowers its customers to provide direction on its entire submission on an ongoing basis. However, customers may state a clear overall preference for maintaining the current level of service rather than see bill increases—which may result from a higher return on equity—perhaps more reflective of a “basic” price submission. We would ask the Commission to consider how it would reconcile the intent of a water business to achieve a “leading” price submission, along with the commensurate return on equity, if customers have clear preferences that conflict with those of the business. This seems a particularly pertinent issue with regard to price: if a group of customers clearly indicate an overwhelming preference for bill reductions rather than increased “value for money”, the water businesses must find efficiencies to offset any increase in the rate of return as approved by the Commission. This may ultimately deter water businesses from attempting an ambitious engagement process with its’ customers to develop future price proposals.

The Commission has been clear in seeking to ‘move away from the current “one size fits all” pricing approach’. While we acknowledge that water businesses do differ in size and capacity, a key implication is that water businesses will be measured on different metrics, as determined by each business. The Commission has indicated that the degree of autonomy—which we understand to mean these varying metrics—will depend on how well a business understands its consumers’ preferences. As each consultation process—and the customer preferences that result from these processes—are likely to be particular to each business, there is a real risk that the Commission’s determinations might become increasingly subjective in the absence of a clear criteria for assessment. We ask the Commission to consider how it might address this issue.

We recognise that the pricing proposal put forward by the Commission is a high level position paper. We expect that in subsequent iterations the Commission will provide a detailed outline of how different elements of the PREMO model will be weighted. For example, to what extent will a water businesses’ Engagement process with its customers effect the Commission’s rate of return determination, as compared with the effect of Management or Risk components?

Performance measures

We would ask the Commission to consider the effect of allowing businesses to report on different performance measures chosen at their own discretion. This may prevent any effective comparison of the performance of water businesses. While we recognise that some water businesses have

² Stephen Littlechild and Bruce Mountain, ‘Customer Engagement Methodologies in Water Price Setting: Experience in England and Wales and Scotland, and Possible Application to Victoria’, July 2015, 3.

appealed for autonomy to set their own targets, to do so would provide another instance where the ESC will be required to make an increasingly subjective judgement about the performance of each water business in the absence of industry-wide benchmarks. A possible consequence is an increased burden on the regulator and other stakeholders to scrutinise each water business's price submission and their performance. Water businesses developing their own performance metrics may also lead to a narrowed focus on these particular metrics resulting in the neglect of other service outputs and a reduced holistic customer experience.

We would also ask the ESC to consider the impact of heavily relying on customer satisfaction ratings for performance reporting. Customer satisfaction is a stated-preference measure, and may be affected by unrelated factors. Behavioural Economics literature³ suggests that satisfaction ratings may be unduly influenced by mood states and recall issues; customers may also be overly-optimistic about existing service – referred to as *status quo bias*. It is also debatable whether customers can offer a truly accurate reflection of their satisfaction with a monopoly service provider, in the absence of a competitor or a substitute good. To address this shortcoming, the ESC might consider how a longitudinal satisfaction benchmark that spans a number of different service industries might be developed. An example of this is the UK Customer Service Satisfaction Index, which provides ratings of customer satisfaction at national, sector and organisational level across 13 sectors of the UK economy, and where Scottish Water has recently been rated the most trustworthy utility.⁴

Trial period and public consultation

The Commission has suggested the idea of an intra-period adjustment for the first period under the new pricing approach, to adjust rate of return for businesses on the basis of their performance.

We would support a conservative approach to both rewards and penalties on return on equity until water businesses and the regulator have more familiarity with the new pricing approach. We would ask the Commission to consider the unintended consequences of intra-period adjustment—to account for significant out performance or under performance of targets—which has the potential to cause significant price changes and bill shock for customers.

Fast tracking

There is certainly merit in water businesses being encouraged to produce higher quality price submissions in return for fast tracked proposals. However, it is unclear whether there will be sufficient opportunity for stakeholders to provide input to fast tracked submissions before these are finalised by the regulator. The Commission has stated there will be a public consultation on its draft determinations, but a fast-tracked approach may limit comprehensive public consultation.

The position paper is clear that the Commission wants to move away from assessing water businesses on a “one size fits all” basis with significant scope for businesses to develop their own performance metrics, demand forecasts and engagement processes. However, it is unclear from

³ Daniel Kahneman et al., ‘A Survey Method for Characterizing Daily Life Experience: The Day Reconstruction Method’, *Science* 306, no. 5702 (3 December 2004): 1776–80.

⁴ Scottish Water, *Record customer satisfaction*, accessed online at: <http://www.scottishwater.co.uk/about-us/publications/ar201415/record-customer-satisfaction>

the position paper whether *all* water businesses could achieve “ambitious”—or even “leading” price submissions—or whether water businesses will be assessed with some comparison to each other. There appears to be some level of assessment by comparison in the PREMO model, particularly under the risk management criteria, but we would appreciate clarity on this point.

Demand Forecasting

The provision of greater autonomy to water businesses to decide demand forecasts used to estimate prices appears to be designed to reduce the likelihood of protracted contests between businesses and the regulator. We have long been concerned that the regulatory framework includes incentives for businesses to over-estimate demand and have thus supported the Commission’s efforts in undertaking its own demand-forecasting. The proposed approach in Appendix B of the position paper links demand forecasting to a businesses’ return by applying a revenue cap (rather than a price cap) above the businesses’ forecast level of demand, and water businesses nominating a buffer above the prices and revenues it has identified. This appears to be designed to limit the risk of gaming returns based on excessive demand forecasting.

As the paper notes, this model relies on there not being collusion between two or more water businesses. We note that detection of collusion is inherently difficult, because collusive arrangements are usually surreptitious. Diagnosing collusion without whistle-blowers may be next to impossible. The Commission may need to consider additional measures to determine whether collusion is occurring, for example, providing incentives to encourage confession through leniency policies etc.

Conclusion

We would like to reiterate that we view the new framework as ambitious in its attempts to place the consumer at the centre of the process, which is a process we are broadly supportive of. While we hope the ESC will consider the issues we have raised in this submission in its forthcoming iterations of the framework, we would congratulate the Commission for its significant efforts in developing this new regulatory framework.

If you have any queries on the submission, please do not hesitate to contact the undersigned.

Yours sincerely,



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