

Our Ref SVWESC20160729
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29 July 2016

Attention: Mr Marcus Crudden

Dear Mr Crudden

ESC Position Paper – A New Model for Pricing Services in Victoria’s Water Sector

Thank you for the opportunity to provide a submission on the Essential Services Commission’s (ESC’s) proposed new direction for pricing in the water sector. We support the approach that ESC is taking in encouraging further efficiencies in the Victorian water sector while providing greater autonomy for water businesses in delivering services and managing risk.

We provide the following comments as an input into ESC’s finalisation of the guidance document.

Section 3.3. Unbundling of the water and sewerage value chain for pricing purposes.

We agree with the water businesses that the proposed unbundling would involve additional costs to water businesses with minimal benefit. One of the expected benefits of forming two bulk water entities and a bulk water transmission entity in south east Queensland was that it would allow the unbundling of costs. This reform proved to be an expensive experiment.

Sections 4.3.2. Cost estimating and application of excessive contingencies.

We agree that at the moment water businesses may be overly risk averse in their forecast costs. Contingencies should reflect the uncertainty of an estimate. In the longer term, at strategic/master planning stages, it would not be feasible to undertake detailed investigations (e.g. geotechnical). Similarly, even in the detailed planning stage there is an optimal level of investigation that should be undertaken to support options analysis. The proposed ESC approach will encourage water businesses to further develop their cost estimating capability through having unit cost databases, analysis of historical costs, and investing in other supporting datasets. We would expect lower contingencies for common activities such as construction of new water reticulation mains or sewer relining

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but it is likely that relatively high contingencies would continue for uncommon or high risk projects. There will be no winners from 'optimism bias'. This comment on cost estimation would also apply to the estimation of operational costs.

Section 4.3.3 'Break from the pack' and outdo their peers.

We consider that the focus on 'breaking from the pack' will lead to innovations emerging. However, care needs to be taken that 'breaking from the pack' in the short term does not compromise the long term. There is a significant level of community confidence in the services provided by Australian water utilities which has been built up over many years and underpins the maintenance of community public health (a factor which is now taken for granted). This trust can quickly erode through any major failure of service, public health-related issue (real or perceived), or negative environmental outcome. We discuss the issue of trust further following with respect to customer engagement.

Section 5. Customer Engagement

While we agree with the ESC proposal, we consider that there are two important considerations in moving to an approach that more heavily focuses on customer outcomes:

1. Trust is fundamental to the relationship between customer and utilities and the basis of all engagement between the two.
2. In seeking to determine customer preferences, utilities should be cautious that their engagement is representative of their customer base.

The most fundamental requirement for the relationship between a utility and its customers is trust. Therefore, we consider that establishing and maintaining this trust is the most important part of customer engagement and that establishing customer preferences is a vital, but secondary, consideration.

To a typical customer the requirements for water and sewerage services are relatively straight-forward and can be broadly summarised as:

- > 24/7 water supply service that is always safe to drink and is provided at an acceptable pressure and flow. Any failures are quickly responded to and customers are kept informed of any changes to supply.
- > 24/7 sewerage services that discharge wastewater off the premises with no odour, no wastewater internal flooding of the property, and any external flooding is very rare
- > Charges are stable or reduced in real terms
- > Should the customer suffer from some financial difficulties, the water business shows some flexibility and understanding in resolving payments
- > There are no major environmental impacts resulting from the provision of water and sewerage services
- > Dealing with the utility is simple and does not take longer than necessary.

Provided the above are consistently achieved by the water business, the typical customer will be relatively satisfied and place their trust in the utility, given that water and sewerage expenditure continues to be quite a small percentage of the household budget. Recent experience in Australia has shown that trust in a utility can quickly be diminished by actual or perceived poor performance with messages spread rapidly by social and then traditional media.

We also consider that there is a risk that in seeking high levels of understanding of customer preferences, as a water business may make decisions based on the input of a non-representative minority (a risk that may be amplified if a well-intentioned but inappropriate or ill-designed engagement approach is taken). This is

especially the case where there is a requirement that a leading water business should demonstrate that customer engagement had heavily influenced the business's proposals (section 6.3.1).

It has been shown in numerous customer surveys in Australia and internationally that many customers are indifferent to, or unable to fully appreciate, proposed changes in service provision. This 'null' result is sometimes seen as a failing of the research. We don't argue that the research can't improve but suggest that the positive side of indifference should be recognised – that in all likelihood customer needs are being met, that the customer trusts their service provider, and that bills are affordable.

The challenge facing utilities in preparing a pricing submission is to optimise capital and operating expenditure within the constraint of customer affordability. The constrained optimisation problem has to consider:

1. Maintaining compliance with legal and regulatory requirements. It should be recognised that legislation is the codification of the community's preferences (and by proxy, utility customers' preferences) through the political and legislative process.
2. Maintaining a corporate risk profile acceptable to the organisation and acceptable to the Board whom face personal liability in some areas.

While we recognise that maintaining compliance and managing risk is a low bar to set for a utility, customer preferences need to complement these requirements.

Section 6.1. Building on Existing Incentives

At the end of the fourth paragraph the following statement is made '*When costs are higher than the forecasts used to establish prices, a business must manage this shortfall rather than increase prices*'. This is reasonable, and in the private sector the shareholders would share the pain through reduced dividends.

Table 6.1. Board attestation

We assume that this Board attestation would also be supported by evidence of the Board's examination and challenge to the price submission (rather than just a sign-off) which, like the business cases, would be available to ESC, if required.

Section 7.3. A new flexible price review process

It would be useful for ESC to clearly define a 'high quality price submission' through providing a listing of the characteristics in one location. While these requirements are contained in various parts of the Position Paper, a simple checklist may provide clarity and assist in reducing differences of opinion between ESC and water businesses during the review process.

Recommendations

Considering the above, we make the following suggestions for the requirements of the Pricing Approach and its application:

1. The Pricing Approach should recognise that trust is the most important prerequisite in the relationship between customer and utility. Therefore, engagement should be firstly focused on maintaining, improving, and measuring/monitoring trust, noting that the relationship is ongoing and dynamic. It may be possible for the ESC to incorporate a measure of trust in its assessment of what constitutes a well-made pricing submission.
2. Water businesses would benefit from clearly defining the drivers for expenditure, and explicitly allocating proportions of initiatives to these drivers to better clarify what elements of expenditure can be influenced by customer preferences. In doing so, customer preferences can be gathered and

applied more meaningfully, with drivers providing a transparent and consistent framework for communicating regarding the need for expenditure between the utility, the regulator, and customers.

3. Utilities should demonstrate that they have rigorously engaged with regulators (economic, health, technical and environmental) to make clear what regulatory requirements are non-negotiable (an important element of complying with IAP2 principles) and where flexibility and innovation is possible to achieve the desired outcome.
4. Where the benefits of expenditure can be monetised, cost-benefit analysis should be used to justify and prioritise expenditure. An industry-wide approach can be taken to standardise analysis assumptions and the level of benefits assumed. For example, there is considerable research on the impacts of dry weather sewage overflows to allow for these projects to be justified by cost benefit analysis.

We wish you success in finalising the Commission's approach.

Yours sincerely



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