

19 June 2015

Water Team - Pricing Framework Review
Essential Services Commission
Level 37, 2 Lonsdale Street
MELBOURNE VIC 3000

RE: REVIEW OF WATER PRICING APPROACH

Thank you for the opportunity to provide comment on the ESC's April 2015 Consultation Paper '*Review of Water Pricing Approach*'.

Central Highlands Water (CHW) understands that the 2014 WIRO does not prescribe the requirement for pricing to be based upon the 'building block' approach and the ESC is seeking thoughts from water corporations on what features of future pricing approaches would be desirable.

CHW appreciates the opportunity to comment, at this early stage on the initial thinking of the ESC and the following represents CHW's views on a range of matters raised in the consultation paper and other relevant observations in this regard.

Efficiency

The clarity around the key objective being 'efficiency' at various levels is welcome (p.11). In particular, CHW makes the following observations in relation to these principles:

- *The promotion of efficient use of prescribed services by customers*
 - CHW's customers are maintaining their efficient use of water by being one of the lowest consumers in the state (at an average of 150 kL per household p.a.) compared to the regional average of 187 kL per household p.a. and the overall state average of 160 kL per household p.a. in 2013-14. CHW is actively working with customers to assist them in maintaining their efficient use of water.
 - In terms of understanding future projected demand, it would be beneficial if the Commission were to provide guidelines for Corporation's demand projections either under a set of principles or specifically as it relates to CHW and its customers. Providing the guidelines /principles are met, the Commission should then accept the outcome of those models. Our research and experience demonstrates that our customers have undergone a step-change in water consumption since the Millennium Drought and are maintaining responsible levels of consumption. By ensuring that future demand forecasts meet the guidelines, then the Commission or its contractors (in the interests of efficiency) should and document those projections.

- *The promotion of efficiency in regulated entities as well as efficiency in, and the financial viability of, the regulated water industry*
 - CHW welcomes the ongoing promotion of efficiency within the industry. However in terms of previous models developed seemed to promote and operate under the “one size fits all” efficiency model. For CHW two major points exist: a) The industry is diverse and is based on a range of geographical ,customer attitudes, supply and business models and b)Water Businesses should be rewarded for operating more efficiently and productively especially if outcomes are being targeted towards improving customer value. If future models are going to be used to measure relative performance and used as a basis to adjust prices then in our view it is imperative that the industry be involved in their development and therefore be committed to their outcomes.
 - As stated above in accepting that a focus on efficiency will become more prominent in the industry, it is vital that the Commission recognise the inherent differences in water corporations and particularly amongst regional water corporations, in terms of customer density, geography, distance, terrain and overall location. For example, a land-locked water corporation such as CHW (i.e. without access to the coast or a major river) is subject to major costs along all parts of the catchment-tap-catchment value chain. Any efficiency target must recognise regional differences and constraints and not assume that a ‘one-size fits all’ approach is adequate.
 - CHW supports the drive to ensure that the financial viability of the water industry and individual water corporations is vitally important and in part is determined by the debt incurred and servicing of that debt by each entity. While the building block approach excluded the recognition of debt as a relevant factor in determination of price, an efficient water corporation is by definition, one that uses debt wisely and seeks to reduce long-term debt thereby reducing the servicing costs to customers. This is the approach of CHW. Therefore, we assume that debt management must become part of the discussion in relation to efficiency and financial viability.
- *The provision to regulated entities of incentives to pursue efficiency improvements*
 - Efficiency gains should initially be available to the water corporation’s discretion to use beneficially either by:
 - Return to customer through reduced prices
 - Reduce debt and so lower long term price pressure
 - Based on the above then a return in the form of a dividend to the shareholder could be considered

Regulatory timeframe

The ideal timeframe is ultimately a balance of regulatory effort and requirements around price submissions and certainty around outcomes.

Currently the 5 year timeframe has a number of positives and negatives associated with it.

A shorter timeframe could be attractive (for example three years) as it reduces uncertainty around years 4 and 5 and would enable more accurate pricing to be made. To ensure this more regular regulatory pricing intervention was managed efficiently, the pricing submission process would need to be streamlined and less complicated and based upon differences between regulatory periods rather than identifying all costs in a comprehensive building block approach.

CHW believes that further conversation, as part of this process will need to be had to confirm what is the optimum and preferred regulatory timeframe.

Building block pricing submission

At the moment the building block approach demands every price component be built up and clearly demonstrated. Potentially a more efficient approach (whether based upon building block or not) is to accept that a stable water corporation with a history of effective management should be empowered to continue to deliver upon its many mandated commitments with minimal regulatory involvement within the context of clear guidelines and outputs.

Providing that a water corporation meets a standard of good performance, good governance and stable outlook, the pricing submission should be able to meet a more “reasonable” test of acceptance, providing prices are not proposed to rise above a pre-determined threshold, say CPI.

For example, if the water corporation is proposing the following outcomes over its forthcoming regulatory period then it could be subject to ‘light handed’ regulation (in terms of the extent of verifying information required as part of the Water Plan process) in the interests of efficiency:

- Prices increase no greater than the agreed threshold (e.g. CPI)
- Service standards and Guaranteed Service Levels maintained or improved overtime
- Efficiencies identified and delivered
- No proposed change to pricing tariff structure
- CapEx proposal maintained within an agreed threshold (e.g. +/- 10%)
- No forecast increase in debt beyond agreed thresholds
- Demand forecasts meet guidelines
- Clear direction from our shareholder as to its expectations over the agreed regulatory period.

And can demonstrate:

- EWOV complaints proportion historically at or below market share
- No governance concerns expressed through VAGO audit processes
- 100% compliance to relevant drinking water standards
- Maintenance & improvement of customer standards, responses and complaints.

Pricing model

The consultation paper seeks views on alternative pricing models other than the current building block. It is stated that different models may apply to different businesses or to different parts of the same business.

At this time CHW does not have a stated preference for any alternative model but in doing so does not discount any potential alternative as the discussions continue through this consultation period.

In CHW’s view, any alternative model proposed to be adopted should be shown to be clearly superior to the current model, otherwise the risk is that more complexity will be incorporated into businesses and the industry that will only increase operating and regulatory costs.

It is important that different models don’t negate the very outcome trying to be achieved – i.e. simplicity to drive efficiencies and lower customer bills.

Transparency on price setting

It is important that the regulator is close to the shareholder during the drafting of the *Guidance Paper* so that water corporations, as discussed above have a very clear understanding of the expectation in terms of overall pricing outcome being sought. This is not dissimilar to the proposed ‘price-based regulation’ from last year, but perhaps not as directive.

In the 2013 pricing process the discrepancy between the corporations' submissions and the regulator's draft decision sent a strong public signal that the regulator and corporations were not closely aligned. The effect of this was to undermine confidence in the process and potentially in our organisation, the water sector as a whole, and the public sector in a broader sense.

Perhaps there needs to be an intermediary step prior to a preliminary decision being announced internally by the Commission if this approach to draft pricing public announcements is going to continue.

In our view any Guidance Paper should clearly articulate the roles, behaviours and expectations of all stakeholders that influence the final price setting outcome, including the ESC, the shareholder and other key government regulators, not just the water corporations. All stakeholders obviously have a stake in an effective and high quality pricing approach.

Allowance for social policy Directions

The new pricing approach should provide some capacity to recognise directions from Government in regards to implementing social policy, for example installation of services or systems that would not normally be considered under a normal competitive framework and also any specific projects related to say climate change, social benefits and new initiatives.

Once again CHW truly appreciates the opportunity to be involved in discussions at this early stage and we trust these comments add value as part of the ongoing Water Pricing Approach Review.

Yours sincerely,



Paul O'Donohue
Managing Director