



Review of Water Pricing Approach

Submission to ESC - June 2015

A customer centric framework with cost based pricing and stronger long term efficiency incentives

Coliban Water's background

Following the creation of Coliban Water in the early 1990's, the corporation embarked on an ambitious program to leverage the benefits of private sector participation in the provision of safe and reliable water and sewerage services to Coliban Water customers. This took the form of competitively outsourced water and sewerage systems operations and maintenance functions, several corporate functions and competitively procured capital works using Build-Own-Operate-Transfer (BOOT) contracts.

With the introduction of independent economic price regulation in 2005, the opening value for the Regulatory Asset Base (RAB) of Coliban Water was \$7 million, despite the accounting value of assets being \$650 million. The ESC report at the time¹ contended Coliban Water would remain financially sustainable under ordinary climatic conditions, and with BOOT expenditure excluded from the RAB and instead treated as operating expenditure.

As the millennium drought hit, the low RAB and inflexible price caps meant we became exposed to increased financial viability risk, and this also impacted our financial sustainability. For four years, from 2006-07 to 2009-10, we had cash flow deficits from operations. In 2010, we sought a Price Determination reopening to increase prices. The price increases that were subsequently approved generated \$5 million in additional revenue. However, VAGO assessed the corporation remaining at risk of not being financially sustainable despite consistent low operating expenditure per customer over consecutive years.²

Our 2013-2018 Water Plan proposed initiatives such as capitalising historical revenue shortfalls to ease pricing impacts, deferring depreciation and the innovative Demand Adjusted Revenue Cap. While proposed price levels were largely approved by the ESC, these other initiatives were ultimately not accepted, exacerbating the insufficient RAB that has existed since inception.

Coliban Water believes that regulatory predictability, as highlighted by the WSAA/Frontier Economics paper "Improving economic regulation of urban water"³, could be improved in a new approach. For example, the ESC's decision to change a longstanding practice of treating Coliban Water's non-operational BOOT costs as operating expenditure was made with limited consultation and only become known to us after the public release of the Draft Decision on Water Pricing. There needs to be improved transparency for the regulated entity when such changes are being contemplated and then examined by the regulator.

Goal of pricing approach

Coliban Water is supportive of **a customer centric framework with cost based pricing and stronger long term efficiency incentives**

and we consider that such a framework is in the best interests of our customers and the corporation alike.

Tailoring of pricing approach

We believe that the positive outcomes of a tailored approach exceed the drawbacks in most cases.

Corporation size

The Water Industry Act (section 4C(a)) states that an objective of the ESC is:

wherever possible, to ensure that the costs of regulation do not exceed the benefits.

The benefits of regulation are higher if the number of impacted customers is larger. Therefore, the regulatory approach and process should be differentiated by the benefits attributable to regulation.

¹ ESC (2005), *Advice to the Minister for Water. Regulatory asset values for the Victorian water businesses*, March.

² As per various NWC Annual Water and Sewerage Performance Reports

³ Available online: <https://www.wsa.aasn.au/WSAAPublications/Documents/Report%20-%20Improving%20Economic%20Regulation%20of%20Urban%20Water.pdf>

The ACCC as price regulator of rural water corporations has different “tiers” of regulation, where large corporations are subject to rigorous price regulation but smaller corporations are only subject to price monitoring and non-discrimination requirements.

The ESC could consider less onerous forms of regulation for corporations that are smaller in size.

Business model

Different corporations have different levels of outsourcing and insourcing. By previously funding assets via BOOT arrangements, we historically had lower capital expenditure and RAB, and higher regulatory operating expenditure.

The approach utilised by the ESC should promote efficiency and adequate servicing solutions to customers without biasing decision making through unintended incentives.

Debt and profitability

The WIRO states that the ESC must

have regard to, and place particular emphasis on ... the financial viability of the regulated water industry.

We submit that the only way of meeting this WIRO requirement is for each individual corporation itself to be a financially sustainable entity. The Act specifies the *regulated water industry* as being comprised of each regulated water corporation.

Robust financeability tests should be applied to each corporation. As outlined in WSAA's submission to the IPART financeability review⁴, such tests need to be sufficiently long term and to take into consideration the financial sustainability risk over the life of a corporation's assets.

The ESC has historically applied short term fixes – ad-hoc adjustments to revenue requirements – rather than capitalising prior period shortfalls. While capitalising Coliban Water's non-operational BOOT expenditure has merits, it does not fully address the problem apparent in 2013 when prior period adjustments (from the 2005-2008 regulatory periods) ceased to apply and the revenue requirement artificially fell. We could face a similar situation at the commencement of the next regulatory period.

Under a building blocks approach, an indicator of extreme financial stress is where actual borrowing costs exceed assumed financing costs. This may occur where:

- Debt exceeds RAB; and/or
- Actual interest rates exceed *real* assumed interest rates.

To eliminate this issue, the pricing approach should be modified to offer true cost recovery by substituting forecast (or actual) financing costs for the traditional building block benchmark.

Consultation

We undertook extensive consultation in the lead up to submitting our 2013-2018 Water Plan, and we are strongly committed to engaging with and involving our customers where possible in the development of our plans.

We agree with the ESC that streamlined regulation or “fast tracking” would be beneficial for corporations that can demonstrate both pricing at or below a threshold (like Local Government proposed rate capping) and backed up by strong and meaningful customer engagement. The appropriate level of consultation should be informed by the pricing impact, so less consultation would be required if real prices were falling, for example.

We note that a similar “fast tracking” approach is currently being utilised by OFWAT in England and Wales.

⁴ Available online:

<https://www.wsaa.asn.au/WSAAPublications/Documents/Submission%20to%20IPART%20on%20financeability.pdf>

Different approaches within a corporation

We note the request to consider the appropriateness of different pricing approaches being used in a single corporation that provides differentiated services, such as both bulk and retail services, or urban and rural services, for example. However, we believe that the pricing approach should only differ *within* a corporation where there are differing competitive attributes of services **and** the size of the corporation is sufficient to enable the regulatory benefits of such an approach to exceed the costs.

We contend that these two criteria are **not** presently met in the Victorian water industry and any pricing approach should be applied at corporation level except where legislation dictates otherwise.

Industry trends

While we support the application of financial and service incentives, we consider that Total Factor Productivity (TFP) regulation would have downside that outweighs the upside or positive value. It is inconsistent with the principle of cost reflectivity and may inadvertently increase the risk of financeability benchmarks not being achieved.

To date, we submit that TFP models within the Water industry have not sufficiently allowed for changes in service regulation, including treatment requirements, expenditure expectations of government or corporation responses to climate change (which will affect different regions in varying ways).

Principles for consideration

It is our view that any pricing approach should be in the long term best interests of our customers and our region.

Cost reflective pricing

In order to hypothetically replicate the outcomes of perfect competition, pricing for monopoly water corporations should trend towards the level of costs in the long run. This is typically signified by the absence of monopoly rents and financially sustainable pricing.

We submit that price caps on their own do not achieve cost reflective pricing, unless the price of each service is equal to its individual LRM, and our customer feedback to date has not supported the volumetric price of water being as low as its LRM. Price caps do not allow customers to support service increases that would be funded through pricing.⁵

The principles and features that follow are all necessary complements of this principle in our opinion.

Customer certainty

From a customer perspective, regulated corporations must have incentives to become more efficient and to reduce costs in real terms in the long run. We have noted previous feedback from our large business customers seeking price “guarantees” that are not limited to arbitrarily-set regulatory periods.

Therefore, it is in the interests of all our customers for us to have as long a regulatory period as possible. Further consideration should be given to a flexible regulatory period length which might be determined by the ESC to be in the range of, say, 5 to 10 years with the corporation able to choose when to seek commencement of a new regulatory period.

⁵ Value capture mechanisms, such as tax increment financing, are widely used in the United States and increasingly so in Great Britain. These mechanisms leverage value in public infrastructure through capturing council rate uplift. This value then, in theory, can be shared by water corporations – but would otherwise be disadvantageous under a price cap only regime.

Regulatory predictability / understanding

As has been noted by the WSAA / Frontier Economics paper and others, an effective pricing approach gives certainty to corporations that regulatory outcomes will be predictable, relevant and well understood by the corporation. This applies for both the short term and long term.

At this point in time, we do not believe that TFP or similar approaches achieve this principle, although there is clearly a role for benchmarking in any pricing approach.

Incentives

In targeting a customer centric pricing approach, both financial and service incentives must be provided to corporations.

Financial incentives give customers surety that corporations are actively seeking incentives that will be shared with customers periodically. This could conceivably be via a “customer dividend” in the form of lower tariffs, or alternatively contribution to community, environmental or recreational infrastructure. In any case, this would involve consultation and engagement with customers and stakeholders.

Service incentives also align with customer interests and consideration should be given to the establishment of a set of service measures that are valued by customers.

Flexibility - just enough

In accepting a regulatory period that is longer or not of fixed duration, corporations are exposed to additional risk. While financial and service incentives will provide long term benefit to customers, flexibility is required so cost recovery can be maintained.

Where a relatively long regulatory period is adopted, a mechanism needs to exist so that prices can be appropriately adjusted either way from the approved price path to maintain alignment between revenue and costs, in situations where customer demand and/or corporation costs vary significantly from forecasts. The objective is to maintain a sustainable sharing of risk between customers and the corporation over the term of a longer regulatory period.

In our 2013-2018 Water Plan, we proposed an innovative Demand Adjusted Revenue Cap. Price caps give corporations upside (and customers downside) with higher-than-assumed demand while revenue caps give customers upside (and corporations downside) with higher-than assumed demand.

Presented in the following table was our 2012 assessment of differing form of price controls against (then) ESC and WIRO principles:⁶

Table 14.1 Performance of alternative price controls against ESC and WIRO principles

| | Price caps | Revenue cap | Tariff basket | Demand Adjusted Revenue Cap |
|---|------------|-------------|---------------|-----------------------------|
| Provide incentives to align price structures with underlying costs; | No | No | No | Yes |
| Manage and allocate demand and supply risks efficiently; | No | No | No | Yes |
| Minimise administrative complexity, cost and intrusiveness | Yes | Partially | Partially | Partially |
| Provide for a sustainable revenue stream | No | Partially | Partially | Yes |

It would be advantageous for the ESC to more thoroughly explore demand adjusted revenue caps and to enable corporations to consult with their customers on the appropriate level of revenue recovery between years.

⁶ For further discussion, please see our 2013-2018 Water Plan, available on the ESC website: <http://www.esc.vic.gov.au/getattachment/a3e57750-d699-4bc1-86f2-7638234a2dee/Coliban-Water-Water-Plan.pdf>

A balance between customer certainty and corporation flexibility must be achieved. To determine this will necessarily involve customers providing feedback within the process to a greater extent than that which has previously occurred.

Customer choice

We considered allowing customer tariff choice as we prepared our 2013-2018 Water Plan.

As expensive augmentations are driven by customer growth and higher consumption on the periphery of our network, customers would benefit by through “opt-in” tariffs that disincentivise customer use during critical peak periods. As renewals and growth capital expenditure is driven by peak flows, time of use pricing in certain pockets of our network could generate savings for customers. The current price of \$2.15 per kL in itself is not significant enough to modify customer behaviour on a peak day and offering prices above this for peak time usage is currently prohibited under the ESC determination.

We have used seasonal pricing on a voluntary basis with a large customer, and preliminary results indicate success at encouraging autumn and spring water consumption rather than during summer.

Customer understanding

Customers must understand the outputs of the price review process – prices on bills. Where customers are asked for input to a price review, customers must be given sufficient information to enable a meaningful contribution.

Customers do not need to understand all aspects of a price review and each and every component of a corporation’s pricing submission. However, we will again pursue best endeavours to make our pricing submission as accessible as possible.

Concepts such as customer forums, similar to the approach utilised by Scotland Water, appear meritorious and deserve greater consideration by the ESC and corporations.

Financeability

Underpinning the pricing approach needs to be the financial sustainability of **each** water corporation. Through effective risk management and business decisions we make in regards to controlling for and mitigating against various risks, we have substantially improved our financial performance and position.

A pricing approach that protects each individual corporation financially would enable optimal risk based decision making if prices could be adjusted in the event of financial unsustainability. However, if the ESC was to interpret the WIRO to meaningfully deny a price reopening, we believe that customers could be worse off as a result of overly risk averse decision making by a corporation.

Summary

We believe that customers’ best interests are served by a customer centric framework with cost based pricing and stronger long term efficiency incentives. This approach must be tailored for different corporations, but nevertheless allow customers to benefit from efficiency incentives while maintaining a level of flexibility to incentivise corporations.

Alternative price controls, such as the innovative Demand Adjusted Revenue Cap, should be encouraged and the pricing approach should outline various price control mechanisms to customers and corporations in the allocation of demand risk between the two parties.

Customer tariff choice should also be further explored as we believe that modified customer behaviour could lead to expenditure reductions and efficiency savings without compromising service levels. Customers need to understand how the risks they bear change with each tariff choice.

Principles and concepts in this paper should ensure the financial sustainability of each corporation in the industry. This would best meet the requirements of the WIRO, the ESC Act and other legislative instruments.