ESC Review of Water Pricing Approach
Consultation Paper

South East Water Response

June 2015

Introduction

South East Water welcomes the opportunity to participate in the Essential Service Commission's review of the appropriate approach to pricing for the Victorian water sector. South East Water is keen to explore alternative pricing options that deliver efficient pricing and service outcomes for customers, and work with the ESC and provide input into the initial and subsequent stages of the review process.

South East Water considers that the current pricing framework has been effective in delivering efficient outcomes for customers. However we also believe that there a number of aspects that could be improved in the current framework to achieve greater customer outcomes. The principal vehicle to achieve this would be a revised pricing approach that would improve on the current framework by providing:

- Greater incentives for businesses to be more cost efficient and rewarded for innovation
- A more streamlined review where the level of regulation should be assessed against the need
- Greater incentive and flexibility for businesses to deliver service levels that customers want
- Cost reflective pricing and long-term viability.

Given the multitude of pricing options and established models from other regulated industries, we support the ESC's proposed approach to use structured criteria to assess various approaches to pricing to achieve the best outcomes for customers. In addition to the criteria proposed we also consider any new framework should be adaptable to the changing nature of the water industry and potential for technological change and innovation within a regulatory period.

South East Water has undertaken an initial review of various practices currently established in other regulated industries in Australia and overseas and has found some approaches to pricing which may achieve better outcomes for Victorian water customers. These include:

- Assessment of the form of regulation, ranging from heavy-handed , light-handed or no regulation, for the services being provided
- Using alternative pricing approaches for different segments of the value chain
- Operating and Capital Expenditure Efficiency sharing mechanisms
- Innovation incentives where regulated businesses are financially rewarded for delivering innovations
- Service level incentives to incentivise businesses to deliver services customer want
- Streamlined price review processes, whereby a lighter review is undertaken by the regulator for businesses who provide quality price submissions, are meeting customer expectations and are not seeking price increases
- Greater flexibility to meet changing circumstances.

The following outlines these concepts in more detail which we consider should be further assessed in terms of their appropriateness for the Victorian water industry.

Form of regulation

South East Water considers that the starting point for review of the economic regulatory framework should be to identify the form of regulation required for the services being provided. This could be through firstly identifying and defining the services that are provided to its customers. Once it is clear what services are being provided, consideration should be given to the characteristics of the market in which they are provided, e.g., whether the service provider has a dominant market position and is exercising that market power, or the service is being provided in a more competitive market. These market characteristics should then be a key determinant of the form of regulation, being either heavy-handed, light-handed or no regulation, which should be applied to the services being provided. This assessment could be undertaken prior to the commencement of a price review, which may result in changes in the form of regulation for each service over time.

Once the form of regulation for each service is determined, we consider the next step is to assess the appropriate regulatory techniques that best align with the ESC's evaluation criteria.

A similar assessment is undertaken by the ESC for the regulation of Victorian Ports. The Australian Energy Regulator (AER) prior to each price review for energy distribution businesses also undertakes this type of assessment. As part of its framework and approach review, the AER determines whether a distribution service is to be:

- Classified as a standard control service and regulated in a heavy-handed manner using a building block approach
- Classified as an alternative control service and regulated in a more light-handed manner, although this could include a simplified building-block approach
- Classified as a negotiated distribution service and subject to an approved negotiating framework between the service provider and its customers or
- Unclassified, in which case the service is not regulated by the AER.

Alternative pricing methodologies

As outlined above, we consider that once the form of regulation review has been undertaken then the appropriate regulatory techniques can be assessed against the ESC criteria, which include:

- Incentives for efficient investment to deliver quality and reliable service to customers
- Incentives for the regulated entity to reduce costs while delivering services to a standard expected by customers (and other regulators)
- Regulatory burden for both the regulation entity and the Commission
- Financial viability of the water industry
- Complexity and transparency
- Predictability and certainty, and
- Ease of understanding for customers.

South East Water has undertaken an initial review of alternative regulatory techniques currently established in other jurisdictions we consider may better align with the ESC's evaluation criteria. Whilst a number of these reforms may potentially allow businesses to earn additional revenues and/or a higher rate of return, they are designed so that the resulting price increases are outweighed by the long-term gain in terms of achieving better customer value, and to improve business productivity and innovation.

Separate pricing approaches across the network

South East Water supports further consideration of applying alternative approaches across the various components of the water and sewerage networks, where separate approaches would better achieve objectives of incentivising efficient investment and potentially reducing regulatory burden. This has recently been undertaken in the UK water sector, where OFWAT (The Water Services Regulation Authority) in its most recent price review created separated pricing approaches for retail and wholesale/distribution network segments.

When applying separate pricing approaches across the value chain, consideration needs to be given to the appropriateness of the methodology for that segment. For example, any pricing framework for the wholesale and distribution components of the network, needs to take into account the lumpy nature of investment in long-life assets, and the unique characteristics of each water and sewerage wholesale and distribution network. Additionally a pricing framework for wholesale/distribution networks needs to provide certainty of return on assets invested over the life of the assets.

Given this, we consider it is more appropriate to explore opportunities for benchmarking elements within a cost based approach for the wholesale and networks components, rather than using a benchmarking approach as a stand-alone methodology to set prices. This has been the experience in the UK water and energy and Australian energy utilities, where benchmarks have been used in the formulation of prices and applied within building block structures.

South East Water considers there is merit in exploring a separate approach to the less asset intensive retail element of the supply chain, where there may be more scope for benchmarking costs across Victorian water utilities. OFWAT in applying a separate pricing approach to the retail segment adopted a benchmarked average cost to serve to calculate retail prices for all water businesses. South East Water considers this could be something worth exploring further, which may simplify the price review process while also creating greater efficiency incentives in the retail segment.

The following outlines in more detail OFWAT's approach to separating pricing approaches applied in its 2014 water price review. OFWAT considers that by targeting price controls, it can set better rewards and penalties ('incentives') for different parts of the companies to encourage them to improve the services they offer to customers and the price they do it for.

OFWAT's 2014 water price review set two wholesale, and two retail price controls:

- Wholesale/distribution - one for wholesale water services, and one for wholesale wastewater services. The wholesale control covers the technical services that the business provides – such as treating water so it is fit to drink, and transporting it through a network of pipes to a customer's property. Prices are set using a cost-based building block type of approach
- Retail - one for household customers, and one for non-household customers. The retail price control will cover customer-related services that the business provide – such as sending customers' bills, and responding to their enquiries. OFWAT then uses an average cost to serve (ACTS) approach to set retail controls for all household customers, based on actual costs. OFWAT has decided to use a three-year glide path for businesses with actual existing costs above ACTS, and for businesses that have actual costs below ACTS.[1]

[1] http://www.ofwat.gov.uk/pricereview/pr14/pap_pos201307finalapproach.pdf

Incentives for delivering efficient investment

South East Water supports the objective to provide incentives to deliver efficient investment. We note while under the current framework, South East Water has achieved significant expenditure efficiencies, we consider it could be improved to provide greater efficiency incentives.

There are a number of efficiency measures used to incentivise businesses in other regulated jurisdictions and industries which aim to provide a greater incentive to deliver efficient investment. For example, the AER currently administers operating and capital efficiency sharing mechanisms efficiencies, which aim to incentivise energy businesses to achieve efficiencies above the benchmark expenditure levels set in price. Under these efficiency sharing schemes, businesses can retain savings over a 5 year period regardless of the year the savings were made, whereas under the current Victorian water pricing framework efficiency gains made towards the latter part of the price review period are returned to customers after only a short period with lower prices in the next pricing period.

The following provides an outline of how the operating expenditure and capital expenditure efficiency mechanisms operate in practice in the Australian distribution businesses, which we consider should be explored as options that could be adopted to provide greater efficiency incentives for the Victorian water sector.

Efficiency Benefit Sharing Scheme (EBSS) – The EBSS shares operating expenditure efficiency gains (underspend) and losses (overspend) between the business and users. The scheme is symmetrical, in that rewards (for underspends) and penalties (for overspends) are treated in the same way. It aims to provide the business with a continuous incentive to improve opex efficiency and thereby reveal efficient level of opex so that it does not artificially either delay or advance an efficiency gain or loss. It is especially aimed at discouraging a business increasing opex in the penultimate year of its regulatory period so as to increase its base year allowance for the purposes of its next regulatory period. The EBSS enables the business to retain benefits of opex efficiency gain for duration of carryover period after which the benefits of the efficiency gain is shared with users through a reduction in its forecast opex (and equivalent for efficiency losses). A five year carry over period results in the business receiving six years of benefits from an efficiency improvement.[2]

Capital Expenditure Sharing Scheme (CESS) – The CESS is designed to incentivise a distribution business to undertake efficient capex across a regulatory period. A business is rewarded if it spends less than its capex allowance and it is penalised if it spends more than the allowance. The scheme works by calculating the cumulative underspend or overspend for the control period and applying a sharing ratio of 30:70 between the business and users. An adjustment is made for the financing benefit or cost to the business of the under/overspends.[3]

Reward for innovation

South East Water notes the ESC's intention to establish strong incentives for water businesses to operate efficiently and innovatively. We agree that a focus of the regulatory framework on efficiency needs to be balanced with a focus innovation and seeking new ways of doing things to achieve better outcomes for customers well past the next regulatory period.

[2] National Electricity Rules, Section 6.5.8 *Efficiency Benefit Sharing Scheme*, Pg 673.
[3] National Electricity Rules, Section 6.5.8A *Capital Expenditure Sharing Scheme*, Pg 673.

South East Water has a major focus on developing innovation as a way of delivering greater value to its customers. For example, recent innovations developed by South East Water, have enabled significant savings to customers in the roll out of the Mornington Peninsula backlog program, while also allowing customers to connect in some cases 15 years ahead of schedule. South East Water's development of remote telemetry technologies also enables real-time remote control and monitoring of the sewerage network, providing significant benefit to both to operation of the sewerage network and to customers in the Mornington Peninsula area. We consider that a framework that encourages and incentivises innovations such as this should be considered as part of a revised pricing approach.

Innovation incentives are currently provided for in the pricing framework administered by the Office of Gas and Electricity Markets (OFGEM) in the UK, where regulated energy businesses are financially rewarded for delivering innovations. South East Water believes the lessons learnt from OFGEM's approach are worth exploring in more detail in how they could be adopted in the Victorian water industry.

Under OFGEM's regulatory framework, it's recognised that although its RIIO (Revenue = Incentives + Innovation + Outputs) pricing framework provides strong incentives to innovate as part of normal business, certain research, development, trials and demonstration projects are speculative in nature and yield uncertain commercial returns. OFGEM therefore allows for a time-limited innovation stimulus package within the RIIO framework to provide additional funding for innovation that the business would not otherwise do as part of "business as usual". The innovation stimulus consists of three components:

- The Network Innovation Competitions (NIC): an annual competition to fund large scale, low carbon and environmental innovative projects. In addition to the transmission and distribution companies, other network licensees can also bid for funding under the NIC. Proponents are funded up to a maximum 90 per cent of the project costs. The NIC is aimed at large innovation projects that have the potential to provide learnings for the whole industry
- The Network Innovation Allowance (NIA): a set use-it-or-lose-it allowance that each distribution business receives to fund small-scale innovative projects as part of its price control. The value of the NIA is based on a business demonstrating it has a well thought through plan for how it will focus its development efforts over the price control period. The NIA is set between 0.5 per cent and 1 per cent of allowed revenues, based on the quality and content of innovation strategy, which forms part of regulatory submission
- The Innovation Roll-out Mechanism (IRM): a revenue adjustment mechanism designed to make funding available for the roll-out of proven low carbon or environmental solutions within the price control period. The IRM is aimed to roll-out new proven solutions that were not identified at the time the business plan was submitted that benefit customers. A revenue adjustment mechanism is applied to prevent delays to rolling out innovations.[4]

Incentives to deliver reliable services expected by customers

We agree with the ESC's criteria in assessing approaches to pricing should include a focus on pricing that incentivises water businesses to better deliver services that customer expect. South East Water therefore believes that a more targeted set of service standards focusing on services customers want should be explored as part of the review of the current pricing framework. South East Water also

[4] https://www.ofgem.gov.uk/ofgem-publications/47144/riioed1sconoutputsincentives.pdf, pp95-103.

considers that an incentive framework for businesses to maintain and/or improve service levels could also be developed once a revised set of service standards is established.

An example of a framework that focuses incentives businesses to deliver service customers want is the service incentive mechanism (SIM), introduced by OFWAT in 2010. It aims to provide water companies in England and Wales with a common output-based measure of customer service quality, against which the companies have been financially incentivized. OFWAT has retained this approach in its 2014 price review as it was seen as an effective tool in delivering service improvements to customers and to continue to encourage frontier companies to maintain or improve their position. The following provides a summary of how OFWAT's SIM operates in practice.

OFWAT assesses each company's customer service performance each year, using the following two sets of measures.

- A quantitative component comprising six customer handling metrics:
    - number of calls abandoned or engaged,
    - unwanted phone contacts,
    - written complaints, and
    - escalated complaints within the company and to the Consumer Council for Water.
- A qualitative component based on the results of customer satisfaction survey with a recent resolved contact (by any media for any reason).

Each component is scored out of 50 (for a total 'SIM score' out of 100) and, as part of setting price controls, companies are rewarded or penalised according to whether they are above or below the average score for the sector. The maximum reward for highly performing companies is capped at 0.5 per cent of revenue of the appointed company's integrated business; the maximum penalty is capped at 1 per cent of revenue. The SIM is a relative system where performance where companies are penalised/rewarded according to relative performance against others in the sector.[5]
South East Water contends that a similar approach could be considered in Victoria with a greater focus on service standards customers want which are amalgamated into an overarching service level target/score.

Streamlined regulatory processes

Under the current regulatory framework the cost is highest during price review processes, which primarily relate to labour costs within the ESC (recovered from businesses) and within the water businesses. South East Water supports the objective to reduce and streamline the current price setting process. Any revisions to the current model should therefore consider what level of reporting requirements are removed and what are created. We also consider that by assessing the form of regulation, as outlined above, may also identify ways in which the regulatory process can be streamlined and targeted for each service provided.

South East Water notes there are a number of examples in other jurisdictions where regulators apply a light-handed approach to businesses which provide quality pricing submissions. For example, under OFGEM's regulatory framework for energy, where a business produces a "well-justified plan", OFGEM proposes not just to focus less regulatory resource on them, but also to undertake an investigation to

[5] http://www.ofwat.gov.uk/regulating/aboutconsumers/sim/pap_con201310sim.pdf?download=Download

decide whether it is appropriate to reach an early, fast-tracked, settlement. The key features of fast-tracking are:

- A business's price control will be finalised approximately nine months ahead of that for a non-fast-tracked business; and
- OFGEM will consult on whether any business should be fast-tracked.

The purpose of the fast-track is to allow a business to get on with business-as-usual activity without focusing resources on the remainder of the price control process; plan with certainty over that extra time; and be the key driver of their review outcome by designing their proposal and not spending a year seeing their plans changed by regulatory scrutiny.[6]

SEW also sees merit in streamlining price review processes for price submissions by setting a price threshold, which if the water business can work within while meeting customer expectations then they do not require detailed scrutiny of its prices by the regulator.

Flexibility

The current regulatory model only allows re-openings of prices during regulatory periods under a tight set of circumstances. South East Water considers there should be greater flexibility in water businesses ability to change service levels and prices, due to customer needs or technology changes that result in a material change in costs during a regulatory period. Consideration should also be given to a materiality threshold (i.e. percentage price or revenue change) for the reopening of prices. We note for example OFGEM has re-openers including for street works, high-value projects and innovation roll-out which are triggered at one per cent of revenue.[7]

Cost reflective pricing and long term viability

South East Water believes that any amendment to the current framework needs to ensure that revenue adequately recovers costs of delivering services to meet customer and shareholder expectations – this being to ensure that objectives of efficiency are balanced with maintaining financial viability, as well as predictability and certainty objectives. A disconnect between price and cost could also lead to either overcharging if the business is able to achieve greater cost efficiencies or undercharging if it is not sufficient to recover operational and investment costs.

South East Water considers that price setting needs to be flexible to cater for potential significant cost changes resulting from changes in customer needs and behavior, changes in financing costs, major supply augmentations, as well as changes in government expectations, and revenue changes from customer demand. Additionally, maintaining a link between costs and prices will also enable a better explanation of price movements to customers, which is consistent with the ESC's objective to ensure ease of understanding for customers.

[6] https://www.ofgem.gov.uk/ofgem-publications/47147/riioed1sconbusinessplans.pdf.
[7] https://www.ofgem.gov.uk/ofgem-publications/47148/riioed1sconuncertaintymechanisms.pdf