

18 June 2015

Water Team
Essential Services Commission
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Melbourne Victoria 3000
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Re: VicWater Response to the Review of water pricing approach Consultation Paper

Thank you for the opportunity to provide a response to the Review of water pricing approach Consultation Paper.

VicWater is the peak body of the Victorian Water Industry with its membership constituted by Victoria's statutory water corporations. Those corporations are responsible for the provision of urban water and wastewater services, rural water supply including irrigation and related drainage services.

The comments in this VicWater submission represent the majority of views received from our members. We note that a number of water corporations will be making separate submissions highlighting issues specific to their business and this is encouraged by VicWater.

The range of views expressed to VicWater, from its members, was varied and in part this was driven by some of the structural differences between the water corporations. For example metropolitan water corporations are not vertically integrated and are classified as being for-profit, regional urban water corporations are classified as being not-for-profit and are vertically integrated with significant headwork assets to manage; and rural water corporations who are also not-for-profit, have significant headwork assets and have integrated decision processes with their customer representative committees.

This does highlight the real probability that there may not be one overall approach which will work optimally with each specific subsector and it may well be the case that different approaches to the various sectors will be required.

These differences are further highlighted in this submission when we raise concerns around the challenge of normalising data for the purposes of performance comparisons.

In responding to the ESC discussion paper, VicWater has drawn on water industry feedback received during workshops that followed the most recent Water Plan, the 2014 Review of Economic Regulation and specific comments provided to VicWater by its members on the Commission's discussion paper.

From VicWater's perspective, we note that a theoretically sound methodology which relies on poor data and processes will still yield an unsatisfactory result. In assessing the proposed approaches the practicalities (cost, timing etc) of implementing the various pricing approaches need to be considered as part of the options assessment.

Therefore VicWater supports the ESC's consultation process to explore the proposals and options via workshops and seminars through to November 2015 to ensure the selected approach or approaches are sound from both a model and practical implementation perspective.

VicWater supports approaches which seek to recover the efficient costs of water corporations, which provide incentives and encourages innovation for improved performance, can be easily understood by customers, ensures customers interest are protected, services are sustainable and protects the financial viability of water corporations.

In terms of the ESC's Review of water pricing approach consultation paper we provide the following comments.

Evaluation Process Criteria

VicWater supports the criteria proposed by the ESC for the evaluation of the pricing proposals with the addition of:

- ◆ Supporting resilient systems and service provision.
- ◆ Pricing which encourages innovation to improve services and performance.

The Commission should also consider how the pricing approach interacts with the diversity of water corporations. For example does a pricing approach deliver unintended financial viability outcomes when applied to a rural water corporation as compared with a vertically integrated regional urban or metropolitan water corporation.

Ideas to strengthen the pricing approach to achieve better outcomes and value for money for Victorian water and sewerage customers. Insights from interstate or overseas experience should be provided where available.

The building block approach to water pricing has broad support among the Victorian water industry and has served the industry well. It is worth noting that rural water corporations are not as positive about the building block approach and address this in their respective submissions.

The building block approach is well understood and provides a robust and transparent framework. It has been a particularly valuable approach in a period of significant investment in security of water supply, and improved water quality and environmental outcomes.

VicWater supports the conclusions reached in *Regulatory pricing models for the Victorian Water sector* (ESC/Deloitte, April 2014):

- ◆ The building block framework could benefit from a formalised approach to setting efficiency targets, improving transparency and supporting customer engagement and understanding of industry performance, and

- ◆ It is important to recognise that the regulatory pricing model is just one component of the regulatory framework. Other factors, such as robust governance arrangements and clarity of objectives for the industry are also fundamental to the achievement of the objectives for the industry.

Some water corporations, primarily in the not for profit sector, have expressed concerns that under the current pricing approach their debt has significantly increased.

The review should consider how the various pricing approaches interact with the efficient capital structure of water corporations, and the extent that this is or is not an issue for financial viability.

An agreed position with VAGO on financial viability and suitable metrics would also be helpful in terms of the various proposed pricing approaches.

What are the advantages and disadvantages of continuing with the current building block approach compared with other approaches? Provide reasoning and examples where possible to support your views.

This is a particularly difficult question to respond to in the absence of a specific model to consider, especially given the lack of in depth experience within the water industry of alternative pricing approaches. VicWater anticipates having more detailed discussions with the Commission on this issue following the release of the 'thought pieces' and during 'phase three' of the Review.

Water corporations generally agree that the building block approach provides transparency in price setting and confidence in investment decisions as the invested funds (capital) generate a financial return.

The mechanism of return on assets, within the building block approach, ensures that corporations are continuing to invest in their infrastructure upgrades and renewals so that future generations are not burdened with a legacy of neglected infrastructure and associated declining service standards.

One of the weaknesses often cited about the building block approach is that it can favour CapEx over OpEx, although VicWater is not aware of any examples where this potential bias has occurred in the Victorian water sector. To avoid the potential for a 'capital bias' in the building block approach it may be worthwhile considering how the WACC is used, rather than simply removing the return on capital deployed or focus on TotEx.

In terms of the pricing approaches identified by the ESC we provide the following comments:

- ◆ The basic principles of the building block approach are relatively easily understood by customers and provide a robust pricing outcome.
- ◆ The building block approach has served Victoria well during a period of significant investment to secure water resources and improve water quality and environmental outcomes.
- ◆ The building block approach could be further improved to better support innovation that has an objective of improving performance and services to customers.

- ◆ Price monitoring within an earned autonomy framework may be an effective alternative to the building block approach, if it reduces the complexity of the water plan process and lightens the regulatory burden to water corporations. However, price monitoring should be accompanied by appropriate checks and balances to ensure that the price path enables appropriate infrastructure investment.
- ◆ Total Factor Productivity (TFP) is not favoured at this point in time by VicWater for setting efficiency factors to be used in prices. This pricing approach requires the generation of extensive data sets and modelling to benchmark and normalise data, increasing the cost and complexity of regulation. Recent exercises using TFP has resulted in curious and potentially distorted results due to errors or lack of success in normalising data.
- ◆ The complexity of TFP is such that the outcomes of a TFP pricing determination are unlikely to be easily communicated to customers. VicWater is happy to reconsider its position on TFP once it has had a chance to review the thought pieces commissioned by the ESC and has a better understanding of how this would work in the Victorian water Industry context.
- ◆ Comparative benchmarking (including indexing and yardstick approaches) are often presented as alternatives to the building block approach. They could easily be integrated into the building block approach as observed in the Commission's report 'Regulatory pricing models for the Victorian Water sector' (April 2014). However, as with TFP, the challenges of normalising data across water corporations with significantly different characteristics would need to be addressed.

What alternative pricing approaches should be considered for the Victorian water sector? Please describe the key features and provide some supportive explanation to demonstrate how these would better meet the stated objectives than the current approach. Where possible, provide examples of where this approach has been used successfully.

VicWater supports independent price setting and the building block approach, but it is open to consider the relative merits of other methodologies. The implementation of an alternative approach should consider the following:

- ◆ The pricing approach should not be biased based on water corporations uncontrollable externalities or structural differences, for example some approaches may favour water corporations that experience high population growth or have centralised infrastructure and low cost water sources.
- ◆ Benchmarking and yardstick approaches (including TFP) will face significant challenges normalising data from water corporations with different structures, locations, purposes and underlying cost drivers. For example, normalising the data for performance comparison between say a small and remote vertically integrated rural and urban water corporation and a large urban retailer or wholesaler would require a significant amount of work with the results having questionable value.
- ◆ The pricing approach should accommodate different water corporation infrastructure investment cycles and thus provide for intergenerational equity
- ◆ Key inputs need to be clear early in the process
- ◆ The ESC has forecast a greater emphasis on community engagement and endorsement as a pathway to lighter handed regulation or earned autonomy. VicWater supports this approach where there is clarity on what constitutes effective community engagement and endorsement and provided there are sufficient checks and balances to protect customer's interests.

Finally, although it is not specifically addressed in the Commission's discussion paper, we would like to reinforce the role of the active shareholder in the pricing process and the need to develop appropriate mechanisms for water corporations to challenge or appeal pricing determinations.

Once again thank you for the opportunity to respond to the Commission's consultation paper. We look forward to the release of the Commission's thought pieces and the next phase of the Review.

Yours sincerely

A handwritten signature in blue ink, appearing to read 'Tony Wright', with a long horizontal flourish extending to the right.

Tony Wright
Chief Executive Officer