ESSENTIAL SERVICES COMMISSION

A NEW MODEL FOR PRICING SERVICES IN VICTORIA'S WATER SECTOR

Position Paper

May 2016

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CHAIRPERSON'S OVERVIEW

Since 2004, the pricing framework applied to the Victorian water industry has remained largely unchanged. It is a 'one size fits all' approach that is predicated on the assumption that a well-designed technocratic model can produce outcomes that are in the long term interests of Victorian consumers. It assumes that providing water businesses with the opportunity to outperform the regulator's determination will drive greater value-for-money for customers. But this is only an assumption. How do we really know whether it is justified or not? The answer must surely lie in asking customers.

During our 2013 price review, we encouraged greater customer engagement by water businesses to ascertain what customers value most, in order to inform their service and price proposals. The sector responded well but the feedback since then has strongly suggested more can, and should, be done. There has also been strong interest in having the Commission develop new opportunities for simpler regulatory processes, and stronger incentives for businesses to deliver efficient outcomes. These messages have come most clearly from the water industry and they are consistent with themes explored in the Victorian Government's recent discussion paper *Water for Victoria*.[1]

This paper proposes a model that we believe can be a genuine 'game changer'. This paper is short (at least by regulators' usual standards), but don't be misled by its briefness. There is elegance in its brevity.

We had a number of objectives when developing our proposed approach.

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[1] Department of Environment, Land, Water and Planning 2016, *Water for Victoria, Discussion paper*, March.

Customers. The technical nature of the current model self-evidently disenfranchises customers and encourages water businesses to spend too much time attending to the regulator and its regulatory processes. Our framework will pivot the businesses' attention squarely towards their customers. There will be no successful regulatory outcomes for the businesses if they do not understand the concerns, priorities and preferences of their customers — and then take those matters into account in developing their pricing proposals.

Autonomy. The current framework either allows or encourages lines of responsibility for outcomes to be blurred. The Boards of water businesses are too often left confused by the Commission's role in light of the duties vested in them. There should be no such confusion. The Boards and their management teams are solely responsible for the outcomes they deliver. The proposed framework leaves no doubt about the autonomy of the water businesses to determine their fates — financial and reputational. They decide how ambitious they want to be.

Performance. Service standards and performance reporting have been central features of the current framework. While there have been marked improvements in reported outcomes over the last decade, are these the outcomes that matter most to most people? Are there really any consequences for water businesses that don't achieve the standards to which they commit? Right now, the answer to both questions is, "dunno". The new framework seeks to ensure that in the future the answer to both questions is a categorical, "Yes".

Simplicity. The current pricing methodology is steeped in obscure concepts involving WACCs and RABs, glide paths and scissor effects, betas and gammas. While we have assiduously guarded the Victorian regime from descending into the false precision that has dogged other pricing frameworks, we still have our fair share of obscure concepts. Deciding which services to deliver and what prices to charge for those services should not be a priestly pseudo-science.

Our proposed approach will not allow water businesses simply to tick a series of regulatory boxes. Regulatory life wasn't meant to be that easy.

Under the proposed regime, water businesses will face incentives to vie for excellence in the development of their proposals. It is they, rather than the regulator, who will define excellence. That excellence will be defined by the meaningfulness of their engagement with customers, the accuracy and reliability of their forecasts, and the innovations they bring in delivering value-for-money to their customers. Customers should expect no less.

The main features of our proposed approach include:

- requiring water businesses to explain and justify how they have engaged with their customers, and requiring them to articulate how that consultation has informed the decisions they have made
- focusing performance on the outcomes that matter to customers, rather than engineers, accountants and regulators
- linking financial outcomes by water businesses to their level of ambition in delivering services so that excellence is rewarded and complacency is not
- adopting a deceptively simple incentive framework that is not shrouded in layers of econometric obscurity
- removing the false precision involved in the costing of capital and de-mystifying the allowance made for water businesses' cost of debt
- introducing new flexibility mechanisms that reward water businesses for high quality submissions that are readily understandable, reliable and accurate, and
- requiring water businesses to assess transparently and honestly the ambition and quality of their own price proposals before submitting them to the regulator.

The framework proposed in this paper has been informed by a year-long research and consultation exercise involving many interested parties including the water industry, customer representative groups, government, other economic regulators and academics. Now commences the next stage of our consultation effort. We look forward to the many conversations that lie ahead.

Dr Ron Ben-David
Chairperson

CONTENTS

1 INTRODUCTION

The Essential Services Commission (the Commission) is the economic regulator of the Victorian water sector. The *Essential Services Commission Act* 2001 specifies that our main objective is to promote the long term interests of Victorian consumers. We regulate water and sewerage prices. We also regulate the standards and conditions of service and supply for water and sewerage services delivered by the 19 State Government owned water corporations.

The Water Industry Regulatory Order (WIRO), made under the *Water Industry Act* 1994, sets out the detailed framework that guides our economic regulatory functions in the water sector, including price regulation and performance reporting.

1.1 REVIEWING OUR WATER PRICING APPROACH

In 2014, the Victorian Government reviewed and revised the WIRO. The changes allow the Commission greater discretion to decide on the manner, approach and method (the pricing approach) used to deliver efficient pricing and service outcomes for Victorian water and sewerage customers.

Given the increased discretion available under the 2014 WIRO, in April 2015 we publicly released a consultation paper[2] to start reviewing our pricing approach for the Victorian water sector. The review is preparation for the 2018 water price review of 16 urban water businesses and Southern Rural Water.[3] It will inform the guidance that

[2] Essential Services Commission 2015a, *Review of Water Pricing Approach, Consultation paper*, April.

[3] Prices for Goulburn-Murray Water and Melbourne Water will be established for a four and five year period respectively, from 1 July 2016. The Commission regulates the prices of Goulburn-Murray Water's infrastructure services under the Australian Competition and Consumer Commission's Water Charge Infrastructure Rules.

we issue to water businesses to explain our expectations for the development and content of price submissions.

This pricing approach review is the most significant opportunity to improve how water prices are determined since our water pricing function was established in 2004. As such, the review outcomes will interest a wide range of parties.

In our April 2015 consultation paper, we stated the objective for our pricing approach review is to:

> *… identify the pricing approach that will produce the best outcomes for Victorian customers, namely, services delivered at the lowest price while meeting all quality and reliability standards. Our approach to pricing will involve establishing strong incentives for the water businesses to operate efficiently and innovatively, while providing for their long term viability. Alternatively stated, our approach to pricing seeks to uphold the long term viability of Victorian water businesses that operate efficiently and invest prudently. Victorian customers should expect no less.*

This objective was well supported in submissions that we received during our consultation. It remains the primary objective of our pricing approach review.

1.2 FOCUS AND STRUCTURE OF THIS PAPER

This paper assumes some understanding of the Commission's current pricing approach. Readers looking for a more detailed understanding of our current approach may refer to our April 2015 consultation paper.

In this paper, we describe our proposed changes to the pricing approach at a relatively high level. We are seeking feedback on the concepts, models and principles underpinning our high level proposals. More work is needed to develop the detail to support the implementation of our proposals. For this reason, we will release additional papers and hold workshops to consult on the detail of our proposals.

This paper is structured as follows:

- Chapter 2 outlines our consultation for the pricing approach review.
- Chapter 3 provides a summary of our proposed changes to the pricing approach.
- Chapter 4 explains the rationale for change and opportunities for improvement.
- Chapter 5 outlines our views on improved customer engagement.
- Chapter 6 sets out our proposed new incentive framework.
- Chapter 7 describes the flexibility mechanisms in our proposed pricing approach.
- Chapter 8 provides some worked examples of the new pricing approach in action.

1.3 WE SEEK FEEDBACK

Submissions in response to this consultation paper are invited by 29 July 2016.

We would prefer to receive written submissions by email to **water@esc.vic.gov.au**

You may also send submissions by mail to:

Water Team – Pricing Approach Review
Essential Services Commission
Level 37, 2 Lonsdale Street
Melbourne VIC 3000

We usually publish submissions on our website. If you do not wish us to disclose information publicly, please provide a confidential version and a version that is suitable for publication.

2 OUR CONSULTATION

Our review process involved participation by customers and water businesses. It also drew on the expertise of world leading experts and their experience of international regulatory frameworks.

In July and August 2015, we released six ideas papers to inform our review. These papers largely drew on recent developments and experiences in other economic regulatory jurisdictions, and considered how they might be applied to the Victorian water sector.[4]

Also in the latter half of 2015, we conducted workshops with interested parties to explore the recommendations of the ideas papers. Our consultation in 2015 culminated in a two-day water pricing conference in November. The conference (box 1.1) was attended by representatives of the Victorian water businesses, interstate water businesses and economic regulators, government departments, academics and consumer representatives. Following the conference, we surveyed attendees and called for further submissions of stakeholder views. Appendix A summarises the submissions.

All papers and submissions that informed our review are available on our website (www.esc.vic.gov.au/water), as are the presentation slides used at public events.

We found that generally, stakeholders were interested in exploring key themes that emerged from the papers, our workshops and the conference. The themes included:

- opportunities to improve how water businesses engage with customers when deciding services and prices to propose in price submissions

[4] Refer to our summary paper: Essential Services Commission 2015b, *Generating ideas on the pricing approach for Victoria's water sector, Summary of papers prepared for the Essential Services Commission*, July.

- simpler regulatory processes and
- incentives for businesses to deliver outcomes that reflect customer preferences.

We also heard that stakeholders see a number of strengths in our current water pricing approach. In particular, water businesses generally view the building block method as critical to helping them remain financially viable and able to deliver quality services.

BOX 1.1 THE COMMISSION'S WATER PRICING CONFERENCE

We hosted a conference over 9 and 10 November 2015 at the Melbourne Convention and Exhibition Centre. About 150 people attended the event to consider the future of water pricing in Victoria. Attendees heard from expert speakers, including Alistair Buchanan (KPMG) who founded the RIIO approach to energy price regulation in the United Kingdom. And Bruce Mountain (CME) overviewed a customer engagement paper that he and Stephen Littlechild (commonly cited as the founder of incentive based regulation) prepared for the Commission.

The Conference also featured presentations by customer representatives, including Emma King (Victorian Council of Social Service), Gerard Brody (Consumer Action Law Centre) and Gavin Dufty (St Vincent de Paul Society). Adam Fennessy (Secretary of the Department of Environment, Land, Water and Planning) gave an overview of directions for water policy. Presentations were also made by Stuart Wilson (Water Services Association of Australia) and Pat McCafferty (Yarra Valley Water).

Panel and table discussions focused on the various pricing approach proposals and learnings from other jurisdictions, and how these might apply to the Victorian water sector. They also questioned how water businesses should engage to better understand their customers' expectations, and how the Commission might operate with less regulatory scrutiny.

3 OUR PROPOSAL

The Commission has formed a view on how the current water pricing approach can be improved to deliver better outcomes to customers. This chapter provides a summary of the new pricing approach. The main changes are explored in more detail in later chapters.

3.1 BUILDING ON THE CURRENT PRICING APPROACH

The Commission proposes to retain a number of elements of the current pricing approach.[5] We will continue to allow prices to be established using the building blocks methodology. Approved prices will continue to allow a water business to recover a rate of return on prudent and efficient capital expenditure on assets, a return of the cost of investing in those assets (depreciation), prudent and efficient operating costs, and tax.

This means the water pricing approach will continue to ensure a water business can recover the efficient costs of delivering on its obligations, while providing a reasonable opportunity to earn a return on the owner's investment. The business may use this return to pay a dividend to the shareholder, fund projects, reduce debt, reduce prices or undertake any combination of these strategies, as decided by the board and shareholder. There is no role for the regulator in such decisions.

[5] For a detailed overview of the existing economic regulatory framework for the Victorian water sector, our current pricing approach, and approaches taken in other jurisdictions, please see chapter 2 of Essential Services Commission 2015a, *op. cit*.

Most water businesses supported the retention of the building blocks methodology in some form. As noted in a submission by Goulburn Valley Water:

> *For Goulburn Valley Water, with a large number of dispersed systems, often servicing small populations, the building block approach has provided an open and transparent approach to regulate water prices and provide consistent standards of service and pricing for all customers. Further, the basis and methodology that underpins the building block approach is capable of being understood by our customers.*[6]

We will also retain other familiar elements of our pricing approach, including:

- approving prices for a relatively long period (generally around five years), noting we remain open to water businesses proposing and justifying their preferred term[7]
- in our reviews of expenditure proposed by a water business, using benchmarking for significant cost categories (such as wages and energy) to inform the expenditure forecasts used to establish maximum prices
- the uncertain and unforeseen events mechanism, which allows prices to be reconsidered if circumstances change unexpectedly and the water business cannot manage the change within previously approved prices[8]
- the financial viability test, which the Commission may use when approved prices are unlikely to allow businesses to deliver required services[9]
- the New Customer Contributions framework, which guides how businesses may recover (from developers) the costs of new connections to a water business's water, sewerage or recycled water network[10]
- the use of pricing principles to allow water businesses to negotiate prices for major customers, recycled water and a range of miscellaneous services

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[6] Goulburn Valley Water 2015, *Submission*, 11 June, pp. 2.

[7] This flexibility was flagged in Essential Services Commission 2011, *2013 Water Price Review, Guidance on water plans*, October, pp. 3. None of the 19 water businesses proposed an alternative regulatory period length.

[8] Essential Services Commission 2013a, Price Review *2013, Greater Metropolitan Water Businesses, Final decision,* June. pp. 180-182.

[9] Essential Services Commission 2014, *Assessing the financial viability of Victorian water businesses: summary of views and proposed new indicator,* June.

[10] Essential Services Commission 2013b, *New customer contributions: explanatory note*, December.

- the setting of service standards and targets, and guaranteed service levels in our codes for urban and rural water businesses[11] and
- support for innovation by allowing businesses to fund (via prices) trials of new processes or technologies that seek to address common challenges facing the water sector (such as through the Intelligent Water Networks program).

3.2 SUMMARY OF NEW PRICING APPROACH

We are proposing changes to the pricing approach to facilitate a greater focus by water businesses on delivering outcomes for customers. Figure 3.1 summarises the price review process, incorporating the main elements of our proposed pricing approach.

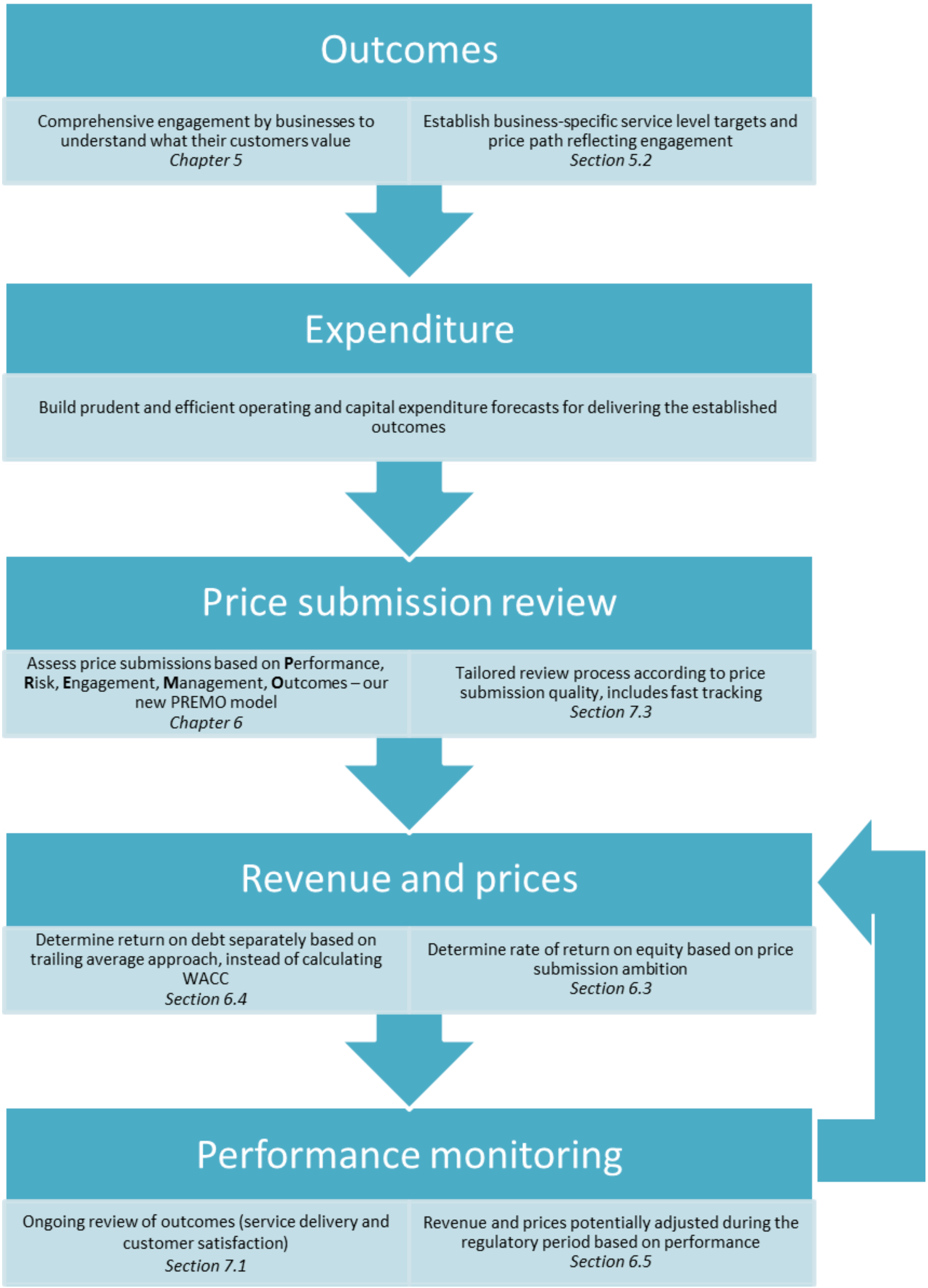
In the first step, a water business would engage with its customers and community to inform the outcomes to be delivered in a pricing period. We want water businesses to engage earlier and more deeply on matters that are of most interest to customers. Proposed outcomes may vary for each water business. Price submissions must demonstrate that comprehensive customer engagement has informed the water business's proposed outcomes (chapter 5 sets out how a business might substantiate its customer engagement in its price submission). Proposed outcomes will also continue to reflect Government or technical regulator obligations.[12]

In the second step, a water business develops its best estimate of the prudent and efficient level of expenditure to deliver on the outcomes identified at the first step. A water business's price submission will demonstrate alignment of expenditure with the outcomes to be delivered. Priorities and options are tested with customers throughout the planning process.

[11] See Essential Services Commission 2014, *Customer Service Code, Urban water businesses*, September; and Essential Services Commission 2013c, *Rural water Customer Service Code*, July.
Information on guaranteed service levels can be found at Essential Services Commission 2013a, *op. cit.*, pp. 5.

[12] Government obligations are typically outlined in a Statement of Obligations issued to water businesses. Technical regulators include the Department of Environment, Land, Water and Planning, and the Department of Health and Human Services.

FIGURE 3.1 THE NEW PRICING APPROACH



The third step involves a new approach to the assessment of price submissions, which will influence the returns allowed in prices for each water business. Unlike the current approach, under our proposal the cost of equity established at the start of a pricing period could vary for each business, depending on their ambition in relation to proposed services and the operational efficiencies they intend to pursue.

This variable cost of equity mechanism is delivered through a new model — PREMO. In its price submission to the Commission, a water business would self-rate the ambition of its submission based on the PREMO elements in figure 3.1. After receiving the price submission, the Commission would also rate it against the PREMO elements.

This assessment process (which is described in chapter 6) would inform the cost of equity to be reflected in revenue and prices (the fourth step). Water businesses would continue to recover a benchmark cost of debt, but we propose to change from the current 'on-the-day' approach to a 'trailing average' approach.

Our proposal allows for a more flexible price review process that is influenced by the quality of price submissions. In particular, businesses putting forward high quality price submissions may benefit from a streamlined price review (chapter 7).

The final step is the ongoing review of outcomes delivered by water businesses. As well as performance reporting, a business's revenue and prices could be adjusted within a regulatory period to reflect performance against outcome commitments.

Many water businesses have called for greater autonomy in the pricing approach. Our proposals provide this opportunity. Under our proposals, a water business may have greater autonomy over the returns it may generate, and the nature of the Commission's review of its price submission. However, the degree of autonomy will depend on how well a business understands and reflects preferences of customers in price submissions, and demonstrates that it will deliver on these outcomes efficiently.

In short, we aim to move away from the current 'one-size-fits-all' pricing approach to one that more clearly distinguishes and recognises the performance of each water business in meeting its customers' needs.

3.3 LONGER TERM REFORM OPPORTUNITIES

We found merit in a number of ideas explored during our review. However, for timing purposes, we propose to further assess these ideas for possible implementation in price reviews after 2018.

In particular, we remain interested in exploring the unbundling (or separation) of the water and sewerage value chain for pricing purposes.[13] A paper prepared by Sapere Research Group for our pricing approach review noted unbundling has benefits, such as allowing for simpler and more transparent performance measures for service delivery by different parts of a water business's operation.[14] This measurement can provide information to businesses and the regulator to drive greater efficiencies.

But we understand unbundling may involve costs for water businesses and the Commission because it would require accounting ring-fencing of the regulatory assets, liabilities and expenditure. A number of businesses also noted unbundling would provide minimal benefit for customers. We intend to assess the costs and benefits of unbundling at a later stage.

[13] Unbundling involves the separation of the value chain into discrete parts. In the water sector, this would likely involve the separation of bulk water and sewerage functions from others, including water and sewerage treatment and distribution, and retailing.

[14] Sapere Research Group 2015, *A new methodology for establishing a water entity's revenue allowance, Final report*, July, pp. vii.

4 REACHING THE LIMITS

The current pricing approach for Victoria's water sector has remained largely unchanged since it was established in 2004. This chapter reflects on how the current approach limits water businesses in responding to their customers' interests in ways that are dynamic, innovative and efficient.

4.1 THE CURRENT PRICING APPROACH

Since economic regulation was introduced into the Victorian water sector in 2004, the approach to setting prices has been underpinned by the 'building blocks' method.[15] Our approach requires a water business to establish its forecast revenue requirement based on the building blocks for a defined level of service.[16] The revenue requirement comprises forecasts for specific cost 'blocks' including:

- a return on the business's assets (such as water storage and treatment facilities) as reflected in its regulatory asset base (RAB)[17]
- a return of the value of those assets (regulatory depreciation)
- operating costs, which include non-capital costs such as labour and energy and
- tax payments.

[15] For more details on the building block method, see Essential Services Commission 2015a, *op. cit.*, pp. 5-6.

[16] As noted earlier, service outcomes will reflect Government and technical regulator obligations, and the service needs of customers.

[17] In this paper, the "cost of equity" refers to the benchmark equity return allowed in maximum prices. The term "return on equity" is used where we are describing the actual equity returns generated by a water business — this may vary from the cost of equity benchmark used to establish maximum prices.

These cost blocks sum to produce the water business's total revenue requirement. Prices are set to generate this revenue over the period, accounting for forecast demand.

The Commission applies various techniques to ensure the revenue sought reflects prudent and efficient management by the water business. Having made our price determination, we typically withdraw from any further involvement — we leave it to the boards and management of each water business to allocate the allowed revenue to deliver the services required by their communities.

By and large, the only role played by the Commission in the intervening years is to monitor and report on the performance of each business, and to check that the prices being charged are consistent with the price determination for each business.

If a business manages to out-perform the cost forecasts used to set prices under the building blocks method, it keeps some or all of the efficiency gains for the remainder of the pricing period. Any cost savings not passed through to customers within a pricing period are reflected in prices at the start of the next period. In this way, customers too benefit from the efficiency savings made by businesses.

If the business has cost overruns, then it must absorb the increases in costs rather than passing them through to customers. This is meant to emulate what might happen in a competitive market where a business cannot simply raise its prices to recover its cost blow-outs, for risk of losing custom to its competitors.

4.2 LESSONS LEARNT AFTER A DECADE

Our experience suggests the role of the building blocks method in our pricing approach has not been well understood. Many parties involved in our price reviews still consider we are responsible for approving a business's individual projects rather than its total revenues. There is a sense that the Commission hampers the autonomy of the boards and management of the water businesses.

Similarly, there is a view that if the Commission excludes revenue sought by a water business, then the water business cannot proceed with specific projects associated with that revenue. It has also been claimed the Commission, by reducing sought after revenue, hampers water businesses' ability to pay down debt — in effect, a claim that we intervene in matters of financial management.

We have also observed some businesses inappropriately defer their obligation to propose prudent and efficient costs to the Commission.[18] Barwon Water noted the water businesses lack incentive to provide a thorough consulted and rationalised price submission, given the Commission's review processes.[19]

Despite the objective of the building blocks method being to provide regulated businesses with an incentive to outperform the cost forecasts used to estimate prices (and thus earn additional profits), we observe the water businesses more typically use the Commission's final determination as setting the revenue envelope up to which they can spend. In other words, the building block model is not creating incentives for management to pursue more efficient practices and to pass on the cost savings to customers.

To be clear, we are not suggesting that water businesses have acted inappropriately in any way. Rather, we conclude that the incentive framework assumed by the current pricing approach is not fully effective in driving intended practices across the water sector. Below, we discuss possible explanations for the limited effectiveness of the current incentive framework.

4.3 THE LIMITS OF THE CURRENT PRICING APPROACH

As discussed in chapter 3, the current pricing approach has many beneficial elements that should form a part of any alternative approach to setting prices. These elements have successfully driven many improvements in how water businesses plan and cost their service delivery. We have no doubt that much has been achieved since 2004 in ensuring customers' bills are fair and reasonable. Nonetheless, we consider some

[18] We observed this behaviour in past price reviews. After price reviews, a number of businesses commented that they couldn't decide on a project, yet sought to recover the project's costs in their price submission. This behaviour effectively delegated the decision on whether the project is prudent to the Commission.

[19] Barwon Water 2015, *Submission*, 11 December, p. 3.

features of the current pricing approach are limiting the opportunities for further improvement.

4.3.1 CUSTOMER ENGAGEMENT

Despite ongoing improvements in customer engagement, many water businesses work on their price submissions for two or three years before meaningfully engaging with customers. Customer engagement is effectively a last step before a business lodges its price submission with the Commission. For this reason, engagement has generally focused on informing customers, or seeking customer views on options that do not materially influence service priorities or prices. More effective customer engagement by water businesses will provide greater assurance that the services delivered and prices charged by water businesses better reflect customers' views and concerns.

4.3.2 EFFICIENCY INCENTIVES

As noted, many water businesses do not set out to beat the cost forecasts used to establish prices. Instead, the current approach provides them with an incentive to overstate forecast expenditures in the hope that we will not uncover all overstated costs. This was certainly the case in earlier price reviews of the Victorian water businesses. More recently, our decisions have not involved large reductions in the revenue allowed for businesses' claimed expenditure (although reduced allowances for particular expenses can still be large).[20]

This might seem as if the regulatory framework has largely driven costs to their efficient levels and promoted honesty in the forecasts submitted by the businesses. There are other interpretations, however.

Over a number of price reviews, the regulator reveals the limits of its power of discovery — that is, its ability to discern overstated cost forecasts by businesses. The rational response from the businesses when preparing their price submissions is to

[20] For example, in 2013 we reduced the cost benchmarks for labour costs well below the levels proposed by some regional urban water business. For more detail, see: Essential Services Commission 2013d, *Price Review 2013, regional urban water businesses, draft decision, volume I*, March, p. 51.

anticipate the regulator’s powers of discovery and to seek revenue at, or slightly above, the level that they expect the regulator will allow.

While it is reasonable to expect revenue forecasts would be lower if there were no independent scrutiny of water businesses’ costs, it is less certain that the final revenue allowance would truly reflect the efficient costs of delivering services.

Possibly related to this point, many businesses adopt overly risk-averse assumptions about forecast costs. This risk aversion is reflected in the relatively large contingencies that businesses propose for capital works, for example. As a result, customers are more likely to inappropriately bear risk on behalf of their water business, and to pay higher prices than they should. A further outcome is costly debate during price reviews, with businesses focusing on the Commission’s processes rather than the delivery of good outcomes for customers.

4.3.3 SERVICE OUTCOMES AND BUSINESS PERFORMANCE

In setting service standards, the Commission (like other utility regulators) has applied a series of performance indicators across all water businesses. Our reasoning is that ‘competition by comparison’ motivates businesses to outperform peers. Experience suggests this motivation may not actually occur. While sector-wide performance has improved on most measures collected, the businesses have tended to cluster around a given level of performance on many measures. Rarely do one or more businesses seek to ‘break from the pack’ and outdo their peers.

The reason for this clustering effect is not fully clear to us. One possible reason is the nature of the performance measures that we have applied. The measures are mostly technical (sewer blocks per 100 kilometres of sewer main, for example) or activity based (customer phone calls answered within 30 seconds, for example). These are important measures of performance. We do not propose to abandon them, but we question whether they drive ongoing improvements in the management of the water businesses.

Further, there is no direct link between a business’s performance against measures of service outcomes, and the return that the business can generate. As noted, the rate of return earned by a business is determined by a combination of:

- how the business performs relative to the expenditure forecasts (and, to a lesser extent, demand forecasts) used to establish maximum prices
- the Commission's final estimate of the weighted average cost of capital (WACC).

As a result, water businesses may place less emphasis on delivering against their service commitments to customers.

4.4 OPPORTUNITIES FOR IMPROVEMENT

One objective of economic regulation is to create incentives for regulated entities that mimic a competitive environment's disciplines on management decisions. In a competitive environment, the task of management is broadly twofold: (1) create the services that customers value most highly (and for which they are prepared to pay) and (2) deliver those services as efficiently as possible. Investors in a business that succeeds in these two objectives will see the return on their investment increase in the form of a higher return on their equity.

Improved service quality, value for money, or both, tells customers that the business is attentive to their needs and interests, and deserves their custom. A higher return on equity tells owners that management is acting to ensure their investments are put to good use. Together, these two outcomes promote:

- the delivery of services most valued by customers
- service delivery where, when and how customers most value it
- service delivery at the lowest sustainable cost.

Our proposed framework seeks to create new and stronger incentives that focus on greater value for money for customers, and on more efficient delivery of services. It links the returns earned by a water business to the business's ambition in relation to proposed service outcomes, informed by customer engagement. It also establishes stronger incentives for businesses to more accurately forecast the efficient cost of delivering services.

We would allow business to earn a higher rate of return when they submit proposals that account for customer preferences and concerns, and that provide accurate cost forecasts. On the flip side, water businesses that deliberately or complacently submit proposals based on inflated costs would earn lower returns. Returns would also be linked to performance against outcome commitments.

This approach contrasts markedly with the current approach whereby all businesses are allowed to earn exactly the same rate of return. The WACC for each business is the same. For most businesses, the WACC is an important determinant of the revenue that they receive, yet they exercise no control over the setting of the WACC.

Instead, we set the WACC during each price review. The WACC's two forecast components — the cost of debt and the cost of equity — are determined by methods that are intended to mimic the market cost of debt and equity. These methods have prompted ongoing arguments between regulators and regulated entities in numerous industries and jurisdictions. In a paper prepared for the Commission, Bruce Mountain and Stephen Littlechild noted:

> *In electricity, the determination of the rate of return on equity has become dominated by ever-increasingly arcane argument about the various forms of the capital asset pricing model … and dividend growth model.*[21]

Ultimately, these arguments produce no benefits in terms of service outcomes for customers. They are simply disputes between financial modellers.

For this reason, we consider such disputes distract the management of the water businesses from their main purpose: the delivery of high quality services and value for money to their customers. The opportunities for improvement (chapter 6) seek to remove this unwelcome and unproductive distraction from our price setting.

Our proposed framework gives the water businesses' boards and management far clearer responsibility for the outcomes that they achieve. There will be no question about the autonomy of water businesses under the new framework. We propose to let price submissions speak for themselves. And, where they do so clearly and robustly, the business should expect little intervention by the Commission.

[21] CME 2015, *Regulatory arrangements for the cost of capital and tax in the regulation of Victorian water companies: issues and ideas*, June, p.18.

4.5 CONCLUSION

The following chapters lay out our proposed approach to reforming the pricing approach to break through the limits that constrain water businesses from pursuing the greatest value for money possible. Chapter 5 discusses our expectations for customer engagement by Victorian water businesses. As regulator, we will never dictate how a business ought to engage with its customers, but the chapter outlines five principles that guide such engagement.

In chapter 6, we propose reforms that provide water businesses with greater regulatory autonomy to pursue value for money on behalf of customers. The proposed approach breaks the one-size-fits-all mould that has been inherent in the pricing approach to date. Water businesses will be given far greater discretion over the scope and scale of their ambitions. Businesses that deliver greater value for money to their customers will be able to earn higher rates of return.

The proposed model recognises flexibility is required if water businesses are to have greater autonomy in pursuing the interests of their customers. Chapter 7 outlines a number of flexibility mechanisms that we propose to help water authorities respond to the new framework.

Chapter 8 provides a worked example of our proposed framework in action. It demonstrates how the framework will provide much stronger incentives for water businesses to be dynamic, innovative and efficient in their pursuit of value for money.

5 CUSTOMER ENGAGEMENT

This chapter outlines the Commission's expectations for customer engagement by Victoria's water businesses. Consistent with our objective to implement a pricing approach that more heavily focuses on customer outcomes, we propose a much broader role for customer engagement by water businesses.[22]

In a competitive market, customers interact directly with the suppliers of goods and services. Customers can choose what they buy and who supplies it. Responding to customer preferences can be the difference between a successful business that grows its customer base, and one that loses customers and exits the market.

Victorian customers cannot choose their water business. Nor can they voluntarily choose not to be a customer, given the essential nature of the services delivered by water businesses. In light of these features, there is a risk that a water business will choose services and prices that reflect its own preferences, rather than those of its customers.

In our 2013 water price review, we placed greater emphasis on water businesses having to consult with their customers. That is, we wanted business to make customers rather than the Commission the focus of their planning. Water businesses generally responded positively, undertaking more engagement and trialling new techniques. For example, Yarra Valley Water used deliberative processes to assess customer preferences on a number of matters, including price paths and tariff structures. These deliberative forums heavily influenced its price submission.[23]

[22] This is consistent with the objective in the Victorian Government's discussion paper *Water for Victoria*, for water businesses to undertake more effective community engagement. See: Department of Environment, Land, Water and Planning 2016, *Water for Victoria, Discussion paper*, March.

[23] Yarra Valley Water 2012, *Yarra Valley Future Water*, *Water Plan 2013-14 to 2017-18*, October, pp. 13.

In chapter 4, we noted that despite ongoing improvements, we want water businesses to undertake more effective customer engagement.

We want water businesses to engage with customers earlier in the price submission planning process. We also want businesses to engage more deeply on matters that are significant to the services received by customers and to the prices that they pay. Price submissions by water businesses must demonstrate the influence of this engagement on proposed services and prices.

A number of papers prepared for our review explored this theme. A KPMG paper noted more effective customer engagement was a key feature of the RIIO[24] energy price reforms in the United Kingdom:

> *… the RIIO framework puts more emphasis on companies taking measures to ensure that they understand their current and future customers' requirements and factor these into their business plans.*[25]

From here, this chapter sets out our views on:

- the form of customer engagement
- the content of customer engagement
- the timing of customer engagement and
- the demonstration of customer engagement to the Commission.

In each relevant section, we include principles that would guide a business's customer engagement and the Commission's assessment.[26]

[24] RIIO stands for Revenue = Incentives + Innovation + Outputs.

[25] KPMG 2015, *Application of the UK's RIIO reforms to the Victorian water sector*, July, pp. 9.

[26] While tailored to the water sector, the principles are consistent with the principles guiding our assessment of customer and community engagement for local government councils seeking a variation to the council rates cap. See Essential Services Commission 2015c, *A blueprint for change*, *Local government rate capping and variation framework review, Final report,* September, pp. 69–70.

5.1 FORM OF CUSTOMER ENGAGEMENT

We do not propose to prescribe how a water business should engage with customers. We consider that each business is much better positioned than the regulator to determine what its customers expect and need from their water business, and how best to interact with its customers to this end. Businesses will be free to develop their own engagement strategies and techniques to allow their customers to be more involved in informing business decisions on services and prices. However, as discussed in chapter 6 and chapter 7, businesses that meaningfully involve customers in decision-making will be more likely than others to earn financial and reputational benefits.

We have observed that customer engagement methods such as deliberative forums, deliberative polling and customer challenge panels allow for a relatively deep exploration of issues with customers. These techniques compare favourably with the past focus of most water businesses on fact sheets or draft price submissions, which generally do not allow for an in-depth exploration of issues with customers, or the discovery of customer preferences, priorities and concerns.

There is a vast array of publicly available information that can help the development of customer engagement strategies. We understand many water businesses already draw on the International Association for Public Participation Australasia's IAP2 Public Participation Spectrum, which defines the public's role in any engagement process.[27]

Water businesses already have customer engagement programs in place and are testing new approaches. Businesses also appear to be actively sharing among themselves the lessons learned from different engagement techniques. These processes should drive ongoing improvements in customer engagement in the water sector.

A non-prescriptive approach is widely supported by water businesses. For example, in submissions to the Commission, Central Highlands Water[28] and Westernport

[27] IAP2 Public Participation Spectrum, www.iap2.org.au/resources/iap2s-public-participation-spectrum.

[28] Central Highlands Water 2015, *Submission*, 10 December, pp. 2.

Water[29] specified they do not support a Commission-prescribed customer engagement approach. These submissions noted each business faces different circumstances that mean a ‘one size fits all’ approach to customer engagement is not desirable. The majority of respondents to our post-conference survey indicated that they prefer that businesses decide on the customer engagement methods.

PRINCIPLE 1

The form of customer engagement undertaken by a water business should be tailored to suit the content of consultation, and to the circumstances facing the water business and its customers.

Further, for customer engagement to be credible, the information provided to customers should be tailored to the form and content of engagement. In assessing price submissions, the Commission will look for evidence that businesses provided customers with appropriate instruction and information, given the form and content of the customer consultation.

PRINCIPLE 2

A water business must provide customers with appropriate instruction and information, given the purpose, form and the content of the customer consultation.

5.2 CONTENT OF CUSTOMER ENGAGEMENT

Initially, customer engagement by a water business should seek to identify those matters of significance to customers. We expect these matters would then be the primary focus of customer engagement. As well as informing service and spending

[29] Westernport Water 2015, *Submission*, 11 December, pp. 3.

priorities, customer engagement should also inform business decisions on trade-offs between competing demands (for example, improved services or lower prices).

In the United Kingdom, South West Water's approach to customer engagement in Ofwat's 2015–20 water price review shows how a business might use engagement to inform price submissions at a strategic level. South West Water used customer engagement:

- to understand high level customer service priorities
- to explore trade-offs between keeping customers' bills affordable while investing in the environment and service improvements and
- as an iterative process; the business undertook successive rounds of engagement to provide feedback on research to customers, and to test initial positions.[30]

We also expect water businesses will engage with customers to inform decisions on particular issues. Water businesses already engage with customers to inform their proposals in specific areas such as service standards and targets, the nature of guaranteed service levels, and tariffs. Customers are well placed to provide views on these areas. Our proposed changes to the pricing approach will also require businesses to engage with customers on some additional matters.

We would expect water businesses will seek to understand the views of their customers on outcomes where there is no clear policy or regulatory direction. A recent example of this in our last price review was the willingness of GWMWater's customers to pay an additional charge to cover the costs of providing services for recreational water uses.[31]

PRINCIPLE 3

A water business's customer engagement should give priority to matters that have a significant influence on the services provided and prices charged by the business.

[30] S Littlechild & B Mountain 2015, *Customer engagement methodologies in water price setting: experience in England and Wales and Scotland, and possible application to Victoria*, July.

[31] GWMWater 2012, *Water Plan 2013-2018*, October, pp. 54–5.

5.3 TIMING OF CUSTOMER ENGAGEMENT

We expect water businesses will engage earlier with their customers. Customer engagement that informs a price submission is best undertaken as early as possible, before the business establishes its priorities. This timing means customers can have genuine input into the development of the priorities eventually outlined in a price submission. We also expect customer engagement to be an iterative process, whereby businesses test their decisions with customers and take on board new feedback and information.

If engagement occurs only at a later stage, customers may be limited to providing feedback on matters that are already largely decided. While later consultation is preferable to no consultation, later consultation has more in common with a communication strategy than an engagement program.

PRINCIPLE 4

A water business should start customer engagement early in its planning. The engagement should be ongoing, to keep testing proposals with customers.

5.4 DEMONSTRATION OF CUSTOMER ENGAGEMENT

We do not expect customer engagement to necessarily lead a water business and its customers to agree on prices and services. Engagement does not guarantee all customers will be fully satisfied with a business's proposals. But, if done well, it will allow a water business to hear, consider and address feedback. The result is a better alignment of business and customer interests.

In assessing price submissions, we will review how well a business demonstrated its engagement effectively captured customer views on major issues of interest to customers. In their price submissions, the businesses will need to show how they have considered and addressed these views. That is, we will assess the influence of engagement and a business's reasoning for accepting or rejecting feedback.

PRINCIPLE 5

A water business should demonstrate in its price submission how it has taken into account the views of its customers.

We propose not to specify how businesses demonstrate to us that they undertook effective customer engagement. We have prepared a tool (figure 5.1) that water businesses may use to describe their customer engagement in their price submission. The tool is based on the model guiding councils' consultation in the context of council applications for rate cap variations.[32]

The tool recognises the three elements of customer engagement discussed earlier in this chapter: form, content and timing. It is a medium for describing the different types of customer engagement, without prescribing how that engagement is to be conducted. The outward arrows in figure 5.1 reflect our expectations for earlier, deeper, and more participatory customer engagement by water businesses.

FORM: This element demonstrates **how** customers may participate in a customer engagement program. It is derived from the IAP2 Public Participation Spectrum. The scale consists of five types of participation, ranging from 'inform' to 'empower'. It shows customers' increasing involvement in decision making.

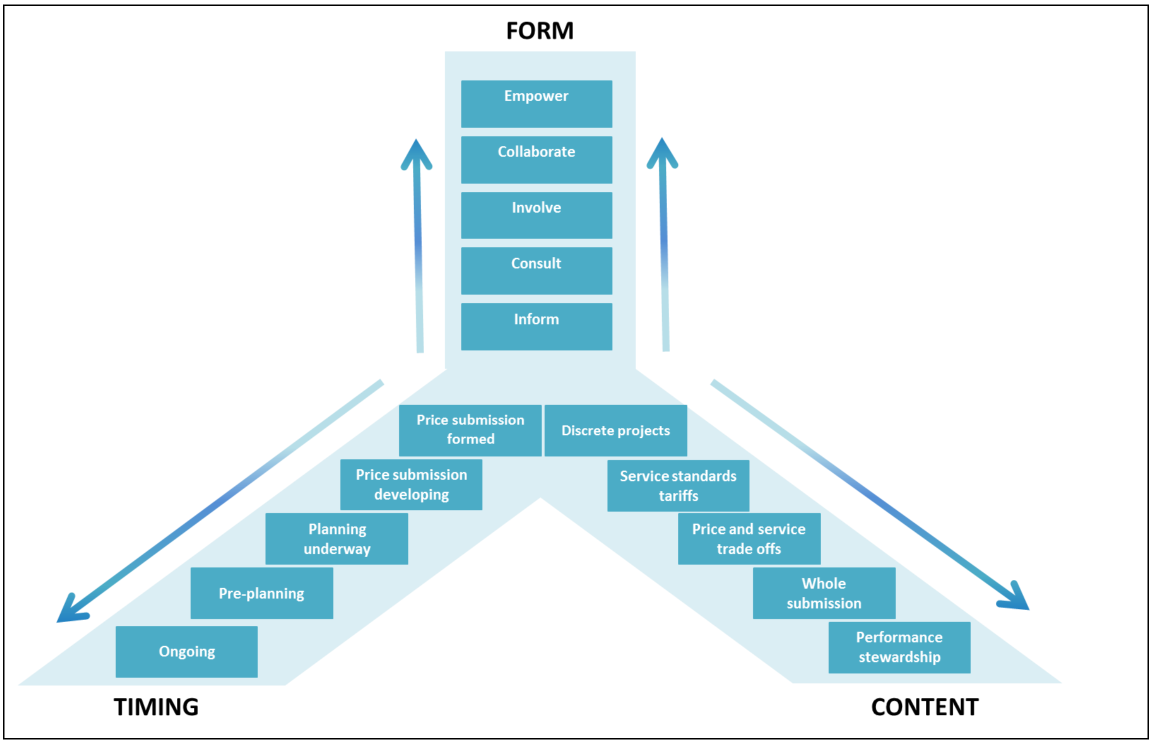
CONTENT: This element relates to **what** is subject to a customer engagement program. The most basic level involves engagement on a small number of specific issues or discrete projects (for example, projects focused on specific towns).

At the next level, customer engagement might include multiple initiatives, such as exploring service standards and targets, guaranteed service levels, and tariff structures. Eventually, customer engagement might involve consultation on price and service trade-offs or entire price submissions.

[32] Essential Services Commission 2015c, *op.cit.*, pp. 82–4.

TIMING: This element relates to **when** engagement takes place. Earlier engagement is at the pre-planning stage, and ideally is ongoing. The latest stage at which a water business might engage is when it forms the price submission.

FIGURE 5.1 CUSTOMER ENGAGEMENT DIAGRAM

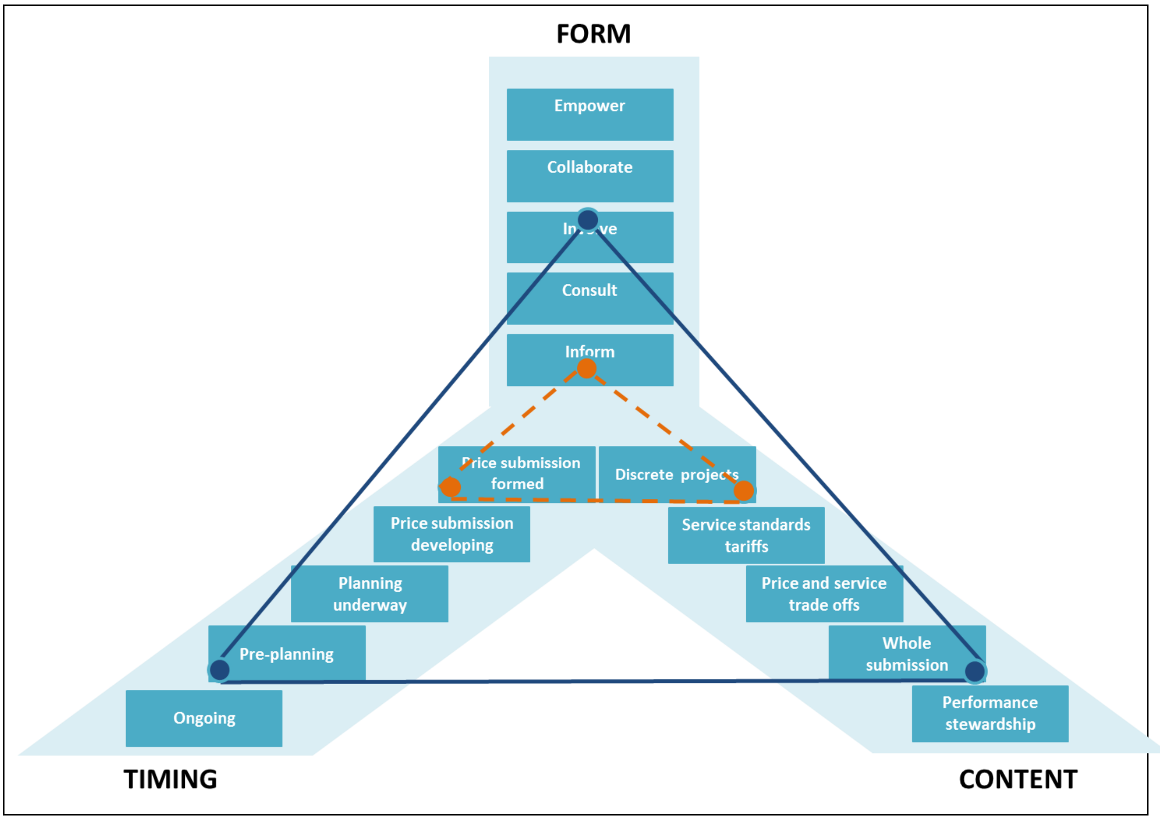


Identifying the participation level, content and timing of a water business's customer engagement produces a triangle across the three axes of the diagram. To show how the diagram can be used to describe customer engagement, we plotted two different approaches in figure 5.2.

The blue (solid) triangle represents a water business that is at the pre-planning stage of its price submission, and involves its customers in the development of most parts of the price submission. The orange (dashed) triangle represents a water business that has already formed a price submission or finalised a project, and is informing customers about the outcome.

The earlier point at which customers come into the discussions, across a broader range of issues in the business operation, the larger the triangle will be. Chapter 6 discusses a proposal whereby one factor influencing the Commission's price review process will depend on the scope and effectiveness of customer engagement. The more expansive the engagement program (that is, the bigger the triangle), the more likely a business will earn higher returns and face less intrusive scrutiny by the Commission of their price submissions.

FIGURE 5.2 EXAMPLES OF CUSTOMER ENGAGEMENT PRACTICES



6 A NEW INCENTIVE FRAMEWORK

Since 2004, the cost of capital has been determined via a form of the capital asset pricing model (CAPM). In a paper prepared for the Commission, Bruce Mountain and Stephen Littlechild recommended we move further away from the use of the CAPM. They noted:

> *Reducing the determination of the rate of return on equity to a formula is however to miss the essence of the issue: the regulatory arrangements should allow the Commission to think widely on the issue guided only by its obligation to promote the long term interest of water users.*[33]

Here, we propose a shift away from using the CAPM to estimate the cost of capital. Unlike the current approach, our proposed approach will allow the cost of equity to vary for each business, depending on the business's ambition in relation to proposed services (informed by customer engagement) and the operating efficiencies that it intends to pursue. We also propose an alternative approach for calculating the cost of debt (although that cost will continue to be calculated on an industry-wide basis).

The proposed approach provides stronger incentives for water businesses to align their expenditure with the service outcomes most valued by their customers. Further, by linking returns to the outcomes delivered by a business, we expect future price reviews will focus less on the cost benchmarks used to establish prices (that is, inputs), and more on what is a reasonable return for a water business given the outcomes delivered to customers.

[33] CME 2015, *op. cit.*, pp.18.

We will also continue to use reputational incentives to influence the behaviour of water businesses. We expect that allowing for a different cost of equity (one that depends on a business's proposed services and cost efficiencies) will also provide a strong reputational signal in terms of the relative performance of each water business.

6.1 BUILDING ON EXISTING INCENTIVES

We propose to build on the incentives embedded in the current pricing approach. That is, we will retain the financial incentive for businesses to make efficiency improvements beyond those assumed in approved prices. Our pricing approach facilitates this incentive by:

- approving maximum prices based on forecast costs at the time of a price determination, thereby delinking the price path from the course of actual costs and
- approving maximum prices for a relatively long period (called a pricing period) with limited scope to change maximum prices within the period due to unexpected changes in costs and demand, for example.

As noted in chapter 4, a business may retain the benefits of any savings (that is, when actual costs are lower than the forecast costs used to establish prices) up to the end of a pricing period. If a water business chooses not to charge below the maximum price and pass on cost savings within a pricing period, then these cost savings are reflected in prices at the start of the next period. In this way, customers too benefit from savings made by businesses. When costs are higher than the forecasts used to establish prices, a business must manage this shortfall rather than increase prices.

From here, this chapter describes a new model that links the cost of equity allowed for each business to vary depending on the level of ambition in a price submission. We also propose an approach that allows the cost of equity to change within a pricing period depending on how a business performs against service commitments made in its price submission.

6.2 NEW MODEL, NEW INCENTIVES

We propose a new model for consultation with interested parties. The central pillars of the model are: customer involvement in informing decision making (chapter 5), the end to largely futile debates over the weighted average cost of capital (WACC), and water businesses being held to account for the outcomes that they deliver.

The three pillars are related but the following discussion focuses on the second pillar. The primary feature of the proposed model is that the returns allowed for each water business will vary depending on the ambitiousness of the business's proposed outcomes in its price submission. The level of ambition proposed by a business must be informed by customer engagement.

We will allow businesses to earn higher returns when they are more ambitious in their proposed service outcomes, cost efficiencies, and absorption of risk on behalf of customers. Alternatively, businesses that have no reason to extend themselves (for example, when customers prefer to retain the status quo) do not need to be compensated for taking more risk on behalf of customers.

The new model consists of the following design features:

- Before a price review, the Commission will establish a range of values for the cost of equity to be reflected in approved prices.
- Water businesses with more ambitious price submissions will be allowed a higher cost of equity.
- The Commission will determine how many different levels of ambition will be recognised within the range, and the cost of equity to be earned at each level.
- Each water business, in consultation with its customers, will determine the level of ambition to be adopted in its price submission.
- In making its price submission, each water business will have to identify its level of ambition (and the corresponding cost of equity) according to an assessment framework that we will establish.
- The Commission will assess each submission against the assessment framework.
- If we concur with the assessment by the water business, then the cost of equity allowed in prices will be the same as that submitted by the water business.

- If we find the assessment conducted by the water business overstates its level of ambition, then we will substitute the proposed cost of equity with a lower rate (which will be lower than would have been the case had the water business accurately assessed its level of ambition)
- The Commission will publish draft decisions of its assessments, so water businesses can submit additional information in support of their claims, ahead of a final decision.
- Price submissions that clearly and robustly support the proposed level of ambition, and that demonstrate customers were closely engaged in developing the proposal, are more likely to be fast tracked through the assessment framework (chapter 7).

Our proposal has similarities to the menu based approach used by the UK energy network regulator, Ofgem. Like Ofgem's approach, our model provides a water business with greater control over the financial returns that it may earn. We also seek to provide greater rewards to businesses that propose prices that reflect their best estimate of efficient costs. In this way, our model provides water businesses with strong incentives to prepare accurate and reliable price submissions at whatever level of ambition they consider appropriate to their circumstances.

In designing the framework outlined below, we sought to avoid the complexity that characterises menu based approaches elsewhere. Our main objectives are to:

- incentivise water businesses to undertake more effective customer engagement to inform the outcomes that a business proposes in price submissions
- provide new incentives for water businesses to put forward their best service and price 'offer' for customers in price submissions, with a business's level of ambition affecting its allowed returns
- reward ambition, but not penalise a water business for proposing the status quo if the business demonstrates that is what its customers want
- reward well justified, accurate and reliable price submissions
- increase the accountability of businesses to deliver on the outcomes proposed in their price submissions

- enable the Commission and others to more clearly distinguish the performance of water businesses in delivering outcomes for their customers (providing a form of reputational incentive).

In addition to proposing a new approach to determining the cost of equity, we propose ending the distracting debates around the cost of debt. Effective debt management is one of the central tasks expected of a water business. Water businesses borrow to fund long-lived assets that will support services for generations to come. For this reason, the pricing framework must provide businesses with incentives to manage their debt effectively and at the lowest cost to their customers.

While there is no universally correct approach to benchmarking the efficient cost of debt, the current on-the-day approach has been found wanting by numerous economic regulators.[34] We propose adopting a 10-year rolling average approach to setting the cost of debt each year (section 6.4). In doing so, we seek to adopt the simplest method possible to avoid the financial intrigues of past determinations.

[34] See, for example, Australian Energy Regulator 2013, *Rate of return guideline explanatory statement*, December, pp. 103–7.

6.3 THE "PREMO MODEL"

Our proposed model consists of five assessment elements: **P**erformance, **R**isk, **E**ngagement, **M**anagement and **O**utcomes (PREMO). Under PREMO, a water business's price submission will be rated first by the business and then by the Commission. These ratings will indicate the business's level of ambition and, therefore, the cost of equity allowed in the pricing model for that business. The assessment criteria will address:

- **R**isk: has the business sought to accept more or less risk on behalf of customers?
- **E**ngagement: how effective was the business's customer engagement? How large is the size of the business's customer engagement triangle (see figure 5.2)?
- **M**anagement: how well are proposals justified by the evidence presented in price submissions? Are the expenditure and demand forecasts based on a sound methodology? Are expenditure proposals aligned with outcomes to be delivered?
- **O**utcomes: do proposed service outcomes represent an improvement, the status quo, or a lessening in service standards?

The **P**erformance element of PREMO allows for a within-price-period adjustment to returns, to reflect performance against outcome commitments (section 6.5).

In table 6.1, we detail the criteria that we expect to guide our assessments in each element of PREMO. The criteria focus on matters that are within a business's control. That is, ratings will not be influenced by factors outside the control of water businesses, such as the impact of government policy or regulatory obligations.

TABLE 6.1 PREMO CRITERIA

Attribute	High-level criteria
Performance (against outcome commitments)	The Commission expects water businesses to deliver on their outcome commitments made to customers. These commitments should reflect the major service priorities that customers identified in the business's customer engagement. Through PREMO, the returns earned by a water business will depend on their performance against outcome commitments.
Risk	Prudent water businesses will take steps to understand, manage and mitigate significant risks to their operations. Risk should be allocated to the party or parties best able to control or manage the risk, while ensuring the party has incentives to reduce the risk or manage it effectively. We will consider whether a water business's price submission demonstrates it identified and allocated risks appropriately. This allocation may be reflected in a business's justification for tariff structures, for example. And we will continue to consider whether a business demonstrated it will deliver outcomes at lowest possible cost, accounting for long term planning. We will consider whether expenditure forecasts reflect reasonable assumptions about risk. In the past, many businesses included relatively large contingencies for capital works, indicating overly risk-averse assumptions. We will also consider whether a business sought to inappropriately pass on demand risk to customers. Our 2013 guidance on price submissions explains our approach to assessing risk.[35] In appendix B, we describe an approach that allows businesses greater autonomy to decide on the demand forecasts to be used to estimate prices. We seek feedback from interested parties on the proposed approach. We would limit our role to a high level check of the assumptions underpinning the demand forecasts (and do not envisage hiring expert consultants to review the forecasts).
Engagement	As noted in chapter 5, we expect earlier, deeper and ongoing customer engagement to inform price submissions. We will consider the size of a business's 'engagement triangle' in figure 5.2. Continued on next page

[35] Essential Services Commission 2011, *op. cit.*, pp.11.

Attribute	High-level criteria
Management accountability	A business's management should be accountable for its price submission. This accountability should cover the proposed outcomes and the quality of supporting justification, including forecasting accuracy. A price submission must demonstrate proposed outcome commitments reflect the views of customers, or government or technical regulator obligations. It must also demonstrate alignment between proposed outcome commitments and expenditure. We propose to introduce a requirement that a water business's board attests that the price submission reflects all the requirements of our guidance. This includes attestation that, in the board's knowledge and belief: • information and documentation provided in the price submission is complete and accurate in all material aspects, and can be relied upon by the Commission in making a price determination • information based on actual data is true and correct or fairly stated • information which is an estimate is, to the extent possible, derived from actual data and has been arrived at on a reasonable basis, and • satisfies the requirements of guidance issued by the Commission. In addition, we expect all businesses to retain contemporaneous supporting documentation on file (for example, business case documents, customer engagement reports and financial models). And they must make those documents available to the Commission if required. Businesses must also provide price submissions and information to the Commission to deadline.
Outcomes	A water business must propose outcomes that reflect customer preferences revealed through customer engagement. The outcome commitments should then align with the expenditure that a water business proposes. Under our proposed approach, the number and nature of service commitments may vary by water business, depending on feedback from customers. This approach differs from the current approach, under which a relatively large number of common service standards are approved for each water business. Each service commitment must be well defined and measurable, and reflect the main customer service priorities. We will issue more detailed guidance on businesses' customer engagement on service commitments.

The Commission's rating of a price submission under PREMO would also consider a business's proposals relative to past performance or practice, and how the proposals compare with those of other water businesses. We would also assess a business's reasoning, in terms of the robustness of a business's forecasting methods (for costs, for example) and the quality of customer engagement.

Before issuing guidance on price submissions for the 2018 price review, we will consult on the criteria to ensure they allow for transparent ratings by water businesses and the Commission. But we consider the PREMO criteria need to be sufficiently broad to introduce a degree of competition for water businesses to put forward their best offer in terms of services and prices. A prescriptive checklist might not produce this outcome, because a business may seek to achieve only the checklist's minimum requirements.

6.3.1 LEVELS OF AMBITION

In the first round of price reviews to be conducted under the new PREMO model, we anticipate the range in the rate of return allowed on equity would be fairly modest — with the top rate being no more than 1.5 percentage points higher than the rate provided to the lowest category of ambition. While we intend consulting on the width of the range, we consider a conservative approach would be warranted until there is greater familiarity with the new model.

The narrowness of the range suggests it will not be possible to have more than four categories of ambition. Cramming additional categories into such a small range would imply a precision that the assessment framework is unlikely to achieve. We thus propose four rating categories for price submissions: 'leading', 'ambitious', 'standard' or 'basic'. Each water business would rate its price submission as one of these four categories depending on its level of ambition against the elements of PREMO assessment framework.

Below, we describe the general characteristics of a 'leading', 'ambitious', 'standard' or 'basic' price submission:

- A **'leading'** price submission would propose a step change in proposed outcome commitments, controllable costs or both, thus setting the water business apart from its peers. It would demonstrate customer engagement had heavily influenced the business's proposals, and show the business had accepted risk on behalf of customers.

- An **'ambitious'** price submission would propose significant improvements in outcome commitments, controllable costs or both. It would demonstrate customer engagement had heavily influenced the business's proposals, and show the business had appropriately allocated risk between itself and customers.
- A **'standard'** price submission would propose generally unchanged outcome commitments or controllable costs. It would be heavily informed by customer engagement, and make reasonable assumptions about risk and its allocation.
- A **'basic'** price submission would propose fewer outcome commitments, or increasing controllable costs. It may not reflect an expansive customer engagement process, or make reasonable assumptions about risk and its allocation.

We will further consult on the detail required for each category to support self-assessments by water businesses. Again, we intend to provide only high level descriptions. A highly prescriptive approach would stifle the opportunity for innovation by water businesses.

6.3.2 HOW PREMO WORKS

This section provides a broad overview of how the PREMO model works to: (1) reward businesses that submit ambitious proposals in the pursuit of delivering high quality services valued by their customers; and (2) create incentives for well informed, accurate and reliable submissions from water authorities. In chapter 8, we provide worked examples of the PREMO model in action.

Step 1: Establishing the range

As a first step, the Commission will propose a range of values for the cost of equity. We will publish this range in the draft guidance material that we release ahead of a price review.

We expect the cost of equity for a price submission with the lowest level of ambition (that is, a proposal rated as 'basic') would be set at a level no lower than the benchmark real cost of debt, and possibly slightly higher.[36] This means a water business will be able, at the very least, to recover interest costs associated with funding capital investment. We expect this rate will remain fairly constant over time, and close to the long-run average cost of debt. At this stage, we expect the cost of equity allowed for a 'basic' price submission will be around 4.1 per cent.

More ambitious submissions would receive a higher allowance for the cost of equity. For illustrative purposes, and given the PREMO is a new model, we propose a relatively narrow range for the cost of equity — for example, the cost of equity at the top of the range might be only 1.2 per cent higher than the bottom of the range. That is, the cost of equity for a 'leading' price submission would be 5.3 per cent. 'Ambitious' and 'standard' price submissions would be interspersed at even increments of 0.4 per cent, or at 4.9 and 4.5 per cent respectively.

The choice of these values is not coincidental. The cost of equity allowed for a 'standard' price submission is 4.5 per cent. This cost is close to the cost of equity benchmark used to establish prices in our 2013 price review. Therefore, a business that proposes to deliver similar outcomes for customers would be allowed a cost of

[36] Setting the cost of equity below the cost of debt means a business may not be able to cover the finance costs of investing in projects to deliver customer services or government and technical regulator obligations.

equity close to the current rate. In other words, a business-as-usual price submission would produce an outcome largely unchanged from the one expected under the current framework.

The size of the range, the number of categories, and the size of the gaps between categories could change as familiarity with PREMO increases. Further, the gaps between categories may increase for increasingly ambitious price submissions.

Step 2: Establishing an incentive matrix

There are two decision (or assessment) points in determining the cost of equity for each water business. The estimation of the cost of equity starts with a water business self-rating its price submission as ‘leading’, ‘ambitious’, ‘standard’ or ‘basic’. A business’s rating will be based on its assessment of its level of ambition (in its price submission) against the criteria discussed in this chapter. The Commission will then apply the same criteria to assess the level of ambition of the price submission. The cost of equity allowed for each business at the start of the pricing period will depend on how well a water business’s self-rating aligns with our rating.

The set of values shown in the upper diagonal of the matrix in figure 6.1 represents outcomes where the Commission concurs with the assessment by the water business. The more ambitious the submission according to both the water business and the Commission, the greater will be the cost of equity (thus, the increasing cost of equity from the bottom right to the top left of the matrix). The increasing rate of return provides an incentive for water businesses to be as ambitious as possible, having consulted customers about their desired outcomes.

The grey shaded area above this diagonal indicates we will never assess a price submission higher than the water business’s self-assessment. This approach provides an incentive for the business to provide an honest self-assessment of its submission.

While the Commission will never assess a price submission higher than the water business’s assessment, the converse is not true. If we find a business overstates its rating, then it will receive a cost of equity that is lower than what it would have received had it accurately assessed its rating (thus the declining cost of equity moving down the columns of the matrix). This approach provides the businesses with an incentive to prepare high quality price submissions that genuinely reflect their true level of ambition.

But water businesses have an even more powerful (financial) incentive not to overstate their level of ambition. If the Commission finds a water business has overstated its ambition, then the cost of equity will be lower than had the water business accurately assessed itself. This design feature sets out to penalise water businesses that seek to game the framework by claiming a level of ambition that they know to be untrue. As such, the allowed cost of equity declines from right to left in each row of the matrix.[37] A simple example explains this effect (and more detailed examples are provided in chapter 8):

> Example: A water business assesses its level of ambition to be 'standard' — that is, garnering a rate of return of 4.5 per cent. The business sets out to 'bluff' the regulator by claiming its submission warrants an assessment of 'ambitious' (and a return of 4.9 per cent) on the basis that it has nothing to lose if the regulator 'calls its bluff'. The design of the matrix means the business bluff comes with a risk. If the regulator rejects the business's assessment and determines the submission is accurately rated 'standard', then the allowed return will be 4.3 per cent. This rate is lower than the return that would have been earned had the business honestly assessed its submission (that is, 4.5 per cent).

In addition to the financial incentive for the business to be honest when assessing its price submission, a downgrading by the regulator is likely to come at a reputational cost to the water business. At a minimum, we would expect the shareholder to be disappointed if a business forfeits a possibly higher rate of return, and to take appropriate action to sanction the business.

The (red) shaded zone at the bottom of the matrix represents an area within which the Commission will reserve its discretion. We may require the water business to resubmit its proposal, and approve prices for a shorter period than sought by the

[37] We note that the 'anti-bluffing' incentive for honest self-assessment could be strengthened by having the numbers in the columns decreasing more rapidly.

business (for example, one or three years rather than five). We expect to rarely exercise this discretion because it would reflect a very poor submission.[38]

The PREMO matrix at figure 6.1 sets out indicative cost of equity estimates (in real terms) that vary depending on the rating of submissions. Such a matrix will be used to set the cost of equity for pricing for each business at the start of a pricing period. We will further consult on the matrix (how it works, and the cost of equity estimates) following the release of this paper. Under the new framework, we will likely confirm the cost of equity matrix in guidance material that we intend to issue to water businesses in late 2016.

FIGURE 6.1 ALLOWABLE (REAL) COST OF EQUITY MATRIX

ESC assessment of submission \ Water business self-assessment	Leading	Ambitious	Standard	Basic
Leading	5.30			
Ambitious	4.70	4.90		
Standard	4.10	4.30	4.50	
Basic			3.90	4.10

[38] We will have less tolerance for a water business overstating its claims if the submission is already particularly modest in its level of ambition. That is, there is only one step before the red shaded area for submissions assessed by a water business as ‘basic’, whereas there are three steps for submissions self-assessed as ‘leading’.

6.4 THE COST OF DEBT

We propose to change our approach to estimating the cost of debt. Previously, we used the 'on-the-day' approach, which estimates the cost of debt just before we make a price determination, based on observable market based interest rate data. Under the on-the-day approach, the cost of debt is fixed for a price period. We propose to establish the cost of debt using a 10 year trailing average approach. This approach accounts for a long run average of past interest rates (typically 10 years). It is updated annually to include the latest interest rate (and to remove the oldest). Prices are adjusted during a pricing period in line with the interest rate.[39]

A main benefit of the trailing average approach, compared with the on-the-day approach, is that it allows for a cost of debt that better reflects the financing costs incurred by a business (accounting for the maturity profile of the business's debt portfolio). The business thus has less need to match its actual debt costs with the regulated allowance determined at a single point in time. In other words, the approach removes the assumption that a water business can refinance its entire debt portfolio at a single point in time coinciding with our price determinations. It also reduces the potential for costly and time consuming debates about the cost of debt allowed.

Because the cost of debt is adjusted each year, the value of the WACC will shift from year to year. In turn, price paths will not be as predictable and stable as in the past. However, using a rolling 10 year average will ensure annual fluctuations in the cost of debt will be very small, and the impact on prices will be marginal.[40]

We envisage using the trailing average approach to establish a benchmark cost of debt. In this way, water businesses still have an incentive to implement efficient financing arrangements. We will further consult on how to calculate the cost of debt.

Note that the gearing assumption used to estimate the returns allowed in revenue would remain the same as for past price reviews; that is, a 60:40 debt to equity ratio.

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[39] For more detail on the on-the-day and the trailing average approach to estimating the cost of debt, see Essential Services Commission 2016, *Melbourne Water Price Review 2016, draft decision*, March, pp. 61–2.

[40] The revenue impact of a change in the cost of debt will vary by water business. As a rough guide, a 0.1 percentage point change in the cost of debt would change revenue by around 1 per cent.

6.5 ADJUSTING RETURNS DURING THE PRICING PERIOD

In papers prepared for the Commission, KPMG and Frontier recommended we consider introducing financial incentives (informed by customer engagement) based on how well a water business delivers on service commitments to customers. Some businesses also supported financial incentives linked to a business's performance against service commitments.

For example, South East Water noted:

> *… water businesses could also propose financial rewards and or penalties for overachieving or underperforming against agreed output delivery measures. This being if there is sufficient evidence that there is a potential benefit to the customer from increased performance.*[41]

PREMO allows the cost of equity established at the start of a pricing period to adjust depending on how well a business performs against the outcome commitments in its price submission. We are open to ideas on whether the incentive framework should be designed to encourage water businesses, *during* a regulatory period, to outperform the commitments made in their price submissions.

At this stage, however, we consider any adjustments to the cost of equity during the pricing period should be the exception rather than the rule. Annual reviews of the permitted cost of equity would distract management from the primary task of preparing accurate and reliable price submissions, and then delivering on the commitments made in those submissions.

Nonetheless, we consider intra-period adjustments might be warranted in two instances:

- If the Commission's final decision downgrades the level of ambition (and the cost of equity) claimed by a water business, then it might be worthwhile allowing the business to have its cost of equity upgraded during the period if its performance in delivering outputs and managing costs outstrips expectations.

[41] South East Water 2016, *Submission*, 21 March, pp. 2.

Example: A water business assesses its level of ambition to be 'ambitious' — that is, deserving a rate of return of 4.9 per cent. In its final decision, the Commission rates that business's price submission as 'standard'. As a result, the business is allowed a cost of equity of 4.3 per cent (rather than the 4.5 per cent it would have earned had it assessed its submission as 'standard'). An intra-period reassessment after two or three years would allow the Commission to upgrade the business's cost of equity to, say, 4.5 per cent (subject to significantly stronger than expected performance).

- The Commission might consider revisiting its final decision if a water business is granted one of the higher rates of return — that is, if the business is rated 'leading' (5.3 per cent) or 'ambitious' (4.9 per cent). If, after two or three years, the business is performing well below the claims made in its price submission, then the Commission could review its assessment and downgrade the allowed cost of equity for that water business. As the Commission approves maximum prices, a water business may voluntarily reduce its prices to give effect to the lower cost of capital.

In the first instance, the reassessment would aim to provide a water business with a financial incentive to recommit to improved performance after an adverse finding from the Commission. (The reputational benefit of an intra-period upgrade might also encourage management to refocus its efforts on outperforming the Commission's expectations.) In the second instance, the reassessment would aim to safeguard customers from paying for services that the business did not deliver at the standard to which its price submission committed.

Our intention is to consult further on whether to implement an intra-period performance adjustment mechanism and, if so, when and how it might work.

6.6 REGULATORY DECISIONS IN THE NEW FRAMEWORK

Although this chapter outlines a new approach to determining the cost of equity and the cost of debt for water businesses, the processes underlying a price review will remain largely unchanged. We will, for example, continue to publish draft decisions that contain the Commission's provisional assessment of the ambition rating (and cost of equity) that a water business claimed in its price submission. As now, we will publish the reasoning behind the draft decision, and invite water businesses to submit additional information in support of their claims. Likewise, customers and other interested parties will be able to submit their views supporting or contesting the Commission's draft decision.

As discussed in chapter 7, the proposed framework supports the establishment of a fast tracking mechanism for high quality price submissions. We consider 'leading' and 'ambitious' price submissions should be primary candidates for a fast tracked price review, given they are likely to be based on well justified and challenging cost and demand forecasts, and effective customer engagement.

Chapter 7 describes the regulatory decision-making processes in further detail, and outlines additional flexibility mechanisms to support the new framework.

7 FLEXIBILITY MECHANISMS

This chapter proposes a number of changes that are intended to support greater flexibility in the pricing approach. We propose a performance reporting framework that focuses more heavily on how well a business performs in terms of delivering outcomes that matter most to their customers. We also propose that businesses review the number and nature of their guaranteed service levels (GSLs) to ensure they reflect the service priorities of their customers.

Later in the chapter, we propose a new flexible price review process that enables each water business to have a tailored price review, including opportunities for “fast-tracking”. Fast-tracked price reviews will be available to businesses that prepare price submissions that clearly justify the proposed level of ambition of a business in terms of service outcomes and cost efficiencies.

Our proposed changes facilitate a shift away from the current one-size-fits-all pricing approach to one that more clearly distinguishes and recognises the performance of each water business.

7.1 PROPOSED CHANGES TO PERFORMANCE REPORTING

Under the current performance reporting framework, it is difficult for us (and others) to objectively identify how well each business is delivering on the needs of its customers. The current performance report focuses on the collection and publication of relatively granular and (largely) engineering based measures. These measures are difficult to aggregate to provide an overall view on business performance.

In energy and water price regulation in the United Kingdom, performance reporting has shifted to focus more on aggregated measures of customer satisfaction (or similar). This shift in reporting appears to have facilitated a greater focus by businesses on delivering good outcomes for their customers.

We propose improvements to our performance reporting framework to provide greater incentives for water businesses to focus on the service outcomes that matter most to customers:

- Our annual performance reporting will give greater prominence to business performance against outcomes, rather than focusing on inputs. This may include outcomes of customer satisfaction (or similar) surveys. Our performance reporting will continue to compare businesses on common outcome measures.
- We will require businesses to self-report to customers on how well they performed against service commitments agreed with customers. This measure was a requirement in our recent draft decision for Goulburn-Murray Water.[42] It is part of strengthening the accountability of water businesses to their customers. These measures will not necessarily be identical across all water businesses as customer priorities can be expected to vary somewhat. Nevertheless, we will work with the businesses to promote as much consistency as possible (particularly in relation to the terms and definitions they adopt).

7.2 THE GUARANTEED SERVICE LEVEL SCHEME

In papers prepared for our pricing approach review, KMPG and Frontier noted there may be opportunities to expand the guaranteed service level (GSL) scheme.[43] The GSL scheme provides incentives for water businesses to make efficient investment decisions, or internalise the costs of making investment decisions that leave some customers with poor service outcomes. It also provides a form of recognition that a customer has received relatively poor levels of service.

We currently require all urban water businesses to propose (in their price submissions) specific GSLs that define a standard of service delivery, and an

[42] Essential Services Commission 2016, *Goulburn-Murray Water Price Review 2016, Draft decision*, February. pp. 9.

[43] See Frontier Economics Ltd London 2015, *Alternative approaches for establishing a water entity's revenue requirement*, June, p. 27; and KPMG 2015; *op. cit.*, pp. 16.

associated rebate amount that will apply if a customer receives a below-standard service. The number and nature of GSLs vary by water business. Businesses are required to consult on the GSLs to ensure that they reflect the service priorities of their customers.

Given that the current set of GSLs was most recently established in our 2013 water price review, the 2018 price review presents a timely opportunity for businesses to review the number and nature of GSLs, and the rebate amounts that will apply in the event of a breach of a GSL. The rebate amounts should be reviewed in consultation with customers given the changes in prices since 2013, and to ensure they continue to provide incentives for a water business to make efficient investment decisions.

7.3 A NEW FLEXIBLE PRICE REVIEW PROCESS

Under the current pricing approach, all price submissions are effectively subject to the same assessment process. In practice, the extent of investigation required to form our decision will vary for each business's proposal, depending on the quality and clarity of the information provided. However, we do not make any public distinction regarding the quality of the submissions we receive or the regulatory effort required to inform our pricing decision. We received some excellent submissions for the 2013 price review. Even so, there is scope for further improvement.

In the United Kingdom, the economic regulators of water (Ofwat) and energy (Ofgem) have introduced 'fast tracking' as an incentive for privately owned water and energy companies to submit higher quality price submissions. Fast tracking allows a business that puts forward a "well justified pricing submission" (that is, evidence-based, supported through customer consultation and with enough evidence of the robustness of its cost and demand estimates) to gain regulatory approval earlier and with less regulatory scrutiny.[44] As KPMG noted in its paper for the Commission:

[44] KPMG 2015, *op. cit.*, pp. 3.

> *A fast tracked price review process lowers the burden of regulatory intervention and enables each of the fast tracked businesses to continue with the delivery of outcomes with less intervention.*[45]

The United Kingdom's fast tracking approach recognises and rewards businesses that provide the best price submissions to the regulator—and customers benefit from good quality price submissions that are tailored towards their needs and expectations. Both financial and reputational incentives are offered to encourage quality submissions, reduce the regulatory costs and increase a business's focus on outcome delivery.

Ofwat and Ofgem generally use a similar fast tracking approach. The extent of review required for a business reflects the quality of the price submission, past performance, and benchmarking of forecast spending against other businesses. Although still in its early years, the UK experience suggests the potential to be fast tracked has motivated companies to prepare high quality price submissions and deliver better price outcomes for customers.

Drawing on the UK experience, the expert papers that we commissioned to inform our review generally recommended some form of fast tracking, earned autonomy or lighter handed regulation. Specifically, these approaches could encourage Victorian water businesses to prepare and submit higher quality price submissions that better meet their customers' expectations. Synergies suggested we could achieve this outcome by:

> *… providing an expedited, simplified and low cost 'light handed' regulatory option to businesses that voluntarily produce robust proposals that meet reasonable expectations of the regulator and the businesses' customers in terms of efficiency improvements, customer engagement, prices and quality of service.*[46]

Frontier also argued that lighter handed regulation incentivises good planning and drives better outcomes for customers. In particular, Frontier contended that

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[45] KPMG 2015, *op. cit.*, pp. 19.

[46] Synergies Economic Consulting Pty Ltd 2015, *An alternative model for Victorian water businesses*, June, pp. 12.

reputational incentives would be relevant to the publicly owned Victorian water sector.[47]

These contentions were tested at our November 2015 water pricing conference. We found 90 per cent of submissions to the Commission clearly supported the concepts of earned autonomy, light handed regulation and fast tracking. GWMWater showed its support, stating in its submission:

> *… where water businesses were considered to have a 'healthy' regulatory and customer culture, there were grounds for having a more light handed regulatory approach.*[48]

Other submissions expressed similar support.

We consider the new Victorian pricing approach *should* recognise water businesses that have robust management processes and customer reflective prices and service levels. High quality price submissions—those that clearly demonstrate prudent and efficient expenditure to deliver services customers want—deserve less intrusive regulatory scrutiny. We can then focus on investigating price submissions we consider to be lower quality or proposing poorer outcomes for customers. The more rigorous scrutiny this affords for a smaller number of businesses should help to ensure efficient pricing and service outcomes for all Victorian water customers, regardless of the quality of their water business's price submission.

Accordingly, we propose to deliver a flexible price review process by:

- tailoring the scope of our assessment to the quality of each price submission, which may include resubmission when businesses provide insufficient information
- fast tracking high quality price submissions through the assessment process to an early draft and final decision
- providing financial and reputational incentives linked to the ambition of a price submission (discussed in chapter 6).

[47] Frontier Economics Ltd London 2015, *op. cit.*, pp. 4.

[48] GWMWater 2015, *Submission*, 10 December, pp. 1.

This process dovetails into the PREMO criteria and classifications set out in chapter 6. In theory, any price submission could earn a streamlined assessment, based on the quality and clarity of the submission document and the supporting data.

However we expect those submissions classified as ‘leading’ or ‘ambitious’ would be likely candidates for a fast tracked draft and final decision. This is because ‘leading’ and ‘ambitious’ price submissions would include relatively large improvements in services and cost efficiencies relative to their peers.[49] Their proposals would also be informed heavily by effective customer engagement and provide accurate forecasts.

7.3.1 FEEDBACK FROM CONSULTATION

A number of businesses provided informative submissions on how price submissions might be assessed with less regulatory scrutiny. Barwon Water suggested the Commission should clearly outline the ‘fast tracking’ criteria so water businesses can efficiently allocate resources.[50] Similarly, Goulburn Valley Water noted:

> *Clear criteria are required that would enable each business to be able to self-assess with a reasonable degree of confidence if it would qualify for the […] option.*[51]

Central Highlands Water and North East Water supported less intrusive regulation in situations where price submissions “fulfil a range of operating criteria and pricing submission proposals”,[52] and “where businesses […] have appropriate management systems and procedures in place and have a proven track record”.[53] Several submissions noted that although having clear criteria was necessary, a ‘one size fits all’ approach was not appropriate, because water businesses vary substantially in size and operate in different communities across the state.

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[49] Alternatively stated, we would likely want to explore in some more detail why a business with a price submission rated as ‘standard’ or ‘basic’ was not able to commit to the more challenging outcomes proposed by those businesses with a price submission rated as ‘ambitious’ or ‘leading’.

[50] Barwon Water 2015, *op. cit.*, pp. 4.

[51] Goulburn Valley Water 2015, *Submission*, 4 December, pp.2.

[52] Central Highlands Water 2015, *op. cit.*, pp. 1.

[53] North East Water 2015, *Submission*, 10 December, pp. 2.

We do not view our flexible pricing proposal as being a 'tick a box' affair, where a submission is scored against a set of criteria to determine whether it warrants fast tracking or not. Instead, we consider a submission may be fast tracked to an early draft decision if we are satisfied with its content and that the proposed outcomes do not warrant further scrutiny beyond the first stage of the review process (see next section).

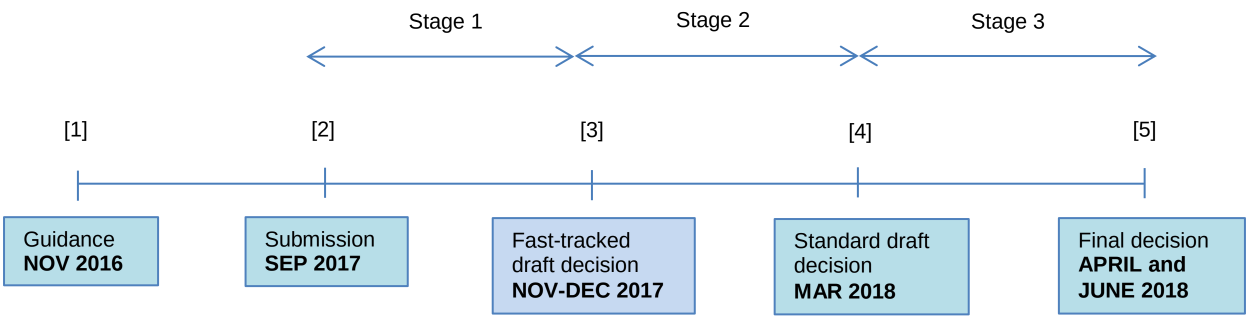
7.3.2 OUR PROPOSED REVIEW PROCESS

We envisage a three stage price review process:

- Stage 1—Price submission evaluation to verify the quality and strength of the submission and the proposed outcomes, and to establish what further verification work, if any, we need to inform our draft decision. If further review is not necessary, we can make our draft decision to accept the submission's proposed prices, or with relatively minor changes, effectively bypassing stage 2.
- Stage 2—Further verification work, which may range from simple requests for further information through to a full review of cost forecasts by an expert consultant. In extreme cases, we may reject the price submission. We will make our draft decision for these businesses when we have completed the additional review.
- Stage 3—Public consultation on our draft decision, leading to our final decision and a price determination for each business. Final price decisions for fast-tracked businesses would be made in April. Final decisions for other businesses would be made in June.

Figure 7.1 sets out our proposed timeline for the 2018 price review, followed by a description of each step.

FIGURE 7.1 REVIEW TIMELINE AND KEY MILESTONES
Indicative timeline



[1] GUIDANCE (NOVEMBER 2016)

The Commission releases its guidance paper for water businesses to use when preparing their pricing submissions, following the consultation processes required by the Water Industry Regulatory Order (WIRO). The guidance will include the attributes of a high quality price submission that may earn a fast tracked draft decision.

[2] SUBMISSION (EARLY SEPTEMBER 2017)

Under our proposed PREMO model, each water business must self-assess the ambition of its price submission (see section 6.3). As noted above, while any submission of suitable high quality could be fast tracked, those price submissions with higher PREMO ratings are more likely to receive a fast tracked price review.

We commence our stage 1 review of all business submissions, focusing initially on those submissions rated as ‘leading’ or ‘ambitious’ by the water business. If we are satisfied with the proposed prices and customer outcomes, and the data and supporting information is robust and clear and we decide that we need look no further, the price submission can be fast tracked. That is, it receives an early draft decision and proceeds straight to public consultation (stage 3). We may request some further information at this stage, but these simple information requests will not necessarily preclude a business from being fast tracked.

If, however, we decide we must investigate further to verify the claims in the submission, we will establish the scope of the further work and advise the business that it will move to stage 2. This assessment may involve an expert consultant reviewing expenditure proposals, and requests to explain, substantiate and justify elements of the price submission. We expect the extent and rigour of this review will reflect the quality of the submission, with the lower quality reviews receiving more intensive scrutiny.

When a price submission provides insufficient evidence of compliance with the guidance, or we consider it falls too short of expectations, we may require the water business to resubmit its price submission. Depending on the extent of issues to be addressed, we may accept a resubmission for the current price review cycle if it can be completed in time. Alternatively, we may require the business to resubmit at a future date and make an interim price determination.

Once the stage 1 review is complete, we will commence the stage 2 review for those businesses assessed as needing further verification work, while we prepare a fast tracked draft decision for those needing no further review. All businesses will be notified of the outcome of the stage 1 review.

[3] FAST TRACKED DRAFT DECISION (NOVEMBER/DECEMBER 2017)

When we are satisfied with the proposals set out in the higher quality price submissions, we can move straight to our draft decision. This approach spares the business further regulatory scrutiny and intrusive review processes. We will release this fast tracked draft decision some three months earlier than the standard draft decision. The business and its customers receive an early assurance of the price review outcomes, and have more time to comment on our draft decision.

At the same time, we will explain how we propose to address prices and standards for any business whose price submission we rejected in this price review cycle.

[4] STANDARD DRAFT DECISION (MARCH 2018)

Once the stage 2 review is complete, we will prepare and release the draft decisions for the remaining water businesses. The public submission and consultation process will commence similar to the current process and timeline.

[5] FINAL DECISION (APRIL AND JUNE 2018)

We will release our final decision in two stages, with an early final decision in April for the fast tracked businesses. We expect the final decision for the fast tracked businesses to be quick and relatively straightforward. Normally, the majority of the price review work revolves around forming our draft decision; fast tracking is essentially us accepting the proposal with little or no change.

We will release the final decision and price determination for the other businesses in June, similar to the current timeline.

8 PREMO IN ACTION

This chapter explores the implications of PREMO for customers and water businesses. First, we discuss how PREMO supports better outcomes for customers. Then, we provide examples of PREMO's possible impact on the water businesses.

8.1 SERVING CONSUMER INTERESTS

Rewarding businesses with a higher cost of equity may seem counterintuitive if the objective of the pricing framework (as a reflection of the Commission's statutory objective) is to promote the long term interests of customers. After all, a higher cost of capital will result in higher prices for customers, all things being equal.

But all things are not 'equal' under the proposed framework.

PREMO rests on water businesses having to engage closely and persistently with their customers. The model imposes an onus on each business to work with its customers to identify concerns, priorities and the willingness to pay for different outcomes. The incentive framework rewards businesses that work to discover customers' preferences and then demonstrate how they have aligned their planning and delivery activities to account for those priorities.

Not only will water businesses be required to satisfy the Commission that they have identified and addressed customers' priorities, they will also be required to report back to their communities on the things that matter most to those communities (chapter 7). By requiring water businesses to work with their customers to develop tailored performance measures, the framework will empower communities to hold their service providers to account in ways that are not now possible. Of course, water businesses that fail to properly identify, monitor and report against these priorities will be ineligible for higher rates of return.

Moreover, higher rates of return will accrue to only those businesses that actively seek to manage risks internally, rather than simply pass on those risks to customers through higher prices. Businesses will earn greater rates of return if they can demonstrate they are prepared to assume greater risks through lower contingencies on capital projects, for example, or more evenly balanced demand forecasts. Businesses that continue to want to charge higher prices to lower potential risks to the business will not be rewarded with a higher rate of return.

Similarly, businesses will only earn greater returns when they can demonstrate they are doggedly seeking to lower their operational and capital expenditures so as to promote greater efficiency in service delivery. When businesses fail to adopt new technologies and innovate in their service delivery, they will not be rewarded with higher rates of return.

Higher rates of return must be earned. They are earned by businesses focusing on delivering value for money to their customers — that is, a focus on better services, delivered more efficiently, more accountably and more in tune with customers' interests and priorities. If water businesses strive and succeed in delivering these outcomes, then they will have earned a higher rate of return precisely because they are delivering better outcomes to their customers.

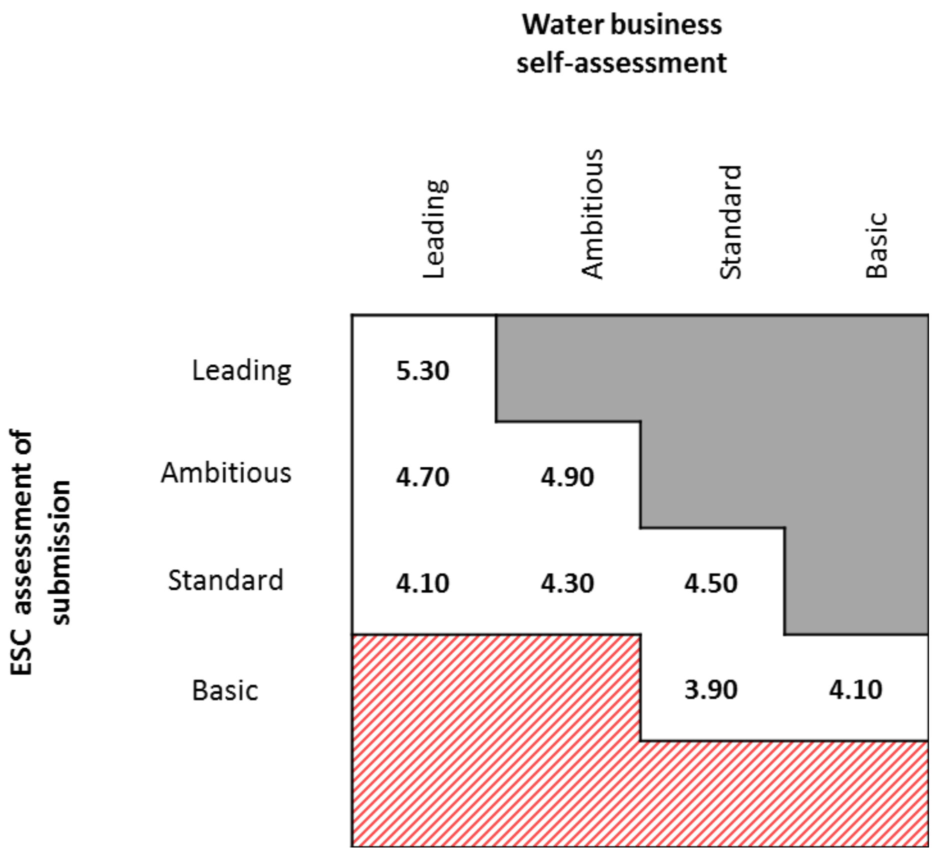
Further, those higher rates will not necessarily equate to higher prices. Often, they won't. And, even if a higher rate of return does equate with higher prices, those higher prices will have been subjected to informed customer scrutiny. This trade-off — between better services and higher prices — is precisely what water business will be required to discuss with their customers before proceeding with a price submission to the Commission.

8.2 IMPACT OF PREMO ON WATER BUSINESSES

In this section, we provide examples of how PREMO may affect water businesses, focusing on the revenue impacts (these build on the brief examples presented in section 6.5). Note that the scenarios and figures presented are hypothetical, and are only intended to provide an indication of how PREMO will work in practice. In our examples, we use the same PREMO matrix presented in chapter 6 (replicated at figure 8.1).

The first example (section 8.2.1) demonstrates where the Commission agrees with a business's self-rating of its price submission. The second (section 8.2.2) provides an example of where the Commission disagrees with a business's self-rating.

FIGURE 8.1 ALLOWABLE (REAL) COST OF EQUITY MATRIX



8.2.1 THE AMBITIOUS PRICE SUBMISSION

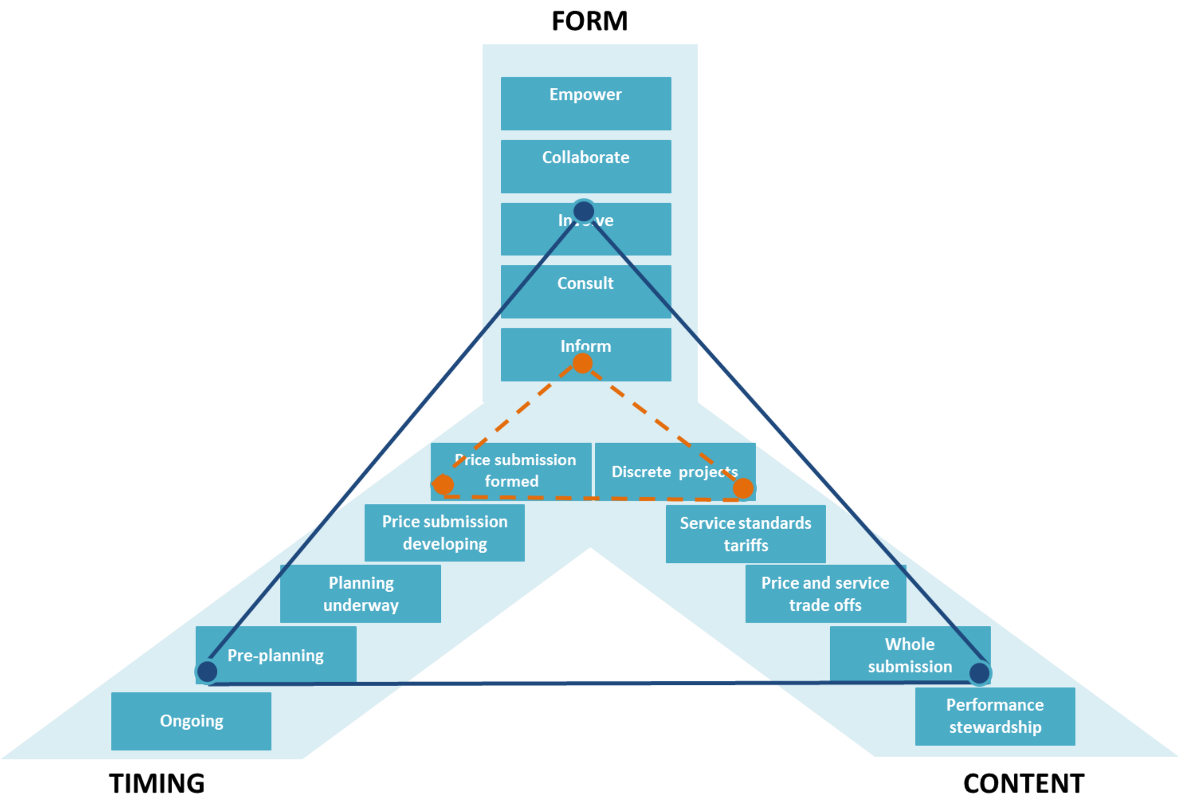
In this example, a water business rates its price submission to be 'ambitious', that is, deserving a cost of equity of 4.9 per cent. This reflects its assessment against the PREMO criteria that:

- Outcomes – informed by its engagement program, more ambitious targets are proposed for service performance. Customers identify speedier improvements in query resolution as a major issue — the business's proposed outcomes therefore reflect this as a priority area for improvement and offer innovative new indicators in support of its proposal.
- Management – as well as proposing ambitious reductions in controllable costs, forecast expenditure is clearly shown to be heavily aligned with proposed outcomes. Relatively more resources are aimed at speedier customer query resolution, as per feedback received during consultation. The submission clearly identifies the outcomes to be delivered by the business, and is underpinned by strong supporting justification, including assurance that its expenditure proposals reflect efficient costs which have been benchmarked against other similar organisations.
- Engagement – consultation was undertaken before the business established the strategic priorities for its price submission. Customers participated heavily in shaping the key outcomes to be delivered. Deliberative processes were used to explore customer views on matters of particular importance to customers such as overall service priorities, and service and price trade-offs. The business re-tested its views with customers throughout the engagement process. The size of the customer engagement triangle for the business is large (solid blue triangle in figure 8.2). In the few instances where the business did not intend to proceed in line with customer preferences, its reasons were explained clearly and it proposed alternative measures to respond to customer concerns.
- Risk – the business has not proposed to change the relative sharing of risk between itself and customers. This was decided having regard to matters such as the form of price control proposed, tariff structures (such as the relative share of fixed versus variable charges) and confidence in the accuracy of its demand forecasts. Some of its larger capital projects also continued to include larger than expected contingencies.

On balance, the business felt it met the requirements of an ‘ambitious’ submission and through it considered upgrading its application to a ‘leading’ proposal, it concluded it fell short of that classification due to its conservative approach to risk management.

The water business compared its efforts on customer engagement with its previous price review, where it consulted well after it had developed key parts of its proposals and price submission, and only on a few critical projects. This was shown as a much smaller triangle (dashed orange triangle in figure 8.2).

FIGURE 8.2 DESCRIBING CUSTOMER ENGAGEMENT
The ambitious price submission



THE COMMISSION'S ASSESSMENT

In its price review assessment, the Commission agreed with the water business's self-assessment against the PREMO criteria. Generally, we considered that the business proposed more ambitious outcomes for customers, informed by expansive customer engagement. Its forecasts of capital and operating expenditure were found to be realistic and better than most other businesses. We therefore considered that the business's price submission rating of 'ambitious' was justified. The Commission therefore used the business's proposed cost of equity and expenditure forecasts to approve maximum prices.

As well, because the submission clearly set out proposed outcomes and provided strong justification for these (such as through using reliable forecasting methodologies), the Commission decided to fast-track the price submission through the price review process. This meant the business was able to focus more on delivering good outcomes for its customers, rather than on regulatory processes.

8.2.2 THE STANDARD PRICE SUBMISSION

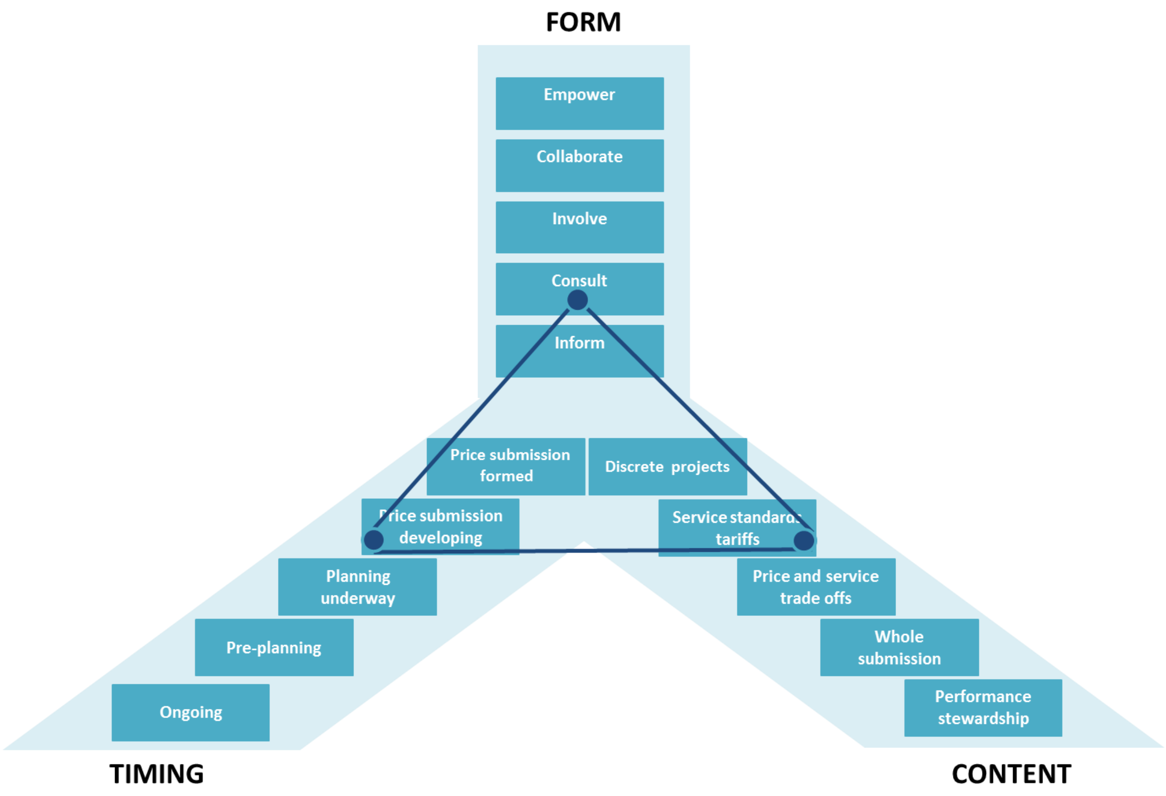
A business assesses its price submission to be 'standard', that is, deserving a rate of return of 4.5 per cent. This reflects its assessment against the PREMO criteria that:

- Outcomes – while some performance targets have moved slightly higher or lower, customers will receive very similar overall levels of service to those received in the current pricing period.
- Management – the business proposes very little change in controllable costs, compared to past outcomes. The focus of the business's expenditure plans, as outlined in the price submission, demonstrates alignment with proposed outcomes.
- Engagement – while customer engagement has improved, the business consulted only on a few parts of its price submission including selected capital projects, service targets and tariff structures. The business tended to use fact sheets as a basis for consultation, rather than more exploratory techniques. It consulted later in the price submission development process, well after it had established

positions on key service priorities and drafting its price submission. This is reflected in the size of its customer engagement triangle (figure 8.3).

- Risk – the business has not proposed to change the relative sharing of risk between itself and customers. As in the example above, this was decided having regard to matters such as the form of price control, tariff structures and demand forecasts.

FIGURE 8.3 DESCRIBING CUSTOMER ENGAGEMENT
The 'standard' price submission

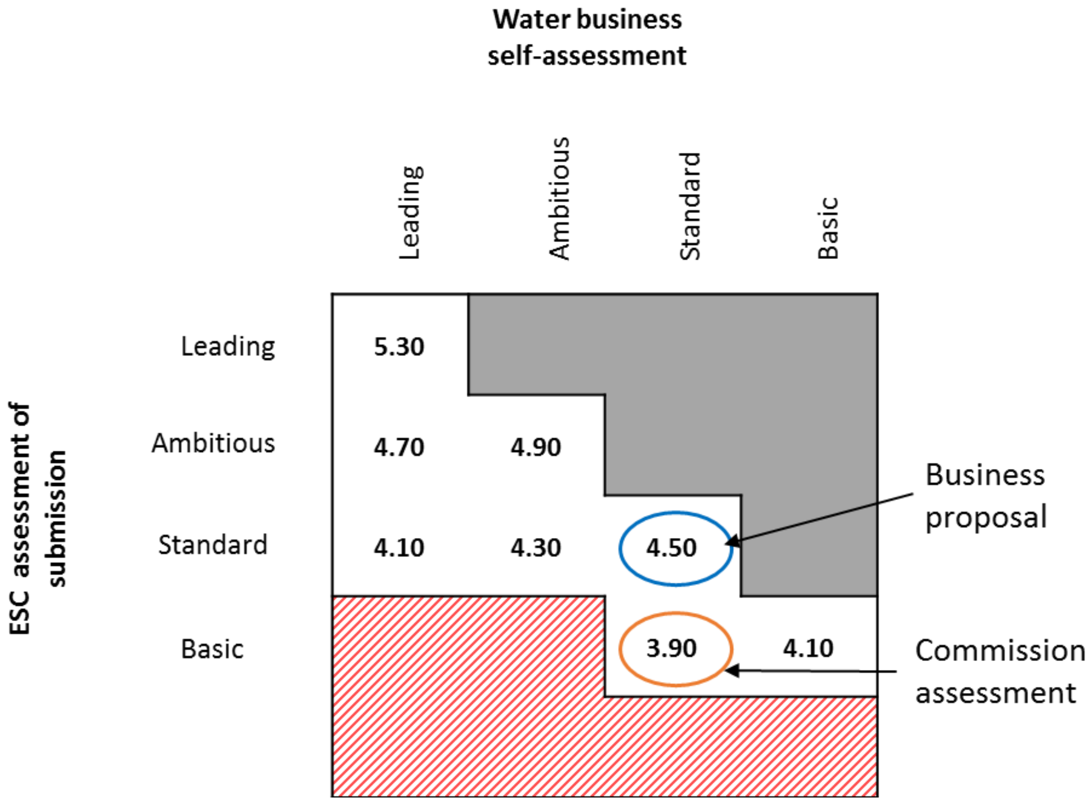


THE COMMISSION'S ASSESSMENT

In its price review assessment, the Commission disagreed with elements of the water business's self-assessment against the PREMO criteria. During our review, we found that forecast operating costs were unjustifiably high, due to assumptions for labour and energy unit costs well above past rates, and well above rates assumed by other water businesses. Our decision reduced the operating cost benchmark by 5 per cent. We also could not be confident that that the business's proposed outcomes adequately reflected the views and concerns of customers, given the relative late stage at which consultation started, and the narrow focus of engagement. In addition, the business's proposed capital program was significantly larger than in the past. This was despite its poor record of meeting its capital commitments in pricing periods.

Therefore, we decided to rate the price submission as 'basic', one grade lower than the 'standard' self-rating by the water business (figure 8.4).

FIGURE 8.4 PRICE SUBMISSION RATINGS



The water business is questioned by the Department of Treasury and Finance as to why it has forfeited its opportunity to earn a higher rate of return. Had it been more honest in its self-assessment and classified its submission as ‘basic’, it would have been allowed a cost of equity of 4.1 per cent rather than the 3.9 per cent allowed by the Commission

9 NEXT STEPS

The Commission proposes a number of significant changes to the way water price are established. We will undertake an extensive round of consultation to test our proposed ideas before finalising our guidance to water businesses in late 2016.

We seek written feedback on this paper by 29 July 2016. We prefer to receive written submissions by email to **water@esc.vic.gov.au.** You may also send submissions by mail to:

Water Team – Pricing Approach Review
Essential Services Commission
Level 37, 2 Lonsdale Street
Melbourne VIC 3000

We usually publish submissions on our website. If you do not wish us to disclose information publicly, please provide a confidential version and a version that is suitable for publication.

As well as seeking feedback on the high level proposals set out in our paper, we also want to explore how they might be implemented. To do so, we will release additional papers and hold workshops with interested parties. Our consultation will consider issues such as how the PREMO incentives will work, price submission assessment criteria, future performance reporting, and the Commission's information requirements.

Please direct telephone enquiries (03 9032 1300) about our review to:

- Marcus Crudden, Director Water
- Dean Wickenton, Senior Regulatory Manager Water
- Chris Hutchins, Project Manager Water.

APPENDIX A — PUBLIC SUBMISSIONS

A.1 JUNE 2015 SUBMISSIONS

The first round of submissions demonstrated strong support for a future pricing approach that is easy to understand, based on customer engagement and has a primary focus on services. Benchmarking, efficiency targets or sharing mechanisms and incentives were seen to be important to incorporate. Submissions were interested in exploring cost reflective pricing and reflecting the market structure or value chain. The written submissions in table A.1 are available on our website.

TABLE A.1 SUBMISSIONS RECEIVED ON OUR APRIL 2015 CONSULTATION PAPER

Name	Date Received
Barwon Water	12 June 2015
Cardno	15 June 2015
Central Highlands Water	15 June 2015
City West Water	15 June 2015
Coliban Water	25 June 2015
CUAC/CALC/VCOSS (joint submission)	11 June 2015
Goulburn Valley Water	11 June 2015
GWMWater	15 June 2015
South East Water	17 June 2015
South Gippsland Water	30 June 2015
Southern Rural Water	15 June 2015
Victorian Farmers Federation	12 June 2015
VicWater	18 June 2015
Western Water	25 June 2015
Yarra Valley Water	15 June 2015

A.2 DECEMBER 2015 SUBMISSIONS

The second round of submissions called for lighter handed regulation, improved customer engagement to inform pricing and the current pricing approach with enhancements. Generally the submissions did not favour benchmarking due to the effort required for implementation and limited time before the next price review. In addition there was not support for prescriptive customer engagement amidst concerns that specified methods could be burdensome for some businesses. The written submissions in table A.2 are available on our website.

TABLE A.2 SUBMISSIONS RECEIVED FOLLOWING OUR NOVEMBER 2015 WATER PRICING CONFERENCE

Name	Date Received
Barwon Water	11 December 2015
Central Highlands Water	10 December 2015
Coliban Water	10 December 2015
Goulburn Valley Water	4 December 2015
GWMWater	10 December 2015
North East Water	10 December 2015
South East Water	21 March 2016
Southern Rural Water	11 December 2015
Wannon Water	14 December 2015
Westernport Water	11 December 2015
Yarra Valley Water	11 December 2015

A.3 OUR RESPONSE

Our response to submissions is included in table A.3 on the following page. We have summarised points raised by water businesses that were related to this proposed pricing approach. The majority of businesses reiterated similar views in June and December 2015; therefore we have focused our attention on the most recent. We will be visiting all water businesses in the coming months and will be available to discuss all queries.

TABLE A.3 OUR RESPONSE TO SUBMISSIONS RECEIVED

Name	Key submission points	ESC comments
Barwon Water	• supports the building block model: - inputs and their relationships with resulting prices are transparent - allows for scenario modelling to be undertaken - has a mechanism to adjust for unforeseen and uncontrollable events - identifies revenue requirements which take account of the financial health of the business • supports incorporating WACC updates based on actual results into annual tariff adjustments similar to CPI • suggests that incentives and clear criteria for businesses to be 'fast-tracked' would incentivise water businesses to prepare submissions that require less audit, and assist businesses with resource allocation • proposes that the Commission provides a clear indication of the level of customer consultation expected from water businesses • suggest the introduction of an efficiency sharing schemes for capital and operating expenditure, instead of static efficiency targets that can limit incentives for improvement over the life of a Price Determination	We agree that the building blocks model is able to deliver on many of the pricing approach objectives and this is being retained. We have also looked to introduce financial and reputational incentives into the pricing approach that hinge on a price submission and also performance during a regulatory period (discussed in chapter 6). This includes fast-tracked price reviews. The intention is to encourage businesses to find the best outcomes for its customers, but the reward should not remove the price savings for customers. We agree that only evaluating a business's track record for a price review is unlikely to incentivise ongoing performance improvement. However we are proposing to incorporate an annual tariff adjustment that slightly increases or decreases revenue depending on a business's performance year on year. We are also looking to introduce a 10 year trailing average Cost of Debt to minimise the impact of fluctuations on prices.
Cardno	• suggests a multi-faceted approach is used to gain a thorough understanding of expenditure forecasts through review of: - governance of the business - businesses processes in developing expenditure plans - benchmarking - analysis of long term expenditure and service level performance - detailed review of sample projects • supports benchmarking using the National Performance Report data set • suggests greater emphasis on asset management including review of asset management plans due its significant on pricing	We agree that the new pricing approach should not be reliant on one or two factors. As discussed in section 6.3, we have outlined the five PREMO criteria that we will use to assess the quality of a water business's price submission. Although these are high level, these criteria do focus on the forecast expenditure for a business and management processes so that a business can deliver on its price proposal. We have not looked to develop an approach based on benchmarking, but we will continue to use our data on cost categories such as labour and energy.
Central Highlands Water	• notes the importance of avoiding a 'one size fits all' model, given the diverse environments within the Victorian water sector. Flexibility must be allowed for smaller regional settings and communities • supports the current building block approach • supports 'light handed regulation' in terms of pricing submission approval for water corporations that fulfil a range of operating criteria • agrees with the need to seek earlier and greater involvement from customers in developing the price submission • there should not be any mandated customer engagement approach, but a business may choose to implement a customer challenge panel or citizen's jury	We are proposing to retain a number of elements of the current approach with the inclusion of some enhancements. Chapter 5 outlines our perspective on customer engagement and section 5.4 describes one method of how to demonstrate customer engagement for a price submission. We agree that developing a model with generic requirements may not allow all businesses to choose the best services and prices for their communities. Therefore we have aimed to allow sufficient flexibility in how we assess price submissions as different factors are of higher importance for each business (discussed further in chapter 7).

TABLE A.3 OUR RESPONSE TO SUBMISSIONS RECEIVED
Continued

Name	Key submission points	ESC comments
City West Water	• generally supports the ESC's criteria for assessing future price approaches • prefers a cost reflective approach and the building blocks methodology with the following changes: - light handed regulation - greater use of benchmarking, eg yardstick regulation a possible method, subject to assurance the measures are relevant to the business - greater acceptance of customer preference over economic efficiency outcomes eg consider non-prescribed services, supported by strong customer willingness to pay in the price regulation - move to calculating the cost of debt on a 10 year rolling average to better reflect long-lived assets and reduce potential for price volatility between regulatory periods	We are proposing to retain building blocks as the financial core of the pricing approach that enables the calculation of prices. We have detailed in chapter 7 how we propose to implement fast-tracking for draft decision to provide lighter handed regulation. There is a greater emphasis on businesses to ensure that their price submissions reflect customer engagement and we have outlined our broad expectations in chapter 5. At this stage we are not proposing to incorporate more benchmarking into the pricing approach. However we are looking to simplify the Cost of Capital by calculating the Cost of Debt using a 10 year trailing average. As CWW mentioned, this should reduce the volatility in prices for customers between regulatory periods.
Coliban Water	• supports enhancement of the current model rather than devise a new regime • proposes greater use of businesses' actual and forecast expenditure in price setting, especially in financial viability tests. Suggests the ESC should ensure each business' financial viability • prefers a lengthy (5 or 10 year) regulatory period to ensure customer certainty with price adjustments to reflect material changes in costs/demand , and potential for an ongoing regulatory period • does not support operating expenditure benchmarking or unbundling for pricing • supports the rolling regulatory period as proposed by Yarra Valley Water • supports fast tracking and believes main determinant for 'Type 1' should be price based • proposes that all 3 year plus capex should be based on corporation analysis of asset renewals and appropriate benchmarking, rather than time consuming forecasting	Although we have proposed a fixed regulatory period, we do envisage that in the future, longer regulatory periods may be justifiable depending on a business's performance against forecast and whether prices reflect customer expectations. For the next price review, there is still the option for a water business to propose any length of regulatory period. We have not proposed rolling price reviews; refer to comments for Yarra Valley Water. It would be possible for businesses to benchmark their capital program if they choose. We approve prices to give businesses enough revenue to prudently and efficiently operate their business. The business then can choose and prioritise how it allocates its expenditure across capital projects.
CUAC, CALC and VCOSS (Consumer Groups joint submission)	• broadly supports the ESC evaluation criteria for future approaches and increase in customer involvement in price determination • suggests an additional criterion for assessing changes to the pricing approach – promotion of the needs of low-income and vulnerable customers – to operate alongside the GSL scheme and other avenues for retailers to manage bill affordability	Our Customer Service Codes will continue to require businesses to protect low-income and vulnerable customers. This is independent of any pricing approach that we might propose to implement. We will continue to monitor business performance against our hardship/payment difficulty measures through our annual performance reporting.

TABLE A.3 OUR RESPONSE TO SUBMISSIONS RECEIVED
Continued

Name	Key submission points	ESC comments
Goulburn Valley Water	• supports the building block approach and would support further consideration of proposals that extend the existing approach • supports the earned autonomy option, but would need clear criteria for business to be able to self-assess or determine a default price path • believes there should be improved incentives for efficiency savings and innovation • notes that the development of improved benchmarking across businesses that is meaningful and will provide greater transparency may take a significant time period to complete and would need to start early in the pricing submission process • does not support unbundling the value chain: - efficiencies (e.g. staffing) are currently achieved through integrating the value chain across the business - establishing separate charges for different customer groups would result in a significant change to the number of tariffs that are currently offered - needs to be phased in across a number of regulatory periods to avoid price shocks for individual customer groups	Overall, we have proposed to retain the current building blocks methodology and pursue enhancements that deliver better outcomes for customers. Chapter 6 of the paper discusses at a high level our proposed incentive framework and the PREMO criteria that could be used to assess price submissions. We note that we will continue to use our information to benchmark cost categories such as labour and energy. As raised in other submissions, the diversity in the Victorian water sector means it can be difficult to undertake detailed benchmarking to inform prices. We agree that at this stage unbundling the value chain should not be a priority, as a number of businesses achieve efficiency by vertically integrating their business. However we believe a detailed costing exercise may become appropriate in the future (discussed in section 3.3 of the paper).
GWMWater	• supports retention of building block model • supports concepts regarding healthy customer and ESC interactions leading to light handed regulation, particularly customer acceptance of price and service offered • supports Synergies consulting model with categories for businesses and 6 preconditions to enable 'fast tracking', along with tailoring based on organisation size to reduce cost of regulation • supports CME's ideas to better align WACC to economic, social and environmental objectives that vary across the water businesses. • notes that how the Commission applies benchmarking and/or incentivises productivity and efficiency becomes critical where water businesses do not demonstrate in their pricing proposals a strong commitment to productivity and efficiency	In summary, we are proposing to retain the building blocks methodology for price setting, but have increased the focus on customer engagement so that we can be confident the approved prices deliver on customer expectations. Where businesses propose good outcomes for customers, these price submissions will be subject to lighter handed regulation – the PREMO criteria for this is outlined in chapter 6.

TABLE A.3 OUR RESPONSE TO SUBMISSIONS RECEIVED
Continued

Name	Key submission points	ESC comments
North East Water	• supports retention of building block model with improvements • supports Synergies paper with building block approach as the basis and a fast tracking mechanism based on price paths within an acceptable range, plus criteria to balance customers and bills with environment and service • considers that direct negotiation could form part of the fast tracking model, covering some or the entire plan • suggests that the regulator sets cost of capital but based on 5 year rolling basis to minimise impacts of fluctuations in actual debt • does not support the current CPI-X methodology for determining price path • cautious of increases to customer engagement effort required as this can be a challenge for smaller corporations to attract the required skills from the existing customer base	We are proposing to retain the building blocks methodology and implement improvements to the current approach. We have focussed on the development of a flexible review process so that businesses can be rewarded with less regulatory scrutiny (discussed in chapter 7). As discussed in section 6.4, we are proposing a Cost of Debt based on a trailing average. However we do not believe that a direct negotiation model for customer engagement would be appropriate at this stage of a new pricing approach or the current state of engagement in the sector. We have decided not to prescribe methods for customer engagement as each water business operates in different communities and environments. We discuss our expectation on customer engagement in chapter 5. Our objective is for businesses to use approaches that allow their customers to be more heavily involved in decision making on services and prices.
South East Water	• supports a focus on ongoing and more meaningful customer engagement to inform water businesses' decision making; the Commission should provide some broad parameters around what it would expect from water businesses • supports the development of greater incentives for businesses to deliver the outcomes which meet their customer's expectations • considers that the set of comparative performance measures that are common to all businesses could be reduced to a small number of core service standards that are focused on customer outcomes, including customer satisfaction • suggests that water businesses could propose financial rewards and or penalties for overachieving or underperforming against agreed output delivery measures • supports further investigation into developing a more streamlined price review process and potentially a framework for fast tracking, including: - a clear framework and criteria for a fast-tracked price review - threshold criteria could be set on elements such as customer engagement, actual performance levels and agreed price path with customers - the Commission to periodically assess its criteria and continue to evolve to ensure the water - ensuring businesses are continually incentivised to meet customer expectations and deliver efficient outcomes	We have outlined in our consultation paper the level of customer engagement we would expect businesses to undertake (refer to chapter 5). We want businesses to engage more deeply on matters that are significant to the services received by customers and to the prices that they pay We agree that it would be best for businesses to determine which performance targets are best for their respective customers. In section 6.5, we outline how we envisage that businesses would be accountable for their own performance based on outcomes proposed in price submissions. We agree that it would then be preferable to focus on a smaller number of indicators for comparison in our annual performance reporting. In chapter 7, we have outlined how we believe we can streamline the regulatory review process. Whether a business can receive a fast-tracked draft decision will be based on our proposed PREMO criteria in table 6.1, but over the mid to long-term we expect we will continue to revise the criteria to ensure the objective is continuous improvement.

TABLE A.3 OUR RESPONSE TO SUBMISSIONS RECEIVED
Continued

Name	Key submission points	ESC comments
South Gippsland Water	• supports VicWater's submission (ie prefers building blocks methodology) • suggests the new approach consider: - structural differences and diversity between water businesses - asset lives and conditions vary between water businesses	As discussed in chapter 3, we are proposing to retain a number of elements of the current pricing approach. The main focus of our proposed changes is to facilitate a greater focus by water businesses on delivering outcomes for customers. Given the diversity in the Victorian water sector, we have considered how to provide autonomy to the water businesses as we aim to move away from the current 'one-size-fits-all' pricing approach to one that more clearly distinguishes and recognises the performance of each water business in meeting its customers' needs.
Southern Rural Water	• does not object to the building blocks approach continuing, but notes alternatives • considers financial viability and improvements in customer value as key objectives for new framework • considers fast tracking a better fit for the Victorian Water Industry – particularly rural corporations - than other incentives. Any financial reward would just be returned to customers creating a circular transaction • suggest exploring the possibility of using our Corporate Plan as a pricing submission. This could mean a greater focus on regulatory matters within the first Corporate Plan of each multi-year regulatory period. Alternatively, it could mean adopting a one year regulatory period	We will continue to allow prices to be established using the building blocks methodology. This means the water pricing approach will continue to provide a water business with a reasonable opportunity to recover the costs of delivering on its obligations, and to earn a return on the owner's investment. Enhancements to the current approach include a requirement for price submissions to demonstrate that comprehensive customer engagement has informed the water business's proposed outcomes. We agree that fast-tracking should provide a strong incentive for the Victorian water sector. As discussed in chapter 6, we are also looking to provide financial incentives as a number of businesses support this concept. We believe that a water business should work to understand how its customers would like share in any surplus revenue, i.e. lower prices, community projects, longer term objectives etc. We do not support the suggestion to use a Corporate Plan as a price submission. The purpose of a Corporate Plan does not fully align with the purpose of a price submission. We would expect to see a price submission that forecasts and justifies prudent and efficient expenditure to deliver services that meet customer expectations.

TABLE A.3 OUR RESPONSE TO SUBMISSIONS RECEIVED
Continued

Name	Key submission points	ESC comments
Wannon Water	• supports building block methodology and the use of secondary tools to enhance the process • supports Fast Tracking/ Earned Autonomy/ Light Handed Reviews and requires clear criteria. These approaches should lead to greater efficiency (for the ESC and the Corporation) and could be a mechanism to drive focus on particular areas, plus reputational benefit • supports YVW's Rolling Price Reviews idea • supports earlier and more ongoing involvement of stakeholders in the development of pricing determinations, including working directly with the public to ensure that public concerns are consistently understood and considered • does not support the application of a set of benchmarks to all water businesses • does not support direct negotiation as it places too much power in the hands of some sub-categories of customer groups • supports some of the benefits within the unbundling/ value chain approach (increased transparency and the monitoring of performance across different business aspects), but has concerns with an increase in administration cost and time. As well as lead time for implementation	We have outlined our views on retaining the Building Blocks methodology, lighter handed regulation and customer engagement within the body of this consultation paper. We have chosen not to pursue a rolling price review, refer to our comments for Yarra Valley Water. We envisage that incentivising ongoing customer engagement and performance improvement will assist businesses to revise and update its planning throughout regulatory periods and not just for price reviews. This information may be used for both the Corporate Plan and price submission, but the documents must be tailored for their specific purpose. We also agree that unbundling and pricing by value chain is not possible at this stage for pricing. Further work and consultation would be necessary to ensure costs are correctly 'ring fenced' such that any new costs do not outweigh the benefits. Similarly a comprehensive approach would be required to develop appropriate benchmarks that are applicable to all water businesses.
Western Water	• supports introduction of incentives (eg efficiency sharing mechanisms), customising pricing approaches to businesses and benchmarking, but within building blocks • cautious of change because doesn't consider enough time for implementation by next price review, suggests new approach should shadow current approach for one regulatory period to ensure its workability • given the existing timeframe, prefers the ESC propose a model for businesses to consider • suggests resourcing be made available to businesses for implementation of a new pricing approach • highlights concerns regarding any increases to cost of regulation for water businesses and ESC, particularly if more data driven • supports financial viability as a critical factor as an objective of pricing approach and suggests ESC ensure each business' financial viability	We believe that our proposed approach can be implemented in time for the 2018 price review. Changes to performance monitoring will occur within the next regulatory period as more time will be required to ensure targets are custom to each water business. Although we have put increased emphasis on customer engagement, a business has the autonomy to choose what level is suitable for its size of business and its customers' needs. In addition, for businesses that put forward a 'leading' or 'ambitious' price submission - they will likely be subject to less regulatory scrutiny.

TABLE A.3 OUR RESPONSE TO SUBMISSIONS RECEIVED
Continued

Name	Key submission points	ESC comments
Westernport Water	• supports CME's view on how to set longer term Cost of Equity and Debt for building blocks. It is a more appropriate rate of recovery for Cost of Debt • supports the use of criteria based regulation to determine level of review based on business size and risk in pricing proposals (Synergies and KPMG) • supports a risk based approach for review but does not support where different prices are applied to the value chain (Frontier) • does not support the use of benchmarking to determine a default price path (Sapere) • does not support a regulated approach to customer engagement because this may impact regional businesses	The positions on tailoring regulatory review (chapter 7) and monitoring to individual businesses, customer engagement approaches (chapter 5) and adopting a longer term view on the cost of equity and debt (section 6.4 of the paper) have been considered in the body of our consultation paper. Rolling price reviews and pricing by value chain have not been incorporated into the proposed pricing approach. For this next price review, we will retain benchmarking based on cost categories such as labour and energy. We do not propose to undertake detailed benchmarking to inform prices.
Victorian Farmers Federation	• recommends benchmarking of rural businesses • suggests new approach be easy for customers to understand and transparent • seeks a clear link between revenue and expenditure (related to above point) • supports ESC's consultation and engagement processes in the future regulation review • suggests consideration of businesses' operating environments in price determination	We will continue to benchmark major cost categories common to businesses, including rural businesses. However given the diversity of business operations, we do not propose to undertake intensive benchmarking to inform prices. We believe that our proposed pricing approach should be easier to understand for customers as we have removed the emphasis on the building blocks to outcomes that are more tangible. The purpose of the changes is to facilitate a greater focus by water businesses on delivering outcomes for customers. The degree of autonomy allowed for a water business will depend on how well a business understands and reflects preferences of customers in price submissions, and delivers on these outcomes efficiently. Our aim is to move away from the current 'one-size-fits-all' pricing approach to one that more clearly distinguishes and recognises the performance of each water business in meeting its customers' needs.

TABLE A.3 OUR RESPONSE TO SUBMISSIONS RECEIVED
Continued

Name	Key submission points	ESC comments
Victorian Water Industry Association	• suggests use of different pricing approaches reflecting the businesses structure ie not for profit, for profit. • supports ESC's consultation approach on the new framework and assessment criteria and proposes additional criteria of: - supporting resilient systems and service provision - encouraging innovation • prefers the building blocks approach with the following improvements: - formalised approach to setting efficiency targets - transparency and greater customer engagement - better understanding of industry performance - recognition of governance arrangements and - clear objectives , both shareholder and regulator • suggests price monitoring as an alternative to building blocks, where appropriate and subject to assurance that revenue requirements are met • does not support total factor productivity as it may be data intensive, complex and hard to communicate to customers • supports benchmarking integrated into the building blocks approach, although suggests it could be data intensive • suggests the following issues for consideration in assessment of the new approach: - reflect businesses structure and unique pressures - light handed regulation - consider infrastructure investment cycles - identify key inputs early in regulatory process - increased community engagement - greater involvement of active shareholder - an appeal mechanism	Our proposed pricing approach has a foundation in the existing building blocks methodology, but improvements are designed to improve autonomy for water businesses and reduce the regulatory burden. It is expected that by allowing a business to focus on its service delivery, outcomes will be improved for customers. We have not proposed to different our approach based on businesses structure, but we are looking to minimise our level of prescription so that the approach can be tailored to all business operating environments. We are not proposing to implement any data intensive benchmarking into the proposed pricing approach; however we will continue to use our current data sets on various cost categories. We envisage that over the short term we will develop an understanding and new benchmarks for performance monitoring once businesses are under the new approach. We will ensure there is flexibility to revise performance targets as customer expectations change and facilitate continuous improvement in the sector.

TABLE A.3 OUR RESPONSE TO SUBMISSIONS RECEIVED
Continued

Name	Key submission points	ESC comments
Yarra Valley Water	YVW reiterated its rolling price determination idea outline in its June submission. This idea centred on an initial conventional price determination for 5 years, followed by mini annual determinations that extend the price control period by one year; thereby achieving a rolling 5 year regulatory period. Advantages of this approach include: • forecast determination prices reflect the most up to date information • may be less resource intensive, as annual reviews (once the initial fixed period is set) would require less information and likely to focus on different issues each year. • price stability will be maintained as at least three years of prices will be known in advance • overcomes the issue of "trueing up" the last year of the current regulatory period in future regulatory periods • WACC calculation would be more up to date • policy issues reflected in price determinations sooner, when relevant, rather than after a time lag YVW also highlighted that it believes customer driven outcomes are a necessity for any utility industry' and that there would be 'merit in exploring options for incentives.'	Although we have not adopted a rolling price review, there are a number of similarities with our pricing approach. Our primary reason for this is that we are aiming to minimise the level of regulatory scrutiny where businesses prove they have robust forecasts and a record of delivering outcomes for customer. We believe there is a risk that the regulatory burden would increase under rolling annual reviews even if we only undertook detailed review of select areas each year. We consider that businesses that undertake ongoing customer engagement and performance monitoring should not need to undertake a concerted effort one year out from a price submission deadline. Therefore although there isn't an annual mini determination, the workload is spread over each regulatory period as businesses manage their operations year on year. We propose to outline criteria such that a business can aim for lighter handed regulation rather than fast mini price determination. We would then focus our resources on a smaller number of businesses that have not clearly proposed the best outcomes and prices for customers. We agree that under a rolling price review, particularly if a shorter regulatory period (i.e. 3 years), prices can be more adaptive to unforeseen events or regulatory changes. If a five year rolling approach is adopted, we are always forecasting and resetting the furthest year, which has the most risk for forecast prices. Depending on the extent and timing of new costs under the proposed pricing approach, we would retain the option of a price reopening as per our current approach. We would expect businesses to first determine whether costs can be absorbed by identifying efficiencies or projects reprioritised before seeking a price reopening.

APPENDIX B — AUTONOMY IN DEMAND FORECASTING

Under the price cap form of price control used by most Victorian water businesses, prices are set depending on the revenue requirement of a business and forecast demand. A water business's demand forecasts are therefore one of the areas critically assessed by the Commission in price reviews.

If demand is higher than the forecast used to estimate maximum prices, then a water business can earn a windfall gain. If demand is lower than forecast, a water business may incur a windfall loss. Therefore, the current pricing approach provides an incentive for a business to err towards underestimating its forecast demand.

Since the inception of price regulation, disputes over demand forecasts have been one of the more common areas of disagreement between the water businesses and the Commission. Water businesses have questioned why the Commission's demand forecasts should have greater standing than their own (given their expertise in understanding local conditions).

Below, we set out a high level model that removes this source of disagreement between the water businesses and the regulator. This is achieved by providing the businesses with greater autonomy over the demand forecasts used to determine their prices.

We welcome any feedback on the proposed 'autonomous demand model'. We will provide further explanation of the model and accommodate feedback through our consultation program following the release of this paper.

HOW THE AUTONOMOUS DEMAND MODEL WOULD WORK

The proposed demand model is a hybrid form of price and revenue cap. It would work as follows:

1. The water business would propose its prices and demand. The price and demand forecasts when combined would establish the business's revenue requirement (as currently occurs).
2. The Commission would adopt the water business's demand forecast and proposed prices subject to minimal scrutiny of the underlying assumptions. Unlike in past price reviews, the Commission would be very unlikely to engage in modelling its own demand forecasts.
3. Up to the water business's forecast level of demand, a price cap form of control would apply based on the prices submitted by the water business.[54]
4. Beyond the water business's forecast level of demand, a revenue cap would apply.

These outcomes are illustrated by the dashed red line in the diagram below, where D^f is the business's demand forecast, and R^f is its forecast revenue requirement at its forecast level of demand.

The final step acknowledges that demand forecasting is inherently uncertain, therefore:

5. Each business would nominate a 'buffer' above the prices and revenue cap it has identified in steps 3 and 4. We expect most buffers will be expressed as a percentage (though other buffer structures may be identified).

This provides the final price path and final revenue cap for the water business. These are shown by the solid green lines in the diagram below.

Water businesses would be expected to 'bid in' their respective buffers competitively. The Commission would then rank the buffers. A water business's ranking would inform the Commission's assessment of the business's rating under the risk element of the PREMO model. In other words, businesses that seek to transfer greater levels

[54] Provided no other adjustments are required to the business's operating or capital expenditures.

of risk to their customers by adopting larger buffers (and therefore higher prices) are likely to be treated parsimoniously under the PREMO model.

We would only expect to challenge a water business's proposed buffer in exceptional circumstances, including if we felt there had been collusion among two or more businesses in determining the size of their buffers.