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Your reference



Water Team – Pricing Approach Review
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Dear Sir/Madam,

REVIEW OF WATER PRICING APPROACH - POSITION PAPER

Gippsland Water has considered a range of issues outlined in the Position Paper released by the Essential Services Commission (ESC) in relation to the Review of Water Pricing. Gippsland Water provides the following comments for consideration as the ESC attempts to finalise its stance on a number of issues outlined in the Position Paper.

Form of customer engagement

Gippsland Water supports the ESC's focus on customer engagement and looks forward to working with the ESC throughout the development of the Pricing Submission. The Position Paper (p23) states that deliberate forums and customer challenge panels allow for a deeper exploration of issues with customers and compare favourably with past practice of using, among other things, fact sheets.

Gippsland Water would note that -

- The IAP2 spectrum includes both the 'inform' and 'consult' phases, both of which could be complemented by well-prepared fact sheets, as part of the overall customer engagement process;
- fact sheets are and will remain an excellent means of conveying sometimes complex data in meaningful ways to customers;
- where customers have little or no ability to influence outcomes (eg: minimum standards for water and wastewater standards set by regulators), fact sheets may allow water corporations to inform customers about the rationale for any significant expenditure in these areas.

The key for water corporations is to determine which element of the IAP2 spectrum is relevant for the various issues they wish to take to their customers and the wider community, and how they deliver on their 'promise to the public'. A deliberative forum might be entirely appropriate where a water corporation is seeking to collaborate with customers on issues where customers can genuinely influence outcomes (for example, service standard modernisation and GSL alignment to customer values).

Autonomy in demand forecasting

The Position Paper (p37 and Appendix B) refers to a potential new approach to demand forecasting (the autonomous demand model), with the ESC acknowledging that demand forecasting is inherently uncertain. Gippsland Water agrees. Trying to anticipate customer growth patterns, let alone water consumption patterns in regions where rainfall (and thus consumption) can vary dramatically from year to year is fraught with danger, despite the care with which water corporations typically undertake this analysis.

Gippsland Water has previously indicated to ESC staff that disputation in relation to demand forecasts reached 'concerning' levels during the 2013 Price Review process. In Gippsland Water's case, the ESC had to enlist the assistance of additional third-party expertise to resolve an impasse between consultants acting on behalf of the ESC and consultants acting on behalf of Gippsland Water. Any proposal that improves outcomes for both the ESC and the water corporations in this area warrants further consideration.

In this light, the ESC's proposed 'autonomous demand model' using price caps combined with revenue caps is worthy of further discussion. Gippsland Water notes however that the Position Paper sheds little light on how the process might work in practice. For example, the Position Paper does not describe the technique behind the imposition of the revenue cap. If the role of the revenue cap is to limit total revenue for a period, and revenue earned exceeds the cap, how would the adjustment mechanism apply? Any annual price adjustment would logically require a one year lag in the adjustment process (eg: prices for year two are set before final revenues are known for year one, thus any adjustment can only apply to year three).

Water corporations and the ESC have always placed significant value on the transparency and stability of prices for customers during a regulatory period. Any within-period adjustment mechanism would place these principles at risk. For water corporations with significant, climate dependant, movements in annual household consumption, year to year stability of prices may be a significant issue.

The analysis of revenue increases in isolation from other events may also lead to the wrong outcomes. For example, if significant growth leads to revenue increases, but also triggers requirements for additional operational or capital expenditure by water corporations, the revenue cap approach, in its current form, has no means with which to consider these additional factors.

Water corporations also have a role to play in development across their regions. A revenue cap approach may be seen as a dis-incentive, stifling water corporations' efforts to promote regional growth outside of growth forecasts included within Price Review processes. This may not be in best interests of customers and the wider regional community in the longer term.

The PREMO model

The Position Paper outlines a new five element assessment model, PREMO (page 36). The ESC proposes that the five PREMO elements - Performance, Risk, Engagement, Management accountability and Outcomes will be used by water corporations to self-assess the 'level of ambition' included in their Price Submission, by selecting one of four rating categories.

At present, the Position Paper does not outline any clear PREMO assessment criteria to guide water corporations in determining what may constitute a 'basic', 'standard', 'ambitious' or 'leading' submission, in this self-assessment process. Assessment criteria must be developed to provide guidance to water corporations. Transparency around assessment criteria will also allow water corporations to understand how the ESC will itself assess individual Price Submissions.

The Allowable Cost of Equity matrix

The Position Paper includes an Allowable Cost of Equity Matrix. The ESC proposes that this matrix will be used to determine a cost of equity outcome for the beginning of the regulatory period, by bringing together the water corporation's PREMO based self-assessment of ambition, and the ESC's assessment of the level of ambition.

Gippsland Water notes that the matrix proposal includes an inbuilt penalty mechanism where the ESC assesses a water corporation's submission less favourably than the corporation's own self-assessment. This mechanism has been explained as an effort to reduce any 'gaming' that might occur if corporations attempt to achieve the highest rates of return available by overstating their level of ambition.

Should this concept be used for the first time as part of the 2018 Price Review process, Gippsland Water believes that the ESC should give consideration to revising the penalty mechanism process. A better approach for the 2018 Price Review process would be to limit any reduction in the event of a lower ESC rating to one of the three lower equity returns (ambitious, standard or basic), rather than apply an additional penalty (eg: a 0.2 penalty in the current ESC matrix for a one-step lower assessment by the ESC).

Should the ESC believe that a penalty mechanism is still warranted post the 2018 Price Review, water corporations, with the benefit of the 2018 process, will have no rationale for over-bidding in 2023.

Management accountability and Board attestation requirements

The ESC indicates in the Position Paper (page 38) that a water corporation's management should be accountable for its price submission. The ESC proposes to introduce a requirement that water corporation Boards 'attest' that the price submission reflects all the requirements of the ESC's guidance.

Gippsland Water understands that this proposal may stem from a number of poor submissions that the ESC received during the 2013 Price Submission process, and concern from an ESC perspective that errors in submissions should have been detected prior to the ESC commencing its review process.

In Gippsland Water's experience, attestation requirements can lead to significant expenditures on external consultants, who are engaged to review matters requiring Board attestation, to provide the Board with a level of comfort that the attestation can be certified.

While the Board has a clear role in the governance of the water corporation, management is actually responsible for the development of the Price Submission. Perhaps management, rather than the Board, should be required to attest that the Price Submission has been prepared on a basis that reflects the guidance provided by the ESC. An attestation by the water corporation's Managing Director could then be relied upon by both the Board and the ESC.

VicWater Submission

Gippsland Water notes that VicWater will also provide the ESC with a response to the Position Paper. Gippsland Water has contributed to and supports the views outlined in the VicWater response.

Yours sincerely



David Mawer
MANAGING DIRECTOR