

29 July 2016

Water Team
Essential Services Commission
Level 37, 2 Lonsdale Street St
MELBOURNE VIC 3000

Dear Water Team

Response to Pricing Approach Position Paper

We welcome the opportunity to provide a response to the Commissions position paper 'A new model for pricing services in Victoria's water sector'.

We are strongly supportive of the proposed framework that reinforces our objective of increasing customer value through the provision of exemplary water and sanitation services that contribute to the health and well-being of current and future generations. There are many elements of the proposed pricing approach that supports the water industry to continue its focus on achieving greater value for customers and the community including:

- deeper, broader and earlier engagement with customers and stakeholders to inform decision-making and the development of the set of outcomes for the regulatory period based on this engagement;
- the continued use of the 'building blocks' approach; and
- the introduction of flexibility and incentive mechanisms including fast-tracking of submissions.

In particular, Yarra Valley Water has put a great deal of effort into our customer engagement for the current price period, and its effectiveness has been acknowledged by a number of parties (including the AER and the ESC's consultants) and consumer advocates. We welcome the ESC focus on greater customer engagement and we intend to "raise the bar" and explore innovative and improved approaches to customer consultation. We are very enthusiastic about what this might generate in terms of community participation and opportunities to increase value.

As requested by Commission staff, this response is focussed on areas, while we also generally support, we would like to further explore. These include:

- **PREMO assessment framework:** The PREMO model provides insight into the criteria by which the Commission will assess the 'level of ambition' and thereby the cost of equity allowance. We further understand that the model is underpinned by a mechanism that rewards businesses that propose improved cost and service outcomes for customers – albeit requires alignment of the individual businesses and Commission's assessment.

The position paper gives some insight into how this mechanism will operate, however we welcome further exploration and ultimately guidance on how businesses can confidently assess

the level of ambition in their submissions and not unintentionally avoid being downgraded. We welcome the opportunity to continue the conversation to:

- understand more fully the criteria for each of the four ambition levels;
 - the relative/comparative impacts of individual components of the model in determining 'level of ambition';
 - the extent to which other water businesses' price submissions will influence the Commission's assessment of an individual company's proposal; and
 - the requirements that will enable a submission to be fast tracked.
- **Price Control:** During the third regulatory period, with the strong support of customers we implemented a revenue cap form of price control. Customers recognised that a water business unlike nearly all other industries should not seek to maximise profits through trying to sell more. We committed to return any excess revenue in full the following year, and customers downside risk was significantly reduced by our commitment to not increase prices by more than 2% per year. Since the introduction of the revenue cap, we have returned \$19 million in excess revenue to our customers over the first three years of this price period. This form of price control delivers timely price adjustments for customers, reduced risk for customers of significant scissor impacts at the end of a price period and disputes over demand forecasts are effectively eliminated.

We understand that based on the PREMO model, a revenue cap could be evaluated as transferring business risk to customers. We are seeking to understand the Commission's position in relation to the continued use our revenue cap form of price control, together with further information in regard to the proposed "autonomous demand model".

- **Intra-period performance adjustment mechanism:** The Commission has expressed an intention to consult further in relation to implementation of an intra-period performance adjustment mechanism. We support the intent of the Commission to hold businesses accountable to achieve the customer outcome commitments in their price submissions. While it is indicated that such a mechanism would be used by exception, we are uncertain as to whether a two to three year window enables adequate time for an appropriate assessment. We believe a more appropriate adjustment mechanism would be as part of the next price period's determination. A framework that comprises a measure up at the end of price period, with a likely penalty to be applied for failure to meet those service commitments will ensure businesses meet their commitments to customers, improve their performance or where they believe they will be unable to improve their performance they could reduce prices during the period. Our proposed amendment to the performance adjustment mechanism would also avoid the potential for significant industry and regulatory resources to be consumed in a 'mini price determination' mid period.
- **Updating the cost of debt based on a 10-year trailing average:** Consistent with our Rolling Price Determination proposal we support the cost of debt being based on a trailing average. A 10-year average is largely consistent with the water industry's borrowing profile. However, in the future there are likely to be rare occasions where the strict application of this rule may not be appropriate and we would support a mechanism being included to address this. In a situation of a large capital investment and interest rates are lower than the 10-year average, customers will unnecessarily pay a premium for the investment. Conversely businesses may be

reluctant to invest knowing that it may be up to ten years before the debt allowance under the rolling average is at least equal to the cost of borrowings.

- **Flexibility mechanisms:** We note that the Commission has built in a number of flexibility mechanisms into the proposed framework associated with service outcomes, self-reporting, guaranteed service levels, and the price review process. We welcome this more flexible approach and are particularly pleased with the move towards customer service outcomes which represent those aspects of our service which customers value most.

We are seeking to understand further the Commission's intentions with its annual performance report and the flexibility mechanisms in the proposed pricing framework.

In providing this response, we acknowledge the extensive and transparent engagement process undertaken by the Commission in developing the proposal and we look forward to the ongoing consultation process to enable preparation of the Commissions Guidance Paper in November 2016.

If you have any queries regarding the above, please contact Brett Mathieson, Manager Regulation and Planning by email on Brett.Mathieson@yvw.com.au or by phone on 9872 2441.

Yours sincerely



Pat McCafferty
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