

29 July 2016

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Essential Services Commission  
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~~Dr Ben David~~ *Ron,*

### **A New Model for Pricing Services in Victoria's Water Sector**

Melbourne Water welcomes the opportunity to provide a response to the Essential Service Commission's Position Paper: A New Model for Pricing Services in Victoria's Water Sector (the Position Paper) published in May 2016.

Melbourne Water is supportive of the Customer-focussed principles underpinning the model proposed by the Commission and we welcome a regulatory framework that better prioritises the needs and expectations of customers. The current building block approach provides for transparent and consistent regulatory decisions, however there is scope to improve its practical application.

Melbourne Water supports the main objectives articulated in the Position Paper as noted below:

- 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.

Melbourne Water also supports in principle the following key changes outlined in the Position Paper:

- Adopting a 10-year rolling average approach to setting the cost of debt each year
- The concept of increased opportunities for 'fast-tracking,' thereby reducing the regulatory oversight for submissions that are clear and well supported (further commentary in relation to this mechanism is provided below)
- The approach to reporting and monitoring on-going performance within the period involving an annual performance report that focuses on service outcomes rather than technical metrics
- A requirement that a water business boards attest that the price submission reflects all the requirements of ESC guidance.

#### Matters for further consideration

Notwithstanding the above, the model impacting return on equity is a significant shift from current practice. For this reason, Melbourne Water recommends a collaborative and conservative approach to avoid unintended impacts on customer bills or the viability of water businesses.

A more detailed explanation of Melbourne Water's views in relation to return on equity is provided below. Our views are framed in the context of the following three regulatory principles which should form the basis of any strong incentives framework:

- Predictability
- Fairness
- Simplicity.

#### *Predictability*

Transparency and predictability is a key strength of independent price regulation. It supports customers in the context of the maximum prices charged for water services and benefits water businesses in providing certainty about future funding streams.

Predictability in regulatory decisions is also important to long-term planning. A solid rules-based foundation, without being overly prescriptive, can better support business strategic investment and service improvement while also promoting the integrity of the regulatory framework and legitimacy of regulatory decisions.

Based on information currently available, Melbourne Water suggests that there may be a risk that increased regulator discretion and reduced reliance on regulatory rules could impact the consistency and predictability of decision-making. Melbourne Water

is committed to working with the Commission to establish clear guidance and a common understanding from which assessments can be made that are fair, consistent, predictable and transparent.

Melbourne Water is also dedicated to working with the Commission on clearly setting out the triggers by which intra-period adjustments shall occur. Melbourne Water supports the Commission's stance that 'intra-period adjustments should be the exception rather than the rule.' Melbourne Water's suggestion is that perhaps they might occur only in 'extreme circumstances' to avoid the additional layer of revenue volatility.

### *Fairness*

Incentive frameworks are most effective when they are proportional. Of importance to the cost of equity parameter is the scale of potential rewards and penalties. The Commission will be aware that decisions about incentives and disincentives will determine whether enough of a signal is sent to encourage the desired change.

If the cost of being penalised for a flawed self-assessment is excessive (particularly in the first application of the new approach), it may, in fact outweigh the benefit of receiving a higher cost of equity. Melbourne Water looks forward to engaging with the Commission to assist calibrating the penalties and rewards in a way that is most conducive to promote positive change.

While Melbourne Water welcomes the option of a light-handed approach to regulation as created by the fast-tracking mechanism, It is important to ensure that it does not result in unintended consequences.

Specifically, Melbourne Water is unclear how interest rate fluctuations will be treated should they occur in the period between the final decision for a fast-tracked price submission and the final decision for a price submission that is not fast-tracked. Melbourne Water looks forward to working with the Commission to ensure that this mechanism is refined in a way that avoids negative implications for a fast-tracked business's Weighted Average Cost of Capital (WACC).

### *Simplicity*

Simplicity is important because it ensures that regulation creates clear incentives for action, as well as ensuring that the regulatory process is efficient and cost-effective. Melbourne Water agrees that the current pricing approach is not well understood. The concepts and the terminology can make it difficult for customers to participate in the process, leading to debates about what could be seen as academic arguments with no clear customer benefit. Melbourne Water notes that the Commission's guidance supporting its most recent price determination process effectively short circuited some of these arguments by clearly articulating which WACC parameters were open to discussion.

Melbourne Water is not yet convinced the proposed approach to the cost of equity results in a simpler pricing framework. We also have questions about its ability to create strong and achievable incentives for sustained performance. The Commission's efforts to use the cost of equity to improve forecasting accuracy and reward/sanction performance against multiple other objectives such as better risk management, enhanced services, improved customer engagement and clearer submissions runs the risk of creating confusion, unintended consequences or conflicting incentives.

The Commission may wish to consider using this single mechanism to incentivise a single outcome while the new framework is in its infancy. As an example, the Commission may consider trialling a standardised cost of equity with a reward for businesses that are able to demonstrate an exceptional level of customer engagement. If proven effective, the other elements may follow as part of future price reviews.

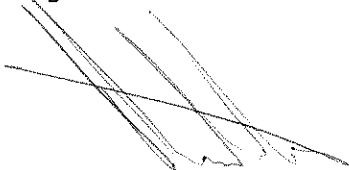
### Concluding Remarks

Melbourne Water is supportive of a range of changes referred to in the Position Paper and perceives them as largely consistent with the aspirations referenced in the Commission's overview.

As indicated, Melbourne Water has some reservations about the complexity of the proposed approach. As such, we are seeking further discussions on specific aspects revolving around the approach to the cost of equity and its ability to achieve the objectives it strives to achieve.

Melbourne Water looks forward to working with the Commission as it prepares guidance for the water industry's next price determination.

Regards

A handwritten signature in black ink, appearing to read 'Michael Wandmaker', written over a set of horizontal lines that serve as a guide for the signature.

Michael Wandmaker  
**Managing Director**