Coliban
WATER

Our ref: **Contact:** Jarrah O'Shea, Manager Economics & Pricing **Your ref:**

22 August 2016

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

Dear Mr Crudden

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

Thank you for the opportunity to provide comments on A new model for pricing services in Victoria's water sector. Coliban Water supports the Commission's stated goals for future regulatory oversight to be underpinned by strong evidence of the delivery of services and products that are valued by customers, and for water businesses to have greater autonomy in decision making.

We are concerned that the proposed Autonomous Demand Model will result in Victorian water businesses facing additional financial risk from both high and low water demand situations. We note that deviation from demand forecasts is due primarily to changes in prevailing local weather and global trends such as the influence of El Nino and La Nina climate conditions. This is particularly the case in northern Victoria where summer water use is highly dependent on seasonal weather conditions. From our assessment, the proposed model may lead to price fluctuations in the water volumetric tariff of up to +/-30 per cent per annum, and driven by circumstances that are largely beyond the control of the regulated entity.

Coliban Water contends that a Demand Adjusted Revenue Cap model, which we presented for the Commission's consideration during the last pricing determination, better meets the ESC's principles of Customers, Autonomy, Performance and Simplicity. This innovative price control was developed to enhance business sustainability while providing bill certainty to customers and mitigating bill volatility.

We are concerned that the Commission's proposed assessment of the "quality" of Pricing Submissions appears somewhat arbitrary and we would welcome the opportunity to contribute further to the method of assessment being considered by the Commission. We urge the Commission to consider phasing in of penalties over future regulatory periods and using its own assessment of a submission's quality in the event that a water business understates its own Pricing Submission.

We request that further clarification be provided to the regulated entities on the proposed 10-year trailing cost of debt approach, and we submit that, as a minimum, the regulatory cost of debt should align to the statutory or 'real' cost of debt. This will help underpin the financial sustainability of water corporations.

Our views are supported by further discussion in a document attached to this letter. Both documents should be read together as Coliban Water's response to the Commission.

If you have any queries about this correspondence, please contact Jarrah O'Shea, Manager Economics and Pricing.

Yours faithfully

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VICTORIA State Government

Response to ESC's Position Paper: *A new model for pricing services in Victoria's water sector*

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1.1 Purpose

This document along with the separate cover letter forms Coliban Water's response to the Essential Services Commission (ESC) Position Paper: *A new model for pricing services in Victoria's water sector*.

1.2 Customer Engagement

The ESC's proposed regulatory model strongly emphasises customer engagement. Coliban Water is supportive of this greater emphasis as we are already committed to deep and ongoing engagement with our customers.

In 2013 we commenced "Your Town" visits to engage directly with customers across our region. We have completed 80 Your Town visits, receiving feedback from more than 900 customers. Information learned from these visits, together with other targeted consultation and engagement, has been fed into operational plans and will form an essential part of our Pricing Submission.

We encourage the ESC to take a pragmatic view of what extent and to what level customer engagement is possible and effective. Given differing customer bases and geographic regions, it may be prohibitively expensive for smaller businesses to deliver the same depth of customer engagement as larger businesses. The ESC needs to account for each water business's capacity to deliver effective and deep customer engagement (such as on a cost per customer basis), rather than applying a blanket assessment of all businesses. Additionally, the ESC should ensure that assessment of customer engagement incorporates consideration of the short period of time available for genuinely engaging with customers through to the end of 2016.

1.3 Autonomous Demand Model

Under the ESC's proposed *Autonomous Demand Model*, a Victorian water business would face a price cap if demand is below forecast (revenue shortfall) and a revenue cap if demand exceeds the forecast. Businesses therefore face significant financial downside where water demand is both below or above forecast levels.

Coliban Water notes a significant body of evidence linking discretionary summer water consumption to annual weather conditions. In our region, summer consumption in recent hot and dry years has been more than double that of recent cool and wet summers. It is impossible to predict, whether six months or six years in advance, if any summer will be warmer or cooler than average, especially when the uncertain impacts of climate change are considered.

While the ESC's proposed demand model allows a "buffer" factor, we note that this is effectively a competitive bidding process and any buffer that is deemed excessive may result in a downgrading of the assessed 'quality' of the water business's Pricing Submission. A shift down by one band may result in a $5 million PREMO revenue penalty for a business with a $400 million Regulatory Asset Base.

Figure 1 below updates the household customer consumption trends in the Coliban Water region, as provided to the ESC in our *2013 Water Plan*.

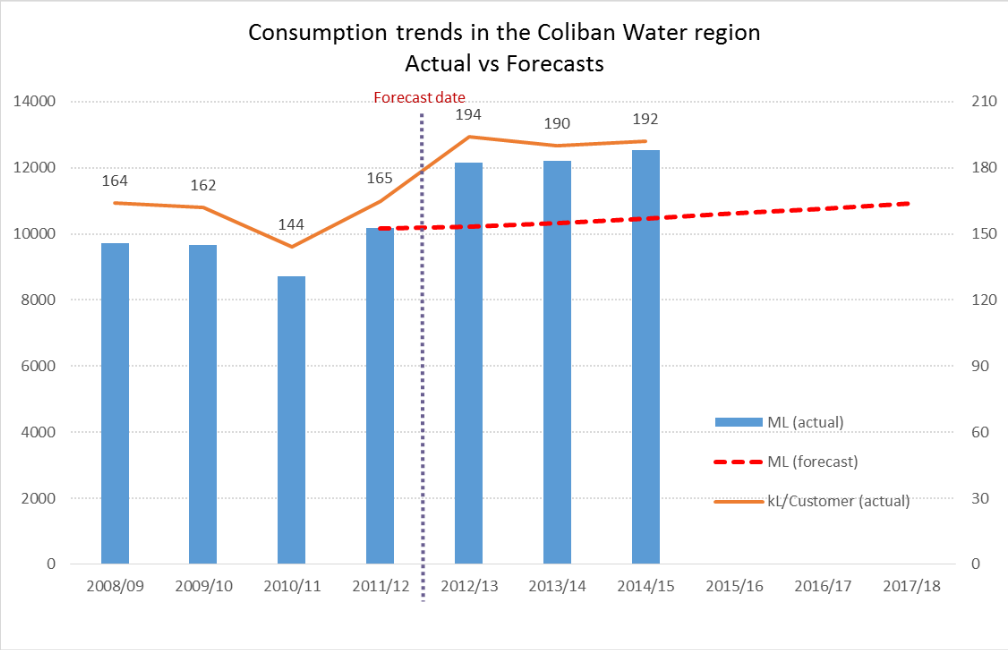

Figure 1. Coliban Water Household Consumption trends (actual vs forecast), 2008-2017

We developed our forecasts for household demand over the period 2013 - 2018 based on best available information at the time. These forecasts were endorsed by the ESC and its consultants. This work was done in 2012 after:

- a severe and lengthy drought up to 2009-10
- a wet year in 2010-11 that was largely free of water restrictions
- a statistical 'median' year in 2011-12

Under the ESC's proposed demand model, climate driven demand changes would have resulted in Coliban Water facing a revenue cap in each of the past three years set on the basis of forecast demand, while the marginal cost of our water at high demand levels has been very high due to our constrained supply of water and reliance on higher cost sources. In this situation, businesses must be allowed to retain at least a portion of their additional revenue to cover higher water source costs and any resultant augmentations. The proposed model does not allow for this, and we contend that it contradicts the concept of cost recovery that has been a universally accepted pricing principle under the National Water Initiative of the Council of Australian Governments.

In addition, the proposed model may lead to significant price swings in volumetric tariffs of up to +/-30 per cent per annum. This is in direct opposition to consistent customer feedback preferring "no price shocks" or bill volatility by having any price changes phased in over a period of time. While we have not undertaken direct customer research into the applicability of the proposed demand model, we submit it does not serve the best interests of either our customers or our business.

Coliban Water is be pleased to share our modelling with the ESC if requested.

1.4 Demand Adjusted Revenue Cap

In our 2013 Water Plan, we proposed an alternative form of price control - a Demand-Adjusted Revenue Cap (DARC). We believe that this form of price control better meets the ESC's principles of Customers, Autonomy, Performance and Simplicity than the proposed price control model.

We note this was viewed reasonably favourably by the ESC in 2013, and we were given an opportunity to re-state a price control following the Determination. Instead, we chose to remain with the known price control method for this regulatory period while reserving the right to pursue a DARC in the future.

The formula for a DARC is similar to a standard revenue cap, but the carry forward adjustment is multiplied by the ratio of the difference between price and cost. This innovative approach to price control has been developed to increase flexibility in tariff structures, enable business sustainability and minimise price fluctuations year on year.

The DARC removes surplus net revenue like a standard revenue cap, but it allows the business to recoup the costs of meeting additional demand. If a business over-recovers revenue in one year, it must reduce revenue in the next year by the difference between the price it charged and the extra costs it incurred in meeting the additional demand. Coliban Water submits that the DARC is more cost reflective than the ESC's proposed model.

The DARC provides incentives to ensure that demand forecasts are as accurate as possible. In other words, the business cannot recover expenditure savings when demand is less than forecast and cannot keep the net profit or over-recovery when demand is more than forecast. The DARC leads to less price volatility than a traditional revenue cap, better maintains alignment between revenue and costs, and reduces the impact of the "scissor effect" between regulatory periods.

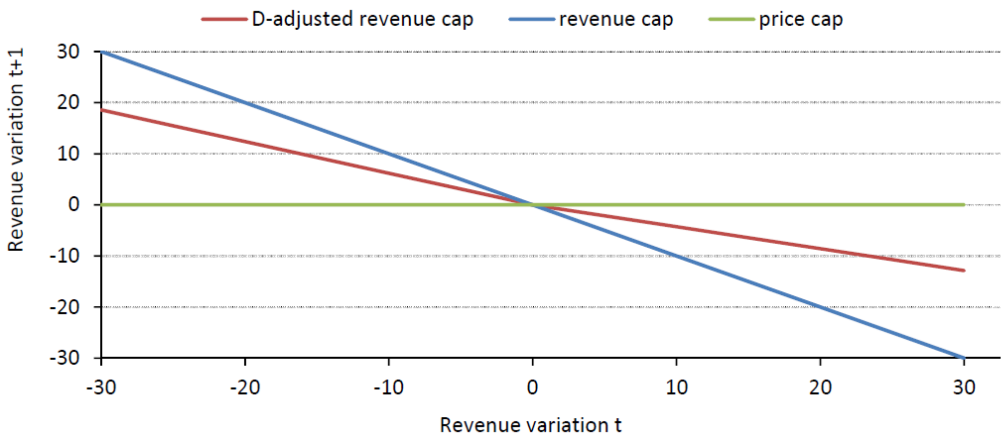

Figure 2. Demand adjusted revenue cap

Given that the DARC considers actual revenue, it is more likely to provide a sustainable revenue stream. The formula for the DARC is less complex than the autonomous demand model and the Melbourne desalination passthroughs. It will not pose any additional administrative cost or complexity.

1.5 Allowable Cost of Equity Matrix

Coliban Water notes that the ESC has to date only provided water businesses with limited guidance for its proposed *Allowable Cost of Equity* return. We support any moves by the ESC to provide early guidance to water businesses in this regard.

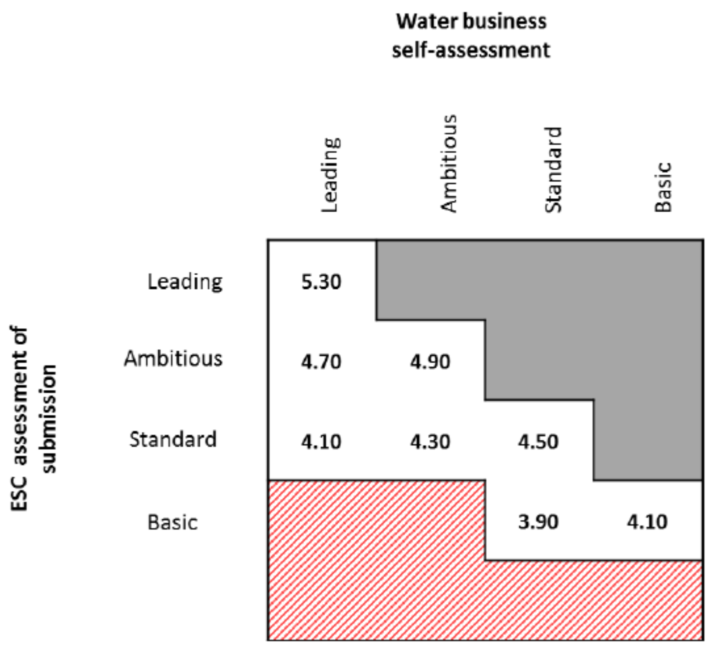

Figure 3. The ESC's Allowable (Real) Cost of Equity Matrix

Under the ESC's proposal (Figure 3), a one band gap between the ESC's and the business's assessment of the 'quality' of the submission (where the ESC's assessment is lower) could result in a $5 million revenue reduction over the 5-year regulatory period (based on $400 million RAB). This is a significant penalty for a water business to pay for misjudging an entirely new and unproven regulatory model, and assessments need to allow for a learning curve to be established.

Coliban Water would welcome extra detail around how the "PREMO" assessment will be made for us to fully support this change. Given the proposed regulatory approach is such a departure from the status quo, we encourage a 'phasing in' mechanism where the penalty for incorrect self-assessment is much reduced or eliminated for this regulatory period. In the event that the water business underestimates its own Pricing Submission, we feel for fairness that the ESC should be consistent in this regard and apply its own assessment instead.

1.6 Trailing Cost of Debt

In previous regulatory periods, the ESC setting the cost of debt at the beginning of a regulatory period introduced significant financial risk to the water business if interest rates subsequently increased. The proposed 10-year trailing average for the cost of debt will smooth out price fluctuations and increase certainty for customers and water businesses. We support the ESC's 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" (Position Paper p.11).

We propose that the ESC tailor its pricing approach by considering each business's actual cost of debt. Coliban Water notes that this approach was supported by consumer bodies including the Consumer Action Law Centre, Consumer Action Utilities Centre and the Victorian Council of Social Service prior to the 2013-18 Water Plan.

Regulated water businesses are subject to pressures and constraints not faced by non-regulated businesses. We do not have any ability to generate a return (via regulatory depreciation) of assets excluded in the initial Regulatory Asset Base. We may be required to make debt-funded investments to meet community obligations that a business in a competitive market does not face. Allowing water businesses to receive in its pricing at least the actual cost of servicing debt will help ensure Victorian water businesses remain financially viable and continue to make appropriate infrastructure investment decisions.

We also seek further clarity about how this cost of debt would be calculated and how it would compare to our actual debt repayment obligations and the refinancing of any debt 'rolled' forward. We have been unable to independently verify the interim calculation of 4.50% (real) cost of debt.

1.7 Financial Sustainability

Coliban Water notes the ESC's requirement under the Water Industry Regulatory Order to ensure the continued financial viability of Victoria's water businesses. Prior to 2013, Coliban Water encountered significant financial distress from unavoidable capital investment, a huge fall in revenue and a large step change in our debt levels. We now find ourselves with significant levels of debt relative to the size of the business. Servicing this debt is onerous; and in 2014-15 over 20 per cent of our gross revenue met borrowing costs.

Regardless of any changes to price controls, assumed debt costs and rates of return, the ESC needs to ensure that Victorian water businesses remain financially viable over the long-term. We deliver services to all customers both now and into the future, while ensuring our finances remain resilient enough to continue to provide the essential services our customers expect and desire. We note and support VAGO's financial indicators and targets for assessing financial sustainability risk, and we believe these metrics best demonstrate our financial sustainability performance.

Financial sustainability is underpinned by the certainty from a binding price determination. Uncertainty caused by a mid-period review of PREMO levels could undermine or compromise financial sustainability, leading to underinvestment and adverse outcomes for customers. Subject to the price review affirming a financially sustainable price path, we would welcome a 10 year regulatory period. We contend this would be in the best interests of our customers and the business.

We will be further engaging with the ESC about how it can best ensure financial sustainability for all water businesses.