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Water Team Pricing Approach Review
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Thank you for the opportunity to make this submission in response to the Essential Services Commission's position paper for pricing services in Victoria's Water sector May 2016.

Lower Murray Water is keen to work with the ESC and contribute to the review process.

Yours Sincerely

A handwritten signature in black ink, appearing to read "Philip Endley".

Philip Endley
Managing Director

Philip Endley
Managing Director

ESC Water Pricing Position Paper

Response from Lower Murray Water

1 ESC Pricing Review

1.1 Submission

This paper provides a response from Lower Murray Water to the Essential Services Commission's (ESC) Position Paper, which makes proposals for the future of urban water pricing.¹ The response takes account of recent discussions between our Board, Senior Management team and customers and members of the ESC's pricing team in Mildura on 21 June 2016.

1.2 Overview

The ESC's paper retains the core elements of the current model. This involves the ESC providing independent oversight of medium-term water pricing submissions developed by the water businesses that ensure the business has the revenue required to cover efficient operating costs and a return on the value of capital invested in the business to deliver its agreed plans and programs.

The Position Paper proposes financial incentives to promote the following priority outcomes:

- **Customers:** the ESC seeks greater engagement of customers in determining the priorities and levels of service that drive investment and prices
- **Autonomy:** the ESC seeks to reinforce the primary role that the water businesses carry in delivering the outcomes they commit to
- **Performance:** the ESC seeks to promote higher performance standards and greater focus on the outcomes that customers consider important
- **Simplicity:** the ESC proposes to streamline the regulatory arrangements for businesses that provide accurate and reliable price submissions that reflect customer preferences

Response: LMW is broadly supportive of the aims of the initiative:

- We welcome the continuity in the underlying model
- We support the emphasis on engaging more deeply with our customers and at an earlier stage
- We welcome greater autonomy in running our business and accept that responsibility
- We believe we are a good performer, matching our customers' expectations
- We will maintain our current package of "good quality at low cost"
- It is important that this approach is recognised and rewarded
- We seek recognition of the unpredictable impact of climatic conditions on our costs and revenues
- We argue for a consistent approach between our urban and rural water services to minimise the confusion and extra costs incurred by having to meet two separate and conflicting regulatory regimes.

¹ ESC (May 2016), *A New Model for Pricing Services in Victoria's Water Sector*

2 Coordination

Lower Murray Water provides a range of services to urban and rural customers across the region:

- Our urban water services are subject to economic regulation by the ESC under the state-based *Water Industry Regulatory Order* and to which this Position Paper will apply directly
- Our rural water services are delivered within the southern Murray Darling Basin and so are subject to economic regulation by the Australian Competition and Consumer Commission (ACCC) under the *Water Charge (Infrastructure) Rules 2010*, although the authority to administer the regime has been delegated to the ESC. We understand that the ESC's Position Paper will not apply to these rural water services.

The risk is that these two strands of our business become subject to separate and conflicting regulatory regimes. That would result in considerable duplication of effort and potential confusion.

Our strong preference is to apply the proposed approach from the ESC Position Paper to all of our services. That will ensure consistency, reduce our workload and minimise risks of conflicting policies and approaches being applied to different services. We commit to engaging our rural customer with the same depth and urgency as proposed for our urban customers and will report on our performance against our commitments in the same way.

We would welcome the reciprocal response for our rural customers of a simpler submission process and greater autonomy to manage our business – in line with your proposed approach for our urban business. We would be pleased for the ESC to transmit this observation to the ACCC.

3 Good quality at a low cost

Lower Murray Water provides an essential service to support the economic and social fabric of the region. Our community is highly diverse, with some of the most disadvantaged groups across Victoria.² Mildura ranks 76th out of the 80 Local Government Areas in Victoria, on the Index of Relative Socio-economic Disadvantage.³ We recognise the responsibility that this places on us to ensure that we strike the right balance between the quality/cost of our levels of service and what is affordable for our customers ensuring those most in need are protected with a 'social tariff'.

Our current package provides the regional community with "good quality at a low cost", which we are confident is a trade-off that matches our community's needs and expectations. We are proud that our household water bills are amongst the lowest in the state, even though our average household water consumption is 2.8 times the Victorian average due to the raised temperatures and low rainfall of the region.

The value of our current approach and performance can be seen in:

- The high level of customer satisfaction recorded in our customer surveys and the low level of complaints received
- Our low average household bills
- The high level of our performance for service continuity, where Lower Murray Water is recognised by the ESC as the best performer for the time taken to rectify leaks and interruptions to supply,⁴ and we have no cases of customers needing to claim under our Guaranteed Service Level scheme
- Our operating costs that are controlled and stable over time
- Our capital expenditure program that is well justified and is being delivered within the timeframes proposed.

² DPCD (2011), Change and disadvantage in regional Victoria: an overview May 2011

³ ABS (2011), Census of Population and Housing 2011. Compiled by <http://www.id.com.au>.

⁴ ESC (2015), 2014-15 Water Performance Report

4 Customer engagement

The Position Paper encourages water businesses to engage with their customers earlier and more deeply in the price setting process. The objective is to identify the priority outcomes that customers seek and to confirm the trade-offs they support between quality and price, before pricing submissions are drafted.

Response: Lower Murray Water welcomes and supports the focus on customers. Customers are and should be the core of our business focus.

Lower Murray Water has consultative committees that provide feedback on our performance and advise on priorities for future investment. We also engage our customers and seek feedback through a suite of other approaches including stakeholder briefings and surveys. We have low levels of complaints and high levels of reported customer satisfaction. Our Board members pride themselves on being representatives of the community and take account of customers' interests in their deliberations. They understand that our prices are constrained by market forces in the rural sector and by the ability to pay in our urban business.

We will ensure that our customers are actively engaged at an earlier stage in the next price submission. The ESC's conference in November 2015 providing valuable evidence of a range of techniques & practices across various industry types. For example, we were interested to learn of the approaches adopted by some of the large water businesses in the UK and Melbourne involving deliberative research groups.

Lower Murray Water welcomes the challenge to implement more extensive and innovative customer engagement approaches to test and validate our business priorities and choices. We note, however, that some of these approaches can be implemented more easily where:

- There is a sizeable customer base. Proponents such as Yarra Valley Water, South West Water in England and Scottish Water, all service over a million inhabitants. That gives them access to funds and interested participants more easily than Lower Murray Water, with its highly dispersed customer base of 69,000 and a far smaller revenue base.
- There is significant growth, as this provides customers with choices about new directions and investments. Lower Murray Water faces low levels of growth in Mildura and Swan Hill and continuing decline in most other centres. We already provide high levels of performance against existing performance standards that meet customer expectations. There is little opportunity or demand from customers for any significant change in priorities.

5 Incentives

5.1 Rates of return

The Position Paper seeks to promote enhanced performance by introducing incentives that mimic a private sector model. In particular, it proposes to encourage more 'ambitious' performance by 'rewarding' better performers with a higher rate of return on capital.

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.

The paper accepts that there will be businesses who choose a less ambitious path:

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.

The ESC's decision on whether a water business justifies this premium will be judged against the acronym PREMO:

- **P**erformance: does the performance drive superior outcomes?
- **R**isk: has the business accepted greater risk on behalf of customers?
- **E**ngagement: has the business engaged deeply with its customers?
- **M**anagement: is the pricing proposal well founded?
- **O**utcomes: does the proposal demonstrate enhanced outcomes?

Response: Lower Murray Water supports the aim to provide incentives to promote innovation and greater efficiency.

Lower Murray Water would not see the offer of higher prices as an incentive to change its plans and performance. We are concerned to promote sustainable regional social and economic outcomes rather than drive for greater profitability. Our current package carefully balances the costs of our services with the ability of our customers to afford higher bills. Subject to the ESC guidelines Lower Murray Water is more likely to choose an approach that is closer to the 'standard' model, maintaining its current package of high performance at low cost.

Lower Murray Water should not be penalised for an approach that continues to deliver a package that matches its customers' choice. It is important that our customers believe they are receiving an optimal outcome. The terms 'standard' and 'ambitious' are value laden and risk undermining the confidence of our customers in our proposed service offering. We seek revised terminology and greater clarity on the criteria that the ESC will use to judge the relative performance and standing of the submissions.

The paper also proposes to adjust the rates of return within the pricing period in response to the businesses' performance outcomes.

Response: We welcome the challenge to demonstrate to our customers that we are meeting our service commitments within the price period. However, adjusting rates of return within the period could run counter to the objective of ensuring the accountability of water businesses by maintaining medium-term price paths. As a principle, adjustable rates of return could be seen to run counter to increasing the autonomy and preparedness of the water corporations to accept risk. It might also produce sub-optimal results by constraining LMW's flexibility to manage expenditure and respond to customer or climatic demands.

5.2 Cost of Debt

The paper proposes to introduce an approach whereby the cost of debt would be re-calculated each year as the 10 year trailing average value for the industry as a whole.

Response: LMW welcomes an approach that ensures that its costs are more properly reflected in its prices.

5.3 Autonomy and simplicity

The paper proposes to promote autonomy and adopt a lighter-touch or 'fast-tracking' approach for better performers.

Businesses putting forward high quality price submissions may benefit from a streamlined price review ... 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.

Response: Lower Murray Water would welcome greater autonomy and a reduction in regulatory oversight. This will ensure that the Board and management team are clearly seen as accountable for running the business. Our scarce resources should be targeted at delivering outcomes to customers rather than in negotiations with the regulator.

We believe we have earned this greater autonomy. This is exemplified by the quality of our last pricing submission, which was approved largely without challenge or change:

- The proposed service standards were approved in full without change
- The proposed operating expenditure was subject to a reduction of 0.8% – the lowest of all the regional water corporations
- The proposed revenues were subject to the smallest reduction at 2%
- We have consistently delivered against our performance commitments

This demonstrates that Lower Murray Water understands its business and its costs, and can be trusted to provide accurate and valid projections as the basis of pricing submissions. We welcome the opportunity to extend and expand our clear autonomy and accountability for managing our business.

We seek clear information and guidance about the criteria that LMW will need to meet for our price submission to be fast tracked and to help support our self-assessment. The Position Paper states that if a submission is deemed leading or ambitious it is likely to be fast tracked. We would argue that high quality, robust and well validated 'standard' submissions should also be eligible for this approach.

6 Demand assessment

The paper proposes to reduce the degree of regulatory intervention involved in setting the level of projected water demand in the pricing submission. This is an important variable as it determines the quantum of the water charge. The paper proposes, as a default option, to accept the water businesses' projections, but to impose a revenue cap to minimise any 'wind-fall gain' in the event that actual demand proves to be higher than forecast.

Response: This is a significant issue for Lower Murray Water:

- Our average household usage at 475kl/yr is 2.8 times the average of all other Victorian businesses
- That demand is highly variable by year, depending on temperature and rainfall, which determine the level of outdoor usage. The extent of this variability between years and seasons is far greater than for other water businesses.
- LMW's urban tariff income is based on 60% water usage in line with "user pay" principles - which gives customer greater control over the size of their bills but exposes the business to revenue risk. This risk was realised in the previous pricing period when LMW lost considerable revenue as a result of demand being lower and the costs of supply being higher than projected.
- We rely on water supplies from the River Murray, so drought conditions can trigger a requirement to purchase additional water in the allocation market. Low flows can also result in adverse water quality incidents such as outbreaks of blue-green algae. Both of these scenarios can result in higher costs for the business. This is unlike most other water businesses whose costs are generally fixed, irrespective of the volume supplied. This makes a revenue cap inappropriate
- In the current Water Plan, LMW employed a comprehensive approach to validate its projections, based on the best available evidence. However, the recent extended dry conditions, the introduction of the water rebate schemes and smaller house land-lots have all changed household behaviour and usage, so the expected "bounce back" after the drought did not occur. This means that our demand forecasting cannot rely simply on extrapolation from past experience, adding a standard volume for the projected growth in household numbers. We are having to re-establish a new baseline from which to make our demand forecasts
- We have also experienced greater variability and unpredictability in climate over the last ten years, which provides inconsistent trends upon which to forecast future demand. Unpredictable weather conditions will directly affect our revenues if they fall outside the modelling parameters
- We welcome greater autonomy to manage these risks within a flexible business management regime where we carry the primary accountability for our decisions within an overall framework
- We support a price-cap for urban services as the most effective and appropriate control mechanism to manage uncertainty and will implement it in a way that leaves Lower Murray Water with responsibility for risk management as far as possible and that minimises price shocks for our customers.