Southern Rural Water
Managing Water. Serving Communities.

12 June 2015

Water Team – Pricing Framework Review
Essential Services Commission

RE: REVIEW OF WATER PRICING APPROACH

Thank you for the opportunity to contribute to the Commission's review of its water pricing approach. Rural water management in Victoria has a different role, philosophy and history to urban water supply, and this is not often well understood. Our aim with this submission is to ensure that the particular context of rural water is recognised within the regulatory model, and that a model to regulate prices for urban water supply is not inappropriately applied to the entitlement based rural water management.

We appreciate that Commission staff have shown a genuine interest in better understanding our business, and in finding sensible solutions for particular regulatory challenges. However, this has typically occurred within certain constraints imposed by an interpretation of the previous WIRO – and we're keen to explore opportunities to find a more fit-for-purpose approach under the revised Order.

We note that the focus for this early stage of the review is on the pricing approach rather than specific details, and so we have kept our submission at this level.

Thank you again for the opportunity to contribute to this review. We understand that there will be much detail to consider in implementing any changes, and we are keen to be part of you continued engagement throughout the review.

Yours sincerely,

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SUBMISSION TO ESC REVIEW OF WATER PRICING APPROACH

Background

Southern Rural Water has four broad functional responsibilities:

- Managing dams to harvest and release water on behalf of bulk entitlement and water share owners
- Operating delivery systems in our three irrigation districts to give farmers efficient and equitable access to their entitlements
- Monitoring water systems and usage to ensure that water is only used in accordance with legal entitlements, and that entitlement holders have equitable access
- Assessing applications for new licences and processing changes to licences

Our particular context includes:

- A history of strong customer engagement in planning and pricing decisions.
- An informed customer base of business owners, for whom water is an economic good, who are exposed to international competition, who fully bear water security risk, who have significant investment in water infrastructure on farm, and who have access to a secondary trading market for water.
- A legacy of irrigation assets design that no longer supports best practice on-farm irrigation.
- A regulatory asset base that represents only 3% of the written down value of our assets
- A strategy of significant investment to upgrade infrastructure and improve service levels to enable more farm production – but which would be unaffordable without some external funding. This puts our customers at a competitive disadvantage compared with irrigation areas that have received full external funding for modernisation upgrades.

Objective of pricing regulation

We have always found the basic premise of regulation difficult to reconcile with our position as a government owned rural water business defined as “not for profit” – particularly given the history of rural water in Victoria.

We operate on behalf of the State in servicing our primary producers, and the importance of agriculture to the Victorian economy has ensured a prominent voice for our customers in matters that affect their productivity. Far from misusing monopoly

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power or earning monopoly rents – rural water management in Victoria has a long history of being under-priced. Achieving full cost recovery for rural water has been a challenge for successive governments over many decades.

The current industry structure emerged from irrigator rate protests in 1991, in response to a long term plan by government to move towards full cost recovery over 20 years. The Rural Water Commission at this time was receiving annual government subsidies of around $16 million, and was seen to be underinvesting in asset maintenance and renewal.

The 1991 rate protest saw irrigators withhold $30 million of payments for water rates and 400 farmers blockade the head office of the Rural Water Commission. The result was a price freeze and further reform which led to the creation of regionally based rural water authorities in 1994 – including Southern Rural Water. This gave irrigators a renewed opportunity to influence and advise the water businesses, and the water businesses benefited from the close engagement and input from customers into business decisions.

This legacy is not forgotten. SRW strives to maintain close relationships with those who own water entitlements. The inherent incentive for our business is to ensure that we work closely with our customers, and to provide the services they need at the lowest viable cost. If we fail in this, then we have failed in the purpose for which we were established.

In this context, traditional incentive mechanisms seem mis-targeted. What does it mean for Southern Rural Water to "keep" some portion of efficiency savings if we reduce costs? Who is the beneficiary of kept savings? Over Southern Rural Water's history, cost savings have always been returned to customers – either through reduced prices or investment in service, based consultation with our customer committees. The ability to improve the value we provide for customers IS the incentive for our business to operate efficiently. The prospect of retaining savings within the business, without benefitting customers, is not an incentive.

Customer influence in the rural sector was recognised in the Council of Australian Governments assessment of water reform in 1999, which found that:

As regards Rural Water Authorities (RWAs), the Council is satisfied with arrangements for separation of service provision functions from standard setting, resource management and regulatory matters. The Council in particular notes the roles of WSCs [Water Services Committees] *as regards setting of standards including price and delivery standards.*

Regulatory challenges

Dealing with risk

The regulatory approach inevitably involves finding a balance between flexibility and certainty, and managing risks. Most of Southern Rural Water's revenue comes from entitlement based charges, which means we have a relatively low exposure to seasonal revenue variation. However, we can still incur significant unplanned costs – particularly associated with floods.

We note that a risk premium is included in the pricing model through the Weighted Average Cost of Capital (WACC), which is applied to the regulatory asset base (RAB). However, our very low RAB gives very little capacity to manage risk - particularly by comparison to the metropolitan and urban sectors where RABs are typically much higher.

For the current regulatory period we had support from our customers to build resilience funds – using un-recovered revenue from our Water Plan 2. The funds will allow us to absorb unforeseen cost or revenue changes without amending our indicative price path

Interest rate risk

The application of the regulatory model also creates some risk by fixing a WACC for a regulatory period. We understand that the prospect of having prices fixed for five years with potentially volatile financial markets led some businesses to explore complex treasury management arrangements, such as interest rate swaps, to manage the risk of interest rate movements. Whilst this is an appropriate and prudent response, there is a cost and increased governance burden which could be avoided if a less rigid regulatory approach allowed for interest rate adjustments – just as prices are currently adjusted each year for CPI.

Capital program contingencies

Our scale has also presented challenges for managing uncertainty in capital projects. Most of our major engineering projects are quite specific in nature and we consider significant contingencies in our assessments. While businesses with larger capital programs might manage uncertainty across a portfolio of works – our program has historically been dominated by a small number of projects with a great deal of uncertainty.

In preparing our last Water Plan, we were also faced with the dilemma of planning for a significant capital investment contingent on partial funding – but without that funding confirmed. Potentially, we could propose two price paths in this instance – and two sets of service outcomes.

Planning for outcomes rather than delivery

The distinction between capital and recurrent expenditure within the current approach seems an unnecessary level of detail. This is particularly the case when planning to deliver new obligations or service outcomes. In preparing our second Water Plan we focussed on the annual cost of delivering outcomes beyond business as usual – without specifying – or necessarily having decided – whether we would deliver the outcomes using capital or recurrent costs. We were subsequently required to transform these proposals into specific operating and capital costs to populate a spreadsheet template. Whilst not a major burden, this did require additional work on our part.

More importantly, we have attempted to structure our Water Plans to be understandable to our customers. Customers shouldn't need to understand – or care - how depreciation is calculated, or how a WACC is determined and applied. However, we eventually need to reconcile our Water Plan proposal with our regulatory determination, and this has led us progressively to align our Water Plan documents with the regulatory templates – making them complex documents and difficult for customers to engage with,

As a business, we try to keep our focus on outcomes, and on understanding the trade-offs between service and cost – regardless of how the outcome might be delivered, and what that means for the particular costs.

Regulatory approach

While we may question how relevant the regulatory objective is to our context, we are supportive of any framework which helps to improve customer value, and which also protects our financial viability. Our particular interest is in minimising the regulatory burden, commensurate with what we would argue is a marginal regulatory benefit.

We are pleased that the revised WIRO retains two principles that we have seen as important:

- the flexibility for regulation to apply to prices, or to the manner in which prices are set
- the regulatory process remains as a propose/respond model – whereby the regulator must either approve our proposal, or make a determination by exception where it considers that our proposal has not complied with the regulatory framework

Since our first Water Plan, we have attempted to operate under regulation with minimal change to our planning and pricing processes. We continue to approach planning and pricing decisions with our customers in mind – rather than with the regulator in mind. We also aim to minimise the cost of regulation, which must ultimately be borne by our customers.

We have been regulated under a revenue cap (for the most part), and we have continued to set prices annually in consultation with our customer committees. Our annual process includes updating our regulatory asset base for works delivered and reforecasting our capital expenditure budgets, as well as recalculating an appropriate rate of return based on market conditions.

By way of example, our prices at the end of Water Plan 2 were between 5% and 18% lower than we had forecast in our Water Plan. More recently, we established a new corporate strategy in 2014 which includes ambitious cost reduction targets beyond our Water Plan 3 proposals. We have already realised some savings, and so we consulted with customers on pricing options in preparing our 2015-16 Corporate Plan. As a result of this, some customers will again have lower prices than forecast, while other customer groups have preferred to continue with existing price paths - particularly where we are working with them to develop projects for irrigation modernisation which will ultimately increase prices.

The building block approach

We do not necessarily subscribe to the assertion that a “building blocks” regulatory approach was mandated by the previous WIRO – but rather that the WIRO sought to ensure the ongoing financial viability of water businesses by specifying that prices should be set to recover the various cost elements.

Notwithstanding this, we have traditionally set prices based on building block type budgets, and expect that we will continue to do so. The issue we would like to consider is not whether our prices should reflect a certain set of costs, but rather how the regulatory process operates, and in particular how it can be structured to deal with the challenges identified above. Importantly, we want to ensure that the process is efficient, and respects our engagement with customers.

We have generally enjoyed a positive working relationship with Commission staff, and found flexibility within the existing processes and approach to accommodate particular regulatory challenges and to find sensible outcomes. However, we believe there is still scope to lessen the regulatory burden and reduce costs for our customers.

For example, one issue we experienced with the previous price reviews was that we were required to produce demand forecasts and to have then reviewed by a consultant. In the case of our second price review, the demand review included invalid findings because the consultant failed to understand our business, and didn’t understand the difference between a licence to take and use water, and an application for a licence. More fundamentally though, when the outcome of the review process is a revenue cap, we fail to see the relevance of demand forecasts. This seems to us an unnecessary cost.

In the interests of reducing the regulatory cost, we offer two alternative approaches below. These are not necessarily alternatives to using building blocks in setting prices, but rather alternative processes for assessing proposals.

Possible alternative processes

Indicator prices with approved variance bands

This is a model we proposed in our first Water Plan, and is similar to the way we have operated in practice. Under this model, our Water Plan would propose:

- 'indicator prices', being forecast prices for each year of the regulatory period; and
- 'variance bands', being margins for variation of future prices within which further approval of the ESC is not required

Each year we would determine prices in consultation with our customer consultative committees, and either:

- advise the ESC of our prices where they remain within our variance bands; or
- seek approval if proposed prices that fall outside our variance bands

Price monitoring

We have reviewed the June 2014 Review Of Victorian Ports Regulation, in which the Commission proposed light handed regulation in the form of price monitoring.

This proposal was informed by a finding that the Port of Melbourne Corporation was not misusing its market power – based on the observed movements in prices, service quality and profitability over the current regulatory period.

We would argue that the same assessment could be made of Southern Rural Water, given our close engagement with customers and the pricing outcomes we have delivered over the last three regulatory periods.

We would be interested in understanding more about how price monitoring operates in practice, and whether this approach might be appropriate for our circumstances.