



24 June 2015

Mr Marcus Crudden
Acting Director, Water
Essential Services Commission
Level 37, 2 Lonsdale Street,
MELBOURNE VIC 3000

By Email: water@esc.vic.gov.au

Dear Marcus,

RE: Response to Review of Water Pricing Approach Consultation Paper

Western Water welcomes the opportunity to make this submission in response to the Essential Services Commission's (ESC) consultation paper into the Review of Water Pricing Approach (April 2015). This is an important opportunity to frame a new regulatory approach that encourages the efficient delivery of affordable water and sewerage services. Western Water has demonstrated its support and willingness to drive efficiency for improved service outcomes in our 2013 Water Plan submission where operating expenditure productivity target exceeded the ESC's benchmark.

Western Water actively pursues efficiency gains across its business function including through economies of scale and scope. We are supportive of a regulatory framework with a greater focus on incentives and benchmarking. We believe that this can be achieved by incorporating incentive mechanisms within the building block framework.

While we remain open to more incentive based regulation, we are cautious about the adoption of any major change due to the limited time before the next price review. There is insufficient time for appropriate consideration of any proposed modifications to the building block framework or of a more significant new framework. A longer consultation period is required to allow the ESC and the industry to explore any financial and operational impacts of a new regime. Proposed changes should form part of a longer reform path, including operating the new framework in shadow for at least one regulatory period.

When assessing new regulatory frameworks, the ESC should consider any additional costs and the benefits that are likely to accrue for our customers. The additional costs of regulation should be evaluated against the costs imposed on businesses, the industry as a whole, the department and the ESC.

More detail is provided in four sections below: (1) review of the regulatory framework, (2) timeframe and process for framework development, (3) implementation of the new framework for the next regulatory period, (4) cost of regulation, and (5) financial viability.



1. Review of the regulatory framework

Western Water supports the continuation of the building block approach for the next price review. Modifications to the existing productivity hurdle could be included, such as a customised approach for each business or an efficiency sharing arrangement. Any modification will need to be consulted on widely and agreed to by the businesses and our shareholder.

Each water business in Victoria is different. We provide different levels of service, we may be vertically integrated and serve both high density cities and sparsely populated regional towns. Any new regulatory approach needs to consider these disparities and that some models may not be suitable for every business. Customisation of model(s) for each business will require a large amount of time and effort to ensure the right model has been adopted for the individual business needs and to ensure the desirable outcomes are being targeted.

Different cost pressures and regulatory requirements exist across the business. Whilst cross-subsidies are minimised, economies of scale and scope can be achieved by combining planning and some delivery functions across the business. Additionally, some businesses are experiencing little or no growth in their smaller towns whereas other towns located on the fringes of Melbourne or in the Melbourne transport corridor, are experiencing large growth that requires large and lumpy capital investments.

2. Timeframe and process for framework development

This consultation paper does not present a preferred approach by the ESC. This open-ended approach does not give the detail, certainty or clarity required to estimate business impacts. The approach does not provide sufficient time for businesses with limited resources to research different frameworks and develop a position. Our Board needs a formal proposition to respond to rather than responding to a wide ranging discursive exercise involving 'thought pieces'.

Modifications to the regulatory framework should be considered as part of an overall reform path for economic regulation of water businesses in Victoria. The current review should form part of a larger program of continued improvement in regulation rather than a one-off review. This will enable businesses, particularly those with small regulatory teams, to review the proposal, interpret how it will work for their business and undertake modelling to estimate the financial impacts over the longer term.

3. Implementation of the new framework

The timeframe proposed by the ESC is too short to implement a new regulatory framework. Other regulators have taken a longer period to implement changes. A new regulatory framework is likely to involve system changes to capture the new data required and re-profile historical data. This will require significant time to implement and will be a particular constraint in the lead up to the next price review. Our staff will need to be dedicating time towards preparing the next price submission including consultation with key stakeholders and customers, and addressing Whole of Water Cycle Management and climate change policies, rather than developing alternative data issues.





Western Water would like to see any changes to the existing regulatory framework implemented only after adequate consultation, and that resourcing be made available to ensure successful implementation. It is suggested that the new regulatory framework be applied through a hands on learning approach such as operating the new framework in a shadow period.

A shadow period for the new framework would run for at least one regulatory period. This would enable both the industry and the ESC to assess the impacts on operations of the new framework without causing unnecessary stress, financial or otherwise. It will also provide an understanding of the potential benefits and costs of changing the regulatory framework.

4. Cost of regulation

A concern in implementing a new regulatory regime is the cost it will impose on the business. A new approach may require the business to collect more data and re-categorise historical data to fit the new framework. This cost is likely to manifest in one of two ways – (1) increased staffing requirements to handle information requests under different approaches and (2) changes to systems and processes to allow for the collection of data.

The use of any data for comparative purposes would require significant effort in development of definitions of expenditure activities, identifying differences in historical reporting and interpretation of the data. A significant amount of time and effort would be required by both the industry and the ESC in developing clear definitions and a reporting framework to ensure consistency.

The productivity work done to date does not provide for meaningful comparison across businesses due its high level analysis. Both the data provided by businesses and the operating environment have not been captured consistently for this type of assessment. This is because each business categorises expenditure differently and a detailed understanding of each businesses' inputs is required in the absence of a clear reporting framework.

Western Water is also aware of the additional cost of regulation that is likely to exist under new approaches applied to the water businesses. A more data intensive regulatory regime would place a greater burden on smaller businesses that need to undertake as much work as larger businesses but have a smaller customer base to spread the cost across. Western Water would like to see the ESC provide support to the small to medium businesses to undertake any new regulatory obligations.

Changes to the regulatory framework could also impose additional regulatory costs on the ESC. The current balance of costs and benefits is appropriate and to ensure this remains, a cap on licence fees should be considered.





5. Financial viability

Western Water supports measures to improve the current regulatory framework, providing the approach ensures that we remain financially viable. The requirement for financial viability of the individual business is no longer in the WIRO; however, it remains in the ESC Act which requires the ESC to ensure the financial viability of the industry. To ensure financial viability of the industry, all participants in the industry must remain financially viable in-line with the fiduciary responsibilities placed on the Board of Directors.

The regulatory framework needs to ensure that the revenue stream permitted can recover the costs of the business. This requires that any price determination allows the business to meet, at a minimum, the Victorian Auditor-General's (VAGO) benchmarks for financial sustainability. In VAGO's *Water Entities: Results of the 2013-14 Audits*, the auditor found that three businesses were rated as having a high financial sustainability risk and ten had medium financial sustainability risk. It was noted in the report that this was partly due to the regulatory framework allowing a shortfall between price and the operating costs for some businesses.

The financial viability of the business should also not be placed at risk during the implementation or transition to the new framework. There needs to be a balance between stretching the businesses to achieve greater efficiency and the long term financial viability of the business. If a regime is implemented without examining the potential financial consequences, it could lead to long term financial issues. This could occur through under-recovery of revenue, or under-investment in maintenance that leads to future capital expenditure. Efficiencies that are not achievable only result in deferral of expenditure. These outcomes can lead to price shocks for customers in future price reviews.

Further, a key component of the current regulatory framework is the re-opening and variation mechanism that exists in the current determinations. This ensures the continued financial viability of a business during a regulatory period. It is recommended that this provision remain under the new framework.

Yours sincerely,

A handwritten signature in black ink, appearing to read "Neil Brennan".

Neil Brennan
MANAGING DIRECTOR

