



12 February 2007

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

Essential Services Commission
Level 2, 35 Spring Street
MELBOURNE VIC 3000

Dear Commissioners

**2008 Water Price Review Consultation Paper
Framework and Approach**

We refer to the Essential Services Commission's (the **Commission**) *2008 Water Price Review Consultation Paper: Framework and Approach* (the **Consultation Paper**) released in December 2006. The Consumer Action Law Centre (**Consumer Action**) welcomes the Commission's early consultation in relation to the 2008 Water Price Review and would like to make the following comments.

Length of regulatory period and dealing with uncertainty

Consumer Action supports the setting of the second regulatory period at five years from 1 July 2008 to 30 June 2013. We agree that the process of reviewing water prices is administratively burdensome and costly for the Commission and the water industry, costs which are eventually passed onto consumers through water prices. We also agree that a longer regulatory period can support a longer term planning horizon by the regulator, the water businesses and Government policy makers. Given that water and water regulation have become politically charged issues, we agree that a longer term policy plan for the water industry has the potential to bring about better outcomes for consumers and the community at large.

We note, however, that there can be short term uncertainty or unexpected developments which arise within the regulatory period. As such, we accept the need for an adjustment mechanism to deal with ongoing uncertainty. However, any such adjustment mechanism must be limited in its application. Allowing water businesses a broad power to reopen price determinations would reduce their incentive to undertake appropriate planning and would increase regulatory costs. Further, we would expect any adjustment mechanism not to unfairly expose customers to risk or price fluctuations. Residential consumers are in many respects the weakest party in the market, and have a limited ability to bear sudden price changes. Furthermore, we agree with the Commission that demand related events should not result in the adjustment of prices. The impact of climate change and the ongoing drought has become a way of operation for water businesses in Victoria, and should not be used as an excuse to reopen price determinations.

We also suggest that the question of the length of the regulatory period be re-considered prior to the third regulatory period to determine whether five years is still appropriate.

Service standards

Service standards are extremely important as they underpin expenditure proposals and the proposed prices of water businesses. We note that the Commission plans to accept service standards based on historical performance. While this approach enables the Commission to limit costs associated with any requirement to improve service standards, thereby limiting price increases over the regulatory period, we are concerned it may entrench for some businesses standards which are far below that received by customers serviced by other businesses. The Commission acknowledges that service standards vary significantly among businesses. We see value in making service standards more consistent, especially for urban businesses, so that Victorian consumers can expect a similar level of service no matter where they live.

The Commission also states that any improvements to service standards must be informed by customer views and preferences. In particular, businesses must provide evidence of consultation with customers and evidence of their support and willingness to pay for the proposed service standards. We agree that robust customer consultation is integral to a business developing its price-service proposal. However, based on the experience of the first regulatory period, we are concerned that water businesses are not adequately consulting with their customers. A research report soon to be released by Consumer Action on the first water price review concludes that poor customer consultation significantly impinges upon the ability of the water price review process to bring about outcomes that are beneficial to consumers. While we hope that businesses will engage in more robust consultation with their customers for the forthcoming water price review, we believe it is incumbent upon the Commission to critically analyse the extent and adequacy of customer consultation before accepting a business' proposals.

We are also concerned about the use of "willingness-to-pay" studies to determine consumer preferences. Such studies are usually undertaken by market research firms which reduce consumer preferences to dollar values. Such analysis does not always take into consideration the views of different classes of consumers nor does it consider the differences in value attributed to different consumers.

We strongly welcome the addition of two core service standards relating to customers experiencing payment difficulties, being restrictions and legal action for non-payment and the number of customers assisted under hardship schemes. While such matters are reported on in the performance-reporting framework, linking them to the price review provides an important incentive for water businesses to achieve optimal outcomes for consumers. However, rather than numbers of customers assisted through hardship schemes, a more beneficial service standard might be levels of customer compliance with alternative hardship payment arrangements. Such a standard would ensure that businesses establish appropriate hardship arrangements and do not set payment plans that are not in accordance with a consumers' capacity to comply. We note that for the first regulatory period, Yarra Valley Water proposed a similar service standard in relation to its hardship programs.

We also welcome service standards relating to drinking water quality, environmental discharge requirements, and water re-use and recycling.

Guaranteed service level payments

We strongly support the extension of the guaranteed service level (**GSL**) payment scheme to all urban water businesses. In our view, customers who receive poor service should not have to pay the same as customers who receive average or better levels of

service. We support the Commission developing a core set of GSLs to apply across the whole water industry.

In the last water price review, the Commission did not approve proposed GSL standards where a water business was obliged to meet that particular standard already, either under the Customer Service Code or under some other obligation or law. In our view, while the existing obligation should encourage water businesses to meet standards without a GSL payment, GSL payments can also act as an important mechanism to promote compliance. We acknowledge a concern that where such payments are used as an enforcement mechanism, businesses may be encouraged not to meet the service standard and instead make the payment where it is cheaper to do so. In our view, if such an outcome occurs, the GSL payment should be increased to ensure the business is incentivised to improve its service. The wrongful disconnection payment payable by energy businesses, when a consumer is disconnected contrary to the provisions of the Energy Retail Code, is an example of the operation of such an incentive scheme, where an amount becomes payable although there is already an obligation to provide a particular level service.

We would also welcome a GSL payment in relation to water businesses' hardship policies, which could be payable when a water business does not treat their customers in accordance with their hardship policy by, for example, disconnecting them when they are participating in a hardship assistance scheme. Such a payment would encourage compliance with the provisions of hardship policies. This would operate in a similar way to the wrongful disconnection payment, discussed above. The wrongful disconnection payment has been particularly successful in ensuring compliance with the Code, and reducing the level of disconnections.

Expenditure proposals

Capital expenditure projects, often being extremely large investments, can have the largest impact on water businesses' revenue requirement and prices. As such, water businesses should be required to set out clear details about capital projects in their Water Plans, explaining priorities as well as identifying actual capital expenditure undertaken in the past. Reporting of capital expenditure that was promised during the last regulatory period will inform the Commission's analysis of current expenditure proposals.

We also believe that explanations of capital expenditure should provide details of levels of debt financing. Without new debt, current water consumers will be required to pay the full cost of infrastructure which will also be of benefit to future consumers. In our view, the cost of providing water should be recovered on the basis of the inter-generational equity it will deliver. Given the extent of water infrastructure planning resulting from the development of Sustainable Water Strategies and other government policies, we believe that water businesses must consider debt funding. Appropriate borrowings for capital investment are an important mechanism for balancing water security with the costs to be eventually borne by customers. We believe that the Commission should review the level of debt financing of capital programs to ensure that the burden to current consumers is lessened and that expenditure is more equitably recovered.

Incentive mechanisms

We support the introduction of an incentive mechanism or efficiency carryover as a measure which provides incentives to businesses to pursue efficiency improvements. Such a mechanism, if implemented appropriately, would be in accordance with the requirements of the Water Industry Regulatory Order (**WIRO**). However, any incentive

mechanism must be well conceived, be efficiently implemented, and be adequately monitored to ensure customers benefit.

We would also suggest that any efficiency benefits be appropriately shared between consumers and the businesses. Consumer activities can significantly influence the magnitude of efficiency gains. For example, efficiency in water businesses may be influenced by how consumers interact with businesses (paying bills, obtaining information, using call centres, reporting problems) as well as consumers' demand for water, especially through initiating and participating in demand reduction initiatives.

We also recommend that where practical and efficient, the Commission should go beyond comparing businesses' overall forecast and actual expenditure and understand the main activities responsible for significant efficiency gains or losses. This may greatly assist in the promotion of efficiency improvements.

Tariff structures

The following comments in relation to water and wastewater tariff structures focus on urban consumers only, rather than rural (irrigation) consumers. While we recognise that the WIRO requires the Commission to approve prices that provide customers with incentives for the sustainable use of water resources, it is our view that prices are not necessarily the best way to deal with demand issues.

Consumers have already reduced their usage significantly over the last 10 years. In the metropolitan region, total per capita water use has reduced from the 1990s average of 423 litres a day to 331 litres in 2005/06 (without the use of restrictions).¹ Current restriction policies will result in lesser water use. While we note that current Government policy requires water authorities to work with the community to reduce total per capita water usage by at least 25 per cent by 2015, increasing to 30 percent by 2020 (compared to 1990s usage), due to the fact that demand for water is relatively inelastic,² we do not believe that water pricing is the best way to achieve these targets. Indeed, for many wealthier consumers who are not on limited incomes, increasing the price of water (even substantially) will not necessarily result in reduced water usage as they will be willing to pay much higher prices. Conversely, those on limited incomes will be most affected by increasing water prices.

While we remain supportive of inclining block tariffs, we are concerned that there is little evidence that they have contributed to reduced water consumption during the first regulatory period. We would welcome further research from the water industry about the effectiveness of inclining block tariffs, as well as their impacts upon consumers. Our continuing support is provided on the basis that the first block is set an affordable tariff and that it covers all non-discretionary water usage. That is, the first block threshold should be set at a level that is roughly the level of non-discretionary indoor water use.

We are particularly concerned that in the first water price review, the Commission did not adequately consider the impact of inclining block tariffs on households with differing compositions. Metropolitan businesses proposed a large household assistance package, the success of which (that is, the level of take up by households) has been variable. We believe, that in assessing a businesses' proposal for inclining block tariffs,

¹ Victorian Government, *Central Region Sustainable Water Strategy: Actions to 2055*, September 2006, p 39.

² See, eg, Foundation for Water Research, *Estimation of the Price Elasticity of Demand for water by means of a contingent valuation approach*. Report No 790/1/00.

the Commission must ensure that adequate measures exist so that large households with minimal elasticity of demand are not disadvantaged by inclining block tariffs.

We also maintain that the effectiveness of the inclining block tariff is severely limited by the large fixed component, which consumers are levied as a service charge. Many consumers complain that their water conservation efforts make minimal impact upon their bill because of the large fixed components that are charged. While we recognise that service charges are required, we would encourage the Commission to ensure that they are kept at the minimum so that a consumer's water conservation activities can have the most impact upon their final bill. We also note the impact of the annual parks charge which is applied to water bills. By including a charge on a bill that is unrelated to water use, the parks charge causes any price signal achieved by the inclining block tariff to be next to useless.

We also welcome further proposals to ensure that non-residential customers' variable charges also enable them to respond to price signals. In many ways, commercial and industrial users are more sensitive to price, and have more capacity to reduce usage. The Government has also announced support for alternative pricing options to encourage sustainable use by industry.³ It should not only be residential consumers who suffer cost consequences of high water usage, particularly given the relative amounts of water used by residential versus non-residential customers, especially in regional areas.

With respect to recycled water prices, it is our view that the Commission must revisit its approach followed in the first regulatory period of setting pricing principles. Although the penetration of access to recycled water is extremely limited in Victoria (ie, it is limited to a small number of "third pipe" estates), the Government is now mandating recycled water projects on a number of residential estates.⁴ With ongoing drought, such mandated projects are likely to continue. For the residents of these estates, recycled water will become an essential service and consumers need to be protected from abuses of monopoly power in terms of prices, pricing policies and standard of services. Users who are required to enter into a contractual arrangement for the supply of recycled water are captive customers of the water agency in the same way as customers of potable water and sewerage monopolies. Pricing principles are unlikely to be adequate protection, due to difficulties for consumers in determining whether uneconomic prices are being charged, and the limited oversight role of the Commission. An alternative approach may be to set a maximum tariff that considers the social and environmental benefits of access to recycled water services.

Customer contributions

The Commission states that upfront contributions for water or sewerage infrastructure have a limited ability to provide locational signals for developments and are not an effective mechanism to affect consumption behaviour. Nevertheless, it is our view that there is capacity for new customer contributions to promote water sensitive urban development.

It is our view that water efficiency measures are the most effective policy measure available. The degree of water efficiency of a property is significantly influenced by the developer. Considering this, water saving efforts can have a greater impact at the development stage, compared with the consumption stage. By allowing rebates or incentives to developers that promote sustainable outcomes, the Commission would be promoting the WIRO principle that prices should provide incentives for sustainable water

³ Ibid, p 50.

⁴ Minister for Water, Press Release – First Mandatory Recycled Water for Melbourne, 15 January 2007.

use. While providing appropriate signals about the cost of services is also a WIRO principle, we believe that there is significant capacity for customer contributions to promote sustainable development.

Should you have any questions about this submission, please contact me on 03 9670 5088.

Yours sincerely

CONSUMER ACTION LAW CENTRE

A handwritten signature in black ink that reads "Gerard Brody". The signature is written in a cursive, flowing style.

Gerard Brody
Senior Policy Officer