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A new regulatory framework for the Victorian water industry

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Introduction

The Australian state of Victoria will be implementing a new water pricing framework for the next regulatory price review in 2018. The framework will apply to 16 of the State's urban water businesses and Southern Rural Water.

In May 2016, the Essential Services Commission (ESC), Victoria's economic regulator, released a position paper setting out a proposed, new pricing approach and invited submissions on its proposal.³ Based on feedback received through this consultation process, the ESC released a final report in October 2016 that sets out the water pricing framework and approach that is to be implemented from 2018.⁴

The ESC notes that submissions were generally supportive of the overall proposal, in particular the focus on customer value and the incentives to prepare high quality price submissions. Accordingly, the water pricing framework set out in the October report is consistent with implementing the approach proposed in the May position paper.

This briefing note summarises the impetus for the new framework, its key features and draws attention to elements that have been modified, refined or firmed up since the ESC's May position paper.

Background

In Victoria, water utility services are delivered by 19 state owned businesses that report to the Victorian government. The water corporations provide a range of water services to customers within their service areas comprising water supply, sewage and trade waste disposal and treatment, water delivery for irrigation and domestic and stock purposes, drainage, and salinity mitigation services.

Melbourne metropolitan area, with a population of almost 5 million people, is serviced by three water retailers-distributors (see Figure 1), and a single wholesale water provider. The three retailers collectively serve 1.9 million customers and manage \$10 billion of infrastructure assets. The wholesaler, Melbourne Water Corporation, sources and treats water from a number of local catchments and a 150 gigalitre desalination plant.

¹ Principal, Synergies Economic Consulting.

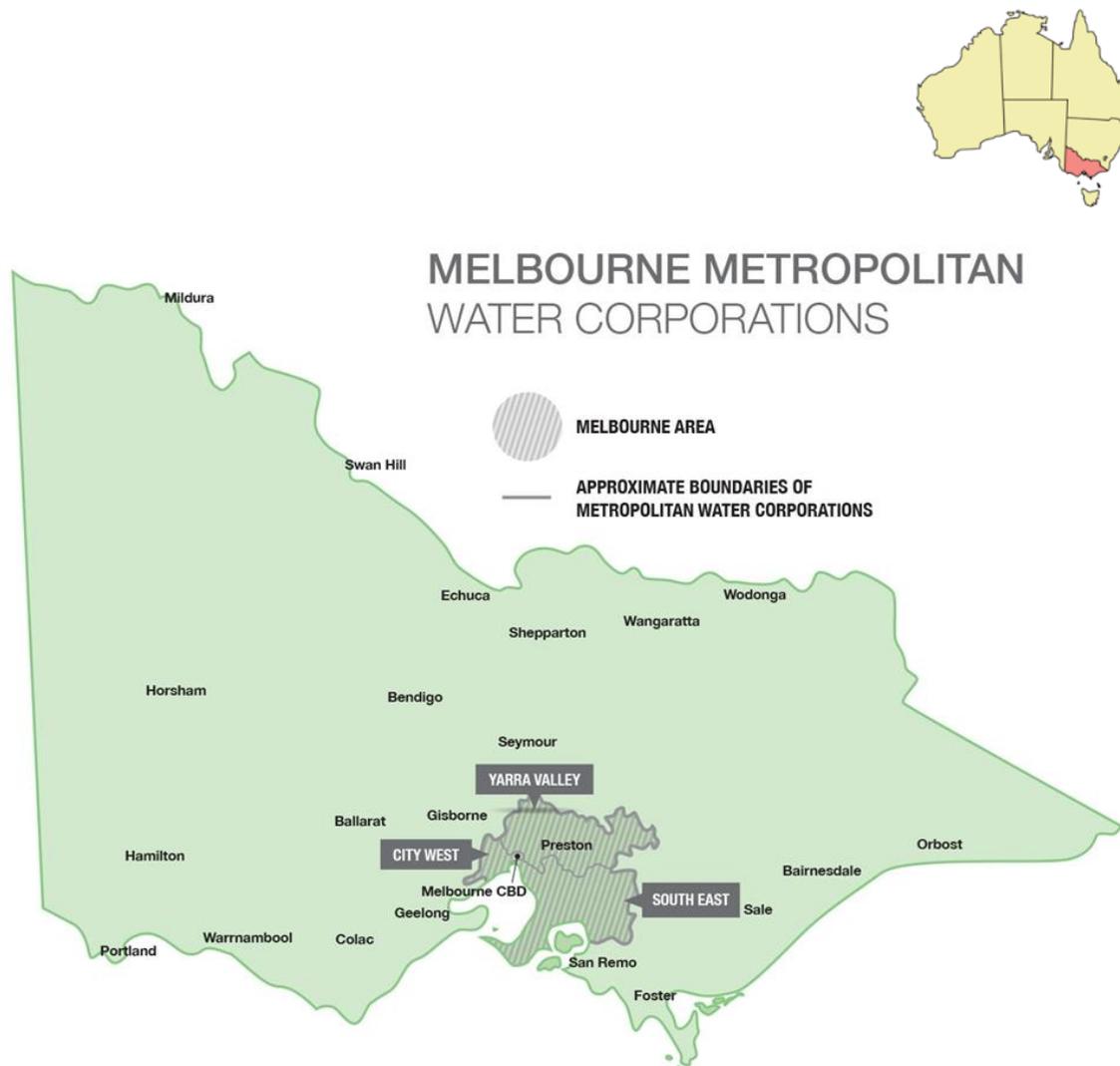
² Director, Synergies Economic Consulting.

³ A New Model for Pricing Services In Victoria's Water Sector, Position Paper, May 2016.

⁴ Water Pricing Framework and Approach - Implementing PREMO from 2018, October 2016.

Regional and rural Victoria is served by 13 water businesses, which provide water for both irrigation and town supply (see Figure 2). A total of 682,000 customers are located in regional areas. Each regional water business is vertically integrated.

Figure 1 Location of the Melbourne metropolitan water corporations



Data source: www.vicwater.org.au

Figure 2 Location of the Victorian regional water corporations



Victorian water businesses have been regulated under a ‘building block’ method since 2004. In the decade or so since the first regulatory review, this method has yielded tangible gains in the form of reduced costs and improved service to customers. There is also a much better system of performance reporting and greater transparency around how prices relate to costs.

Despite these gains, it has become apparent that more can and should be done to promote efficiency in the sector and better outcomes for customers. The ESC’s position paper identified the following limitations of the current regulatory framework:

- There is over emphasis on the scrutiny of input costs – and much less effort afforded to meaningful customer engagement as a means of shaping a business’s strategy and service outcomes.

- The efficiency incentives have not worked as intended. At present, provision is made for businesses to retain profits for a period of time if they outperform expenditure benchmarks. Water businesses have typically not demonstrated ambition to lift performance in return for these rewards.
- Businesses have not been encouraged or rewarded for choosing to have autonomy in setting their own performance goals (informed by customer engagement) to which they are held accountable.
- Businesses have limited incentives to be accountable to customers for delivering on their service commitments, as there have been no material consequences for water businesses that do not achieve the standards to which they commit.

These weaknesses have been the impetus for the ESC's search for a new and better approach that builds on the efficiency gains achieved thus far. The ESC sought to develop a regulatory approach that would deliver greater customer focus, more effective incentives to lift performance (both financial and non-financial), greater business autonomy, meaningful performance outcomes and regulatory simplicity.

Key features of the new framework

The new model has several key features that are crafted to work together to achieve ESC's stated objectives. The framework capitalises on the fact that there is a relatively large number of water businesses in Victoria, which provides some scope for competitive tension and comparative performance through rankings.

A central feature of the new approach is to reward those businesses that demonstrate 'ambition' in their pricing submission. Businesses demonstrating ambition are defined by those that choose to challenge themselves to meet all statutory and regulatory objectives while also delivering the outcomes and prices customers value. The reward will be in the form of a higher allowable rate of return (as opposed to the current regulatory approach in which a standard cost of equity is applied across all businesses). It is also expected that businesses will attain reputational benefits from producing a high quality submission, and this will further incentivise efficiency improvement.

The design features of the new framework are as follows:

An assessment framework for rating the quality of submissions (PREMO)

Five criteria form the basis of the assessment framework, referred to as "PREMO". PREMO is an acronym for the parameters of an assessment. Ambition will be assessed against the five elements of PREMO:

- Performance measures for outcomes have been specified and adhered to
- Risks to operations have been adequately managed and allocated appropriately

- Engagement with customers has been adequately demonstrated and shown to have informed the business strategy and service levels
- Management is effective, demonstrated through expenditure and demand forecasts that are well supported by data, based on sound methodology and aligned with outcomes to be delivered
- Outcomes are defined that represent an improvement in service standards

Self assessment

Each water business, in consultation with its customers, will determine the level of ambition to be adopted in its price submission. Businesses will be required to self-assess their level of ambition (and corresponding cost of equity) against the PREMO assessment criteria. After receiving the price submission, ESC will also rate it against the PREMO elements.

Using the PREMO assessment framework, price submissions will be rated by businesses and ESC as belonging to one of four categories: Leading, Advanced, Standard or Basic.

The allowed rate of return on equity will increase progressively with movement up the scale from Basic to Leading. As an indicative guide, the ESC has advised that the allowable cost of equity for a ‘Leading’ submission will be around 1.2% above that of a ‘Basic’ price submission (assessed in conventional regulatory terms). The allowable cost of equity for a ‘Basic’ submission will be below conventional regulatory benchmarks.⁵

This represents a significant departure from the previous regulatory framework in which a single weighted average cost of capital (WACC) was applied uniformly to every water business. Water businesses will continue to recover a benchmark cost of debt, but estimated using a ‘trailing average’ approach rather than the previous ‘on-the-day’ approach.

ESC advises that the allowed return on equity for a Standard price submission would be largely unchanged from the one expected under the current framework, given that this level represents a continuation of current outcomes and targets for cost efficiency.

Financial disincentives apply for businesses that overstate their level of ambition. An “incentive matrix” has been formulated (see Figure 3), which assigns businesses a return on equity that is lower than what it would have received had it accurately assessed its rating.

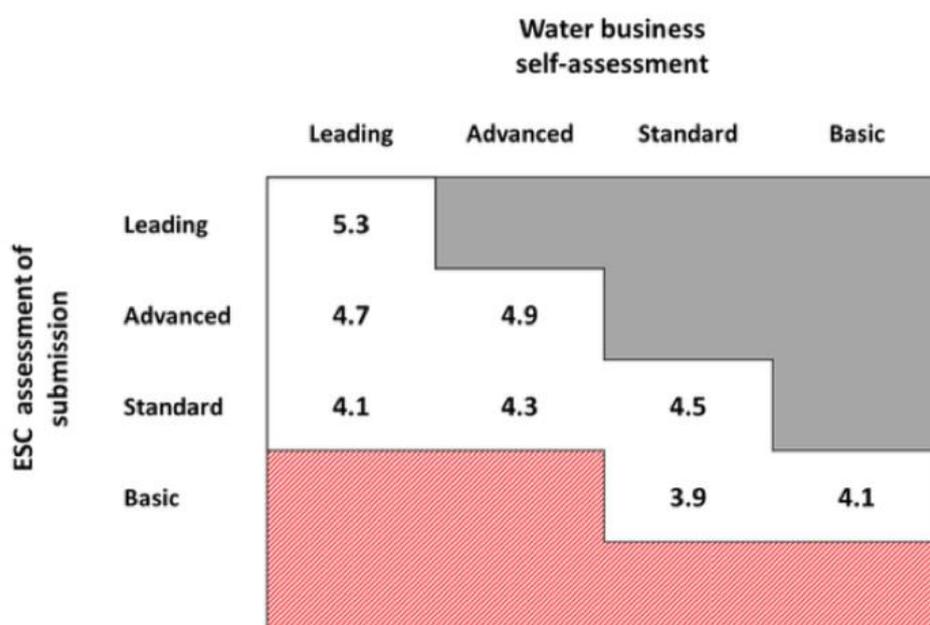
This is effectively a penalty for businesses that seek to game the framework by claiming a level of ambition that they know, or ought to know, to be untrue. Not only do they run the risk of their submission being downgraded (lowering the return on equity for which they qualify), they are also penalised to have a lower return on equity than would have been the case had they accurately assessed their level of ambition in the first place. There is a ‘red zone’ for very poorly developed submissions for which the consequences are unspecified at this time.

⁵ The cost of equity benchmark for the 2013 price review was 4.5%, which coincides with the level proposed for a standard price submission.

Provision made for within-period adjustments to cost of equity

The framework allows the cost of equity established at the start of a pricing period to be adjusted depending on how well a business performs against the outcome commitments in its price submission (however ESC indicates that in-period adjustments should be the exception rather than the rule).

Figure 3 PREMO Incentive Matrix – Indicative regulated return on equity (real).



Fast tracking

High quality submissions will be fast tracked through the assessment process to an early draft and final decision, potentially saving businesses costs and time and conferring reputational benefits on successful businesses – thus representing an added incentive to prepare a high quality submission.

The ESC does not intend to provide a check-list set of criteria for a business to qualify for fast tracking. Instead, it considers that a price submission can be fast tracked to an early draft decision if it is satisfied with the proposals in the price submission, and considers that no further enquiry is required because of the “significant, transparent and credible evidence put forward in the submission”.

ESC guidance on meeting PREMO requirements

ESC has advised that it will provide further guidance to water businesses prior to price reviews, as required under the Water Industry Regulatory Order (WIRO). This will supplement the framework that has been outlined in the ESC’s October report.

Customer engagement

The new framework requires businesses, as a first step, to engage with its customers and community to inform the outcomes to be delivered in a pricing period.

The ESC is not intending to prescribe the manner in which water businesses engage with their customers. It takes the view that each water business is best positioned to explore different approaches to find the engagement strategy that works best for its customers.

However, ESC has developed five principles for good customer engagement, which will form the basis of its assessment of price submissions.

1. The form of customer engagement undertaken by a water business should be tailored to suit the content on which it is seeking to engage, and to the circumstances facing the water business and its customers. ^[L]_[SEP]
2. A water business must provide customers with appropriate instruction and information, given the purpose, form and the content of the customer engagement. ^[L]_[SEP]
3. A water business's customer engagement should give priority to matters that have a significant influence on the services provided and prices charged by the business. ^[L]_[SEP]
4. A water business should start customer engagement early in its planning. The engagement should be ongoing, to keep testing proposals with customers. ^[L]_[SEP]
5. A water business should demonstrate in its price submission how it has taken into account the views of its customers. ^[L]_[SEP]

Outcomes and reporting

The new framework is to be 'outcomes focussed', which represents a key shift in emphasis from the previous framework (which has typically focussed on the cost of inputs). A business will be required to describe what its customers will receive for the prices charged, and how this relates to customers' expectations as revealed through the engagement. A business will also be expected to report its performance against the proposed customer outcomes, to clearly demonstrate whether it has delivered the customer value it promised for the prices charged.

According to ESC, the proposed customer outcomes will effectively replace the previous core 'service standards' encapsulated in the ESC's Customer Service Code (although ESC has committed to retaining the service standards as they do serve as a comparative measure of performance for specific metrics for each business from year-to-year, and also across businesses each year, so form an important part of ESC's comparative performance reporting program).

ESC stipulates that the outcomes should be:

- derived through engagement with customers

- be tested with customers to ensure they do capture and reflect customer expectations; and
- be measurable.

In addition to defining outcomes that reflect customer expectations and preferences, a price submission will need to contain/demonstrate:

- The measurable outputs and deliverables that will demonstrate achievement of each outcome
- The actions or programs that the business will undertake to meet the agreed targets
- The costs and cost savings associated with each of these
- How these costs are reflected in tariff structures and prices charged to customers

Form of price control

The framework requires businesses to clearly indicate the form of price control for each service, accompanied by an explanation of how the proposed form of control meets the WIRO requirements. The form of price control can include processes for approving individual prices, pricing principles, and explicit price controls (such as a price cap, revenue cap, or hybrid approach). The business must demonstrate that any change in price control has been undertaken in consultation with customers and takes into account risk management, price stability, transition arrangements, and customer choice.

Prices and tariff structures

ESC intends to continue its previous approach of allowing businesses a large degree of discretion to decide on tariff structures. Under the new framework, businesses will be required to justify any proposed change in prices or tariffs with reference to appropriate customer engagement and support.

Implications for water businesses

While the new pricing approach retains many of the elements of the current model (notably the retention of the building blocks methodology), there will be a substantial learning phase over which businesses will need to understand the new assessment criteria and how to prepare their pricing submission to meet the requirements of the new model.

The ESC has undertaken to provide more guidance ahead of the 2018 price review and this guidance will be crucial to water businesses successfully navigating the new environment. The PREMO criteria focus on matters that are within a business's control but each business will need to consider how the criteria apply to their own business, where they likely rate along the "ambition scale", what would be involved in lifting performance to the next level, and whether the incentives proposed by the ESC are sufficient to warrant the cost of attaining the uplift.

For some businesses, the new model will require a significant change in the way businesses engage with their customers. The model emphasises the need to make engagement the first step in developing a price submission, not a last step. This will challenge existing norms and require a deliberate cultural change within some organisations. There is a significant and deliberate attempt to shift away from formalised customer panels and representatives to place the focus on the business engaging with its customers – a development to be applauded.

The shift to an outcomes-based framework for measuring and reporting outcomes may also prove challenging for some. The aim will be to develop measures that give an overall view on business performance (i.e. how well it is meeting its strategy) as opposed to granular, engineering-based measures.

While the new approach may appear confrontational to some water businesses, it has several laudable attributes that will reduce businesses' incentives to game the process and will focus their attention on customers and outcomes. These initiatives will substantially enhance the accountability of businesses and boards in the regulatory process. It is the first time a regulator has offered regulated businesses a genuine opportunity to outperform its peers, another welcome innovation.