25 January 2013

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

Mr Marcus Crudden
Acting Director, Water
Water Price Review
Essential Services Commission
Level 37, 2 Lonsdale Street
Melbourne Vic 3000

Dear Mr Crudden,

Water Price Review 2013-2018

The Consumer Action Law Centre (**Consumer Action**) and the Consumer Utility Advocacy Centre Ltd (**CUAC**) welcome the opportunity to comment on the Metropolitan and Regional Businesses Water Plans for 2013-2018.

Our comments in this submission apply to the Essential Services Commission's consideration of the Water Plans of both metropolitan and regional businesses. However, our detailed comments are largely in relation to metropolitan businesses where proposed price rises, and thus consumer impacts, are likely to be greatest.

About Consumer Action

Consumer Action is an independent, not-for-profit, campaign-focused casework and policy organisation. Consumer Action offers free legal advice, pursues consumer litigation and provides financial counselling to vulnerable and disadvantaged consumers across Victoria. Consumer Action is also a nationally-recognised and influential policy and research body, pursuing a law reform agenda across a range of important consumer issues at a governmental level, in the media, and in the community directly.

About CUAC

CUAC is a specialist consumer organisation established in 2002 to represent Victorian energy and water consumers in policy and regulatory processes. As Australia's only consumer organisation focused specifically on the energy and water sectors, CUAC has developed an in-depth knowledge of the interests, experiences and needs of energy and water consumers.

Opening Remarks

Access to water is a basic human right, and the Commission must ensure that water remains affordable, especially for low income and vulnerable consumers. The impact of price increases is more than financial. A La Trobe University study which was funded by CUAC found that the health, welfare and wellbeing of rural seniors can also be adversely affected by high prices.[1] We believe that as an essential service, water must remain affordable for all consumers. The Commission's approval of water prices plays a key role in ensuring access to water remains affordable for all.

We do recognise that water is a precious resource and that efficiency is an important water pricing consideration. Attached to this submission is a policy position paper published by Consumer Action in 2012 about water pricing for sustainable household consumption.[2]

We note the new Water Industry Regulatory Order 2012 (**WIRO**), which provides a framework for economic regulation by the Commission for services provided by the regulated water industry. In particular, we note the change to the Regulatory Principles so that the Commission must separately 'take into account the interests of customers of the regulated entity, including low income and vulnerable customers'[3]. In our view, this stand alone principle (rather than being just one of a number of pricing principles) should be interpreted so that customer impacts, particularly impacts on low and vulnerable customers, play a stronger role in the Commission's decision making.

We are concerned that insufficient attention has been given to affordability issues in the water plans. We urge the Commission to ensure that there is an appropriate price path to ameliorate the impact of the proposed price increases and that the hardship support proposed by the water retailers is adequate to address the substantial price rises. We are of the view that all water retailers should be addressing hardship as a specific issue in their water plans and specifying additional hardship support, in light of the large price rises.

1 Collaboration between Centre for Water Policy Management and John Richards Initiative into Aged Care in Rural Communities, La Trobe University, *Water Products and Tariffs: Perceptions, Attitudes and Preferences of Rural Seniors (October 2012)*.

2 Available at: http://consumeraction.org.au/wp-content/uploads/2012/11/Water-Pricing-position-March12.pdf

3 Clause 14(1)(c), Water Industry Regulatory Order 2012.

Pricing and Tariffs

Price paths

The significant price increases proposed by the metropolitan water retailers will have a considerable impact on household bills and capacity to pay of some households.

Western Water (WW) has proposed a weighted average residential and non-residential water price rise of 8.9 per cent in the first year, followed by increases of around 8.5 per cent each year until 2017-18 ("smooth price path"). Yarra Valley Water (YVW), South East Water (SEW) and City West Water (CWW) have proposed steep price increases (weighted average of residential and non-residential water prices) of around 50 per cent for 2013-14 (YVW – 49.8 per cent; SEW – 50 per cent; CWW – 47.5 per cent) followed by CPI increases for 2014-18 ("matched price path").[4] While no further increases have been proposed by these three metropolitan water businesses for 2014-18, CPI increases alone could account for an additional 12 per cent to their proposed price rise.

These pricing proposals would result in estimated bill increases of between $269 to $343 for indicative owner-occupiers, between 2012-13 to 2017-18 (excluding the waterways and drainage charges $87.32 for July 2013, real 2.7 per cent increases for each year in 2014-18).[5] Over the same period, an average tenant's bill is estimated to increase by $134 to $177.[6] These estimates are indicative and the actual price impact for certain household types might be larger.

The substantial price increase, in particular the sudden introduction in 2013 (i.e. the matched price path proposed by YVW, SEW and CWW) is likely to produce bill shock for many customers and result in more customers experiencing hardship. While we welcome the additional initiatives which some water retailers have proposed to support customers experiencing hardship (e.g. YVW's SmoothPay billing option and the audit and retrofit assistance package;[7] SEW's alternative payment schedules)[8], they may be inadequate to address actual need. Further, CWW has not proposed any additional hardship support.[9] Given that the water concession for 2013 is capped at $277.04 for water and sewage services, and $138.52 for a single service (such as water), the concession would not cover the proposed price increase for some households. We believe that the concession framework needs to be reviewed so that water remains affordable to customers.

We acknowledge the complexities involved in determining the most appropriate price paths where substantial price increases are required, as there are pros and cons to each approach and different customers have different preferences depending on their capacity to absorb an upfront increase. A

4 Essential Services Commission, Summary of Regional Businesses Water Plans (November 2012), at 6.

5 Essential Services Commission, Summary of Regional Businesses Water Plans (November 2012), at 10.

6 Essential Services Commission, Summary of Regional Businesses Water Plans (November 2012), at 2-3.

7 Yarra Valley Water, Water Plan 2013-18, at 22, 41.

8 South East Water, Water Plan 2013-19, at 4, 13.

9 City West Water, Water Plan 2013-18, at 63.

matched price path allows water retailers to match cost with revenue. While a smooth price path minimises bill shock, it results in higher total prices for customers over the sum of the pricing period because the water retailer has higher borrowing costs in the initial years.

The metropolitan water retailers have taken an "either or" approach to the price paths—either the "smooth" price path or the "matched" price path. Alternative price paths have not been considered. A smoother price path, for instance, has not been considered by SEW and CWW. In contrast, YVW has stated that they are open to alternative price paths and "can envisage a price path something between a matched and an even price path that might have some appeal and ease the initial burden on customers."[10] However, YVW did not elaborate on how this might look like in their water plan.

WW has proposed a smooth price path after consultation with customers, while the other three metropolitan water retailers have proposed a matched increase. SEW has proposed a matched approach notwithstanding that their focus groups had a "slightly stronger overall preference for the smoothed option."[11] YVW has proposed a matched increase aligned with the preference expressed by their customers in focus group discussions. However, in YVW's online survey, the largest group (41 per cent) indicated a preference for a smoothed price path compared with 22 per cent favouring a matched increase. 31 per cent either did not know which pricing path they preferred or had no preference. 6 per cent indicated that they desired "something in between."[12]

The above feedback from customers suggests that the Commission should consider price path options along the line suggested by YVW. Combining the 41 per cent and 6 per cent from YVW's online survey, this indicates that close to half (47 per cent) expressed a preference for an alternative price path, compared with 22 per cent supporting the current proposal.

The preference for the smooth or matched price path also depends on the cost of each of these options to the business. This, in turn depends on the cost of financing the smooth option. If the cost of finance (or debt) is low then the smooth price path becomes more affordable and attractive. Conversely, if the cost of finance is high then the matched price path is likely a more affordable option for consumers. We note that in previous price reviews and in the Commission's recent consultation paper on debt management powers, the cost of debt for Victorian water businesses have been based on the 10-year Commonwealth bond rate plus a debt margin—in the latter this was calculated to be 6.9 per cent per annum in 2012-13.[13]

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10 Yarra Valley Water, Water Plan 2013-18, at 31.

11 South East Water, Water Plan 2013-18, at 10 (Table 2.1 Summary of customer feedback on our draft water plan).

12 Yarra Valley Water. Water Plan 2013-18, at 30-31.

13 Essential Services Commission, *Regulation of Debt Management Powers: Consultation Paper,* September 2012, at 20

Tariff structures

Inclining block tariffs (IBT)

The proposed metropolitan price increases for residential customers will occur within the existing tariff structures for water services. This comprises a fixed service charge and a variable usage charge based on the three step inclining block tariff (IBT).

YVW, SEW and CWW jointly explored customer preference regarding tariff structure. 42 per cent of the total respondents indicated a preference for the current three-step IBT; 22 per cent favoured a one-step tariff; 18 per cent expressed preference for a two-step IBT; 19 per cent either had no preference or did not know what their preference was.[14] While a majority (41 per cent) expressed preference for retaining the three-step IBT, 40 per cent indicated a preference for an alternative (one-step and two-step IBT). This suggests that there is room for improving the current tariff structure and perhaps moving away from the IBT which does not appear to perform particularly well on any of the three important measures of social equity, sustainability and efficiency.

Most economists agree that IBTs are less efficient than two-part tariffs with the variable charge set at the short or long-run marginal cost.

While IBTs do give access to lower-cost water for low income households with low or moderate usage, IBTs are also problematic on social equity grounds. Because they are based on household rather than per capita usage, in practice, they fail to distinguish between essential and discretionary use. In this way they penalise large households with a higher marginal rate for water, even though those households may actually be more water efficient than others. Aboriginal households, for instance, have a higher number of occupants on average than non-Aboriginal households. This, together with their cultural practice of hosting extended relatives for long periods of time, meant that bill-payers in such circumstances have little capacity to reduce consumption in response to price signals.[15] If IBTs are to continue, concessions need to accommodate larger households that are pushed onto higher blocks. In light of the social equity issue, it is also worth exploring other alternatives which better target subsidies to low-income and vulnerable consumers, such as discounted or wholly subsidised fixed charges for different customer classes.

Customers of YVW, SEW and CWW who expressed a preference for retaining the existing three-step IBT cited the need to encourage water conservation and reward low users.[16] We query whether respondents clearly understood the impact of the fixed service charges and variable usage charges in responding to the question on whether they preferred retaining the three-step IBT. We are not aware of

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14 Yarra Valley Water. Water Plan 2013-18, at 25-26, 58. Customers were asked, *"What are your views on the step tariffs? Would you prefer to keep the three-steps or would you prefer two steps or one?"*

15 Consumer Utilities Advocacy Centre, *Wein, Paen, Ya Ang Gim, Victorian Aboriginal experiences of Energy and Water (December 2011).*

16 Yarra Valley Water, Water Plan 2013-18, at 26.

any research demonstrating that IBTs have been effective in terms of demand management in Victoria. While we are not aware of any research and do not have the data to investigate this question, it would seem that the price signal an IBT sends to high water users who are perhaps using water wastefully or for discretionary purposes, are fairly weak because of the lower cost of the first block as well as the presence of a fixed charge.

The Commission has identified the continuation of the IBT by the metropolitan water retailers, as a matter that requires further investigation. We note that in contrast to the metropolitan water retailers, the regional water retailers have proposed variations of their current tariff structure. While fixed and variable charges would still apply, only three regional water retailers (Central Highlands Water, Lower Murray Water and Wannon Water) have proposed to retain the IBT for the variable component. Four regional water retailers (Wannon Water, South Gippsland Water, Goldburn Valley Water and East Gippsland Water) have proposed to increase the share of variable water usage charges relative to fixed service charges. [17]

While we are not opposed towards moving away from the current tariff structure, any move has to be supported by detailed analysis of customer impacts on various households.

The proposal to increase the share of variable water charges relative to the fixed charges would impact renters, especially those in regional areas. While the average metropolitan consumer's bill is already around 50 per cent variable, variable charges comprise 20 to 30 per cent of the typical bill for most regional water businesses. Given that total water charges are substantially higher in regional areas, the increase for some renters could be very significant. The annual tenant bill rises by $116 for East Gippsland Water (EGW) customers; this is the largest increase of any of the regional water retailers, mainly driven by their proposal to increase the proportion of water usage charges relative to the fixed service charge in customer bills.[18] Tenants would not see rents decreasing commensurately and moreover, tenants' capacity to respond to price signals with water efficiency improvements is severely constrained. Measures to assist tenants need to be put into place. We agree with the Commission, that the impact of increased share of variable usage charges in bills for residential customers of EGW is an issue that requires further investigation.

We recommend that the Commission and water retailers undertake research on how the current tariff structure can be improved, including modelling the impacts of alternative tariff structures such as the one and two part IBT, and variations to the proportion of fixed and variable charges on a customer's bill, for different households (including seniors, low income, owner occupier, and tenant occupier households). We recognise that this is a complex matter and that different household types have different preferences. In contrast to tenants, increasing the share of variable water charges to the fixed charges might be preferable for some seniors. In a 2012 La Trobe University research study which was funded by CUAC, "participants expressed frustration with current tariff structures that are heavily weighted towards the fixed component. They complained that this approach was irrational and failed to

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17 Essential Services Commission, Summary of Regional Businesses Water Plans (November 2012), at 6-9.

18 Essential Services Commission, Summary of Regional Businesses Water Plans (November 2012), at 5.-

send a conservation signal. For single or double person households such as these, the current bill structure affords little possibility that reduced usage will result in a reduced financial impost."[19]

Customer tariff choice

We note that YVW proposes an 'opt-in' trial of a 100% variable price for 1000 consumers. It appears that this trial is designed to inform the potential of customer tariff choice in future regulatory periods. In general, we are concerned about the application of "choice" to water tariffs, as it has the very real prospect of confusing consumers and doing so without delivering any substantial consumer benefits.[20] Experience with choice in industries such as energy, telecommunications and even banking suggests that while there may be consumer benefits from consumers making a choice that suits their preferences, adding tariff complexity and choice can also add to consumer costs. If a consumer has to spend time comparing different options, it imposes search costs. If the other benefits of choice are low, then these search costs can outweigh the benefits that the choices can provide. Any movement towards greater tariff choice needs to carefully assess the actual costs and benefits of any change.

While we support YVW's trial—it may indeed provide useful data to test our concerns—we submit that the results should be made publically available, so that a wide range of stakeholders can consider this issue more closely. The trial could inform any developments on the improvement of the current tariff structure. YVW is the only metropolitan water retailer to propose variable tariffs for customers in a customer trial. We would support other metropolitan water retailers also undertaking further trials.

Fixed service charges for all properties

Water retailers have proposed to move away from basing fixed water and sewage charges on a property title basis to a connection (or residence/business) basis. This proposal is equitable; we understand it would affect a relatively small number of property owners who live in a site with multiple residences on a single property title. We support the proposed two phase introduction of this measure (50 per cent of the charge applying in 2014-15 and full implementation in 2015-26)[21] as it would help to reduce price shocks to property owners. These changes, however, need to be clearly communicated to affected customers, who should also at the same time, be alerted to any support and payment options that may be available to them to manage the change.

D-Factor

We agree that customers should not pay for desalination water costs until water from the desalination plant is ordered; that is, the water price passed to consumers will reflect the actual cost of the order. There should, however, be an independent verification process to ascertain whether water is required and how much water is required, from the desalination plant.

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19 Collaboration between Centre for Water Policy Management and John Richards Initiative into Aged Care in Rural Communities, La Trobe University, *Water Products and Tariffs: Perceptions, Attitudes and Preferences of Rural Seniors (October 2012)*, at 9.

20 See Available at: http://consumeraction.org.au/wp-content/uploads/2012/11/Water-Pricing-position-March12.pdf

21 Essential Services Commission, Summary of Regional Businesses Water Plans (November 2012), at 6.

Recycled water services

Recycled water pricing should provide customers some incentive to use recycled rather than potable water where appropriate. Given the wider benefits of recycled water use, we believe that some degree of cross-subsidisation to recycled water customers is acceptable. Such cross-subsidisation, however, should be kept to a minimum, with recycled water prices set only slightly below those for potable water.

Scissor Effect

The metropolitan water retailers submit an allowance to be included in the 2013-2018 regulatory period for a so called "scissor effect". According to CWW's Water Plan, this relates to a revenue under-recovery from the 2009-2013 pricing period. The under-recovery is said to be caused by the Commission allowing prices that were higher than costs to be charged for the first two years of the pricing period, followed by charging prices lower than costs in the second two years.[22]

In our view, the assumptions underlying this under-recovery should be tested by the Commission. We note that it has been found that Melbourne Water in fact over-recovered desalination costs in the previous pricing period, and that these costs were passed onto consumers by the water retailers through prices. It was only when consumers discovered this after the publication of Melbourne Water's draft water plan that the Government took steps to force water retailers to repay the amounts in the current period.[23] Given this, we question strongly whether the water retailers did in fact under-recover in the previous pricing period, and if so, why retailers' costs exceeded the forecasts on which prices for the last regulatory period were approved.

Form of Price Control

Metropolitan water retailers are proposing to move away from individual price caps as a form of price control. SEW proposes prices be set via a weighted average price cap (or tariff basket) with a 3 per cent constraint on upward price movements, and YVW proposes a revenue cap with a 2 per cent constraint on upward price movements. CWW proposes to retain individual price caps, with an option to move away from this during the regulatory period.

In our view, any change from individual price caps may provide greater control to businesses, while reducing certainty for consumers. This is because a tariff basket or revenue cap approach allows retailers to shift costs between different tariffs and thereby shift costs between customer classes (i.e. between residential and business customers). While we acknowledge that generally an individual price cap might discourage businesses to take measures to reduce demand, as increased volume means increased revenue for the business, we think this is less of a problem for the water industry. This is because there are already a range of measures in place which encourage reduced water usage, and there is a cultural

[22] City West Water, Water Plan 3, page 6.

[23] Minister for Water Peter Walsh, *Media Release—Money collected for Labor's desal to be returned,* 19 June 2012, available at: http://www.premier.vic.gov.au/media-centre/media-releases/4208-money-collected-for-labors-desal-to-be-returned-.html

bias in water retailers to ensure water use is sustainable. Individual price caps also can provide incentives for cost reductions, which might be passed on to consumers in future regulatory periods.

We would ask for strong justification to be made by businesses before any move away from individual price caps, and we would oppose this move unless benefits to consumers can be clearly shown. While we understand that economic regulation is premised on allowing a reasonable return to the regulated business, there needs to be some consideration as to what level of return is acceptable. We note that in the latest annual reports for 2011-12, SEW, YVW, CWW and Melbourne Water paid $269.8 million to the State Government in dividends. Questions should be asked about whether this level of profitability constitutes reasonable returns. This should be given particular consideration given that government revenue raising through utilities charges can be more regressive than reliance on other more progressive forms of taxation.

Service Standards and Guaranteed Service Levels

We broadly support the proposal that service standards and guaranteed service levels should be based on historical benchmarks (i.e. a five year average level of service) but argue that business should be encouraged to improve service standards over time. In our view, the regulatory regime should encourage businesses to improve efficiencies over time.

We note that SEW is intending to reduce a number of its service standards. We challenge whether this is necessary and have particular concerns relating to SEW's intent to increase the target for the number of complaints to EWOV as SEW expects an increase in customer complaints following the proposed price increase in 2013-14. We also note that SEW intend to limit this service standard to complaints that are investigated by EWOV, not all complaints made to EWOV. In our view, if the transition to higher prices is well managed and publicised, the number of complaints will not necessarily rise; if complaints do rise, then retailers need to increase resources to deal with complaints, We note that, in any event, EWOV cannot investigate pricing, and that a water retailer is best placed to identify the impact of complaints about price rises, particularly as the complaint relates to affordability, and refer the customer to its hardship program. We welcome SEW's intent to increase focus on call quality and first call resolution, but believe that this should be reflected in service standards that align with its 5 year average.

SEW also intends to lower the percentage target of telephone calls answered within 30 seconds from 94.9 per cent to 82.7 per cent for accounts and faults, in order to prevent their costs from rising due to a necessary increase in staff. We acknowledge SEW's claim that costs may rise should service standards be maintained at the current level, but also note that the intended drop is over ten percent. This is a substantial figure that may cause consumer detriment. The Commission should clarify with SEW as to whether SEW has sought the views of its customers on their willingness to pay for this service level, and whether SEW has considered cutting costs in other areas to offset this cost.

We continue to support the operation of the Guaranteed Service Levels (GSL) payments, as they can provide redress for customers receiving poor service while also providing incentives for businesses to improve services. We note that the metropolitan water businesses are not proposing changes in their GSL schemes except for YVW which is proposing to increase the payment amount for 'no more than 3 sewerage interruptions within any 12 month period' and 'sewerage interruption restored within 4 hours' from $50 to $100. We submit that other retailers should increase the amount of payments to prevent GSLs from losing their relative value over time.

Revenue and Capital Expenditure

Capital Expenditure

Given the existing investment in the desalination plant (DP) to increase the water supply, we question the need for further capital investments and infrastructure investments in this pricing period, particularly as they relate to supply augmentation (including alternative water supplies). As prices are already significantly increasing for consumers, any further increase should be deferred unless it can be shown to be absolutely necessary, (i.e. renewals).

The Commission should also ascertain whether the proposed capital expenditure projects can be completed in the current price period. Past experience indicates that many capex projects (such as the DP) have been delayed. Capex should only be included in the current price plan where it is clear that it will be completed within this time period. We note particularly that SEW is proposing a 20 per cent increase in capex from the previous regulatory period. We think that the Commission should closely scrutinise these proposals to ensure that they are necessary in the current period.

Where expensive capital investments are required, the cost of these should be borne by the consumers who will benefit from this investment, that is, for the length of the life of the capital investment. As such, businesses should therefore consider appropriate use of debt rather than recovery only from prices, so that today's consumers are not excessively subsidising future consumers. We note that Melbourne Water considered charging DP costs over a fifty year period (the actual asset life) rather than the current proposal of 27 years. Although Melbourne Water rejected this, we would strongly suggest that the Commission consider the 50 year option more closely. While Melbourne Water suggests that this approach may result in reductions in service, it is not clear to us why this would be so. It is our view that appropriate levels of debt, is not 'counter to maintaining safe and reliable services and sound financial governance on behalf of the community'.

Operating Expenditure

We note that most of the operating expenditure of Melbourne Water relate to the desalinated water security charge. These costs are passed on to metropolitan water retailers through bulk water charges, also classified as opex. While we understand that Melbourne Water has treated these payments as opex due to its arrangement with the public private partnership that is building the desalination plants, we consider that at least some of the payment streams could be capitalised, and thus be paid off over a number of years. This may reduce the upfront cost to consumers through water bills.

The Commission should also closely consider the directly controllable opex of WW, Melbourne Water and CWW, all of whom are flagging increases for the new price period. These increases must be assessed and justified.

Demand Forecasts

In their demand forecasts, the businesses are assuming that there will not be a significant change in demand following the removal of water restrictions on 1 December 2012. In our view, the Commission should test this assumption with real figures (eg: the December 2012 to February 2013 period) before accepting these forecasts. We note media reports that indicate that Victoria's water use has increased since the removal of water restrictions. [24]

Concessions

While we recognise this is not within the control of the Commission, we are concerned that the significant price rises will reduce the value of the current capped concession rate. We are in support of the VCOSS call to make the water concession a percentage rather than a flat rate to allow concessions to naturally rise with price increases.[25] As a secondary option, we submit that water concession arrangements need to be reviewed ensure that water remains affordable for low income earners.
We recognise that concessions are a matter for the State Government, however it is our belief that the Commission must maintain its focus on issues of affordability in determining appropriate price increases. We suggest that the Commission make a formal recommendation to State Government to review concessions as part of its water plan review.

Similarly, water retailers must manage the impact of price increases on their customers, maintaining regular monitoring of hardship policies to ensure their relevance. We note that Coliban Water is proposing to improve their hardship policy, by introducing a payment plan incentive scheme.[26] We welcome this, and submit that all water retailers should similarly consider measures to improve their hardship policies so that consumers are able to maintain connection to this essential service.

[24] Jason Dowling, 'Is the wally back? Melbourne's water use surges', *The Age,* 18 January 2013, available at: http://www.theage.com.au/victoria/is-the-wally-back-melbourne-water-use-surges-20130117-2cwan.html

[25] See, VCOSS 2013-14 Budget Submission, available at: http://vcoss.org.au/state-budget-submission-2013-14/#make

[26] Coliban Water, Water Plan 2013-18, at 35.

Please contact the undersigned if you have any questions about this submission...

Yours sincerely

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