Coliban WATER

Your ref. **Our ref.** 201/18 **Contact:** Jessica Saigar 4408 5438

26 August 2011

Mr Andrew Chow
Director, Water and Local Government
Essential Services Commission
Level 2
35 Spring Street
Melbourne VIC 3000

Dear Andrew

2013 Water Price Review – Tariff Issues Paper

Coliban Water welcomes the opportunity to respond to the Essential Services Commission's Tariff Issues Paper for the upcoming water price review.

Our attached response is focused on four key areas:

- our support of tariff options and customer choice;
- our support for the removal of inclining block tariffs (IBTs);
- an argument against locational based pricing; and
- non-price cap regulatory mechanisms.

The ESC's paper and our response both highlight the fundamental change Coliban and others will be embarking on in the upcoming regulatory period, i.e. the removal of IBTs and possibly offering customer choice tariffs. It would be appropriate if the ESC provided an in-principle endorsement of the approaches put forward by Coliban and others in their response to your paper.

At the end of our response, we have highlighted our views on three additional areas of pricing that will be relevant to the 2013 Price Review. These are rural tariffs, equality between residential and non-residential pricing, and the merits of meter based charging.

If you have any queries or would like to discuss any positions raised, please contact Jessica Saigar on 4408 5438.

Yours faithfully

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	Question	Coliban Response
Proposed pricing principles	Do the proposed principles adequately address the WIRO and other relevant requirements in relation to pricing matters?	The proposed principles tend to reflect the WIRO. The subsidy free pricing and inefficient bypass principle seems to be beyond the existing price approval considerations in the WIRO. The WIRO only requires that the ESC should be satisfied that prices provide the appropriate signals to customers regarding the cost of providing services. Further comment on this principle is provided below.
	What amendments – changes or additions – are needed to ensure the principles are clear, useful and applicable in the 2013 Water Price Review	3.2 Economically Sustainably Revenue: Coliban proposes no changes or additions to this principle and supports it as one of the ESC's pricing principles. 3.3 Subsidy free pricing and inefficient bypass: The majority of customers, if not all customers, do have prices that lie between the avoidable and the standalone costs. Coliban applies postage stamp pricing across three distinct districts. Water customers are either Northern, Central or Non-potable, and sewerage customers are either Major, Enviro 1 or Enviro 2. Within the Central district, for example, the level of avoidable cost varies from town to town, as does the standalone cost. This principle is consistent with postage stamp pricing as long as the town with the highest avoidable cost is lower than or equal to the town with the lowest standalone cost for the same customer class. The customers whose standalone cost is the lowest are contributing a higher proportion to the shared fixed costs and common fixed costs even though they are paying the same price. An important thing to note is whether or not customers in small townships are receiving greater quality of service, or value of service, than densely populated areas. If not, it would seem unfair that for the same value of service that is received, small townships would face higher prices than densely populated areas. Our board has endorsed a principle of regional equality – customers receiving similar services should pay a similar price.

		Differential pricing occurs between residential and non-residential water customers, and many would suggest that these are two different customer classes. However, the question remains if a café next to a house is in a different customer class to the house. Coliban would suggest that these are the same customer class – as they receive the same level of water service (but not necessarily wastewater service). In regards to rural pricing, it should be at the businesses' discretion of how to allocate the fixed costs amongst its users as long as prices are set between avoidable and standalone costs. Incremental cost has been used as the method for reviewing whether a new project proceeds. 3.4 Tariff structure: These principles are in line with our Board endorsed principles of tariff simplicity, innovation and fairness. 3.5 Volumetric charge: It is unclear if this principle is implying long run marginal costs (LRMC) or short run marginal costs (SRMC). If Coliban deems that the 'relevant marginal cost' is SRMC, then the volumetric, or variable, charge would be practically zero when dams are spilling. However if we presume that the relevant marginal cost is LRMC, the variable charge would be greater and more closely matched to our current first tier price. However, we need to take into account what our customers want. Feedback from our customers continues to indicate that they wish to have more control over their water bill; variable prices may need to be greater than LRMC to accommodate our customers' wishes and to ensure our tariff structures are in line with government policy. Given the wide interpretation of 'marginal costs' and as long as the WIRO principles are met, this ESC principle should, however, not impose additional restrictions on our business. 3.6 Customer focus principle

		Simple tariff structures are important for customers to understand and respond to price signals . In regards to service standards, customer preferences must be taken into account. If customers wish improved level of service or want new services, and are willing to pay for this, then the business should deliver on these. The marginal cost of implementing new tariff options is expected to be small, as a number of communications are regularly made to customers through quarterly bills and annual tariff approvals. Price path stability reduces price shocks to customers. Any move away from IBTs should be accompanied by a clear transition strategy. Hardship policies play an important role in assisting low income and vulnerable customers and it is important businesses promote Government assistance, rebates and grants.
	Are there any other matters that we will need to consider in applying these proposed principles?	The ESC needs to consider the appropriateness of applying these principles across all water businesses equally – different businesses with different customers may have different preferences. The ESC should also consider the impact of tariff choices on different classes of customers. If low use customers are offered a different tariff, uptake of this will only occur if it results in an overall lower bill to them compared to the default tariff option. Careful application of subsidy free pricing within customer classes should be applied when considering transitional impacts as businesses move from IBT to one variable price – higher users may be better off and lower users may be worse off.
Form of Price Control	What tariff innovations could be proposed for the 2013 Water Price Review period?	Tariff innovations are available to address pensioners and large families' perceived inequity. For pensioners a high variable charge with zero or very low fixed charge could apply. This would allow pensioners to have (almost) complete control over their water bill. Large families may find they are better off with a lower variable charge and a higher fixed charge than the default option. This choice would ensure residents and businesses pay the same amount for the same volume of water.
	What are the implications	With a number of tariff options available that will most likely affect the very high and very low users of water,

	for the form of price control?	tariff baskets, average revenue yield, revenue caps or hybrids (including some price caps) might be best suited to manage the prices of these users. To provide incentives for businesses to implement non-IBT and more innovative tariff options, such as no fixed and high variable, more flexibility in annually setting of these prices is warranted. Price caps do not provide enough flexibility to ensure the tariffs for these users do not result in any perverse incentives. Revenue caps are one example of a price control mechanism that provides flexibility. This price control mechanism allows businesses to respond to changes in demand. It does this by setting revenue based on long term forecasts that is allowed to be collected every year of the quinquennium. Each year the business reports their revenue to the regulatory body to determine the over and under recovery that occurred and their allowable revenue is adjusted. From this, the business forecasts demand for one year and prices are solved to generate the allowable revenue. This mechanism reduces the uncertainty that exists in long term forecasts, and the resulting demand variability. Demand variability was experienced by a number of Victorian water businesses as we came out of the recent drought, most notably Coliban who had their determination re-opened by the ESC due to issues with low demand. For example, Coliban has approximately 20 per cent of customers who use 50kL of water or less a year. If after one year of introducing a zero fixed and high variable tariff, the business wishes to expand the number of customers who use this tariff option it may require a reduction in the variable charge faced by these customers. This charge would need to be reduced to capture more customers who would be better off under this option rather than a default two-part tariff option. Conversely, the business may seek to reduce the number of customers using this option if more than expected are choosing this option purely on the basis of having greater control over their bill and see no reduction or even an increase in the size of their bill.
	How will equity implications of tariff changes be managed?	Coliban agrees that a standard two part tariff without IBTs will improve equity for large families who will no longer be paying the third tier price for water. In terms of simultaneously transitioning away from IBTs and towards tariff choices, there are many options

		available to businesses. One option is for a straight transfer to a two part tariff and this could become a default option for customers. This is particularly important for tenants to ensure that they are fairly treated under the new system. Alternatively, a business could propose to transition from the IBTs to a single variable charge by reducing the number of blocks to two and moving the two blocks price towards one price by the end of the period. This would be similar to the approach taken by Sydney Water to remove IBTs over 2 years. In 2007-08, Sydney Water had a two tier IBT with $1.34 and $1.83 for the first and second tiers respectively[i]. In 2008-09, Sydney Water increased the first tier closer to the second tier with prices for the first and second tiers being $1.61 and $1.83[ii]. In 2009-10, Sydney water removed the first tier and had a uniform variable price of $1.87[iii]. Furthermore, an alignment of residential and non-residential water tariffs would mean that large families who use as much water as a small business would no longer be paying more because of they are not a business. This is an example of where a tariff change would enhance equity considerations.
	Are there any significant cost forecasting uncertainties for water retailers, such as demand or variable bulk supply costs? If so, what are the appropriate mechanisms for managing these risks?	There are significant cost forecasting uncertainties, in Coliban's case these are centred on demand and long term supply. A non-price cap mechanism seems to mitigate the majority of this risk. However, price control mechanisms like revenue caps can often lead to price instability as the business adjusts prices to meet demand and the allowable revenue. To minimise risk when price caps are chosen, it is suggested that triggers be built into the determination for automatic re-opening when major unforseen or uncertain events occur. The type of triggers may be when revenue varies by greater than a predetermined percentage of the revenue requirement. Coliban has historically had a very high proportion of the water component of the bill being composed of the variable charge, approximately 70 per cent, in response to customers' requests. This has made us susceptible to demand variability. In the past couple of years, demand has been significantly below forecasts submitted and approved by the ESC. This has affected revenue negatively and put us in an undesirable financial position. Customers in our Wimmera district receive either potable (Wedderburn and Korong Vale) or non-potable (Borung and Wychitella) water which is purchased through the Wimmera pipeline operated by GWMWater. With the foreshadowed price increases of 50 per cent per year until we are placed on the GWMW "pipeline tariff", this

		would significantly increase our bulk water costs. The variable costs imposed by GWMWater for non-potable water for these towns will be at least $0.80/kL in 2012/13 whereas the most we can charge these customers is $0.68/kL + CPI. In cases such as this, where costs are outside our control, we would argue that an automatic pass through of costs each year of the regulatory period would be suitable.
Bulk water tariffs and transfer charges	Can the current headworks charging structure be improved?	Coliban believes there are aspects of Goulburn-Murray Water's (G-MW) tariffs that can be improved. The Regional Urban Storage Ancillary Fee (RUSAF) is levied by G-MW on water entitlements owned by (and in some cases water delivered to) regional urban authorities. G-MW argues this charge is for the purposes of maintaining recreational facilities at storages and other assets. This charge is a significant impost on our urban customers and the average cost can exceed $30 per customer per year in some towns. We do not believe our customers are getting value for money as theydo not get a choice as to whether they pay for the services. Coliban argues that costs for such services should not be recovered from our customers and that other funding sources should be explored. If G-MW can demonstrate our customers have a willingness to pay for these services, then our customers who use these services should pay G-MW directly for their use of G-MW infrastructure. Coliban will continue to work with G-MW to resolve this issue in a manner which protects the interests of our customers.
Retail tariffs	What are the implications of increased variability and uncertainty in bulk water costs for retail tariff structures and levels?	As discussed above, Coliban purchases bulk water from GWMWater for our towns in the Wimmera district Recent increases (50% per year) in bulk charges were not budgeted for during the last price review and two towns will be paying more for bulk water than the revenue received. A solution to this problem would be for automatic pass through of bulk water charges as it would be cost reflective and minimise risk to the retailers.

	What are the efficient options for managing this uncertainty and meeting other WIRO objectives and the pricing principles?	A more flexible regulatory mechanism provides one option for managing uncertainty. Price caps provide little flexibility when dealing with uncertainty, as the prices are set and the quantities are uncertain resulting in over and under revenue compounding over the regulatory period.
	Are there net benefits in reflecting differences in distribution system costs by time or location in retail tariffs?	There are some benefits in reflecting time of use pricing in retail tariffs but the costs to apply this to the entire residential and non-residential customer base would outweigh the benefits. However, for large non-residential customers there is a larger benefit to the system if time of use pricing was to apply. It is possible that large non-residential customers placed on supply by agreements that allows for off-peak water usage would reduce peak demand and delay the need for augmentation. These large non-residential users could expect a decrease in their water tariff for water taken outside peak times. There are no or few benefits in locational pricing in retail tariffs, and such a move would not be Pareto optimal – please see earlier response to the subsidy free pricing principle.
	Are there any factors that would support a water business's default retail water tariff not being a two-part tariff?	The default tariff for all customers should include a fixed and a variable component. If a default tariff was to be 100 per cent fixed, perverse incentives for water usage would prevail. If the default tariff was however to be 100 per cent variable, this is mostly likely to disadvantage large families who may use less water per head but overall have larger water consumption than smaller families, couples and single person households. A 100 per cent variable tariff is suitable when a customer makes that choice, the customer is not a tenant, and has sought advice from their business regarding any resulting impact on their total bill.
	What approach should we take to innovations to default tariff offerings?	The default tariff option should be the tariff of main interest to the ESC and should be a two-part tariff. Revenue, as modelled by the ESC, should be based on customers making optimal tariff choices for their level of consumption.

	Are businesses in a position to be able to offer choice to water customers?	Businesses are in a position to offer choice in two ways: - tariff options; and- - additional options. Various aspects of tariff options are discussed extensively elsewhere in this response. Additional options include community and green energy options. Not all customers may wish to pay for their business to achieve environmental and social objectives beyond specified KPIs, these options could be offered separately to customers as add-ons to the bill. It is important to note that only customers who wish to pay for these specified objectives would do so and no other customer would be worse off.
	What constraints are there in offering a choice in water tariffs?	Three often cited constraints in offering tariff options are the businesses' billing systems, communication of tariff options and whether or not customers would like tariff options. Billing systems can already cope with non-postage stamp pricing and specifying whether a customer is in a particular pricing zone or is a residential or a non-residential customer (or indeed whether a certain percentage of a customer's use is residential or non-residential). Any introduction of tariff options would not impose significant cost on businesses. It is important tariff options are communicated appropriately to customers. Coliban is proud of the community consultation it has previously undertaken and can easily distribute information relating to tariff options to all of its customers to enable them to make informed choices. Such choices should, in the first instance, be relatively simple to understand. A default tariff, which meets WIRO and ESC principles, would act as a safety net to ensure no customer is disadvantaged. If a customer did not want to choose their tariff, they would remain on the default. Businesses should not need to demonstrate customer support for tariff options – given the cost of implementing tariff options is so low, if the majority of customers wish to remain on the default tariff, this should not stop the minority of customers choosing an alternative option.

Sewerage and trade waste tariffs	Are there any issues with regional urban water businesses' sewerage tariffs?	Coliban does not charge a variable fee for sewerage for residential customers, thereby providing less complexity to residential sewerage tariffs. For non-residential customers there is a variable fee. Coliban has commenced an investigation into addressing this issue within the next water plan.
	Do trade waste disposal charges provide the right balance between efficiency, and the ability of customers to respond, simplicity, and equity?	Coliban's own schedule of fees for trade waste charges are difficult to understand and are remaining legacy issues. Due to different treatment plants and for historical reasons different charges are levied across the district. Coliban is seeking to simplify the trade waste charges to ensure that the fees are simple, equitable and allow customers to respond to the variable cost of discharge of trade waste where this discharge exceeds domestic waste water concentrations.
Recycled Water	Are any changes required in the approach to determining recycled water prices having regard to the experience in the last Price Review period, the proposed pricing principles, the WIRO Regulatory Principles or the NWI pricing principles for recycled water and storm water?	Recycled water pricing should reflect the incremental cost beyond the Government's requirements (such as EPA discharge requirements or meeting the ESC's service standards). Pricing also needs to reflect costs of the treating different classes of recycled water. Ideally, there appears to be some economic merit in having recycled water prices reflect the level of restrictions as more value is placed on the recycled water when potable water usage is limited. However, for simplicity purposes residential recycled water prices should be set at some percentage of potable prices.

Tariffs and customer choice	Should the Commission allow water businesses to offer customers choice in tariff offerings? If so, is the Commission's proposal to regulate only default tariffs supported?	It would be appropriate for the ESC to regulate all tariff options given the regulatory mechanism chosen by the business. The ESC should forecast the business revenue based on optimal tariff choices made by the customers. The current WIRO does not limit the businesses to propose only one tariff option. If a business chooses to have more than one tariff option and this tariff option meets the principles outlined in the WIRO the business is allowed to pursue that tariff structure. Coliban believes it is not the ESC's role to decide if a tariff is allowed or not, but to assess if it meets the WIRO principles.
	What role should the Commission play with respect to alternative tariffs offered by water businesses?	Alternative tariff options that a business offers to its customers should be at the discretion of the business. If the ESC was to just address the price and quantities of the default tariff option for the revenue requirement, there would be little or no incentive to offer tariff options to customers. The current WIRO requires the ESC to assess activities that relate to: (i) retail water services; (ii) retail recycled water services; (iii) retail sewerage services; (iv) storage operator and bulk water services; (v) bulk sewerage services; (vi) bulk recycled water services; (vii) metropolitan drainage services; (viii) irrigation drainage services; (ix) connection services; (x) services to which developer charges apply; and (xi) diversion services.[iv] If a tariff option is not associated with one of these activities, its expenditure and revenue should be classed as non-prescribed and the ESC should not play a role in price regulating these options.

	If tariff choice is introduced, what aspects of consumer protection would need to be introduced or enhanced?	The Customer Service Code could be adjusted to ensure that customers are aware of their cheapest tariff option, and it is the optimal tariff for them to choose. If a customer chooses to be on another tariff, that is their choice, and it is not the role of the business to prevent a customer from choosing that option. This is most likely to occur with customers who are marginally better off with one option rather than another, but prefer an option with high variable and no fixed charge and allows them to feel 100 per cent in control of their water bill. The Customer Service Code should be careful in its wording to prevent customers from changing tariff options too frequently. Coliban is actively considering tariff option implementation and this may involve a customer having to choose a tariff option for at least one year. If customers were permitted to constantly change, rational customers may opt for a variable-only tariff during Winter and a low variable tariff during Summer.
Other considerations	Rural tariffs	Coliban has been working extensively on what the structure of future rural tariffs will be. Coliban will continue to work with our rural customers to ensure that WIRO principles are met and more business certainty is achieved.
	Residential and non-residential pricing	As residential and non-residential customers receive the same quality of water and service, it would seem appropriate to charge a similar price to all customers of a given consumption level. Coliban acknowledges that wastewater services differ according to the quality of the discharge and that wastewater charges may need to be different for residential and non-residential customers. Further internal investigation is occurring on this topic.
	Meter based charging	Coliban is investigating whether or not charging for different size meters is appropriate and whether it sends the right signals to customers about the cost of water usage. Coliban seeks the ESC's views on the appropriateness of applying meter based charges (for water and wastewater services) in the coming regulatory period in the next tariff guidance paper.

[i] Sydney Water Annual Report 2007-08
[ii] Sydney Water Annual Report 2008-09
[iii] Sydney Water Annual Report 2009-10
[iv] *Water Industry Regulatory Order (2005)*