Proposed Approach to Melbourne Water's 2016 Water Price Review

Melbourne Water Submission

1 Introduction

Melbourne Water welcomes the opportunity to respond to the Essential Services Commission's (the Commission) Consultation Paper, *Proposed Approach to Melbourne Water's 2016 Water Price Review*.

Melbourne Water sees this price review as an important opportunity to:

- engage early and in a meaningful way with customers and the community on service priorities
- ensure customers receive the desired services levels at the lowest sustainable cost
- review the structure of prices used to recover this cost
- build on recent efficiency initiatives to ensure sustainable savings are reflected in future prices
- commence a move to lighter-handed regulation

This response concentrates on the key issues and areas which the Commission has indicated will be a particular focus for this review.

Melbourne Water notes this submission is the first stage in the price determination process and looks forward to working through these important issues with the Commission and our customers.

2 Key issues

2.1 Customer consultation

Melbourne Water is committed to early, transparent and meaningful consultation with customers, consumers and stakeholders throughout the price review process. Meaningful consultation ensures Melbourne Water delivers services of greatest value to its customers and is consistent with more light handed regulation. To ensure this, Melbourne Water is committed to seeking out and acting on customer feedback.

Melbourne Water's key customers for bulk water and sewerage services are the Retail Water Businesses and Melbourne Water acknowledges their key role in this process. For waterways and drainage services, the key customer base is our 1.9 million residential, non-residential and rural customers. While the retailer water businesses remain an important stakeholder for waterways and drainage services (in that they provide the billing and collection service), Melbourne Water is engaging its end-customers directly to establish appropriate levels for this service.

Melbourne Water notes that the Commission requires customer consultation during the development of the price submission and agrees that we should be given flexibility to determine the manner in which that consultation is conducted. Our consultation with the retail water businesses and state government departments commenced in late 2014 and will continue until the final submission is due to the Commission in November 2015. Furthermore, peak bodies representing consumer advocacy groups and industry were engaged early and invited to nominate the manner in which they wanted to participate in the process.

Melbourne Water notes the Commission's view that it will place considerable weight on consumers views received through well-structured deliberative forum processes. To that end, Melbourne Water is undertaking a comprehensive consultation program with consumers on the Waterways and Drainage Charge, driven by the revision of the Waterways and Drainage Strategy. Externally facilitated focus group sessions were held in February and March 2015 with a random selection of participants to canvas a variety of views from consumers. The data will then be used to develop a follow-up quantitative survey with the results to inform the price submission. Further, deliberative customer consultation is being planned to support any changes to tariff design and the treatment of the Victorian Desalination Plant costs.

2.2 Building block methodology

The Commission notes that the Water Industry Regulatory Order (WIRO) is no longer premised on the adoption of a building block approach to determining a business's revenue allowance. The Commission is proposing to conduct a broader review of the pricing methodology to be used for future water price reviews throughout the period April 2015 to October 2016.

However, given the time available to consider applying a substantially different approach, the Commission proposes to continue to use the building block methodology to determine Melbourne Water's revenue allowance from which prices are derived for the 2016 regulatory period.

The building block approach involves firstly validating the service outcomes that Melbourne Water proposes to deliver and then determining the revenue required to deliver these outcomes by:

- establishing an efficient level of operating expenditure
- establishing an efficient level of capital expenditure
- updating the regulatory asset base to reflect efficient capital expenditure
- applying a rate of return to the regulatory asset base
- establishing regulatory depreciation (which depends on the regulatory asset base), and
- establishing the tax allowance.

The Commission does, however, seek suggested improvements to its application of the building block methodology for Melbourne Water's 2016 water price review.

Melbourne Water supports the continued use of the building blocks methodology for the 2016 price review. However, it believes that there is scope for improving the application of this methodology to commence the transition to light handed regulation, avoid duplication of previous reviews, reduce regulatory compliance costs and improve net benefits to customers.

In particular, it considers that there is scope to improve the approach to determining the efficient level of operating and capital expenditure. It also considers that changes are needed to the approach for determining an appropriate rate of return to reflect regulatory best practice. These issues are discussed in more detail below.

2.3 Regulatory period and adjusting prices within a regulatory period

The Commission has flagged in its consultation paper its preference for a regulatory period of five or six years for Melbourne Water's fourth regulatory period commencing on 1 July 2016, with Melbourne Water able to propose a preferred period. Following consultation with retail businesses and other stakeholders it is likely to proposes a five year regulatory period.

Melbourne Water sees as an important corollary of a longer regulatory period the ability to adjust to unforeseen events. As noted in the Commission's Consultation Paper, Melbourne Water's 2013 price determination included mechanisms that allow for prices to adjust in order to account for uncertain and unforeseen events and specifically, to take into account differences between forecast and actual desalination costs (covering desalination security payments and the cost of any water ordered). Melbourne Water agrees that these adjustment mechanisms have worked well and that it intends to retain these mechanisms in a similar form.

2.4 Service outcomes

Melbourne Water notes the requirement to define and specify all proposed service outcomes. Melbourne Water has commenced and will continue to liaise closely with regulators, government, customers and others in clearly specifying its proposed service outcomes which will underpin its price submission. At this stage, it is does not envisage dramatic changes to these service outcomes.

2.5 Assessing prudent and efficient expenditure

In its consultation paper the Commission proposes a continuation of the regulatory approach that it has adopted in previous price reviews. The Commission's proposed approach is premised on the assumption that the context of the forthcoming review is consistent with past reviews. Melbourne Water notes that this 2016 Price Review represents the third extensive review of Melbourne Water's cost base in as many years.

Melbourne Water welcomes the transparency and rigor the 2016 Price Review brings. However, to ensure a cost-effective process, the determination should not duplicate work done by previous reviews particularly where proposals have customer support.

2.5.1 Operating expenditure

The Commission's consultation paper notes that operating expenditure will be assessed similarly to previous price reviews. However, the Commission will assess Melbourne Water's water, sewerage and waterways and drainage services as discrete businesses.

As mentioned above Melbourne Water considers that there is an opportunity during the forthcoming price review for the Commission to streamline its assessment approach and process and to adopt a more streamlined approach. There are a number of ways of achieving this. For example, rather than revisiting areas that have previously been addressed, the Commission could confine its review to those elements of Melbourne Water's proposal that differ from previous proposals. For example, there is limited value in reassessing the trends and assumptions in a number of major operating expenditure cost items that have already been subject to extensive scrutiny and can be shown to have not changed from the previous review.

2.5.2 Productivity and Efficiency

Clause 8(b)(iii) of the WIRO requires the Commission to place particular emphasis on providing incentives for businesses to pursue efficiency improvements. For previous price reviews the Commission has imposed a flat one per cent per annum productivity hurdle on controllable operating expenditure in the form of an annual reduction from the baseline. Melbourne Water questions whether a review based on both the productivity hurdle and reviewing individual categories of operating expenditure is consistent with light handed regulation.

Further, the Commission's consultation paper stated that it expects Melbourne Water to aim for an annual efficiency gain in the order of two per cent per annum. The empirical basis for moving to a two per cent hurdle rate is not clear to Melbourne Water. Further, Melbourne Water notes that the operating expenditures that will be included in its price submission will reflect savings targets of around 7% of operating costs per annum and 10% of total capital expenditure identified as part of a 2014 review conducted on behalf of its shareholder.

The Commission also states that it is open to Melbourne Water proposing an efficiency carryover mechanism as an additional or alternative form of efficiency incentive. Melbourne Water is actively exploring such an option and would also be willing to consider proposing an efficiency carry over mechanism, particularly if in doing so, it is providing the Commission with the degree of confidence it needs to pursue more light-handed assessments of operating and capital expenditure.

2.5.3 Capital expenditure

As with operating expenditure, Melbourne Water believes the Commission should adopt a streamlined approach to its assessment of the prudency of capital expenditure forecasts.

We believe that there are a number of options available to the Commission to minimise its regulatory burden by recognising explicitly the outcomes of recent expenditure reviews.

The Commission could limit its assessment to those aspects of Melbourne Water's capital expenditure forecasts that have not been subject to previous consideration. For example, the Commission's consultation paper requests Melbourne Water identify at least 15 discrete capital projects (by total project cost) to be started or completed over the fourth regulatory period, comprising the top five projects in the three main asset categories of water, sewerage and waterways and drainage, as well as any other individual projects with a total value over $50 million. We note that the vast majority of these 15 projects have already been scrutinised by the Commission and by the Shareholder. Melbourne Water considers that the Commission should limit its assessment to those aspects of proposed forecast capital expenditure that have not been subject to previous review, especially where customer support can be demonstrated.

2.6 Determining a regulatory rate of return

A key aspect of the approach to regulating Melbourne Water's prices is setting the rate of return calculated on Melbourne Water's investment in regulated assets. The rate of return is necessary to enable Melbourne Water to recover the cost of debt and equity to finance its functions.

In its Consultation Paper the Commission proposes to set a real post-tax Weighted Average Cost of Capital (WACC) based on the same approach it adopted in the 2013 price review final decision. This involves estimating the cost of equity using the domestic capital asset pricing model with the following parameters:

- the cost of equity is to be calculated using a market risk premium of 6 per cent
- the risk-free rate is to be based on the yield of a 10 year Commonwealth Government Security bond (using an averaging period of 40 business days commencing as close as practically possible to the start of the regulatory period)
- the cost of equity is to be calculated using an equity beta of 0.65 and
- the benchmark debt risk premium is to be estimated on the basis of a benchmark gearing level of 60:40 debt to equity on the yields of BBB+ to BBB-rated corporate bonds with 10 year maturity.

The Commission does however state in its Consultation Paper that it would determine a WACC that takes into account prevailing market conditions and recent decisions by other regulators.

Melbourne Water notes that recent decisions and reviews by other regulators have led to some significant changes in the approach to determining an appropriate rate of return for regulated businesses, including water businesses. Recent developments have included:

- **Market Risk Premium (MRP)**: Historically, regulators in Australia have adopted a fixed estimate of the MRP of 6%. Recently many regulators have moved away from this practice. In particular regulators recognise that such an approach produces implausible outcomes in non-standard market conditions (e.g., it is not credible that the cost of equity fell to historical lows during the peak of the GFC). Regulators now have regard to a broader range of evidence and estimation methods, which leads to estimates of MRP well above 6% in the current market conditions.

- **Beta**: The standard approach to estimating beta is to look at the (average) estimate of a sample of relevant, comparable firms. Direct estimates of beta use share price data on the comparator firms. Since there are no listed water businesses in Australia, Australian regulators have typically employed estimated betas for water businesses by:
  - examining the estimated betas of other infrastructure industries (e.g. electricity networks); and/or
  - drawing on estimates by other regulators (who themselves may be benchmarking their estimates to those by other regulators, or estimates for electricity networks).
  - Estimates that make use of information on listed water businesses overseas (i.e. in the UK and the US) are materially higher than the 0.65 estimate proposed by the Commission.
- **Cost of equity** – Use of broader evidence: Many regulators have accepted the need to have regard to a broader range of models and evidence than was previously the case. This broader range of evidence supports estimates of the required return on equity that are materially above the estimate that would be generated from the Commission's approach.
- **Cost of Debt** – Trailing average approach: The new National Gas Rules and National Electricity Rules have been amended to allow the Australian Energy Regulator (AER) to set the allowed return on debt according to a 10-year trailing average, rather than according to the rate on the day at the beginning of each regulatory determination, and the AER has adopted that approach for all of the energy networks that it regulates. This approach provides for a much closer match between the allowed return and the actual debt service cost. This can benefit customers in that it results in prices that are more stable over time and it reduces the volatility of the cash flow to equity.
- **Gamma**: In 2011, the Australian Competition Tribunal found that the AER had erred in the way that it had estimated the value of dividend imputation tax credits (the so-called "gamma" parameter). The Tribunal ruled that gamma should be set to 0.25. This led regulators including the AER, ERA and IPART to set gamma to 0.25. By contrast, the Commission has adopted a gamma of 0.5 throughout. The AER now proposes to set gamma to 0.4.
- **Internal consistency**: The recent rule changes and other regulatory developments have brought a renewed focus on the internal consistency of WACC estimates. For example, in its 2013 Price Review, the Commission concluded that the debt risk premium had increased threefold relative to pre-GFC market conditions, but the equity risk premium had not changed at all. It is not plausible that investors would require a threefold premium for risk when

> purchasing debt securities, but no additional premium at all when purchasing equity securities in the same firm. Indeed, the Commission concluded that the premium required for (residual) equity in the benchmark firm was 3.6%, but that the (first-ranking) debt risk premium was in the order of 3-4%. It is implausible to have an equity risk premium that is lower than the debt risk premium for the same firm.

In consultation with our customers Melbourne Water would like to propose a number of specific changes to the current methodology.

In its 2013 Metropolitan Water Price Review, the Commission indicated that it would conduct a review of its approach the rate of return methodology in 2013-14:

> The review will include an assessment of alternative approaches, and inform the Commission's approach to estimating the rate of return for water businesses for the fourth regulatory period. The Commission will involve all interested parties in its review.[1]

Given the importance of setting a rate of return which will enable Melbourne Water to finance its ongoing activities, the proposal to increase the length of the regulatory period to 5 or 6 years, and the possible capitalisation of desalination security payments, it is essential that the Commission consider appropriate changes to its methodology for determining WACC in this price review.

2.7 Treatment of desalination security payments

A key issue for this review is the treatment of desalination security payments.

During the 2013 price review, the Commission asked that Melbourne Water consider the benefits and risks of spreading the recovery of some of its desalination security payments over a period that approximates the plant's useful life.

The Commission has flagged in its Consultation Paper that its guidance will require Melbourne Water to propose an approach to the recovery of its desalination security payments for the fourth regulatory period. In doing so, Melbourne Water will need to consider the trade-off between spreading the recovery of desalination security payments over a period that better matches the expected life of the desalination plant and introducing a potential risk that either Melbourne Water's service obligations would be compromised or create price volatility. The Commission further stated that Melbourne Water's proposal must:

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[1] Essential Services Commission 2013, Price Review 2013: Greater Metropolitan Water Businesses — final decision, June, p. 111.

- not be conditional (e.g. on favourable decisions in relation to other determinants of its allowed revenues).
- be developed in consultation with all interested parties including the water retailers, end-use customers and their representative bodies.
- use relevant and up-to-date financial information, including detail on (and quantification of) any financial constraints.
- include a summary of why the proposed approach has been selected and identify its relative merits against other alternatives considered against all relevant matters in the WIRO.

Melbourne Water has commenced analysis of this issue and confirms that it will develop a proposal for inclusion in its price submission. This proposal will be informed by a suitably participatory engagement process. Melbourne Water notes that there are important interactions between this issue and the determination of an appropriate rate of return (see above) and the financial viability test.

2.8 Assessing financial viability

The Consultation Paper notes the Commission is required to undertake its role in a way which ensures that an efficient business remains financially viable. As per the paper:

> It is possible that the prices estimated via regulatory pricing models (such as building block, benchmarking or index approaches) may not provide a business with sufficient cash flow to remain viable in the short-term. This may reflect a number of factors, such as the use of benchmark finance costs in establishing prices under the building block.
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> A financial viability assessment allows us to make a ‘safety net’ adjustment to prices if the regulatory pricing model results in prices that would leave a water business financially unviable. It is in the long term interests of customers that a business is financially viable so it can provide services desired by customers. A business should be in a position to do so when expected revenues enable an efficient water business to pay its bills as they fall due, and undertake its forecast capital program in order to deliver services.

Melbourne Water supports the application of a financial viability test as a important consistency check to ensure that the revenues allowed by the Commission are sufficient to meet Melbourne Water’s funding obligations.

Revenue allowances are set by the Commission on a 'notional' basis (i.e. they do not necessarily reflect Melbourne Water's actual costs). Melbourne Water has funding obligations that it must meet, and its allowed revenues must be sufficient to meet those obligations. If the business cannot meet those obligations, its perceived creditworthiness would decline, its credit rating may be downgraded, resulting in higher financing costs and reduced financial viability.

What matters in terms of a business's ability to meet its financial obligations is that the profile of its cash inflows matches its obligations. Full recovery of costs over the lifetime of the regulated assets does not necessarily ensure financeability, because cost recovery may occur so slowly that in any given period there are insufficient cash flows to meet the financing obligations of the business. Therefore, the timing of cash flows matters.

The Commission's approach to conducting financial viability assessments involves:

- Using the four quantitative indicators which focus mainly on cash flow
- Adopting benchmarks for the indicators which are consistent with water businesses achieving an investment grade credit rating.
- Among the set of indicators, rank interest cover highest in terms of importance in conducting our financial viability assessments, with gearing ranked second, and less weight given to FFO / net debt, internal financing ratio.
- If a viability test suggests an adjustment to prices is necessary, it will make adjustments on a net present value neutral basis.
- Using historic and forecast actual data for financial viability assessments as opposed to notional data.
- Considering adjustments proposed by businesses to the inputs used in the tests (such as for leases) on a case-by-case basis, allowing only material adjustments proposed and substantiated by businesses.

While Melbourne Water supports the Commission's financeability test, it is vital, particularly in the context of desalination capitalisation, that all aspects of the regulatory allowances be subjected to the financeability test. If some elements of the regulatory decision are excluded, the test may provide a misleading view of the actual financial position of the business.

It is particularly important that any elements of the regulatory proposal that affects the profile/timing of the business's cash flows be subjected to a financeability test. Exclusion from the test of any regulatory decision that defers cashflows, or spreads the same present value of cashflows over a longer period, is likely to make the financial position of the regulated business look more sustainable than it actually is.

As noted, in our submission to the Commission’s financial viability review, Melbourne Water is of the view that a measure of overall statutory profit or an equivalent measure remains one of the indicators that should guide the overall estimation of financial viability.

2.9 Minimising cross-subsidies

Another area which the Commission has flagged for particular attention in the 2016 price review relates to the progressive removal of cross-subsidies. Subject to further customer consultation, it is likely the cross subsidies for bulk water and sewerage services will be largely eliminated for next regulatory period.

Melbourne Water is investigating possible options for more cost-reflective pricing for waterways and drainage services.

Melbourne Water would also note that while the WIRO requires the Commission to regulate prices to provide signals about the efficient costs of providing prescribed services to customers, it also requires the avoidance of price shocks where possible. In addition, the WIRO requires the Commission to take into account the interests of customers of the regulated entity, including low income and vulnerable customers, and to enable customers or potential customers to easily understand the prices charged or the manner in which such prices are calculated, determined or otherwise regulated. Together, these requirements provide for any changes in tariff structures to be carefully considered and implemented.

2.10 Waterways and drainage

The Commission has flagged that a key focus for the 2016 review will be the waterways and drainage functions of Melbourne Water, encompassing both the expenditure on these activities and the pricing arrangements for recovering these costs.

Melbourne Water welcomes the review of these activities which includes programs to improve the health of rivers and catchments, improve stormwater quality, provide drainage infrastructure to service urban growth, and to provide flood protection.

Melbourne Water notes it has unique responsibilities set out in our Statement of Obligations which sets out a requirement for a Waterways and Drainage Strategy. We note that the Department of Environment, Land, Water and Planning (DELWP) are currently reviewing these obligations and we are working with the Department to ensure greater transparency for our waterways function. In particular we note that the Statement of Obligations provides that guidance for this process can be issued and are working to support the development any guidance released.

With regard to Waterways and Drainage obligations and expenditure, the Commission will require Melbourne Water's price submission to clearly demonstrate that its proposed expenditure is prudent and efficient. It will also require evidence of customer willingness to pay where expenditure does not relate to clearly defined government or regulatory obligations (e.g. expenditure related to the amenity or ecological state of waterways).

As described in the earlier sections, Melbourne Water is undertaking detailed consultation with consumers to establish appropriate levels of services and ensuring it has the processes and mechanisms in place to ensure these services are delivered efficiently.

Additionally, consistent with the Commission's expectations Melbourne Water is actively assessing options to reform waterways and drainage charge tariffs for non-residential customers and is testing the options with customers as part of the consultation process.

3 Other issues

There are several other issues on which the Commission has sought feedback. In a number of cases, finalisation of Melbourne Water's position is, appropriately, dependent on consultation with customers and other stakeholders.

These issues include:

- the form of price control, e.g. a revenue cap
- seeking customer views on defining a "price shock"
- the proposed approach to developer charges (although Melbourne Water does not currently have any plans to change the pricing principles applying to these charges).