



16 June 2014

Professor Graeme Samuel AC
Independent Reviewer
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Office of Living Victoria
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By email: erf.review@olv.vic.gov.au

Dear Mr Samuel

**Economic regulation, governance and efficiency in the Victorian water sector:
Preliminary advice from the Independent Reviewer**

The Consumer Action Law Centre (**Consumer Action**), the Consumer Utilities Advocacy Centre (**CUAC**) and the Victorian Council of Social Service (**VCOSS**) welcome the opportunity to comment on the May 2014 Preliminary Advice from the Independent Reviewer. This joint submission builds upon the points we have raised in our 25 March 2014 letter to you, which we would like to have considered as a constituent part of this submission.

Our organisations are very concerned that while the Preliminary Advice has outlined some important regulatory principles and concerns for the pricing of water, the proposed new regulatory and governance model fails in a number of key respects. This includes a failure to deliver upon the very regulatory principles the Preliminary Advice contends are important, including:

- Economic efficiency
- Transparency, role clarity and accountability
- Simplicity and low regulatory burden
- Independent price setting and oversight
- Consumer engagement, and
- Competition

We broadly support these principles and the finding in the Preliminary Advice that these principles can underscore an effective regulatory framework. An effective regulatory framework is important

to Victorian consumers who rely on an independent and transparent price setting process to deliver efficient and fair water prices for Victorians within the context of monopoly businesses providing an essential water service.

While we recognise that the current framework can and should be improved upon—particularly through measures which improve the efficiency of businesses and thereby provide price reductions to Victorians—we are very concerned that the proposals put forward by the Independent Reviewer, if accepted by the Victorian Government, will fail to deliver upon the principles enunciated or the long-term outcomes expected by the Victorian community.

This submission responds by stressing the key principles of independent water regulation from the consumer perspective, and argues that any replacement model for the current regulatory framework needs to demonstrate that it will substantially improve delivery on these principles and overall consumer outcomes. This submission recommends the following principles need to be paramount in any revised model for water pricing regulation in Victoria and we address these in detail below:

- Robust, stable and clear objectives of economic regulation
- Transparency, role clarity, accountability, and independence
- Consumer engagement

Robust, stable and clear objectives of economic regulation

Consumer advocates are supportive of a principled approach to economic regulation of essential services and infrastructure, underpinned by clear objectives.

We are aware that there has been criticism of the objectives of the water pricing regulatory framework in Victoria, not only by the Independent Reviewer but also by the Essential Services Commission (the ‘Commission’), the Productivity Commission and others. The critique is that there are many objectives that reduce clarity and add to uncertainty.

While we accept this critique, and that economic efficiency as a primary objective can contribute to ensuring that monopoly water businesses do not use their power to recover economic rents from consumers, it is also true that an independent regulator is required to consider trade-offs, both between service standards and ‘efficient’ prices, as well as how costs are allocated among classes of customers. Supplementary objectives can provide guidance as to how these trade-offs are assessed, and can mean that there is clarity and consistency, that accords with public interests directed from government.

We are supportive of the current objective of the *Essential Services Commission Act 2001* (Vic) (the ‘ESC Act’) which is to promote the long-term interests of Victorian consumers with regards to price, quality and reliability of essential services. The use of the word ‘promote’ is particularly important—it imparts an obligation on the regulator to be proactive and consider ways in which consumer outcomes can be improved. We are also supportive of over-arching objectives relating to economic efficiency, as is included in the *Water Regulatory Industry Order* (WIRO), which includes requirements that businesses should not recover revenues that reflect monopoly rents or inefficient expenditure.

In the main, it is our view that the Commission has contributed to improved efficiency in prices, compared to that proposed by water businesses. For example, the final decision on the Water Price Review 2013-2018 reduced prices by over \$1 billion from that initially proposed by the businesses. As noted in the introduction, our organisations are supportive of efforts to improve efficiency beyond what the independent regulator has achieved, and the Victorian government playing an active role in achieving efficiency as part of its business role as the shareholder. We recognise that there are different functions for the shareholder and the independent regulator.

The Fairer Bills initiative, essentially being a function of the ‘active shareholder’, has delivered positive bill reductions for Victorians. That said, we are concerned that there has been a real lack of transparency about the savings made as part of that initiative. While there have been public pronouncements that service standards will be maintained, it is very difficult to see how this position can be maintained over the long term if these bill reductions continue. Without transparency about where the ‘efficiencies’ have been gained, it is impossible for consumers to have confidence in the ability of businesses to deliver upon service standards.

As noted above, we are supportive of clearly-enunciated supplementary objectives, which assist the regulator to make decisions between different approaches that might ‘overall’ achieve efficient outcomes. For example, we are supportive of the objectives in the ESC Act that ensure that the safety, health or welfare of a community or a section of the community are not endangered or seriously prejudiced by regulatory decision-making.

Further, as organisations that support the participation of the more disadvantaged and more vulnerable members of our community, we are particularly supportive of supplementary objectives that reference the needs of these groups. For example, section 8A of the ESC Act requires the Commission to consider the benefits and costs of regulation for consumers, particularly low-income and vulnerable consumers. Similarly, the WIRO requires the Commission to take into account the interests of consumers, including low-income and vulnerable consumers.

The Commission has been effective in drawing upon these objectives in the setting of the Customer Service Codes and in supporting vulnerable customers during pricing determinations. The Water Customer Service Codes have a focus on billing, payments and collection. These requirements particularly support those in the community that may be unable to pay their water bills. By stipulating robust service standards around non-payment, the codes protect consumers from losing access to an essential service necessary for health and wellbeing.

The last two pricing determinations have also included important decisions which protected the interests of vulnerable consumers. In the final decision of the Water Price Review 2009-13, the Commission extended the Guaranteed Service Level scheme to increase the businesses’ incentives to adequately address payment difficulties experienced by their customers. This decision contributed to an assurance that customers experiencing hardship are treated fairly, with dignity and in a timely manner. In the more recent final decision of the Water Price Review 2013-18, recognising the significant bill impacts of the requirement for water businesses to recover the cost of the desalination plant, the Commission allowed \$5.25 million in revenue for retailers to use to assist customers in managing the impact of the proposed price increases.

These decisions were in response to the positions put by our organisations about the ongoing need to assist hardship customers, and we have seen positive proposals from the water retailers being

implemented. Despite water prices increasing, restriction levels have remained low, as have consumer complaints. Without objectives which require the regulator to consider the needs of vulnerable consumers, we are concerned that the above decisions would not have been made. This would negatively influence all Victorians, who benefit from a regulatory framework that supports those experiencing financial or other vulnerability—many if not all consumers can be at risk from falling into financial difficulties.

It is our view that robust and clear regulatory principles, including supplementary principles that support particular vulnerable classes of consumers, contribute to stability and confidence in the regulatory framework. Without clarity and stability, there are real risks that pricing of water becomes captured by more temporal concerns, including short-term political interests, rather than the long-term interests of consumers.

Transparency, role clarity, accountability, and independence

The preliminary advice from the Independent Reviewer includes transparency, role clarity, accountability, and independence among its core principles.

***Transparency:** Performance expectations of water corporations are to be clear and actual performance against these expectations assessed and reported in a timely way, and open to appropriate scrutiny. Information should be available to decision makers and the broader community, and actions should be taken to ensure performance is achieved.*

***Role clarity and accountability:** The role and objectives of government, water corporations and regulators should be clear. The Government sets clear and consistent objectives for water corporations which are aligned with government policy and clearly defines their purpose and establishes clear responsibilities for boards.*

***Independent price setting and oversight:** Prices should be set independently of government. There should be a clear articulation of the role of government, and clear delineation of the policy, shareholder and regulatory roles.¹*

We fully support these fundamental principles of regulation of essential services. However we are not convinced that the proposed new framework will be able to reliably embody any of them.

The importance of a transparent process so pricing and service standard decisions can be understood

The current water price review process is a very public one. The Commission publishes a framework paper, open for public consultation, which details the approach they will take in assessing water plans and areas that need to be addressed by the plans. Water businesses submit draft plans, which are assessed by the Commission but also able to be reviewed by the public. A draft decision is published on each plan, again in a public process inviting public comment. Businesses then submit final water plans, again publically, for approval by the Commission – which then publishes a final decision. Anyone who cares to can examine the water business proposals and see in significant detail

¹ Economic regulation, governance and efficiency in the Victorian water sector: Preliminary advice from the Independent Reviewer, May 2014

how they propose to run their business over the next five years: infrastructure works, tariff structures, forecast average household bills, water collection, storage, delivery and usage policies, maintenance plans, customer protection and hardship frameworks, and so on. The desalination charge over-recovery that became an issue of public interest and led to a policy response a few years ago was revealed not by a whistleblower or government audit but by consumer advocates and journalists simply reading the publicly available water plan on Melbourne Water's website. Yarra Valley Water's decision (based on customer consultation) to add marginally to water prices to fund efficiency and hardship initiatives was spelled out in black and white in their water plan and thus open for debate by anyone who chose to read it. (This is discussed further in the section on consumer engagement.)

Such transparency not only provides for public feedback and debate, but also encourages water businesses to have a defensible rationale for decisions about these kinds of trade-offs between price and service quality.

These examples highlight the way the public water price review process responds to these core features of essential services regulation: the relationship between price and service quality, and the importance of locally-based utilities being accountable to their communities.

The interplay between pricing decisions and service standards

The last water price review provided a number of examples of the trade-off between lowest possible price and the quality of service delivery. Water businesses – like other utilities – need to allow for the anticipated costs of dealing with complaints, additional staff resources for dealing with difficult or disadvantaged customers, and the costs of writing off or collecting debt. During the early 2000s, a number of water businesses undertook cost-benefit analyses of customer debt-management and found that targeted support and assistance combined with some debt write-off brought a net financial benefit compared to traditional debt collection. This was instrumental in the development of the current approach to hardship in both the water and energy sectors in Victoria and (in the case of energy), nationally. Through engaging differently with customers in hardship, many water businesses have gained a greater understanding of these customers' needs and issues. Part of this growing understanding has been the recognition that a small group of very vulnerable customers require more intensive – and expensive – support and assistance. This may include case management over an extended period of time, liaising with health and welfare workers in the community, more generous payment terms and a higher level of debt write-off. It can also involve undertaking water efficiency audits, repairing pipes, and providing and installing replacement water appliances (such as washing machines) and fixtures (such as hot water systems). Such programs are funded by smoothing the cost over all customers – raising prices (marginally) but providing significant benefit to customers who need it most. Further, since customers completing such programs typically remain out of hardship, a financial benefit flows in the medium term back to the business (and on to its whole customer base via incremental reductions in the additional costs of dealing with hardship).

A similar argument can be made with respect to service standards. Water businesses have a number of specified service standard KPIs (such as average time to respond to emergency call, average number of hours off supply due to planned and unplanned maintenance, and so on) and setting these targets always requires finding the right balance between cost and service quality. Typically, the balance is found when the cost of improving a standard further is sufficiently disproportional to the degree of improvement. This equation works out differently for different types of service standards,

and customer consultation is often the mechanism used by businesses to ascertain the different values customers place on different outcomes. (For example, sewage backflow into dwellings is considered more undesirable than waiting for an emergency repair of a broken water main, so customers will more willingly pay a price premium for a lower sewage backflow target than for fewer average hours off supply.)

To sum up: there are strong arguments for some service standards and for hardship response to be set based not solely on the efficient cost, but with weight also given to customer preferences and vulnerable customers' needs. Customer (and consumer advocate) consultative processes inform these decisions, additional objectives (to economic efficiency) facilitate them, and an open and transparent process subjects them to scrutiny.

The importance of locally-based water authorities, accountable to their communities

The discussion above also highlights the value of local accountability. Environmental outcomes (another parallel objective that demands consideration in the price process), social outcomes, and service standards have different shape and meaning to different communities. This is the result of a range of factors including demographic, locational, and geographic differences (such as socio-economic profile, predominant household types, industry predominance, climate and topography). A local connection facilitates the customer consultation vital to water plan development and the trade-offs required, and also provides greater accountability for delivering on standards and objectives. Water boards grounded in local communities is one aspect of this local connection. We are concerned about the casual approach expressed in the Preliminary Advice toward discharging boards and amalgamating water businesses with performance problems. Clearly the shareholder must take seriously its responsibility to ensure the business is performing well and delivering on its customers' needs and expectations. However the local connection and the accountability of businesses to their communities are also of significant importance.

Balancing an active shareholder with an independent price determination process

As noted above, we fully support the Independent Reviewer's emphasis on the need for government as shareholder of Victorian water businesses to play a more active role. By pursuing greater efficiencies, providing incentives to improve performance, and expressing core social and environmental objectives for water businesses, a more active shareholder could add value to the water sector in the interests of the shareholder's constituency, the Victorian community. In particular, we note the great value to Victorian households of the efficiency review conducted by the shareholder which found further efficiencies than the price review process was able to extract, for direct financial benefit to all Victorian water customers.

However, we note that the efficiency review had the current water plans and price paths as a baseline from which to reach further. The comprehensive economic framework that underpins the current price determination process cannot be as flexible as an independent review process which can examine specifics at a higher level. We see value in an ongoing approach that uses efficiency reviews to get further mileage from a more comprehensive regulatory process – so long as it is a transparent process – but struggle to see how an efficiency review can work alone as the core process.

A related key principle of the regulatory framework is the independence of the regulator. The proposed model is very unclear about how it will ensure independence in price setting beyond saying that this will be achieved. The proposed model is not clear who the future ‘Independent Reviewer’ is, whether they will be a regulator with a statutory mandate, or whether they will be a reviewer brought in to perform the shareholder’s efficiency mandate, as appears to have been the case with the most recent Independent Reviewer.

Consumer organisations submit that independence of the regulator, performing its functions according to clear and stable objectives that promote the long-term interest of consumers, is necessary for effective price regulation of essential services. Without such independence, backed by statute, there is a risk that water prices become more aligned with political interests, which may not necessarily align with consumer interests.

We note also that the Independent Reviewer consider that the regulatory system should only be concerned with abuse of market power, while it is the shareholder’s job to ensure the business is operating efficiently.² This seems overly simplistic. One way the shareholder ensures a business is running efficiently is by having a robust regulatory system in place; and the robustness of a regulatory system is enhanced by having an independent regulator operating within a framework designed to deliver policy objectives.

The necessity for accountability between pricing reviews

Melbourne Water’s desalination cost over-recovery was a perfect example of the need for an ‘always on’ regulatory process. With intimate knowledge of the sector and an ongoing role in developing and implementing the various regulatory instruments, the Commission was perfectly positioned to respond to the policy requirement to assess the degree of over-recovery, develop the most effective methodology for returning funds to households, and monitor that funds were indeed returned.

We are concerned that the proposed system does not allow for this between-reviews adjustment process – an infrequent but not uncommon phenomenon in the water industry. We note that allowance has been made for price paths to be reopened for *force majeure* events; but it is unclear how and by whom that decision is made, and the price path adjustment undertaken and scrutinised. There is also a lack of clarity around what will happen for incidents or eventualities that are not *force majeure* events but nevertheless have a cost impact or windfall. (For example, the desalination cost over-recovery could hardly be defined as a *force majeure* event.) The Independent Reviewers suggested³ that in such a situation where a cost increase has occurred, prices will be required to remain steady and the impact should be absorbed by the dividend to government – and that this provides an incentive for government to not burden the sector with more regulation. However, again, it is unclear what body will be responsible for making such decisions, and in the absence of an independent body, the possibility of conflicting incentives for government is raised. It is also unclear what will happen if a similar situation leads to a *decrease* in costs. Will prices be lowered? Or will the dividend increase? And how will this decision be made?

² Explained at the public forum on the Preliminary Advice held in Melbourne on Wednesday 4 June 2014. The Independent Reviewer also conceded that the proposed process is ‘*not more independent*’ than the current system.

³ At the public forum on the Preliminary Advice held in Melbourne on Wednesday 4 June 2014.

Additionally, pricing decisions are integrally connected to industry and business sustainability. The Commission, as the ongoing regulator responsible for the industry as a whole, has considerable incentive to err slightly on the side of caution to ensure the industry's sustainability is assured. This is why the efficiency review was able to extract additional efficiencies to the regular process – and why we support an independent efficiency review process provided it is transparent. But an ad hoc review panel that disbands after the price path is set has the opposite incentive – and on balance, slightly more expensive water is preferable to water businesses collapsing or catchments breaking down.

Consumer engagement

We strongly support more effective engagement with the community and consumer advocates particularly where they are directly impacted by decisions. We are pleased that the Independent Reviewer has at paragraph 6.10 recognised the importance of informing consumers about prices and involving consumers in the process for reviewing prices. We are concerned however that the Preliminary Advice has not articulated what the mechanism for consumer engagement under the proposed new regime is.

While the Preliminary Advice acknowledges the need for consumer engagement, the model proposed appears to reduce consumer engagement in the price setting process – only water corporations will be required to consult, and there appears to be reduced input of consumers at the actual point of pricing decisions. While the comment under Box 6 (page 30) assumes economic efficiency is automatically consistent with the long term interests of consumers, there is no equivalent comment with regard to consumer engagement in the price review process. This appears to be the reverse of the 'best practice' approaches taken at the federal level.

Recently, various initiatives at the federal level have acknowledged the importance of involving consumers in energy and water issues, including the following:

- Within the energy space, the long term interests of consumers are reflected in the objective of the National Energy Retail Law: *The objective of this Law is to promote efficient investment in, and efficient operation and use of, energy services for the long term interests of consumers of energy with respect to price, quality, safety, reliability and security of supply of energy.*
- The Standing Council on Energy and Resources' (SCER now called the COAG Energy Council) 'Putting Consumers First' is a comprehensive package of national energy market reforms to respond to the current challenges of rising electricity prices. The package of reforms aims to restore the focus of the electricity market on serving the long term interests of consumers.
- The Australian Energy Market Commission's (AEMC's) inclusion of the 'Consumer Priority' following its strategic review and the release of their 'Consumer Engagement Blueprint'
- The Australian Energy Regulator's (AER's) Better Regulation Program which led to the development of seven new guidelines including a consumer engagement guideline for network service providers (traditionally these businesses do not have a customer interface)

and the establishment of the Consumer Challenge Panel to strengthen consumer input into network spending

- The SCER's (now called the COAG Energy Council) establishment of Energy Consumers Australia, a national energy advocacy body to increase the consumer voice in national energy market matters which materially affect energy consumers, in particular residential and small business consumers
- The National Water Commission's (NWC's) inclusion of '*a customer focused sector, an engaged community*' as one of the six themes in their *Urban Water Futures Discussion Paper* (October 2013)

We are of the view that the Victorian framework for water should likewise promote the long term interests of consumers by engaging them in policy and regulatory processes. There is also a need to improve knowledge and understanding of consumer issues; a role which we believe government, industry and consumer groups share.

In contrast, under the current framework, the Commission has developed experience and expertise in consumer consultations, and this has improved with each water pricing review. The Commission has taken positive steps to increase the amount, quality, and scope of consultative processes with consumer advocates – as well as promoting consumer consultation by water businesses. This has not been acknowledged in the Preliminary Advice. The Commission has also created the expectation that water businesses consult with their customers about customer preferences when preparing pricing proposals. This has also improved with each water plan process, particularly for metropolitan water businesses.

During the last water price review, the Commission set up their Customer Reference Panel with the aim to identify and understand water customer concerns, to provide insights into contentious issues (e.g. inclining block tariffs, price paths) and to test early views on panel members. In their Draft Decision, the Commission required Melbourne Water to resubmit an alternative proposal for the recovery of the desalination security costs for further consideration, one which took account, the WIRO requirements and developed in consultation with water businesses, end-user customers and their representative bodies.

As mentioned earlier, in response to the concerns expressed by consumer advocates with the price rises, the Commission's Final Decision allowed water businesses to allocate \$5.25 million to support vulnerable customers in hardship. Following the Commission's 2013 Final Decision, the Commission hosted a 'Water Industry Hardship Support Program Workshop' in July for consumer advocates and industry to discuss how outcomes generated by funds allowed by the Commission for hardship support could be measured. The outcome of the workshop, which was the development of the hardship indicators, was published in the Commission's Final Decision on Measuring the Effects of Additional Hardship Allowances (December 2013).

Such initiatives by the Commission have led to more robust regulatory processes and improved water businesses' responses to consumer issues. In addition, more water businesses approached us individually and collectively for consumer input into their water plans in the last water price review.

Consumers have a valuable contribution to make to urban water policy. Water policy decisions are not exclusively technical or economic but frequently involve values, objective-setting processes, and complex trade-offs. The impacts of decisions are varied, difficult to compare, and in many areas, unquantifiable. Because of this, decisions are not made solely on scientific, engineering or economic grounds. Instead, value judgements are required, and these are areas in which consumer perspectives can be particularly valuable. Engaging the community on these value questions can be expected to bring different perspectives and priorities into focus. In our discussions with consumers, community groups and community service workers, we find that concerns often centre on issues such as:

- Costs and benefits of initiatives, and how well these have been investigated prior to implementation
- Differential impacts of policy for consumers of different types and in different areas, and the plans that are in place to deal with these impacts
- Process and transparency, and whether consumer input reflects the range of circumstances of consumers

We highlight one example where consumer engagement has informed the price and service standard decisions of water businesses. Yarra Valley Water (YVW) undertook an extensive program of research and engagement to gather insights from their customers to guide the direction of their water plan for the period 2013-18. This included a broad combination of research and engagement, using extensive market research (quantitative and qualitative), key stakeholder briefings and ongoing review and input from their Customer Advisory Group. Part of their survey sought customer feedback on whether they were prepared to spend around 80 cents per quarter (on the average quarterly bill) to fund water efficiency programs that had a focus on maintaining the current conservation ethos. This included exchanges for water efficient showerheads, community engagement and education, programs to assist businesses to save water etc). This was strongly supported by customers and YVW proposed in their water plans, to continue a level of investment in water efficiency with the primary aim of locking in behavioural change that occurred during the drought in respect of water use. YVW also asked customers if they would be willing to pay an additional five cents per quarter (on the average quarterly bill) to fund an initiative to provide eligible low income households with a water audit and water efficient appliance retrofit, and for their views on a ‘SmoothPay’ option to pay their bills. As customer support was strong, YVW included these initiatives in their water plans.

CUAC’s research [Meaningful & Genuine Engagement: Perspectives from Consumer Advocates](#) revealed that a key component of effective engagement is a commitment to meaningfully and genuinely engage with consumer advocates and the community, on an ongoing basis. This is critical to good policy-making, as it acknowledges that consumer perspectives have value and can shape key policies and business decisions. At a recent *Consumer Engagement in Energy Networks: Innovations & Challenges* forum organised by CUAC, a YVW representative acknowledged that, ‘consumer engagement is hard but it is worth it.’ It leads to improved consumer outcomes and wider support for decisions.

We welcome further opportunity to continue to engage with you on the important review. If you require further information, please do not hesitate to contact the undersigned.

Yours sincerely

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