ESSENTIAL SERVICES COMMISSION

Essential Services Commission

Asian Development Bank Water Professionals

26 September 2014

TRIM REF:

Agenda

- Who is the ESC?
- Water pricing
- Performance monitoring
- Customer protection framework

Session 1 – Who is the ESC?

Who is the ESC?

- We are the independent economic regulator for essential services in Victoria established by legislation *(Essential Services Commission Act 2001)*
- The ESC has a number of regulatory roles in key sectors including water, electricity, gas, transport (ports, taxis, tow-trucks, rail)
- The primary objective of the ESC is to ‘promote the long-term interests of Victorian consumers with regard to the price, quality and reliability of essential services’
- Key roles:
  - Pricing
  - Energy and Water customers protection framework
  - Performance monitoring of utility services
  - Administration of the Victorian energy efficiency targets scheme
  - Advice to government

Why is the ESC established?

- Set up in 1994 to provide support to the Victorian Government's microeconomic reform program to improve the efficiency and competitiveness of the State's economy
- An independent regulatory body was seen as necessary to ensure that the benefits of industry restructuring were passed on to household, commercial and industrial customers
- Since its establishment, the Commission has now widened its program to include Ministerial reviews and the administration of the Victorian energy efficiency target scheme.

Structure of the ESC

- Structured as a Commission comprising a Chairperson and two part-time Commissioners, supported by around 65 staff
- Chairperson and Commissioners cannot be removed from office unless Parliament decides to do so
- Not subject to direction or control
- The ESC's regulatory and analytical staff are mostly qualified in economics, accounting, law and engineering
- Specialist consultants experienced in advice on technical, economic and legal matters also support the ESC as needed
- Funded by State Budget appropriation (annual $17m)
- Some regulated entities pay licence fees (water around $3m per annum)

How does the ESC go about doing its work?

- Matters that the ESC takes into account include:
  - Incentives for long-term investment
  - Financial viability of the industry
  - Degree of, and scope for, competition within the industry, including countervailing market power and information asymmetries
  - Relevant health, safety, environmental and social legislation applying to the industry
  - Benefits and costs of regulation (including impacts on low income and vulnerable customers)
- Open and transparent process and consultation

Some examples of the ESC's decisions

- Every five years, the ESC sets the water prices for 19 urban and rural water businesses
- Every five years, the ESC reviews the economic regulation in Victorian ports and recommends any changes to regulation to the Minister
- In July 2014, the ESC set the taxi fares for metropolitan Melbourne to apply for the next two years
- In 2012–13, almost 8 million energy efficiency certificates were created (each certificate represents a deemed tonne of greenhouse gas abated). This brings to around 19 million the total number of certificates registered by the ESC since start of scheme in 2009

A Typical Industry Restructure

- Vertically integrated utility is disaggregated into generation, transmission, distribution and retail businesses
- Wholesale market trialled and established
- Retail competition is then phased-in
- Create competition wherever possible and monopolies are regulated through incentive-based regulation
- Institutions like the ESC and ESV (technical and safety regulation) are established
- Ombudsman, ie Energy and Water Ombudsman of Victoria is also created to assist resolution of customer complaints
- Over time, customer advocacy bodies are also set up

Questions?

Session 2 – Water Pricing

Water Industry Act

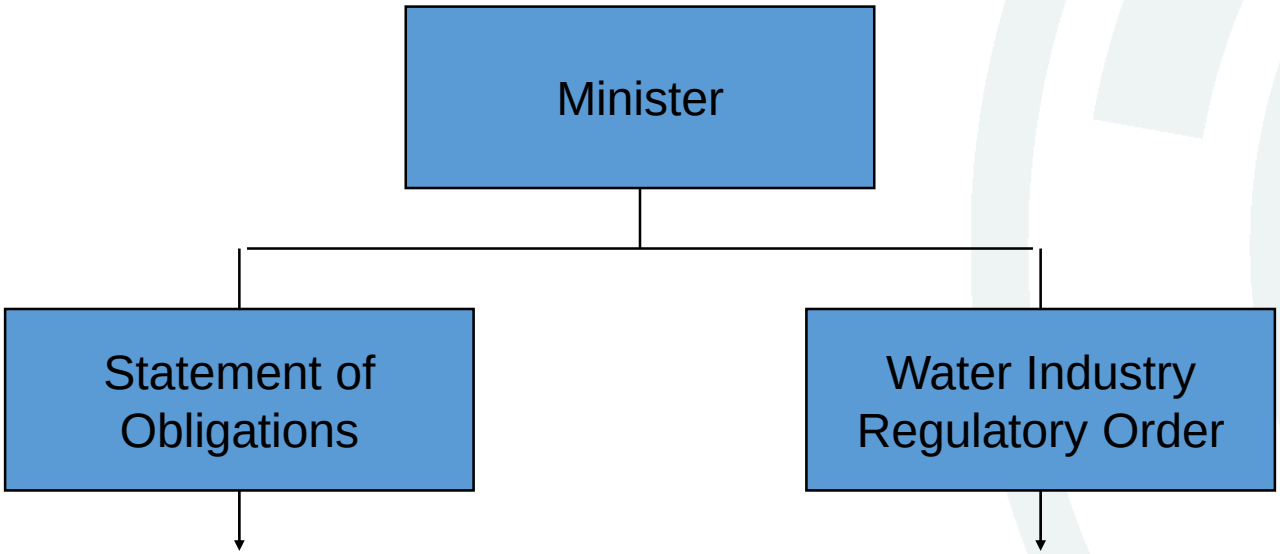
- Objectives set out in ESC Act and Water Industry Act – in part they are:
  - Facilitate investment, efficiency, viability
  - Have regard to safety, environmental, etc. obligations
  - Have regard to different operating environments
- Water Industry Regulatory Order
- Statements of Obligations

Regulatory responsibility

Function	Agency
Pricing	ESC
Customer service	ESC
Resource allocation	DEPI
Dam safety	DEPI
Environmental	EPA
Water quality	Department of Health

Regulatory Framework

- Establishes ESC as economic regulator of water authorities since 2004



Water Authorities
Must prepare Water Plans with outcomes, revenues, prices

ESC
Must assess Water Plans against WIRO requirements

Water Industry Regulatory Order

- Water Industry Regulatory Order (WIRO) prescribes:
  - Goods and services ESC to regulate
  - Businesses subject to regulation
  - Powers to regulate prices, standards, conduct and monitor the sector
  - Principles and process for approving price/service proposals

Statement of Obligations

- One for each water business
- Relationship between the Minister and the water business
- An SoO includes:
  - performance standards
  - policy/regulatory obligations to be met
  - community service obligations, and
  - customer and community consultation

Victoria's water industry

- 19 state owned water corporations
  - Established under Water Act
  - Defined by geographic boundaries
  - Monopoly industry / no meaningful competition
  - Businesses operate as standalone entities
  - Boards appointed by Government

Victoria's water industry

- Three main sectors:

Melbourne

- Melbourne Water is bulk water and sewerage provider
- Three retailers - City West, South East & Yarra Valley

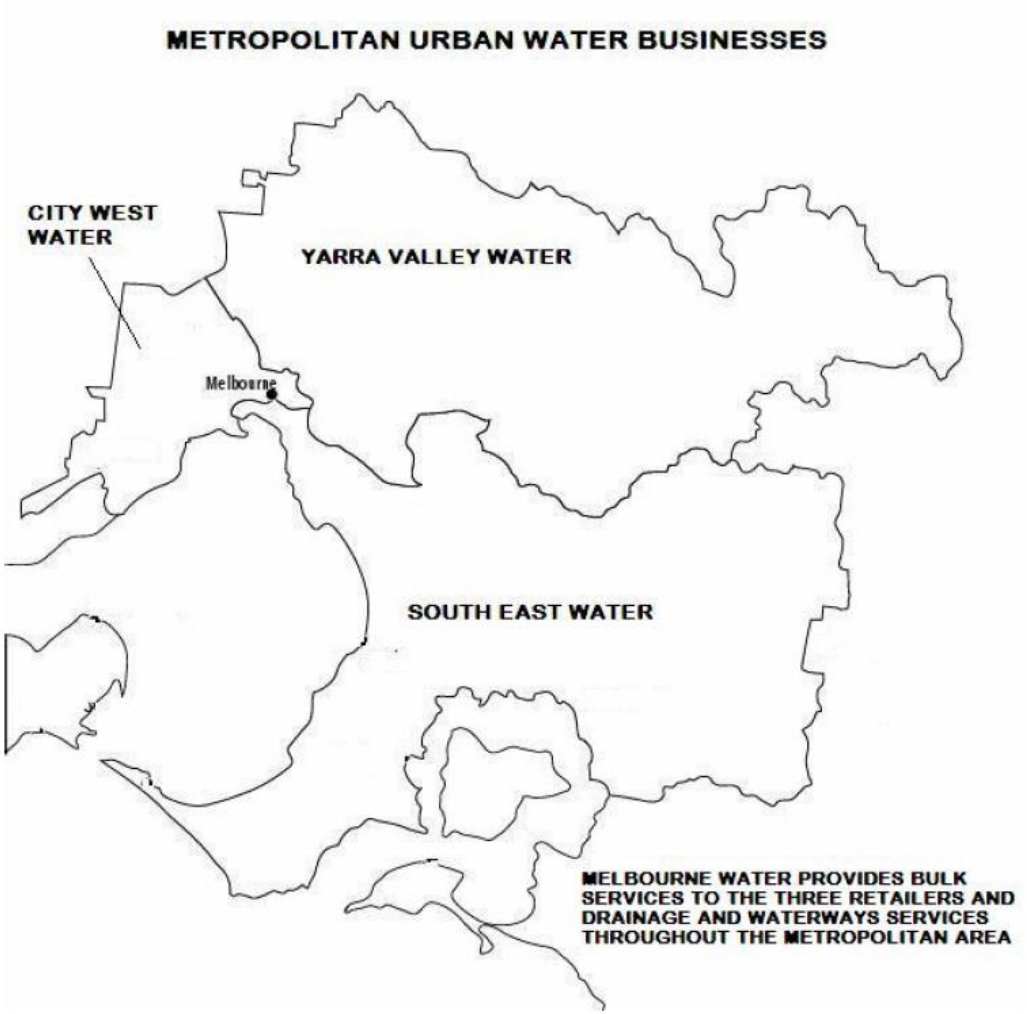
Regional Victoria

- 13 businesses provide water and sewerage services

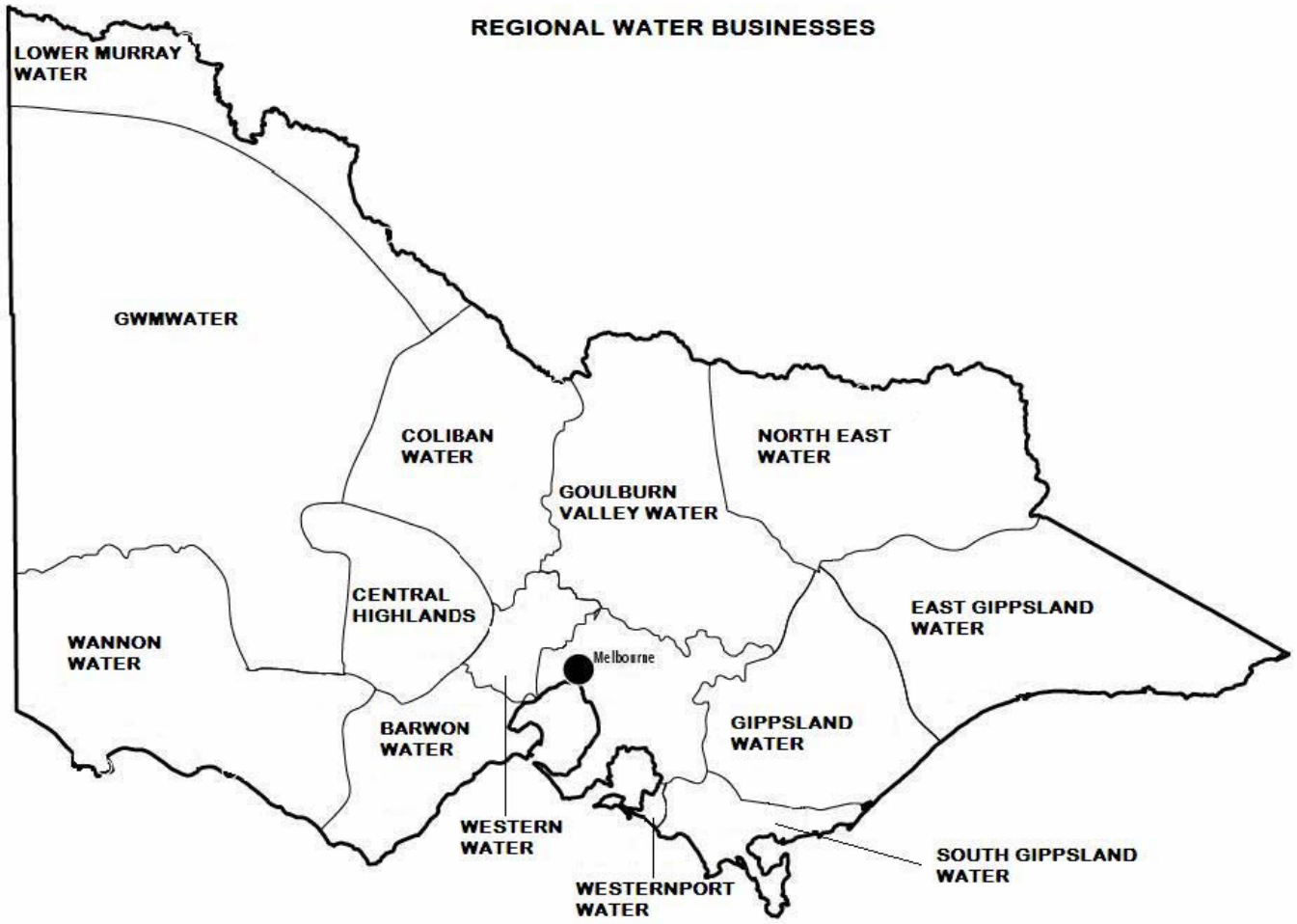
Rural Victoria

- Four businesses providing irrigation services to farmers

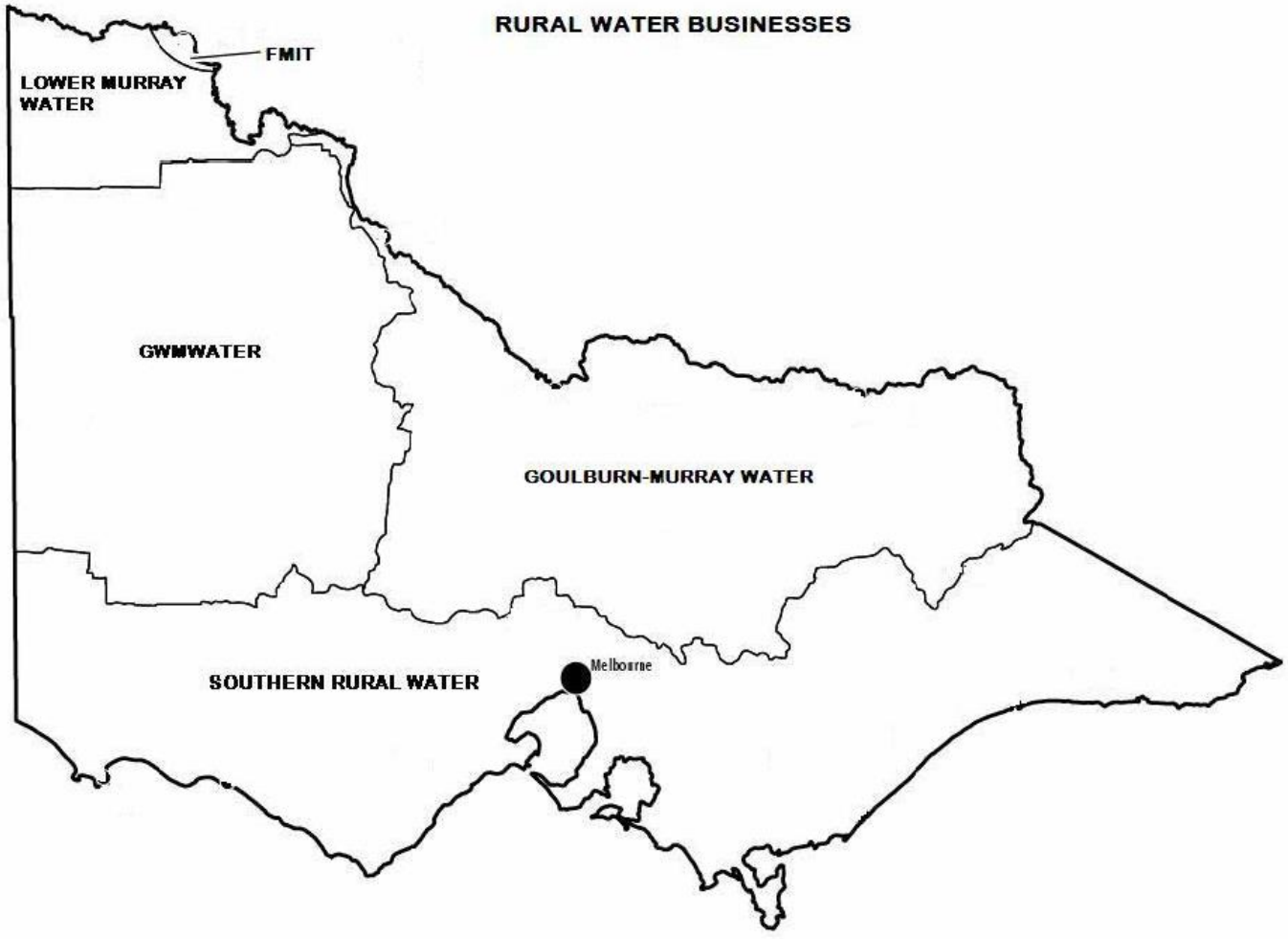
Victoria's water industry



Victoria's water industry



Victoria's water industry



Victoria's water industry

- Businesses provide services to around 2.2 million urban customers (connections)
- Regulated revenue around $4b+ per annum
- Ave. household bills in Melbourne around $1,100 per year (water and sewerage)
  - Or about 2 per cent of annual average income

    [[Electricity + gas bills about 5 per cent of ave. income]]

Our role in the water industry

- Independent economic regulator
  - Decisions not subject to Government direction / influence
  - Operate according to regulatory framework established by the Victorian Government (currently under review)
- Three main functions:
  - Authorise maximum prices / tariffs
  - Report on water business performance
  - Administer customer protection framework

[Energy and Water Ombudsman resolves non-price disputes between customers and businesses]

Our main outputs

- Decisions / determinations on prices
  - Major price reviews (every five years)
  - Annual tariff approvals
  - Within period price applications
- Annual performance report
- Customer codes
- Regulatory accounts
- Inquiries (hardship, licensing, productivity)

… wide consultation underpins our approach

Forms of price regulation

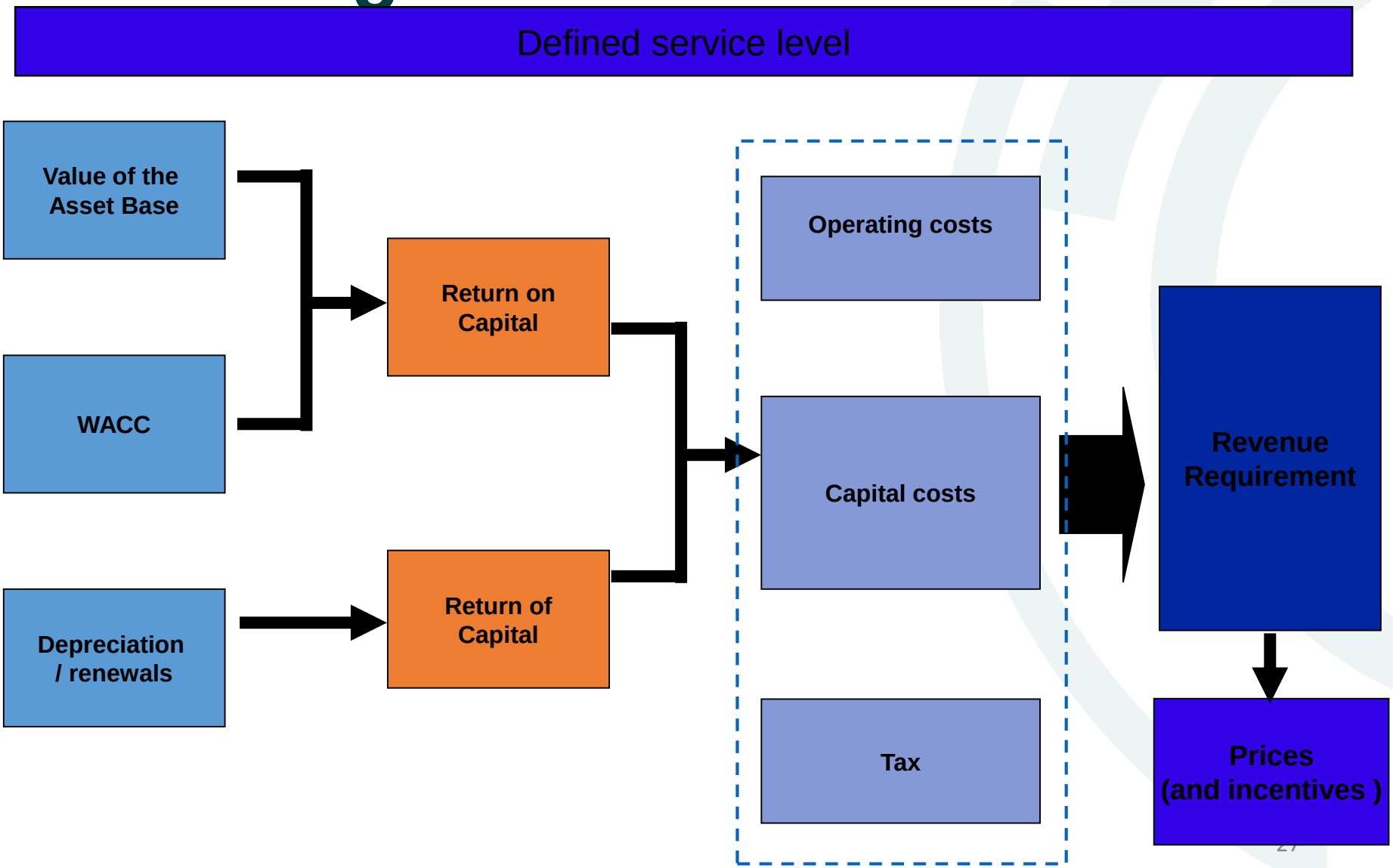
- price monitoring
- negotiate arbitrate
- **building block cost based pricing – generally price or revenue caps**
- total factor productivity linked price caps – a form of index based pricing
- franchise bidding

WIRO is based on a building block model, currently under review

Approach to setting prices

- Building block approach
- Revenue
  - Return on Assets
  - Return of Assets
  - Operating costs
  - Taxes
- Price is revenue divided by quantities

Building block model



Building block

- Three main components:
  - **Outcomes –** what is to be delivered by water authorities and for whom?
  - **Revenue –** how much money is required to cover opex, capex, return on and of past investments?
  - **Prices –** what will individual customers have to pay given likely levels of demand?

- *Important iterations between outcomes & prices e.g. customer willingness to pay, tariff structures to influence demand/investment, collective impact of regulators' demands*

Price review process

- Commission provides guidance to water businesses on content of price submissions
- Water businesses prepare price submissions in consultation with:
  - EPA, DH, DEPI & DTF
  - Customers
- Water businesses expose draft price submissions for public comment
- Businesses incorporate feedback into final price submissions which is submitted to Commission

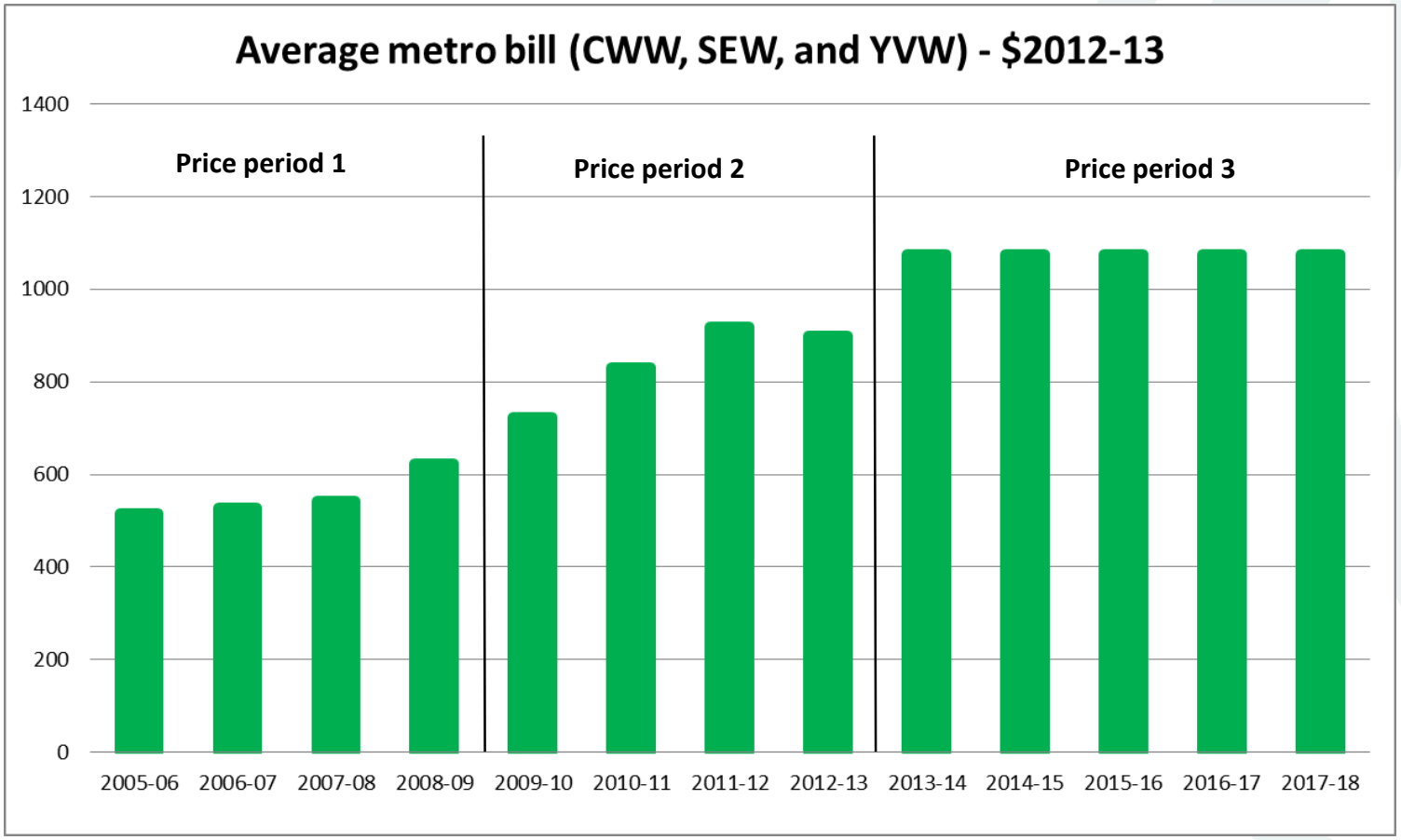
Approval of price submissions

- Commission tests price submissions against principles in ESC Act, Water Act and WIRO
- Prices should:
  - Provide a sustainable revenue stream
  - Not reflect monopoly rents and/or inefficient expenditure
  - Provide signals regarding the costs of supply
  - Be readily understandable by customers
  - Take into account the interests of customers

Pricing process

- ESC Draft Decision must either propose to
  - Approve prices (or pricing process) set out in Water Plans, or
  - Refuse to approve them and propose changes needed to obtain approval
  - Seek public comments
- Final Decision may approve revisions or specify required prices

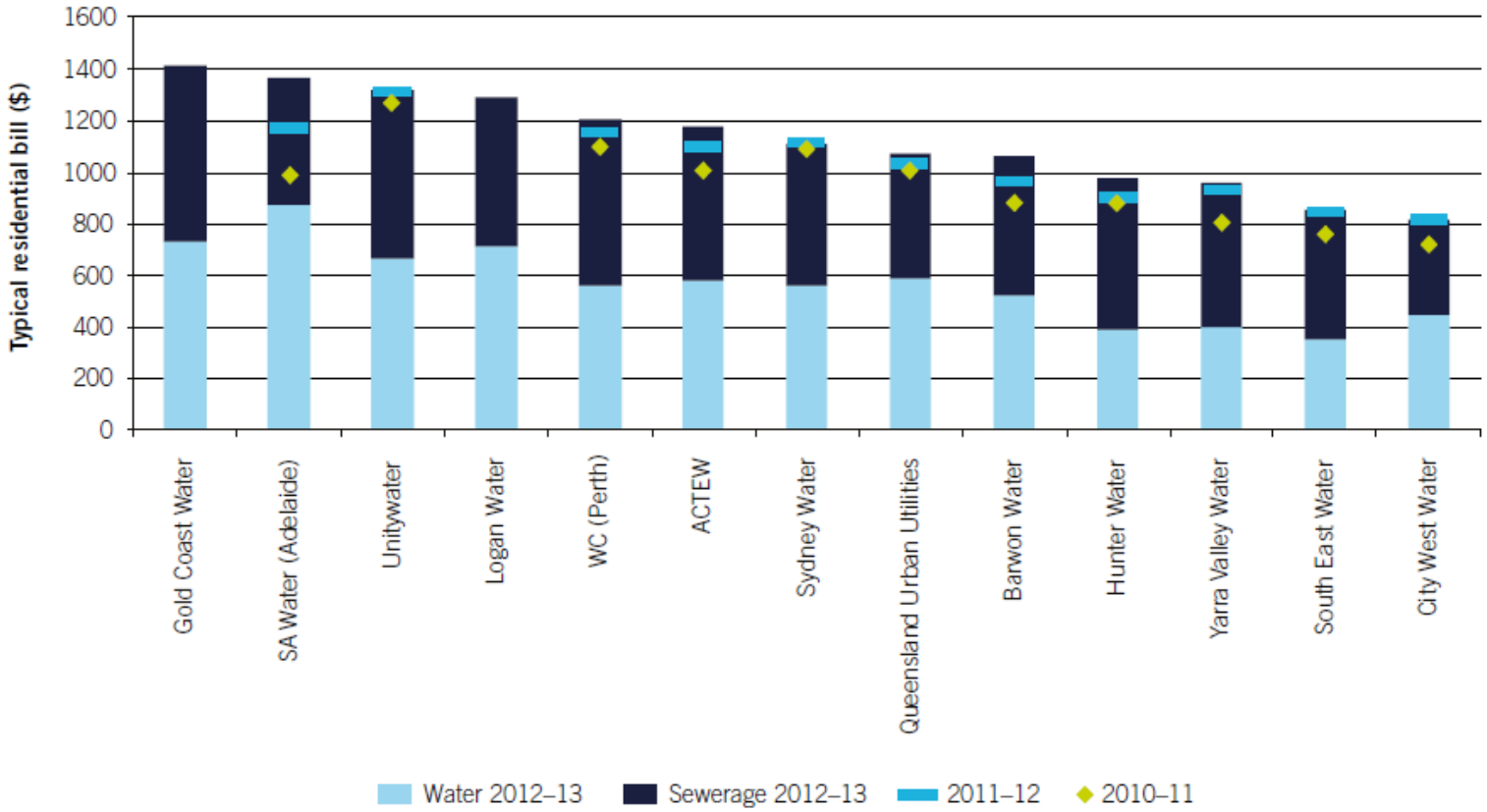
Trends in customer bills (metro)



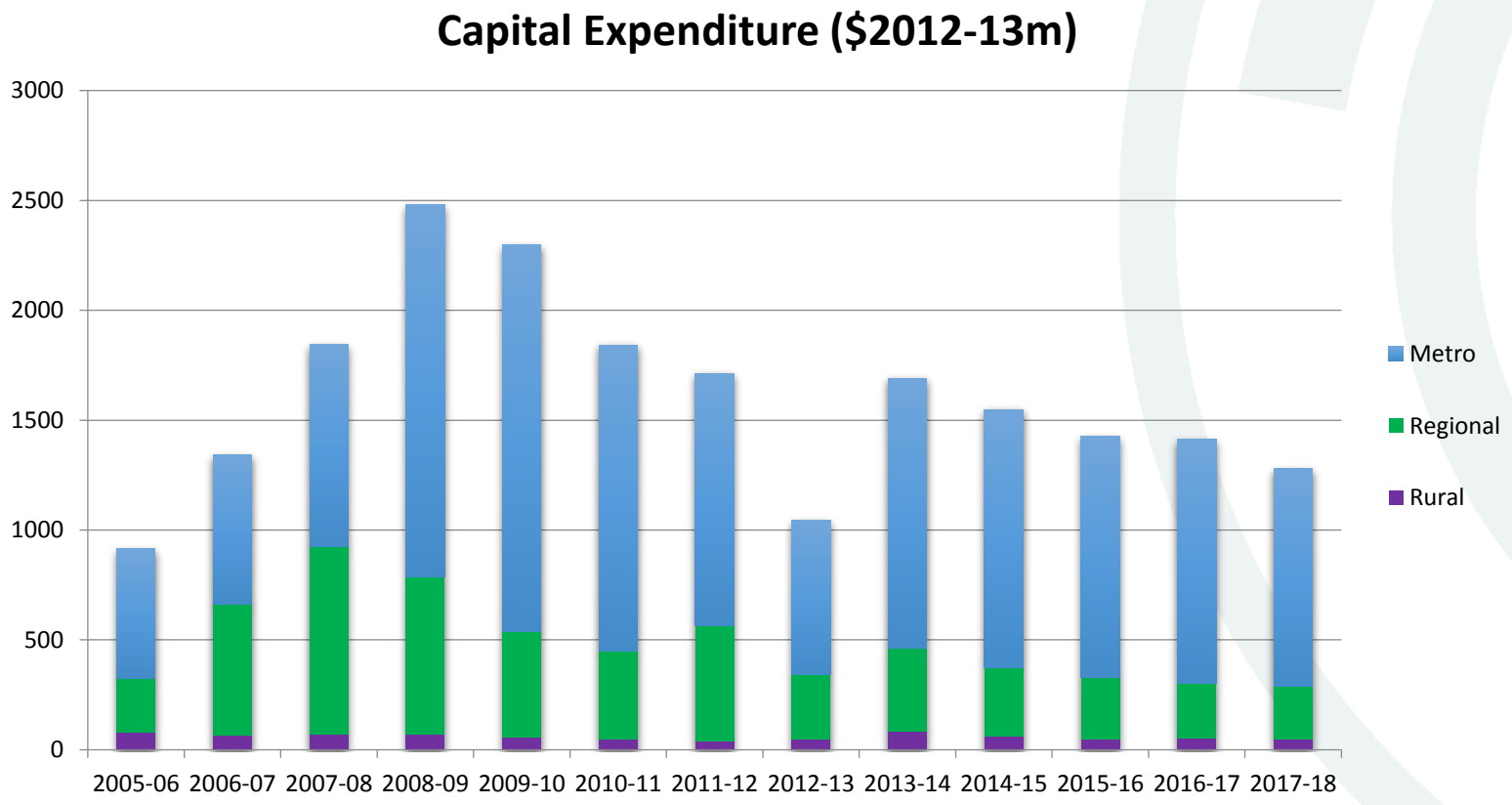
Bill comparison across States

Figure 5.2: P3, P6 Typical residential bill (based on average residential water supplied), 2010–11 to 2012–13 ($)

For utilities with 100 000+ connected properties



Major projects a key driver of prices / bills in recent years



Typical tariff structure

- Residential - water
  - Fixed service charge
  - Variable / usage charges (3 steps)
- Residential – sewerage
  - Fixed service charge
  - Variable component deduced from water meter reading (metro only)
- Residential – recycled
  - Fixed service charge (small)
  - Variable / usage charge (around step 1 of potable)

Typical tariff structure contd

- Non-Residential - water
  - Fixed service charge
  - Variable / usage charges (single)
- Non-Residential – sewerage
  - Fixed service charge
  - Variable component deduced from water meter reading (metro only)
- Non-Residential – recycled
  - No fixed service charge
  - Variable / usage charge (around 75% of potable)

Service levels

- Potential price quality trade-off under incentive based regulation
  - incentive for regulated firm to cut costs to earn higher profits
  - this could cause service quality to decline
  - stricter price regulation may also risk service quality degradation through reduced service rather than improved efficiency
- Need to clearly define outputs to be delivered
  - Water quality
  - Effluent quality
  - Reliability – frequency, duration
  - Resource security – weakness in water compared to energy sector
  - Dam safety
- Maintenance of efficient service quality levels can be achieved through non-financial or financial mechanisms such as
  - public reporting (performance reports)
  - the establishment and enforcement of service quality standards (GSL payments)
  - through service incentive mechanisms applied under price or revenue regulation use of an S factor in electricity, proposed RP factor in water

Questions

Session 3 Performance monitoring

Performance monitoring

- **Under WIRO the Commission is required to monitor and publicly report on the performance of the water businesses**

- **Establishing, Monitoring & Reporting on performance**
  - industry-wide indicators, reporting to promote yardstick competition
  - Statewide performance reporting and auditing framework established during 2004
  - built on work Commission already undertakes for metropolitan sector
  - undertake regulatory audits of the data
  - publish a report each December
  - contribute to a national reporting framework

Coverage

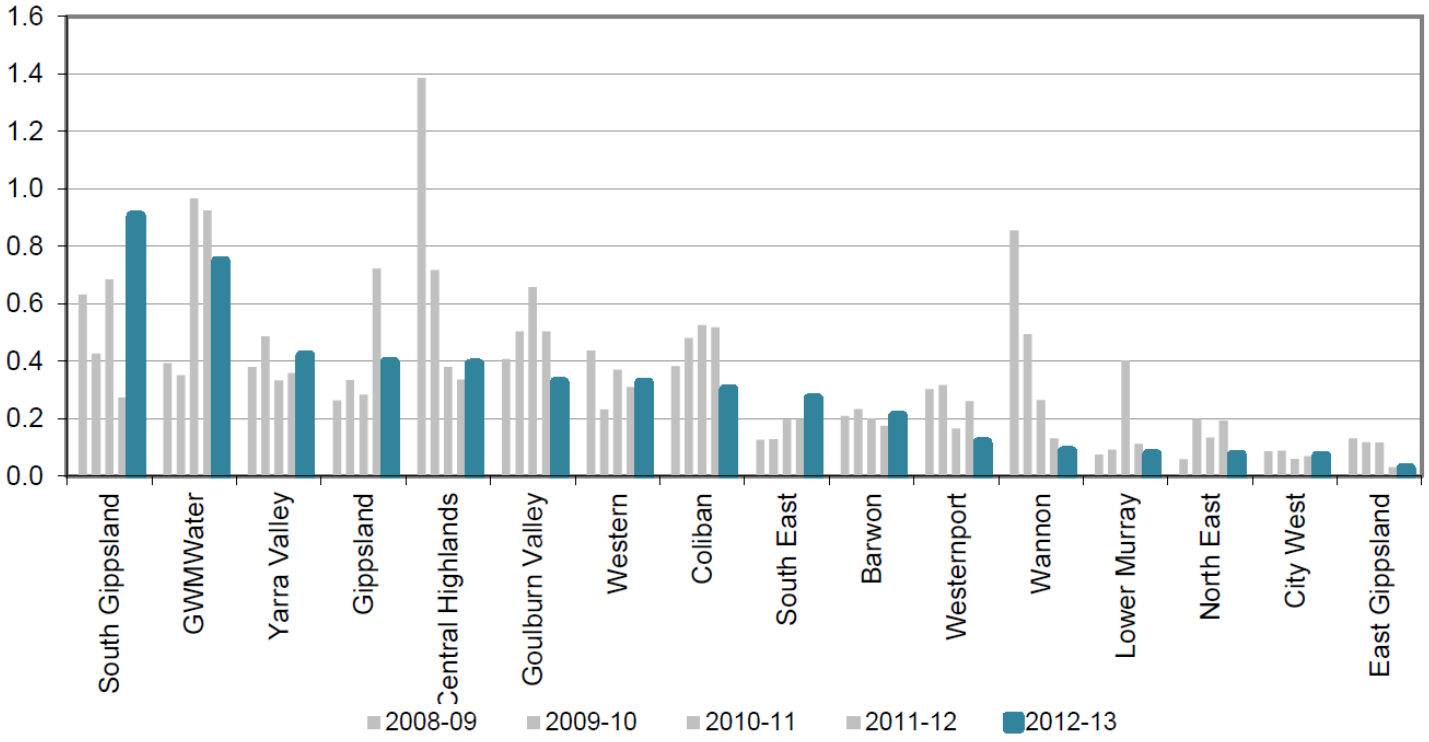
- Report covers key aspects of service
  - Water quality
  - Prices
  - Payment difficulties
  - Reliability of supply
  - Environmental
  - Recycling

Focus

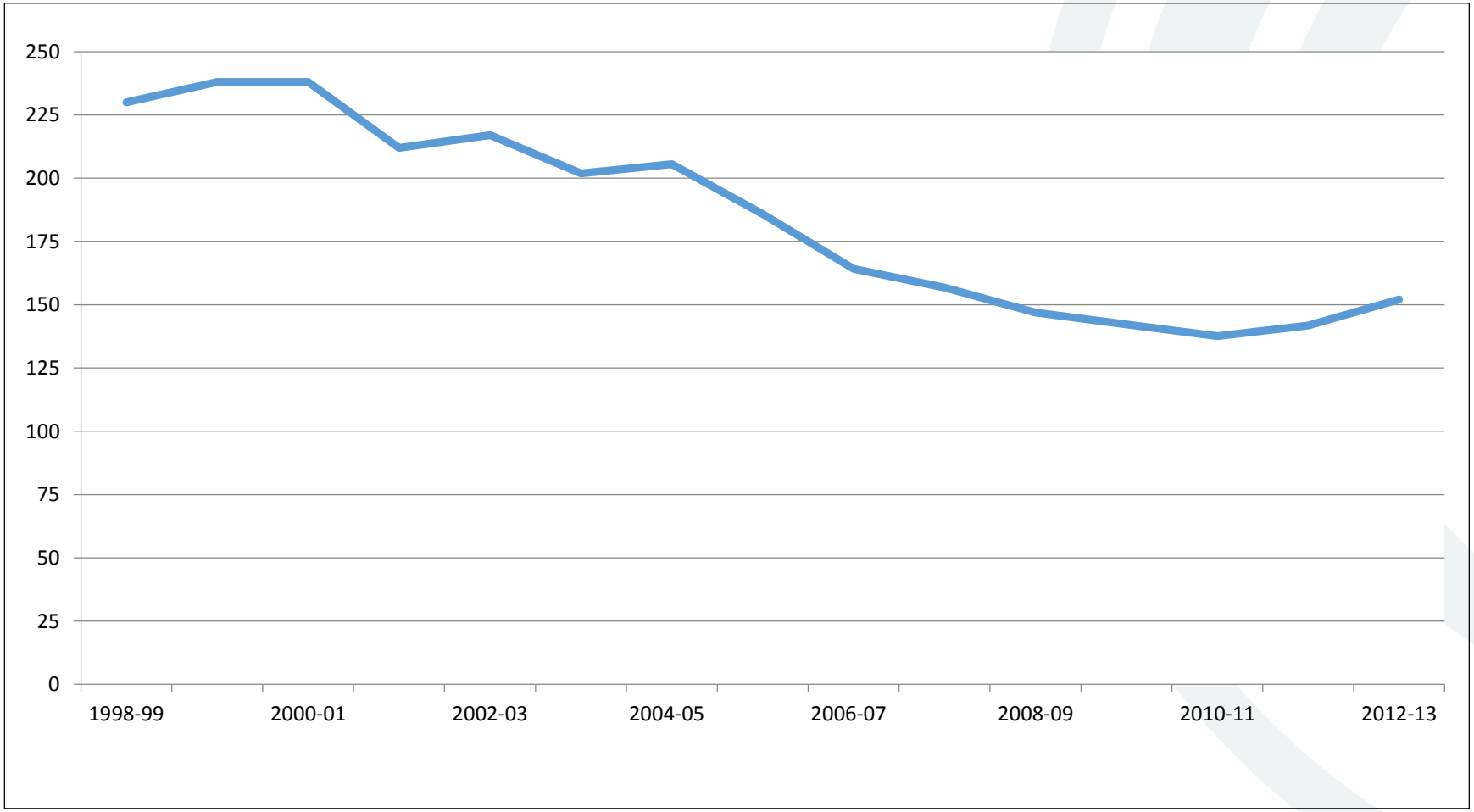
- Comparison between businesses
- Long term trends in performance
- Some examples

Water quality

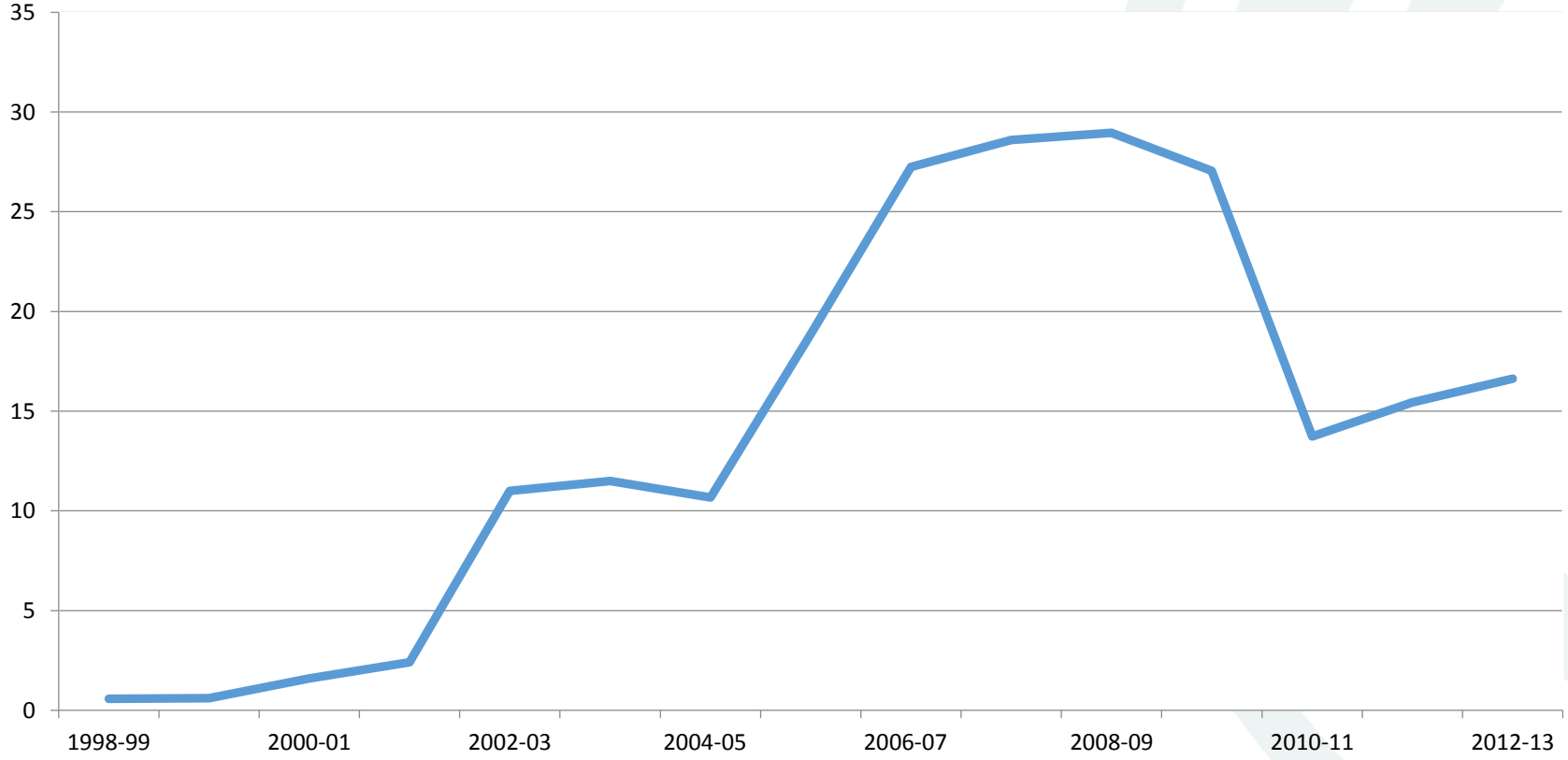
FIGURE 6.1 WATER QUALITY COMPLAINTS — ALL CAUSES
(per 100 customers)



Household water consumption (kL per annum)



Recycled Water (%)



Session 4 Customer protection framework

Customer Service Codes

- The Commission is responsible for establishing the terms and conditions of service and supply

- Established Urban and Rural Customer Service Code and a Trade waste Customer Service Code

- The Customer Service Codes cover matters such as
  - Information on bills
  - Billing and payment terms
  - Time to pay
  - Assistance with payment difficulties
  - Complaint handling processes
  - Maintenance responsibilities
  - Repair times

GSLs

- Also established Guaranteed Service Levels where businesses are required to make payment to customers if they fail to meet certain performance levels

- Questions