icon WATER

4 January 2016

Mr Malcolm Gray
Senior Commissioner
Independent Competition and Regulatory Commission
GPO Box 296
CANBERRA CITY ACT 2601

Dear Mr Gray Malcolm

Submission in response to Issues Paper: Tariff Review 2016

I refer to the Issues Paper (**Paper**) published by the Independent Competition and Regulatory Commission (**ICRC**) on 23 November 2015 in relation to its review of tariff structures for regulated water and sewerage services. Icon Water notes the common deadline for submissions on the Paper and the forthcoming technical papers is 1 July 2016 and that the ICRC has invited stakeholders to make multiple submissions if so desired. This submission provides Icon Water's initial views on the proposed framework for the review and priority issues requiring attention. Icon Water intends to make at least one other submission prior to the deadline, detailing specific proposals in relation to pricing reform. The exact timing of the second submission will depend on the outcomes from the technical papers.

Harper Competition Policy Review

As you would be aware, the Australian Government responded to the final report of the Competition Policy Review chaired by Professor Ian Harper on 24 November 2014. In its response, the Government supported the recommendation in relation to water, which included a recommendation that "*state and territory regulators should collectively develop best practice pricing guidelines for urban water…*" and that governments should develop timelines for full implementation of the National Water Initiative (**NWI**).[1]

It will therefore be important for the ICRC to have regard to the NWI pricing principles and any consensus amongst other jurisdictional economic regulators on what constitutes best practice in order to optimally harmonise the tariff structures planned for the regulatory period commencing in 2018 and the pricing guidelines that are ultimately developed as part of the national reforms.

Control mechanism

The regulatory control mechanism that will apply from 1 July 2018 is a key component of the context for the tariff review. The ICRC has rightly noted in the Paper that under some common control mechanisms Icon Water would be responsible for setting tariff structures, with controls placed on revenue or weighted average prices. If tariff structures were being considered after consultation and determination of the control mechanism, it would be clear whether the output of the review should be

[1] Australian Government 2015, *Response to the Competition Policy Review*, November, p 18

recommendations on specific tariff structures or recommendations on principles within which the utility would be required to operate. Because this tariff review is being undertaken in advance of the broader 2018 price investigation, it will be important for the review to maintain an open stance on this issue and contemplate both types of recommendation.

The ICRC offers a view on the control mechanism by stating, "*it seems likely that the Commission will set prices for the next regulatory period...*"[2] Icon Water would support the ICRC reaching an early conclusion on this issue, but only after it has published a considered assessment of alternative approaches and consulted with stakeholders. Icon Water understands that it is not the ICRC's intention to undertake this process as part of the current tariff review, since the ICRC has indicated that the control mechanism issue will influence the tariff review only in the sense that it has implications for revenue risk.[3] Therefore, Icon Water does not intend to make specific proposals on control mechanisms in its submissions to this review. A transparent and consultative approach to this issue in the early part of the 2018 price review will be necessary to inform the rationale and content of Icon Water's regulatory proposal in 2017.

Objective and principles

Icon Water supports the objective and principles outlined in the Paper. The use of a single, overarching objective will allow for more transparent and evidence-based analysis of alternative tariff structures and it is appropriate that the objective be defined in terms of the welfare of Icon Water customers over the long term. As the ICRC notes, the primacy given to economic efficiency in the objective will assist in making trade-offs between the pricing principles.[4] It will be important, for example, that drought pricing arrangements that would improve economic efficiency (*Pricing principle 1*) and full cost recovery (*Pricing principle 2*) are not precluded on the basis that they would make prices less stable (*Pricing principles 4 and 5*).

Promoting the use of existing infrastructure where it is valued above marginal cost, in accordance with *Pricing principle 1*, will be critical to achieving the objective. It is appropriate that principles have been included in relation to full cost recovery and revenue sustainability. These principles do not simply safeguard the viability of Icon Water. They safeguard incentives to make purpose-specific investments in infrastructure when they are required to deliver the services that customers want over the long term. It is appropriate that the influence of customer impact considerations be limited mainly to the decision on the length of any transition period, as provided for in *Pricing principle 5*, without compromising the ultimate goal of a welfare-maximising tariff structure.

Uneconomic bypass

As noted in the Paper, there is a stark contrast between the level of water security in the ACT now and at the time tariff structures were last substantively reviewed by the ICRC in 2007.[5] There was a significant focus at that time on the role of tariff structures in discouraging 'discretionary' water consumption. A different focus is needed for the present review. One of the primary issues requiring attention is the role of tariff structures in discouraging uneconomic bypass.

Investments by customers in alternative sources of water lead to Icon Water's predominantly fixed costs being spread over fewer sales or fewer customers, thereby putting upward pressure on prices for remaining customers and tending to make additional uneconomic projects viable, and so on. These types of investments add to the overall cost of water supply in the ACT and typically provide no significant improvement in supply security.

Icon Water is aware that the level of the Tier 2 water price, at $5.22 per kilolitre, is a key factor in customers considering alternative sources, such as investments in non-potable supply. These

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[2] ICRC 2015, *Issues Paper – Tariff Review 2016*, Report 7 of 2015, November, p 10
[3] ICRC 2015, *Issues Paper – Tariff Review 2016*, Report 7 of 2015, November, p 10
[4] ICRC 2015, *Issues Paper – Tariff Review 2016*, Report 7 of 2015, November, pp 45-46
[5] ICRC 2015, *Issues Paper – Tariff Review 2016*, Report 7 of 2015, November, pp 4,33

investments would not be profitable for customers if Icon Water's consumption charge was more reflective of the costs imposed by consumption. Given the current high level of water security, the marginal cost of supply from Icon Water's network would be considerably lower than the current Tier 2 price. Icon Water is not in a position to offer prudent discounts on the regulated price,[6] since valid claims for discounts could potentially be made by several customers, leading to a significant under-recovery of costs that cannot be fully recouped under the current price direction.[7]

Significant welfare losses would be avoided by reducing the Tier 2 price, at least for non-residential customers, in order to prevent uneconomic bypass of the primary water network and better utilise the water supply security in which Icon Water on behalf of customers has already invested. This reform would require other elements of the water tariff structure to increase, in order to maintain full cost recovery, and potentially a means of transition in order to limit annual impacts on individual customers. Icon Water is currently assessing a range of options and will develop a proposal for its next submission to this review.

Flexibility in drought conditions

Experience during the millennium drought confirmed that, when the regulatory approach to price setting does not have the necessary flexibility to respond to new information about demand, periods of reduced consumption due to temporary water restrictions can result in substantial under-recovery of costs.[8] These shortfalls must be either recouped from customers at a later date or borne by Icon Water's shareholders. The latter is counter to full cost recovery (*Pricing principle 2*). The former leads to a mismatch between prices and the economic cost of consumption, with lower prices during water shortages and higher prices when water may be plentiful. There is clearly scope to improve the approach to price regulation in this area.

Icon Water continues to support the implementation of a revenue-neutral drought pricing scheme that would involve updating consumption prices to account for expectations about demand when changes in water restrictions occur. There is potential for significant improvement in allocative efficiency under this approach. Price increases, which result in consumers forgoing their lowest value uses of water, would reduce reliance on behavioural restrictions that potentially prevent high value uses of water. The existing temporary water restrictions scheme primarily targets outdoor water use by households, whereas the concurrent application of price increases and water restrictions would extend conservation incentives to a broader coverage of customers and uses.[9] Even if the forecasts of the demand response to restrictions are imprecise, any revenue variance would likely be smaller than the variance that would arise under the current arrangements. Existing techniques for managing this risk, such as the demand volatility adjustment mechanism in the current price direction[10] and the 'unders and overs account' typically applied under the revenue cap control mechanism,[11] would remain possible under a revenue-neutral drought pricing scheme.

Liquid trade waste

The ICRC has noted that Icon Water is in the process of developing a new trade waste policy and charging regime.[12] Discharge of liquid trade waste to the sewerage system can impose costs in several ways. High volumes can cause sewer overflows, solid substances can cause blockages,

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[6] ICRC 2015, *Issues Paper – Tariff Review 2016*, Report 7 of 2015, November, p 76

[7] For an example of a framework for prudent discounting, see Section 96 of the National Gas Rules.

[8] For example, see ACTEW 2013, *Response to the Draft Report Regulated Water and Sewerage Services*, 12 April, p 96

[9] ACTEW 2012, *Main submission to the ICRC*, July, pp 28-31

[10] Industry Panel 2015, *Substituted Price Direction – Regulated Water and Sewerage Services 1 July 2013 to 30 June 2018*, April, pp 12-13.

[11] AER 2014, *Final Framework and approach for the Victorian Electricity Distributors – Regulatory control period commencing 1 January 2016*, 24 October, p 75.

[12] ICRC 2015, *Issues Paper – Tariff Review 2016*, Report 7 of 2015, November, p 83

corrosive substances can reduce sewerage asset lives, and chemicals can produce gases that result in dangerous working conditions and disruptions to treatment plant processes. The intent of the policy and charging regime being developed by Icon Water would be to signal these costs and provide an incentive for customers to undertake pre-treatment where it would reduce overall costs. Icon Water is working closely with the technical regulator on this issue and expects to discuss the structure of the charging regime with the ICRC as it is developed over the course of 2016.

We look forward to working with the ICRC on this review. If you wish to discuss any of the matters raised in this letter, please contact Dr Ben McNair, Principal Economist, on [redacted].

Yours sincerely

[redacted]

John Knox
Managing Director

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