

# PREPARING FOR A NEW WATER REGULATORY PRICING FRAMEWORK – GETTING THE MOST OUT OF THE REGULATORY PRICING REVIEW PROCESS

David Francis<sup>1</sup>, Ana Dijanosic<sup>2</sup>

1. Market Sector Manager, Water Advisory

[francisdav@halcrow.com](mailto:francisdav@halcrow.com), Halcrow Pacific Pty Ltd, Melbourne, VIC

2. Senior Consultant

[dijanosica@halcrow.com](mailto:dijanosica@halcrow.com), Halcrow Pacific Pty Ltd, Sydney, NSW

## ABSTRACT

Regulatory pricing review frameworks across Australia are currently being extended, reviewed, or developed as a result of structural developments in the water industry, changes to the relevant legislative process, a desire to improve the effectiveness of the review process, and / or the natural evolution of the regulatory pricing review process. This paper examines the proposed changes, with a focus on Queensland, and offers some insights into the process.

Water businesses must be fully aware of the changes to ensure they are prepared for the regulatory review process. Appropriate preparations for a review can facilitate an effective and efficient process and help achieve appropriate outcomes; for the water business, the regulator, and the community. It is intended that this paper might offer some guidance.

## INTRODUCTION

A number of regulatory pricing review frameworks across Australia are currently being extended, reviewed, or developed. These changes have arisen for a number of different reasons including: structural changes in the water industry (South East Queensland and Tasmania); changes to the relevant legislative process (South Australia); a desire to improve the effectiveness of the review process (Western Australia); or the natural evolution of the regulatory pricing review process.

It is imperative for water businesses to be fully aware of the scope of the changes to regulatory frameworks currently being implemented and proposed to ensure they are prepared for the requirements of the regulatory review process.

This paper examines the current state, proposed changes and potential new directions for regulatory pricing review frameworks and provides a brief update on progress to date in implementing the changes.

This paper offers some insights into the process from the perspective of an independent regulatory reviewer, based on our experience and involvement in a number of regulatory pricing reviews around

Australia. The typical role of the regulatory reviewer is to act as an independent advisor to the regulator providing advice on the water business' strategic, capital and operational processes and the prudence and efficiency of the capital and operating expenditure proposed by the water business.

It is intended that the insights in this paper might offer a guide for water businesses as to what a regulatory reviewer, acting on behalf of the relevant regulator, expects to assess in order to complete the review process. This paper aims to demonstrate that the appropriate preparations for a regulatory pricing review can facilitate an effective and efficient review process and go some way to achieving the most appropriate outcomes for the water business, the regulator, and the community.

## REVIEW OF REGULATORY FRAMEWORKS

This section provides a brief overview of the current regulatory pricing review frameworks in place around Australia, with a particular focus on Queensland. It also provides a brief summary of any proposed changes to these frameworks.

### **Queensland**

The Queensland water industry is dominated by the South East Queensland region with Brisbane as the central focus. The region is home to the South East Queensland Water Grid, a multi-billion dollar network of interconnected bulk, distribution and retail infrastructure that supplies water and wastewater services to a population of almost 2.8 million (QWC, 2008 & QCA, 2009).

The majority of the water businesses in Queensland are owned and operated by Local Councils, either singularly or in groups of Councils. The source and bulk infrastructure businesses within the South East Queensland Water Grid are generally the exception, with these businesses being State owned statutory authorities.

Recent reforms to the industry in South East Queensland have created three new Council-owned distribution-retail businesses based in three regions. The central entity includes Brisbane, Somerset, Lockyer Valley, Ipswich and Scenic Rim Councils.

The northern entity includes the Sunshine Coast and Moreton Bay Councils, while the southern entity is made up of the Redland, Logan and Gold Coast Councils. The new businesses take responsibility for the construction, operation and maintenance of the distribution and retail assets from the individual Councils.

Brisbane City Council's water business, 'Brisbane Water', has already moved across to the new entity, 'Queensland Urban Utilities', with the other Councils' water businesses scheduled to transfer across prior to the required date of 01 July 2010

The Queensland Competition Authority (QCA) is the primary statutory authority for the state with its functions defined under the Queensland Competition Authority Act 1997 (the QCA Act). The QCA has responsibility for overseeing prices for water and wastewater related services provided by either government monopoly (or near monopoly) water businesses, where the QCA has the power to recommend prices; and water suppliers, as defined in the Act, where the QCA has the power to actually set prices for services.

Through the current regulatory pricing review process, the QCA either investigates the pricing practices of the government monopolies or simply monitors the maximum prices charged by them. The QCA can only perform these functions on request from the relevant State Government Ministers, however, the QCA has a mandate to undertake an investigation of the SEQWater business without a referral from the Ministers.

For the majority of Council-owned water businesses, the current regulatory review framework for water and wastewater is incorporated within the review of the Council's Infrastructure Charges Schedules (ICS), as set out in a Priority Infrastructure Plan. The ICS cover all trunk infrastructure including water, wastewater, drainage, roads, open spaces, pathways.

With the recent water reforms occurring in the South East Queensland region, the role of the QCA in regulating the three new water businesses created has been investigated and defined. The Premier and Treasurer of Queensland have directed the QCA to recommend an interim price monitoring framework that will apply during the transition period for the three businesses, that is, the period between 01 July 2010 and 30 June 2013 (QCA, 2009,pg iv).

The interim framework seeks only to monitor the prices of services provided by the three water businesses to ensure that:

1. the businesses do not over-exercise their market power;

2. that information is provided to customers explaining the reasons behind annual increases in prices; and
3. to implement an approach that can be transitioned into a more comprehensive regulatory review process in the future. (QCA, 2009,pg iv)

The interim framework has the following functions: to focus on revenues and pricing policies, to promote disaggregation of costs to align prices, costs and service levels; and to incorporate trigger provisions for more a comprehensive price-setting framework should revenues significantly exceed a guideline Maximum Allowable Revenue for a sustained period (QCA, 2009,pg v).

The interim framework also introduces the prudence and efficiency test to capital and operating expenditure that is common in other jurisdictions. These two tests can have a major impact on the operation of the business. All proposed and historical expenditure needs to be assessed to identify a demonstrated need for the expenditure in line with planning strategies or legislative obligations (the prudence test) and further that the proposed expenditure is cost-effective in comparison to other options considered or market benchmarks (the efficiency test).

While the interim framework involves only the monitoring of the prices set for services, it places a specific requirement on each of the three water businesses to submit a fairly comprehensive annual information return covering information on revenues; service standards; demand volumes; the initial regulatory asset base; expenditure to be rolled into the regulatory asset base; actual capital expenditure; contributed, donated and/or gifted asset values; depreciation; indexation; return on capital; and operating costs.

### **Tasmania**

The water industry in Tasmania has recently undergone a significant consolidation with the previous twenty-eight Local Government owned retail entities and three bulk water authorities being transferred into three, regionally based, Local Council owned water corporations. Previously the water businesses were dominated by the three bulk water entities, Cradle Coast and Esk Water in the north and Hobart Water in the south. The remaining Local Council owned entities were diverse in size and location but required stand alone systems for the provision of water and wastewater services.

The Government Prices Oversight Commission (GPOC), the independent regulator which had responsibility for the water industry, had a price monitoring mandate with urban retail prices actually set by the businesses themselves.

The State Government can request that the GPOC undertake an investigation of pricing policies (NWC, 2007).

The GPOC has powers under its enabling legislation to conduct investigations into the pricing policies and was undertaking such reviews of the three bulk water authorities on a three yearly cycle up until 2007 (NWC, 2007).

The creation of the three new water businesses as part of the recent reform process has necessitated a change in the regulatory pricing review framework. The GPOC took on a more formal role as the Economic Regulator of Water and Sewerage. In this new role the GPOC took responsibility for providing advice on interim pricing and licensing arrangements that would apply until the transition period for the reform process expired. In the future the GPOC will provide advice to the State Government on regulatory price determinations.

### **South Australia**

The water industry in South Australia is dominated by a single utility, the state owned South Australia Water Corporation, which provides bulk, distribution and retail water and wastewater services to the entire state.

The regulator in South Australia, the Essential Services Commission of South Australia (ESCoSA) has been undertaking regulatory reviews into the water industry since 2004, however unlike the other states, water and wastewater services are not regulated services. As such the ESCoSA's role in the regulatory review process has been limited to post-reviews of the State Government's processes for setting the prices of water and wastewater charges, that is, the reviews have occurred after the prices have been set.

In June 2009 the State Government released a new strategy document for South Australia entitled *Water for Good* (Government of South Australia, 2009) which provides a plan to meet the water supply needs for South Australia up to 2050.

A key component of this strategy is the expansion of the role of the ESCoSA. This expansion includes the appointment of the ESCoSA as the independent economic regulator for monopoly water and wastewater service providers in South Australia. The strategy also allows for an expansion of the regulatory review framework to include the implementation of operating licences for service providers, prices to be reviewed and set by ESCoSA, and third party access to service provision to be facilitated.

### **Western Australia**

The water industry in Western Australia is dominated by a single utility providing bulk, distribution and some retail water supply services and wastewater collection, treatment and disposal services across the state.

The Water Corporation is a state owned corporation with an appointed board of directors. There are two other service providers that are currently regulated, the Aqwest / Bunbury Water Board and the Busselton Water Board, both of which are Council owned entities.

The remainder of the state is serviced by local council owned businesses however at present these entities are not independently regulated.

The regulatory pricing review framework for the state is managed by the Economic Regulation Authority (ERA) however the ERA does not have a formal regulatory role for water and wastewater services. Rather, the ERA provides an advisory role to the State Government, responding to matters referred to it by the State Government. In this role, the ERA does not make decisions but provides recommendations and guidance for the State to consider (ERA, 2010).

The ERA does have a regulatory role in licensing the various water and wastewater service providers across the state and has a regular program of operational performance audits against the requirements of the operating licences and a review of asset management planning processes.

At present, there are no significant changes proposed for the regulatory framework in Western Australia.

### **New South Wales**

The regulated water industry in New South Wales is centred around the Sydney and Hunter regions with the key regulated businesses comprising Sydney Water Corporation, Sydney Catchment Authority, State Water Corporation and Hunter Water Corporation. Water management related services provided by the State Government, through the Department of Environment, Climate Change and Water, are also regulated at present. More recently, IPART has commenced a review of water and wastewater services provided by Country Energy in Broken Hill.

The regulator in New South Wales is the Independent Pricing and Regulatory Tribunal (IPART). IPART has been the regulator in New South Wales since 1992 and it now has six key functions related to:

1. price setting for monopoly services;
2. licence administration and compliance;
3. third party access facilitation;

4. competitive neutrality investigations;
5. administration of the Greenhouse Gas Reduction Scheme; and,
6. administration of the Energy Savings Scheme. (IPART, 2010)

IPART has a regular function reviewing the prices of the regulated businesses on a typical four yearly schedule and also has an annual program of operational performance audits of the regulated business' operating licence requirements.

IPART recently established a formal third party access framework under the Water Industry Competition Act 2006 and has received a number of applications under this framework. To date, there is one licence holder and current applications received relate to small scale non-potable water supply schemes and sewerage infrastructure operations and services.

At present, there are no significant changes proposed for the regulatory framework in New South Wales, however some early work is being investigated relating to revenue frameworks for local government.

#### **Australian Capital Territory**

There is only one water and wastewater service provider in the ACT; ACTEW Corporation, which covers the entire territory. ACTEW is a territory owned corporation with two key voting shareholders, the ACT Chief and Deputy Chief Ministers, and a Board which is appointed by the Shareholders.

ACTEW is a small organisation with a core team of staff managing high level planning and strategy, capital works contracts, system operations, sustainability, and regulatory compliance. Water and wastewater delivery services for capital works and operations is contracted to ActewAGL under the terms of what was, at the time, Australia's first utility joint venture.

The regulator in the ACT is the Independent Competition and Regulatory Commission (ICRC) and as a statutory body, it is responsible for the regulation of prices and access to infrastructure services; and the investigation of competitive neutrality complaints and government-regulated activities.

Under the terms of the enabling legislation, the ICRC undertakes regular reviews of the prices charged by ACTEW for water and wastewater services however the ICRC must wait for the release of a ministerial direction to undertake the reviews.

#### **Victoria**

The water industry in Victoria covers the whole state with all nineteen businesses coming under regulatory control. In the Melbourne metropolitan area there is one bulk service provider and three retail businesses.

In Victoria's regional areas there are thirteen regional water businesses providing retail or combined retail and bulk services, and there are two rural businesses providing only bulk services.

All the water businesses across the state are State Government Business Entities which are guided by skill based Boards of Directors. The businesses provide water and wastewater services to over 4.6 million people across the State.

The Essential Services Commission of Victoria (ESC) is, among its other functions, the economic regulator for all water businesses across the state, regulating prices and service standards. The ESC has the power and function to make price determinations; regulate standards and conditions of service; develop Codes in relation to its functions and powers; and to require regulated businesses to provide information to support the ESC's review processes (ESC, 2010).

The ESC has a role undertaking performance comparisons of the urban water and wastewater businesses through the preparation of an annual report. The ESC has also just recently released its final report on its inquiry into the state-based access regime for water and sewerage infrastructure services (ESC, 2009).

#### **Northern Territory**

The provision of water and wastewater services in the Northern Territory is undertaken by Power and Water Corporation, the first government owned corporation in the Territory. Power and Water Corporation supplies services to 80,000 customers, spread over an area of more than 1.3 million square kilometres.

The primary regulator for the water industry is the Northern Territory Utilities Commission ('the Commission'). The Commission assumed the responsibility for regulatory water related services in 2001 with the passage of its enabling legislation. The primary responsibilities of the Commission relating to the water industry are the licensing of water and sewerage service provision.

The Commission can be assigned some price or service standard monitoring functions by the relevant Minister however their role is a price monitoring role rather than a price setting role. At present, prices for services are still set by the relevant regulatory Minister through the release of a Water and Sewerage Pricing Order.

The Commission has had a regular program with regulatory pricing reviews occurring approximately every year. The current pricing order, however, has been set for a period of four years (a similar price path period as those set by other state regulators).

### PREPARING FOR A REGULATORY REVIEW

The previous section provided an overview of the diverse regulatory frameworks in place across Australia and highlighted some of the proposed changes to these frameworks. Even with such a variety of frameworks and requirements for the regulatory review processes, there are common requirements that if applied prior to a regulatory review might assist in gaining the optimal solution.

Regulatory frameworks around Australia are becoming more robust and this is leading to the requirement for water businesses to publicly report on and justify their expenditure programs, in the process becoming more transparent about how they manage their capital and operating expenditure. Regulatory reviews are taking on a new significance in this process and the potential impacts on unprepared businesses can be significant.

This section tries to identify these requirements by providing some guidance on how to prepare for a regulatory review, taken from the perspective of an independent regulatory reviewer.

The regulatory review process operates differently across the various jurisdictions however the fundamental approach is the same. This applies whether the regulatory framework is based on price monitoring and guidance (as currently proposed in Queensland and similar to the system in Western Australia) or price setting (such as the current framework in New South Wales and Victoria). This fundamental approach, at its most basic, involves a review of the prudence and the efficiency of historical and proposed capital and operating expenditure.

The assessment of prudence requires the reviewer to investigate the reasoning behind the levels of expenditure proposed and to determine whether the reasoning is appropriate. That is, whether the expenditure is consistent with and clearly linked to the water business' obligations, be these legislative driven by a corporate vision or mission statement, or by direct or indirect customer action or advocacy.

The assessment is generally undertaken by reviewing documentation supporting the expenditure under review ranging from corporate level Statements of Corporate Intent, to planning and strategy studies, asset management plans and more specifically to design investigations.

In the case of operating expenditure supporting documentation might include operating budgets and plans, evidence of regulatory obligations, levels of service requirements, or simply evidence of capital assets requiring ongoing operational expenditure.

The prudence of proposed expenditure is generally demonstrated where the following issues can be adequately addressed: (QCA, 2009)

1. the expenditure is required as a result of a legal obligation, new growth, or renewal of existing infrastructure, or where it achieves an increase in the reliability or the quality of service provision that is explicitly endorsed or desired by customers.
2. clear linkages exist between the various levels of planning and strategy documents and the proposed expenditure. A business should be able to easily demonstrate how expenditure on a particular project's assets relates to the achievement of business obligations such as a component of the business' corporate goals and objectives or to legislative requirements such as water quality.
3. sufficient supporting documentation is available for each project to address each stage of the project or asset life cycle. This would include documents covering the planning, feasibility, design, construction and operational phases of the life cycle. The provision of these types of documents during the regulatory review process goes a long way to demonstrating the prudence of expenditure.

In NSW, the Independent Pricing and Regulatory Tribunal defined a similar test for its assessment of capital expenditure. The prudence test assesses whether, 'in the circumstances that existed at the time, the decision to invest in the asset is one that [the agency], acting prudently, would be expected to make'.

The prudence test assesses both: 'the prudence of how the decision was made to invest; and the prudence of how the investment was executed (that is, the construction to delivery and operation of the asset), having regard to information available at the time.' (IPART, 2009)

While the assessment of prudence by the regulatory review is intended to provide assurance that the proposed expenditure is appropriate, it does not constitute a full assessment of all the options considered by the proponent.

The assessment is reliant on the experience of the regulatory reviewer to gain sufficient understanding of the process undertaken and to provide as detailed a review as the available time permits.

Demonstrating, for the regulatory review process, that expenditure is required may involve the provision of documents such as correspondence from the relevant Minister outlining the legislative requirement, or growth projections showing likely population increases in areas targeted for capital works.

It is expected that planning and strategy studies will have been completed which demonstrate a clear need for a solution and that identify all reasonable options that would fulfil the identified need. A progressive options analysis, that assesses, ranks and prioritises all of the options using a basic triple bottom line or equivalent approach is also expected.

A regulatory reviewer will also expect to see evidence of an appropriate and robust governance framework shadowing the process. The involvement of and sponsorship from appropriate executive managers and relevant approvals and endorsement at the Board level demonstrates a robust approach.

Where the expenditure relates to an increase in required base service levels, evidence that might be provided could include benchmarking results showing comparatively lower performance in targeted areas.

We would expect that the outcomes of the benchmarking and proposed actions would be clearly linked to corporate objectives to achieve higher service performance, supported of course by the customer's willingness to pay for such an increase in service levels.

Where an increase in service levels is driven by a change in legislation, the prudence of the expenditure is generally not questioned and the focus of the review shifts to the efficiency of the expenditure proposed to fulfil the legislative requirement.

Where expenditure relates to improvements that are endorsed or desired by customers, typical evidence that might be provided includes overwhelming positive responses from customer surveys or outcomes from customer consultative groups. In these cases, the scope of the surveys and the consultation undertaken must include the full impacts of the proposed expenditure including the impact on service prices.

The efficiency test for expenditure is generally made when the following can be demonstrated:

1. the proposed works are deemed to be the most appropriate solution after having due regard for alternative options, which may include other capital or operating options or non-expenditure options such as water conservation, demand management or adjustments to service levels.

2. the cost estimates for the proposed works have been benchmarked against market rates using unit rate databases with appropriate consideration of issues affecting costs such as market indices and escalation factors.

Demonstrating that capital or operating expenditure proposed is efficient may involve the provision of supporting documents including feasibility studies or options analysis studies where multiple options are considered which detail the options considered, the conditions under which options were assessed, and reasoning for the choice of the optimal solution.

It is critically important to provide cost estimates which are as detailed as possible at this stage of the process. The assessment of options needs to be done on estimates which are robust and that allow for all components of the proposed options. This should include items such as risk, contingency, owner's costs, consultant's fees, contractor margins, independent reviews, and any other miscellaneous works.

An appropriate, or at least a consistent, level of accuracy is required to undertake the comparative analysis of the options. The exclusion of any costs at this stage of the process, should be robustly defended, with any uncertainty taken into account through appropriate risk or contingency allowances.

Relevant documents can also include independent peer reviews of costs; evidence of the consistent use, and regular updating, of unit rates databases; and supporting documentation for the determination of contingencies, allowances, and escalation factors. Careful consideration of these latter factors is especially important where market conditions are volatile; whether the volatility be related to increases or decreases in the market or industry.

In the majority of cases, the information contained in the types of documents that are listed here can be presented concisely in a detailed business case, a consolidated document that, while alone might not necessarily provide all of the detail required, can provide the structure around which a response to the requirements identified here can be formulated. Extensive referencing of the supporting documents is essential to provide the level of detail required for a robust case. A regulatory reviewer would expect to see business cases for all projects with the level of detail included reflective of the project size and / or associated risk factors.

A number of suitable business case templates exist and this paper does not recommend one particular example over another, however one observation is offered and that is to ensure that the maximum amount of detail possible goes into the business case. This is one example where it is certainly not the case that less is more.

The assessment of efficiency is a critical part of the regulatory review process as ultimately this assessment by the regulatory reviewer will either confirm the level of expenditure proposed or will recommend what the reviewer believes is an efficient level of expenditure to meet the needs first identified at the planning stage.

This part of the process provides the greatest opportunity, and the greatest risk, to achieving the optimal outcome from the regulatory review.

## CONCLUSION

This paper has provided a brief overview of the current water regulatory frameworks in place around Australia. In addition, current and proposed changes to the frameworks have been briefly outlined.

The discussion outlines the various characteristics of the frameworks in each state and highlights a diverse range of processes. From single service providers to multiple large and small scale businesses and from full state regulatory coverage to those with a distinctly metropolitan focus.

A range of levels of regulation were also presented from simple price monitoring and compliance functions, to guidelines or recommendations for pricing, and finally to enforceable price determinations; from setting operating guidelines to full operational compliance auditing, comparative performance reporting, and benchmarking.

With this background, the discussion identifies some common threads in all of the regulatory frameworks; some guidelines that may assist a business in preparing for a review and may help in achieving the optimal outcome.

The common requirements identified were two tests used extensively in the regulatory review process, that is, the prudence test and the efficiency test. In their most basic sense, these tests were defined as:

1. Prudence test – is there a real and demonstrable need for the project?
2. Efficiency test – is the solution / expenditure proposed the optimal way of fulfilling the identified need?

To assist in responding to these two tests, various examples of supporting documentation that a regulatory reviewer would expect to examine were identified. One example was highlighted as being one of the most suitable forms of supporting documentation, and that is the detailed project business case.

So if there is one final statement made in concluding this paper on how to prepare for a water regulatory pricing review, it would be that less is definitely not more in this area.

Businesses need to develop as much detail on their capital and operating expenditure programs as befits each project. What is needed is a clear and logical process supporting the demonstration firstly of the need for the project and secondly that the proposed works are the optimal method of fulfilling this need.

## REFERENCES / FURTHER INFORMATION

- ESC [Essential Services Commission]. 2010. Website reference <http://www.esc.vic.gov.au/public/Water/Our+Role.htm>.
- ESC [Essential Services Commission]. 2009. Inquiry into an Access Regime for Water and Sewerage Infrastructure Services: Final Report Government of South Australia, 2009. Water for Good: A plan to ensure our water future to 2050
- IPART. [Independent Pricing and Regulatory Tribunal]. Review of the Department of Water and Energy's (DWE) water management expenditure (RFQ No W03/2009), page 3.
- IPART [Independent Pricing and Regulatory Tribunal]. 2010. Website reference [http://www.ipart.nsw.gov.au/about\\_us/functions.asp](http://www.ipart.nsw.gov.au/about_us/functions.asp).
- NWC [National Water Commission]. 2007. Water Storage and Delivery Charges in the Urban Water Sector in Australia. National Water Initiative Steering Group on Water Charges
- NWC [National Water Commission]. 2008a. Urban Water Pricing: National Water Commission position. National Water Commission Position Statement 2 July 2008.
- NWC [National Water Commission]. 2008b. Approaches to urban water pricing. Waterlines Occasional Paper No 7 July 2008.
- QCA [Queensland Competition Authority]. 2009. Draft Report SEQ Interim Price Monitoring Information Requirements for 2010/11. Queensland Competition Authority, QLD, Australia.
- QWC [Queensland Water Commission]. 2008. <http://www.qwc.qld.gov.au/Commissioning+the+Water+Grid>. Updated November 2008