

26 September 2013

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

Dear Mr ^{Malcolm} Gray

Application for Review by an Industry Panel of the Price Direction for Regulated Water and Sewerage Services 1 July 2013 to 30 June 2019

Pursuant to Part 4C of the *Independent Competition and Regulatory Commission Act 1997* (the Act), ACTEW Corporation Limited (ACTEW) applies for review by an industry panel of the Price Direction of 26 June 2013 for regulated water and sewerage services for the period from 1 July 2013 to 30 June 2019 (the Price Direction). In accordance with Section 24K(2) of the Act, this application is being lodged with the Independent Competition and Regulatory Commission (the Commission) within three months of the Final Report into that Price Direction investigation (the Final Report) being presented to the ACT Legislative Assembly.¹

This request follows assessment by ACTEW of whether the Price Direction and its associated Final Report have been made with proper regard to the criteria set out in section 20(2) of the Act. This culminated in ACTEW seeking an external opinion on the matter from an internationally recognised expert, Mr Greg Houston. Mr Houston's letter of 17 September 2013 points to significant shortcomings in the analysis and conclusions in the Price Direction and Final Report. The implications of those shortcomings in the short and medium term are such that ACTEW feels obliged to exercise its right under the Act to seek review of the Price Direction by an industry panel.

ACTEW has decided to apply for review to address what Mr Houston describes as "*the vacuum that [the Price Direction] creates as to both the methodological framework and the way that framework will be applied at future reviews.*" ACTEW submits that a substitute Price Direction ought to be made by the industry panel to provide a more certain basis on which ACTEW can make the operating, investment and financing decisions that are necessary to provide an efficient and effective water and sewerage service.

Some of ACTEW's key concerns with the Price Direction relate directly to a lack of regard for the requirement in the Act to recognise properly the cost of providing services (section 20(2)(e) of the

¹ The Final Report was presented to the Legislative Assembly on 6 August 2013 (Legislative Assembly for the ACT, Debates – weekly Hansard, Eighth Assembly, 6 August 2013, p2534.)

Act) and an appropriate rate of return (section 20(2)(d) of the Act). Addressing these concerns will necessarily put upward pressure on prices and potential social impacts will need to be managed. To that end, ACTEW is not seeking to recover any part of the estimated \$236 million revenue pass-through from the 2008 to 2013 regulatory period.² Any further management of price impacts should properly be cost reflective in present value terms, as distinct from the approach taken in the Price Direction, which reduces prices below a cost-reflective level with no opportunity for recovery in future regulatory periods.

Scope of Review

ACTEW understands that the industry panel, once constituted, will conduct a merits review of the Price Direction made by the Commission and that following that review the industry panel may either:

- substitute a new price direction for the original price direction; or
- confirm the original direction.

ACTEW also understands that the procedure for the conduct of the review will be determined and notified to the parties by the industry panel within the framework required by the Act.

ACTEW intends to provide detailed submissions to the industry panel on a number of issues that arise out of the Price Direction consistent with any directions timetable established by the industry panel. The areas of primary concern to ACTEW with the Price Direction and Final Report include:

- the decision to adopt a firm-specific cost of capital;
- the decision to set the rate of return on equity below the level that the Final Report determined should be the lower bound for this parameter, to achieve target price outcomes; and
- the decision to adopt a regulatory model under which all key elements of the building block revenue model will be reset every two years.

The reasons for some of these concerns are summarised below.

Firm-specific Cost of Capital

The Final Report set a firm-specific weighted average cost of capital (WACC) at 4.42 per cent in nominal terms (1.87 per cent in real terms) for the first two years of the regulatory period, based on ACTEW's estimated actual debt costs (reflecting government ownership), a firm-specific return on equity and ACTEW's actual gearing ratio. ACTEW submits that in deciding to adopt a firm-specific rather than a 'typical firm' approach to determining the WACC the Commission has not had proper regard to criterion (d) under Section 20(2) of the Act, namely an appropriate rate of return on any investment in the regulated industry.

The weight of regulatory precedent in Australia for both major urban water businesses and other utility businesses is to adopt a typical, private-sector firm approach to estimating the WACC including in circumstances where the regulated firm is publicly owned. This approach is taken to ensure competitive neutrality between government and non-government businesses and to ensure an efficient allocation of resources across the economy. The firm-specific approach has been rejected by all other regulators in Australia.

² Section 7 of the Final Price Direction in ICRC Report 1 of 2008 provides for revenue pass-throughs under a deadband mechanism.

The Final Report states that “*the weight of the argument should focus on economic efficiency*” rather than on regulatory precedent.³ Yet, the report does not provide any justification for the position that the firm-specific approach would be more efficient than a typical firm approach. Rather, the Commission claims only that it is not convinced that a typical firm approach is more efficient.⁴ The report by Professor Lewis Evans submitted to the Commission by ACTEW in April 2013, in contrast, provides substantive arguments that a typical firm approach would provide more efficient price signals and lead to more efficient resource allocation.⁵

A crucial element of the Commission’s reasoning in adopting a firm-specific approach to WACC is its decision to apply a cost-of-service regulatory model.⁶ Yet, the application of cost-of-service regulation does not ‘require’ the adoption of a firm-specific WACC. Indeed, the regulatory approach used in the United States (US), which is typically cited as an example of cost-of-service regulation, does not adopt a firm-specific approach in setting the cost of equity. Rather, the cost of equity is determined by reference to a set of comparator firms. In the Hope case, which was seminal in establishing the regulatory approach in the US, the Court stated: “...*the return to the equity owner should be commensurate with returns on investments in other enterprises having corresponding risks.*”⁷

ACTEW maintains the view expressed in its April 2013 submission that the ACT Competitive Neutrality Policy requires the application of competitive neutrality principles to ACTEW and that these principles preclude a firm-specific approach.⁸

Return on Equity

The Final Report concludes that a firm-specific return on equity should be set between upper and lower bounds and that the lower bound is the ACT Government borrowing rate of 4.25 per cent. It concludes that to be sustainable the approach to return on capital must be changed to a nominal return on an unindexed asset base and that this change would lead to an impost on current customers. The report goes on to claim that the only viable way of reducing this impost is to reduce the return on equity. The Commission adopted a return on equity of 2.8 per cent for the first two years of the regulatory period.⁹

ACTEW submits that in making this apparently ad hoc decision to set the return on equity below the level determined as the lower bound for that parameter, as a transitional measure to achieve a particular price outcome, the Commission has departed from the principle that revenues should reflect costs, including an appropriate return on investment, and has therefore not had proper regard to criteria (d), (e), and (i) under Section 20(2) of the Act.

The Final Report does not demonstrate how this rate of return on equity was calculated, nor does it provide any clear principles or theory as to how return on equity will be calculated beyond the second year of the regulatory period. ACTEW’s submissions of July 2012 and April 2013, in contrast,

³ ICRC 2013, Final Report - Regulated Water and Sewerage Services 1 July 2013 to 30 June 2019, June, p42.

⁴ ICRC 2013, Final Report - Regulated Water and Sewerage Services 1 July 2013 to 30 June 2019, June, p62.

⁵ ACTEW 2013, Response to the Draft Report – Regulated Water and Sewerage Services, April, p159-160.

⁶ ICRC 2013, Final Report - Regulated Water and Sewerage Services 1 July 2013 to 30 June 2019, June, p34,43.

⁷ Federal Power Commission v. Hope Natural Gas Company, 320 US 391 (1944).

⁸ ACTEW 2013, Response to the Draft Report – Regulated Water and Sewerage Services, April, p159.

⁹ ICRC 2013, Final Report - Regulated Water and Sewerage Services 1 July 2013 to 30 June 2019, June, p65-67.

proposed that a benchmark return on equity be set using the Capital Asset Pricing Model (CAPM) with ten-year sample periods for the risk-free rate and the market risk premium.^{10,11}

Two year Revenue Reset Periods

The Price Direction is based on a regulatory model under which all key elements of the building block revenue model are reset every two years (over a regulatory period of six years). ACTEW submits that, in making this decision, the Commission has not had proper regard to criteria (c), (e) and (i) under Section 20(2) of the Act. ACTEW also submits that this decision is inconsistent with the requirements of Section 20A of the Act. In particular, this decision will:

- in combination with the absence of principles or methods for updating demand forecasts and the rate of return on equity, leave ACTEW with a highly uncertain basis on which to make critical operating, investment and financing decisions (Section 20(2)(i) and Section 20A);
- reduce financial incentives for ACTEW to find innovative ways to reduce costs over time (Section 20(2)(c)); and
- increase the costs associated with the regulatory regime (Section 20(2)(e)).

In the absence of any determined principles or methods for setting demand forecasts or the return on equity, and given the prospect of further ad hoc decisions directed at achieving particular price outcomes, the form of regulation adopted by the Commission leaves ACTEW with what Mr Houston has characterised as “*a highly uncertain basis on which to plan the operation, investment and financing decisions that are necessary to run an efficient, effective water services operation.*”

ACTEW maintains the position expressed in its April 2013 submission that this form of regulation does not satisfy the requirements of Section 20A of the Act, since the Price Direction provides for subjective assessments of expenditure forecasts, demand forecasts and return on equity at ‘biennial recalibrations’ over the six year period.¹² The proposed regime of ‘biennial recalibrations’ may also deny ACTEW the important right to seek review of substantive pricing decisions made by the Commission as envisaged by the Price Direction within the regulatory period in circumstances where the right of review enshrined under Part 4C of the Act is intended to be available in respect of any such substantive pricing decisions.

ACTEW also maintains the view expressed in its April 2013 submission that this decision in reality reflects a sequence of three two-year regulatory periods.¹³ The report by NERA Economic Consulting submitted by ACTEW to the Commission in April 2013 showed that regulatory precedent in the ACT and elsewhere in Australia is to revisit revenue building blocks once every four to five years.¹⁴ The consensus among other regulators, supported by economic theory, is that longer regulatory periods provide stronger incentives for businesses to achieve efficiencies, which are then passed on to consumers. This approach has been consistently applied to both private sector and government-owned businesses.

The Final Report does not provide any explanation or justification for the conclusion that the cost-of-service regime that has been adopted will result in more efficient outcomes than the typical incentive-

¹⁰ ACTEW 2012, Main submission to the ICRC – Regulated water and sewerage services 2013-18, July, p181-197.

¹¹ ACTEW 2013, Response to the Draft Report – Regulated Water and Sewerage Services, April, p76-94.

¹² ACTEW 2013, Response to the Draft Report – Regulated Water and Sewerage Services, April, p121-124.

¹³ ACTEW 2013, Response to the Draft Report – Regulated Water and Sewerage Services, April, p120.

¹⁴ NERA Economic Consulting 2013, *Assessment of the ICRC's Proposed Regulatory Model*, A Report for ACTEW, April.

based approach. The Final Report alludes to “*identifying opportunities for improvement*,”¹⁵ suggesting that the Commission is proposing to rely on external parties to identify potential efficiencies, since it contends that ACTEW has no financial incentive to identify such efficiencies itself. This reasoning fails to recognise the intrinsic difficulties that external parties will face when attempting to reach more informed decisions than ACTEW itself. The approach is likely to involve costly and systematic reliance on external engineering and other consultants to ‘second guess’ management and board decisions. Ultimately, this approach will be less effective in achieving efficient cost levels than the well-accepted incentive regulation model.

Further, as argued in the report by NERA Economic Consulting submitted to the Commission in April 2013, the form of regulation adopted by the Commission will increase the cost of the regulatory regime.¹⁶ The increased frequency of revenue resets does not substantially lessen the information that will need to be provided by ACTEW at each reset to substantiate its actual capital expenditure, expenditure forecasts, and demand forecasts. In its submission of April 2013, ACTEW estimated the cost of each regulatory review to be in the order of \$5.5 million to \$6 million.¹⁷ Undertaking reviews every two years, rather than every five years could increase the cost of the regulatory regime by between \$1.65 million and \$1.8 million per annum on average.

Conclusion and Next Steps

The various issues raised above are material and significant in their impact on ACTEW’s ability to recover the prudent and efficient costs of providing water and sewerage services in the ACT.¹⁸ As noted by Mr Houston in his letter, “*the cost to ACTEW of the most egregious elements of the ICRC decision (as compared with the adoption of well-established regulatory norms) is in the order of hundreds of millions of dollars.*”

It is instructive to bear in mind the process by which the Price Direction was made. Key considerations could have been tested and discussed at an earlier stage had the Commission followed the consultation process proposed in its Context Paper of November 2011, which foreshadowed ‘preliminary conclusions’ and ‘working conclusions’ reports, ahead of the Draft Report, that were never released.¹⁹ Instead, thinking and conclusions were only made available for the first time on 26 February 2013 as part of the Draft Report and Proposed Price Direction, which, in conjunction with a media release that indicated there would be “*price reductions delivered in the Final Report*”,²⁰ created customer and community expectations of a substantial price decrease in the Final Report. The extent of these expectations was later discovered to be misrepresented, due to a mistake in the Commission’s water volumes forecast “*that meant that the 16 per cent decrease [the Commission] spoke of should have really only been around about a 10 per cent decrease.*”²¹ It was in the context of these expectations that very significant elements of the Final Report were made without consultation, with

¹⁵ ICRC 2013, Final Report - Regulated Water and Sewerage Services 1 July 2013 to 30 June 2019, June, p33.

¹⁶ NERA Economic Consulting 2013, *Assessment of the ICRC’s Proposed Regulatory Model*, A Report for ACTEW, April, p18-22.

¹⁷ ACTEW 2013, Response to the Draft Report – Regulated Water and Sewerage Services, April, p126.

¹⁸ For example, a 100 basis point change in the WACC corresponds to a change in ACTEW’s revenue requirement of approximately \$20 million per annum; a 100 basis point change in the return on equity corresponds to a change in ACTEW’s revenue requirement of approximately \$8 million per annum; and a one per cent change in demand forecasts corresponds to a change in revenue of around \$2 million per annum.

¹⁹ ICRC 2011, Context Paper – Water in the ACT, Report 8 of 2011, November, p26.

²⁰ ICRC 2013, Media Release – Release of draft report and proposed Price Direction - regulated water and sewerage services, 26 February 2013.

²¹ Legislative Assembly for the ACT, Select Committee on Estimates 2013-14, 1 July 2013, Transcript of evidence, p1268.

an apparent focus on generating particular price outcomes. Of particular concern is Mr Houston's view that *"the ICRC's decision is close to the low water mark in terms of the relatively poor process that it has adopted."*

ACTEW understands that this application must be heard by an industry panel of three members. Once the parties to the review have been determined by the industry panel as required by the Act, ACTEW would welcome the opportunity to address the industry panel regarding the process proposed to be adopted by the industry panel for the conduct of the review up to and including the hearing of its application for review, and in relation to the filing of evidentiary materials and detailed written submissions on the issues in contention.

Would you please advise on the steps that the Commission will now take in relation to this application for review and correspondence in relation to this matter should be directed to Mr David Graham, Director Regulatory Affairs and Pricing on 02 6248 3605.

Yours sincerely



Mark Sullivan
Managing Director