



Attachment 4

Regulatory controls

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4.1 Introduction

This attachment sets out Icon Water’s proposed regulatory controls for the 2023–28 regulatory period. Regulatory controls are the precise arrangements by which prices for water and wastewater services are set and adjusted during the regulatory period. They include:

- the form of price control and any ancillary mechanisms
- the annual price reset process
- pass through arrangements for unforeseen costs.

Box 4-1: Key points

- Icon Water proposes a continuation of the current regulatory controls, including:
 - using a post-tax building-block framework to determine maximum allowed prices over the 2023–28 regulatory period
 - a hybrid price and revenue cap form of price control over the five-year regulatory period with individual price caps for water and wastewater services
 - an end-of-period demand volatility adjustment mechanism (‘deadband’) to be applied if water sales revenue over the regulatory period varies by more than ± 6 per cent of the regulatory allowance
 - an annual price reset process where the Independent Competition and Regulatory Commission (the Commission) adjusts prices to account for changes to consumer price index (CPI), any pass-through amounts (subject to an annual materiality threshold), and updates to the regulatory cost of debt
 - pass-through arrangements to deal with unexpected, uncontrolled events.
- Icon Water proposes a new pass-through provision for unforeseen costs arising from the Australian Capital Territory (ACT) Government’s Better Building reforms.

4.1.1 Regulatory and policy context

There are several legislative requirements and local and national water policies that have direct implications for decisions on regulatory controls. These requirements and policies are reflected in the terms of reference for the price review,¹ which state that the Commission must consider the following when making a price direction:

- the Commission’s legislative requirements under the *Independent Competition and Regulatory Commission Act 1997* (the ICRC Act), including:
 - objectives in section 7
 - price direction objective in section 19L
 - requirements in section 20(2).
- the policies of the ACT Government as they relate to the supply and use of water and wastewater services, including the ACT Water Strategy 2014–44 Striking the Balance

¹ ACT Government, *Independent Competition and Regulatory Commission (Regulated Water and Sewerage Services) Terms of Reference Determination 2021*. Disallowable instrument DI2021-278 made under the *Independent Competition and Regulatory Commission Act 1997*. 2021.

- the 2004 National Water Initiative, Murray-Darling Basin Plan commitments and associated policies and agreements.

Of direct relevance to regulatory controls are the statements in the terms of reference that the Commission should consider:

- minimising the potential for significant price fluctuations during the regulatory period, while ensuring the recovery of the prudent and efficient costs of Icon Water
- continuing to use the current regulatory model, and where identified, implement improvements to aspects of the methodology, including improvements identified in reviews undertaken in accordance with the reset principles in clause 13 of the Price Direction for Regulated Water and Sewerage services 1 July 2018 to 30 June 2023.

One of the reviews undertaken by the Commission in accordance with the reset principles in the 2018 Price Direction was of incentive mechanisms, including regulatory controls. The current regulatory controls and the findings of the Commission's mid-term review of regulatory controls are discussed below.

4.1.2 Current regulatory controls

Table 4-1 highlights the Commission's final decision on regulatory controls for the 2018–23 regulatory period.

Table 4-1: Regulatory controls in the 2018–23 regulatory period

| Component | The Commission's 2018 final decision |
|--|--|
| Regulatory period | Five years, from 1 July 2018 to 30 June 2023 |
| Form of control and measure to deal with demand risks | A hybrid price and revenue cap and demand volatility adjustment mechanism to account for deviations between actual and forecast water sales revenue, in excess of a six per cent 'deadband', over the full five-year regulatory period. If the deadband is exceeded, the Commission is required to include in the revenue requirement for the 2023–28 regulatory period any under- or over-recovery of revenue associated with this deviation. |
| Measures to deal with expenditure risks | Escalation of prices with the CPI. Cost pass-through provisions, with a materiality threshold of \$2 million per year applied to some events. Updating prices annually to account for changes in the trailing average of the cost of debt. Ex-post review of capital expenditure. |
| Measures to deal with unforeseen events | Reopening the price direction for major unforeseen events with an impact exceeding a materiality threshold of \$13.19 million per year. |
| Miscellaneous fees and charges | Fees and charges adjusted in line with CPI in each year of the regulatory period. |

| Component | The Commission's 2018 final decision |
|---------------------|--|
| Revenue calculation | A building block framework applied using a post-tax revenue model. |

Source: Independent Competition and Regulatory Commission, *Regulated water and sewerage service prices 2018–23*, Final Report, 2018.

Water sales over the 2018–23 regulatory period are expected to be comfortably within the six per cent deadband around forecast sales, requiring no price adjustment in the 2023–28 period on account of the demand volatility adjustment mechanism. Cost pass-through adjustments have been made during the 2018–23 regulatory period on account of charges and taxes set by the ACT Government and payments from the Commonwealth Government. Specifically, these include adjustments for the Utilities Network Facilities Tax (UNFT), Water Abstraction Charge (WAC) and subvention payments from the Commonwealth Government.

4.1.3 Commission review of incentive mechanisms

One of the reset principles included in the 2018 Price Direction (section 13d) was that the Commission would undertake a review of incentive mechanisms during the 2018–23 regulatory period. The Commission completed the review in August 2020.² The purpose of the review was to ensure that the Commission's approach to determining water and wastewater prices provides appropriate and effective incentives for Icon Water to operate efficiently.

As part of the review, the Commission assessed the current arrangements, as well as potential additions and alternative approaches. The additions and approaches investigated included expenditure efficiency sharing schemes, a total expenditure ('totex') approach, service incentive mechanisms, alternative price or revenue control mechanisms, and the Victorian 'PREMO' approach. The assessment framework reflected the objectives and considerations set out in the ICRC Act.

When reviewing the current hybrid form of control, the Commission recognised the inherent difficulties of accurately forecasting water demand and the need to share demand risk through a demand volatility adjustment mechanism.

The Commission concluded that the incentive mechanisms currently in place have been effective in strengthening Icon Water's incentives to operate, invest and deliver services efficiently.

The Commission's assessment of alternative incentive mechanisms found that such mechanisms can improve incentives for a regulated business to find and implement efficiencies in its operating and capital expenditures and to deliver regulated services at standards valued by customers. However, some of these alternative mechanisms have significant implementation challenges and, in some cases, the benefits are likely to be more than offset by the implementation costs. Further, some mechanisms are less likely to achieve net benefits in the ACT context. Neither Icon Water's submission nor any other submission to the review supported the adoption of new incentive mechanisms.

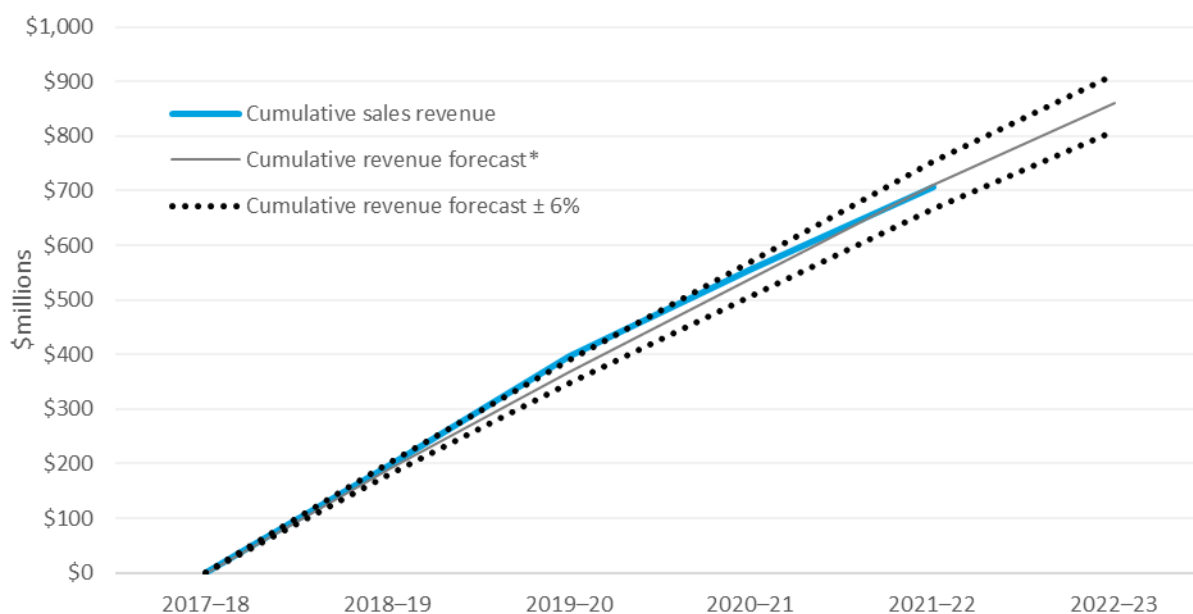
4.1.4 Icon Water's proposed approach

The key features of the current regulatory controls have been in place since 2008. In past price proposals, we sought changes to the regulatory controls to mitigate the risk of a continuation of the

² Independent Competition and Regulatory Commission, *Water and sewerage services price regulation: Incentive mechanisms*, Final report, August 2020.

persistent shortfalls in revenue relative to full cost recovery that had been observed between 2008 and 2018. These shortfalls were primarily the result of unrealistically high forecasts of demand for water. In its 2018 decision, the Commission accepted the water demand forecasts proposed by Icon Water.³ Having more confidence in those demand forecasts, we agreed with the Commission’s proposal to continue with a hybrid price and revenue cap.⁴ Across the 2018–23 regulatory period to date, we’ve observed actual water usage has tracked reasonably closely to forecast demand (Figure 4-1).

Figure 4-1: Water sales volume (actual vs forecast)



Source: Icon Water.

Note: The cumulative revenue forecast has been adjusted for increases in the consumer price index (CPI) and pass-through costs.

We acknowledge the principle that maintaining a consistent regulatory approach over time provides better incentives for investment in the long-lived assets needed to deliver the outcomes customers want.

Icon Water therefore proposes a continuation of the current hybrid price and revenue cap form of regulation and is not proposing significant changes to regulatory controls for the 2023–28 regulatory period. We do not propose any change to the threshold value of six per cent of water sales revenue applied as part of the demand volatility adjustment mechanism for the 2023–28 regulatory period, but agree there may be merit in revisiting this threshold in future regulatory periods if there is a material increase in the uncertainty surrounding water demand forecasts or other elements of Icon Water’s regulatory framework.

We are proposing an addition to the cost pass-through arrangements to include a new pass-through provision for unforeseen costs arising from the ACT Government’s Managing Building Better reforms. Further detail on this proposed change is provided in this attachment.

We agree with the conclusions reached by the Commission in its review of incentive mechanisms and support continued monitoring for the development of new incentive mechanisms that may be suitable for implementation in future price determinations.

³ ICRC (2017). Regulated water and sewerage services prices 2018-23. Draft report, December, p. 129.

⁴ Icon Water (2018). Revised price proposal, February, p. vii.

4.2 Form of price control and ancillary mechanisms

4.2.1 Introduction

Section 20A(1) of the ICRC Act states that a price direction must include the form of control that will apply, which may be:

- a price cap – a maximum price or both a minimum and maximum price for each regulated service, and/or
- a revenue cap – a maximum amount of revenue that may be earned providing regulated water and wastewater services.

Section 20A(3) allows a price direction to include a formula for calculating or method for ascertaining the prices or amounts determined under the price or revenue cap.

4.2.2 Form of price control

Hybrid price and revenue cap

Icon Water proposes the continuation of the current hybrid price and revenue cap form of regulation, which includes:

- maximum prices for water and wastewater services for the first year of the regulatory period and a method for adjusting prices for each of the remaining four years (discussed in sections 4.3 and 4.4 below)
- an end-of-period demand volatility adjustment mechanism, subject to a deadband of six per cent of water sales revenue (tier 1 and tier 2 water usage charge revenue).

We propose the demand volatility adjustment continues to be specified as a reset principle in the price direction to safeguard the credibility and integrity of the mechanism.

4.2.3 Incentive mechanisms

Following the Commission's review of incentive mechanisms, Icon Water agrees with the Commission's final decision to maintain its current approaches to incentive mechanisms for operating and capital expenditure, service standards and price control mechanisms.⁵

⁵ Independent Competition and Regulatory Commission, *Water and sewerage services price regulation: Incentive mechanisms, Final report, 2020*.

4.3 Annual price reset process

4.3.1 Standard water and wastewater services charges

Icon Water proposes to retain the current annual price adjustment method under which prices for standard water and wastewater services charges are adjusted. In this method the water supply charge, the water volumetric prices, the wastewater supply charge, and the wastewater fixtures charge are adjusted on 1 July each year on account of CPI, the smoothing factor (X factor) specified in the price direction, the trailing average cost of debt, and any cost pass-through events. Our proposed application of the X factor to individual components of the tariff structure is discussed in **Attachment 12: Tariff structure and proposed prices**.

Icon Water proposes that adjustments on account of CPI continue to be calculated in accordance with the following formula:

$$CPI_t = \frac{CPI_{Jun(t-2)} + CPI_{Sep(t-1)} + CPI_{Dec(t-1)} + CPI_{Mar(t-1)}}{CPI_{Jun(t-3)} + CPI_{Sep(t-2)} + CPI_{Dec(t-2)} + CPI_{Mar(t-2)}} - 1$$

Where CPI means the All Groups Consumer Price Index (weighted average of eight capital cities) as published by the Australian Bureau of Statistics.

4.3.2 Miscellaneous fees and charges and capital contributions

Icon Water currently provides several regulated miscellaneous water and wastewater services, including:

- special meter readings
- testing of water meters
- the provision of rate certificates
- tapping into water mains
- installation of fire hydrants
- disconnection
- installation and removal of stop valve locking covers
- meter relocation.

We have reviewed the costs of delivering these miscellaneous services and other fees, and propose changes to some of the fees and charges for 2023–24 to better reflect the cost of providing these services. These changes are discussed in **Attachment 12: Tariff structure and proposed prices**.

We propose the current form of control for miscellaneous fees and other charges be applied at annual price resets thereafter. That is, Icon Water proposes the price to be charged for each miscellaneous service and other charge in 2024–25 and subsequent years should be increased in line with the change in the CPI in each year of the regulatory period, as per the formula:

$$p_t = p_{t-1} * (1 + CPI)$$

where:

- p_t is the price to be charged for the relevant miscellaneous service in year t
- p_{t-1} is the price charged for the relevant miscellaneous service in the previous year.

We propose that the provisions for new miscellaneous services contained in section 8.1 of the 2018 Price Direction be retained.

4.3.3 Capital contribution arrangements

Icon Water proposes a continuation of the current arrangements whereby the Precinct Charge and, if relevant, the Precinct Map that are used to calculate the Class 2 infrastructure charge for developments within a precinct under the *Utilities (Water and Sewerage Capital Contributions Code) Determination 2017* are updated annually.

4.4 Cost pass-through arrangements

4.4.1 Events

Pass-through adjustments provide an efficient means of sharing risks relating to unforeseeable or unknown events that could have a major cost impact. Importantly, applications and adjustments for pass-through events should be made within the regulatory period to limit the potential for any major period-to-period bill impacts from material unforeseeable cost changes.

The 2018 Price Direction provides for the following pass-through events within the regulatory period:

- Water Abstraction Charge (WAC) event
- Utilities Network Facilities Tax (UNFT) event
- subvention payment event
- change in other taxes event
- service standard event
- regulatory obligations event
- Tantangara Transfer Payment event.

Icon Water proposes to retain these pass-through events for the 2023–28 regulatory period and to add one additional event relating to costs that may be imposed by the ACT Government’s Managing Buildings Better reforms.

ACT’s Managing Buildings Better reforms

In 2020, the ACT Government commenced a series of Managing Buildings Better reforms to improve the management of apartments, townhouses and mixed-use developments and commercial units. One objective of the reforms is to allow “*a more equitable distribution of building costs, such as water, maintenance and insurance*”.

The initial package of reforms has been introduced, with no implication for Icon Water. Icon Water understands that a second stage of reforms to unit title legislation is being considered, although no announcement has been made at the time of this 2023–28 price proposal.

There may be changes and planning amendments stemming from the broad packages of reforms, which individually have an impact below the materiality threshold for existing cost pass-through events, but in total have a material impact on the cost-of-service provision.

We propose that a new *Managing Buildings Better* reforms pass-through event be defined in the 2023 Price Direction as follows.

A Managing Buildings Better Reforms event means either:

- a) a change to the *Unit Titles Legislation Amendment Act 2020* (ACT) and/or;
- b) a legislative or administrative act or decision in connection with the ACT’s Managing Buildings Better reforms.

That has the effect of:

- a) substantially varying, during the course of the regulatory period, the manner in which Icon Water is required to provide a regulated water or sewerage service

- b) imposing, removing or varying, during the course of the regulatory period, minimum service standards applicable to regulated water and sewerage services; or
- c) altering, during the regulatory period, the nature or scope of the regulated water or sewerage services provided by Icon Water; and
- d) materially increases or materially decreases the costs to Icon Water of providing regulated water or sewerage services.

As there is uncertainty around the scale, timing and impact of these Government-led reforms, we propose that no materiality threshold apply to this event, consistent with the WAC, UNFT and subvention events. We anticipate this event will apply only for the 2023–28 regulatory period, as once the reforms have been confirmed any uplift in cost would in the future be included as part of forecast operating expenditure.

4.4.2 Materiality threshold

A materiality threshold is applied to the change in other taxes, service standards, regulatory obligations, and Tantangara Transfer Payment events in the 2018 price direction. The materiality threshold allows for the costs of an event to be passed through to customers if the total annualised cost associated with the event exceeds \$2 million (\$2017–18) in the year for which the pass through is sought. We propose that this materiality threshold be maintained at the same level in real terms. Based on the forecast increase in CPI in 2022–23 of 2.5 per cent in the 2018 final decision, the materiality threshold for the 2023–28 price direction would be \$2.64 million (\$2022–23).

4.4.3 Price direction variation trigger events

Section 12 of the 2018 Price Direction lists the price variation trigger events that would allow the Commission to initiate a reference for a variation of the price direction:

- an act of terrorism
- a major natural disaster
- major damage to infrastructure
- a significant change in Icon Water’s financial or corporate structure
- an unforeseen or force majeure event that severely restricts Icon Water’s ability to provide services.

Icon Water proposes these price variation trigger events be retained in the 2023 Price Direction.

Abbreviations and acronyms

| | |
|------------|---|
| ACT | Australian Capital Territory |
| Commission | Independent Competition and Regulatory Commission |
| CPI | Consumer price index |
| ICRC Act | <i>Independent Competition and Regulatory Commission Act 1997</i> |
| UNFT | Utilities Network Facilities Tax |
| WAC | Water Abstraction Charge |