



"BUNBURY WATER BOARD"
AQWEST

Our Ref: NE: W1639

Your Ref:

Enquiries: Brad Bevis

(08) 9780 9505

12 September 2008

Inquiry on the Tariffs of the Water Corporation,
Aqwest and Busselton Water
Economic Regulation Authority
PO Box 8469
PERTH BC WA 6849

Email: watertariffs@era.wa.gov.au

Dear Sir/Madam,

RE: 2008/2009 INQUIRY INTO TARIFFS OF AQWEST (BUNBURY WATER BOARD)

Thank you for the opportunity to provide feedback to your Issues Paper dated 04 August 2008 and titled Inquiry into Tariffs of the Water Corporation, Aqwest and Busselton Water. Before providing any feedback on the 2008/2009 Issues Paper it is appropriate to briefly revisit previous pricing inquiries involving Aqwest which were conducted by the Economic Regulation Authority in 2005 and 2007.

2005 Pricing Inquiry

Aqwest has previously expressed the following concerns in respect to the 2005 Economic Regulation Authority (ERA) final Report: Urban Water and Wastewater Pricing:

- The outcomes as applicable to Aqwest were in error. It was assumed that they were based on flawed assumptions or mistaken assessment of the information provided by Aqwest at that time.
- It appeared that the ERA adjusted figures for inflation when they were already provided in real terms. This introduced gross errors into the ERA modelling which impacted on efficiency gains, Regulatory Asset Values and pricing.
- At no stage did Aqwest suggest that it would pursue efficiency gains of 2.8 percent which suggests that adjustments had been made for inflation when the figures provided were already expressed in real terms.
- The fact that Regulation Asset Values for the Water Corporation and Busselton Water largely matched their book values where Aqwest's were calculated at just above 50% of book value would suggest some form of gross error or differential treatment.

- The fact that Water Corporation and Busselton Water prices were suggested to rise by an average of 0.7% per annum but Aqwest's were suggested to decrease by 1.4% per year again suggested a gross error or differential treatment.
- Aqwest has always stated in its planning documents that it will maintain prices at current levels in real terms for the next five years. Coming off the lowest base charges in Western Australia (for average domestic consumption) and one of the lowest in Australia, the suggested decrease of 1.4% per annum appeared irresponsible and unsustainable.
- The calculation of the Long Run Marginal Cost (LRMC) which was the basis of the ERA consumption charging regime was not detailed or justified in any way. It appeared to be at the lower end of Aqwest's own estimates and adopted some very conservative assumptions about what is marginal in the water industry. It was not considered as being appropriate to ensure the sustainability of Aqwest. No comment was provided on the wildly different figure of 16 cents quoted in the Draft Report. Aqwest did not accept the ERA view as a basis for managing a business.
- The preconceived notion expressed by the ERA at the onset of the 2005 Inquiry of a move to a single step tariff based on long run marginal cost, since adjusted to a two step tariff was strongly opposed. Aqwest's opposition was clearly communicated at all stages of the Inquiry and was included in detail in the public submissions to the ERA and available on the ERA website. The ERA proposal was estimated to increase average domestic consumers cost by around 10% and increase demand by an unknown amount for no benefit but to satisfy some nicety of economic theory and the ERA's preconceived notions. In fact the ERA two step tariff proposal in place at that time was considered contrary to LRMC theory without achieving the benefits of the scheme.
- At all stages of the 2005 Inquiry Aqwest objected strongly to the methodology applied to the calculation of the Regulation Asset Value. These objections were set out in detail in its public submission made available on the ERA website. Aqwest believed the calculations were in error but more importantly the process served no practical purpose as it was based on an assumption that the prices are right where the purpose of the inquiry was to find out if they were.
- The Council of Australian Governments (COAG) advocated the use of book values for small agencies to ensure they were not under charging. Once again, on the basis of a preconceived notion of economic theory, the COAG recommendation was ignored. At the Draft Stage the ERA estimated a Regulation Asset Value of from zero to \$16 million for Aqwest, which was finally reported at \$25 million. No explanation of these wildly variable figures was given and Aqwest considered the \$25 million to be grossly in error. The book value as at 30 June 2005 was approximately \$63 million.
- Aqwest was of the view that the recommendations of the Report as related to Aqwest did not provide a sound basis for the setting of Prices and Budgets for the future sustainability of Aqwest. This raised the question of accountability and what may happen if these recommendations proved to be wrong.
- The Board of Aqwest was mindful of it's responsibilities in accordance with the Water Boards Act and as Directors in accordance with Statutory Corporations Liability of Directors Act and did not accept the findings of the Report.

- In the mid 1980's Aqwest's prices were considerably lower than the Water Corporation's, Aqwest's assets were grossly undervalued, demands and borrowings were high. ERA's 2005 Report effectively recommended a return to this irresponsible position.

2007 Pricing Inquiry

The recommendations made by the Economic Regulation Authority in their Report titled "Inquiry into Tariffs of Bunbury and Busselton Water Boards 08 February 2008" were as follows:

- "1) *Pricing structures need to be reassessed as part of a major review of the Water Boards' costs and tariffs.*
- 2) *For the purpose of setting tariffs for 2008/09:*
- Usage charges that are currently more than \$1.20 kL should be held at their current levels, while usage charges that are less than \$1.20 kL should be increased with inflation:*
 - Non-residential fixed charges should be set in accordance with the Water Boards' current transition path to meter-based charges; and*
 - The residential fixed charge should be set at a level sufficient to enable the Water Boards to recover their costs (after deducting revenue gained from other charges, developer contributions and other revenue)."*

Aqwest had the following concerns with the Report dated 08 February 2008:

(i) Long Run Marginal Cost Concept (LRMC)

The ERA has advised Aqwest on more than one occasion that Aqwest has an abundant supply of water and should therefore sell as much as possible, for as cheaply as possible.

Aqwest totally rejects the above philosophy as irresponsible.

(ii) Charging Tiers / Pricing Structures

Aqwest had the following six (6) tier charging scale as at the date of the Report:

Consumption Level	Charge per Kilotre
0 > < 150kL	\$0.41 per kL
151 > < 350kL	\$0.74 per kL
351 > < 500kL	\$1.07 per kL
501 > < 700kL	\$1.41 per kL
701 > < 1000kL	\$1.69 per kL
1001 >	\$2.47 per kL

Average consumption per residential service in Bunbury for the consumption year ending 30 June 2007 was 314kL. For average consumption Aqwest has the lowest base charges in Western Australia as demonstrated below:

	Aqwest	Busselton Water	Water Corporation South West
Annual Supply Charge	\$97.00	\$113.20	\$162.60
Meter Rental	Nil	\$16.10	Nil
150kL	(x \$0.41) \$61.50	(x \$0.44) \$66.00	(x \$0.569) \$85.35
164kL	(x \$0.74) \$121.36	(x \$0.63) \$103.32	(x \$0.784) \$128.57
TOTAL	\$279.86	\$298.62	\$376.52

The six (6) tier sliding charging scale rewards those customers who conserve water.

The ERA recommends a two (2) tier charging scale. Under this regime there is no reward for those who conserve water.

The Water Corporation has an eleven (11) tier scale in Binningup and Dalyellup and a nine (9) tier scale in Eaton/Australind.

The ERA recommended charge of \$0.66 per kL up to 500kL under a two tier resulted in an increase of 11.33% (\$207.24 / \$182.86) for average consumption of 314kL.

(iii) Regulatory Accounting

The financial model utilised by the ERA may be very applicable to the gas and electricity industries. ERA's 2008 Report confirmed the opinion that Aqwest derived from the 2005 Report in that it is flawed when applied to the operations of a water utility.

(iv) Strategic Development Plan

Aqwest's Strategic Development Plan details Key Result Areas (KRA's), Commitments and Objectives. The most important KRA is **Sustainability**, Aqwest's commitment is to **Performance** and the **Objectives** for this KRA are as follows:

AQWEST will:

- Manage the long term viability of the resource
- Ensure the long term financial viability of the business
- Act in an environmentally responsible way
- Meet all community obligations and responsibilities
- Stay committed to State and Federal Government sustainability initiatives
- Steadily progress to a position of pricing for sustainability

The ERA's recommendations compromised the long term viability of the business and the long term availability of the resource.

Aqwest's conclusion in respect to the 08 February 2008 Report was as follows:

- *In respect to Recommendation (1).*
Aqwest considers that an annual review of Aqwest's pricing structure by the ERA is excessive.

- *In respect to Recommendation 2(a).*
Aqwest does not support the recommendation.
- *In respect to Recommendation 2(b).*
Aqwest supports this recommendation (as per the current status quo).
- *In respect to Recommendation 2(c).*
Aqwest considers that the revenue derived from non operational revenue sources, i.e. developer contributions, should not be considered in any equation to determine water prices.

Issues Paper dated 04 August 2008 – Inquiry into Tariffs of the Water Corporation, Aqwest and Busselton Water

In accordance with the Terms of Reference (TOR) it is noted that the ERA will consider and report on the appropriate charging structures and recommended tariff levels for the Water Corporation, Aqwest and Busselton Water Boards' water supply services.

It is also noted that the Authority must give consideration to, but will not be limited to, the following:

- The method used to determine the revenue requirements of each service provider;
- The operating and capital costs of providing services, with a focus on:
 - cost effectiveness in the supply of services; and
 - resources necessary to meet the required service standards.
- The appropriate rate of return on each service provider's assets;
- The efficiency of demand management activities;
- The impact of the recommendations on each service provider's net financial position;
- The impact of the recommendations on the Government's net financial position, in particular, net debt, dividends, tax equivalent payments and the level of Government funding (through Community Service Obligation Payments); and
- The environmental and social impact of the recommendations.

Particular areas of focus for the Economic Regulation Authority are noted to be as follows:

- The method used to determine the revenue requirements of each service provider;
- The operating and capital costs of providing services;
- The appropriate rate of return on each service provider's assets;
- The efficiency of demand management activities;
- The impact of the recommendations on each service provider's net financial position;
- The impact of the recommendations on the Government's net financial position; and
- The environmental and social impact of the recommendations.

Aqwest's response to the Issues Paper will address those water supply issues highlighted in the Issues Paper for response by the Authority.

Issues***Are the current levels of service appropriate?***

Response: Aqwest complies with the service requirements detailed in its Operating Licence.
Aqwest aspires to the highest level of customer service.
Overall customer satisfaction in 2008 was the highest this century.

What pricing principles should guide the setting of water usage charges?

Response: a) Residential – six (6) tier consumption scale rewarding those customers who conserve water. Annual supply fee.
b) Non Residential – two (2) tier consumption scale. Annual supply fee based on meter size.
c) (a) and (b) to be at sufficient levels to return realistic and sustainable returns on asset investment.
d) Long run marginal cost (LRMC) pricing appears flawed when applied to the water industry (see prior comments 2005 and 2007 Inquiries).

Should country water usage charges be set in relation to marginal cost?

Response: No. Flawed as previously demonstrated in 2005 and 2007.

Are current CSO's consistent with the objectives sought by Government?

Response: Aqwest does not apply for nor receive any CSO's from the State Government. Aqwest deliberately adopts this approach on the basis that rebates offered to Senior and Pensioner customers are therefore viewed as genuine discounts, not a situation where you give with one hand (rebate) and take with the other (CSO's).

Are current CSOs value for money or should they be modified in some way?

Response: N/A.

Should the uniform tariff threshold be changed?

Response: N/A.

Should discounts be provided for non-discretionary water usage, such as the first 150 kL of annual water usage?

Response: Aqwest's current charge per 1,000 litres for the first 150,000 litres of annual consumption is 42 cents. This is extraordinarily cheap and additional discounts are not required.

Should very high volume water users pay a penalty rate?

Response: Yes, the higher the consumption the higher the charge.

Should demand restrictions and other demand management measures continue in the metropolitan area given the construction of the second desalination plant?

Response: Yes.

Should demand restrictions be determined on a scheme-by-scheme basis as opposed to North and South of the State?

Response: No, a consistent approach across Western Australia needs to apply.

Should tariffs be adjusted to take into account any environmental externalities, and if so, how?

Response: Aqwest currently has no opinion on this issue.

In reviewing each water utility's processes for undertaking capital expenditure, are there any particular matters the Authority should consider?

Response: Aqwest completes an annual Ten (10) Year Capital Works Plan and completed a large capital works program in 2007/2008.

The Authority invites the water utilities and others to consider appropriate parameters for determining the rates of return.

Response: Aqwest's Ten (10) Year Finance Plan projects the following Economic Real Rate of Return over the next ten (10) years:

Year	Economic Real Rate of Return
2008/2009	2.56%
2009/2010	2.42%
2010/2011	2.37%
2011/2012	2.42%
2012/2013	2.50%
2013/2014	2.03%
2014/2015	1.35%
2015/2016	1.57%
2016/2017	1.82%
2017/2018	2.30%

The above figures are obviously not acceptable in the long term.

Realistic rates of return based on asset book value need to be implemented.

Aqwest defines Economic Real Rate of Return and Return on Assets as follows:

- Economic Real Rate of Return
 - =
$$\frac{\text{Revenue from Operation} - (\text{Total Expenses})}{\text{Written down Replacement Value of Assets}}$$

- Return on Assets
 - = $\frac{\text{Earnings before interest and tax and after abnormals}}{\text{Average total assets}}$
 - = $\frac{\text{Profit before income tax equivalent and interest paid}}{\text{Average total assets}}$

Aqwest's current target for both return indicators is greater than 4%. Aqwest considers that greater than 6% (based on book value of assets) is probably more realistic in the current economic environment.

What is the appropriate inflation measure to apply to the escalation of tariffs on an annual basis?

Response: Water Efficiency Measures (WEMs) implemented on 01 October 2007 have resulted in an overall 10% reduction in consumption for 2007/2008. This has a significant impact on revenue. Issues such as this significant decrease in revenue need to be considered in addition to any appropriate inflation measure.

What is the appropriate treatment of infrastructure network assets for the purpose of determining the revenue requirement for a water utility?

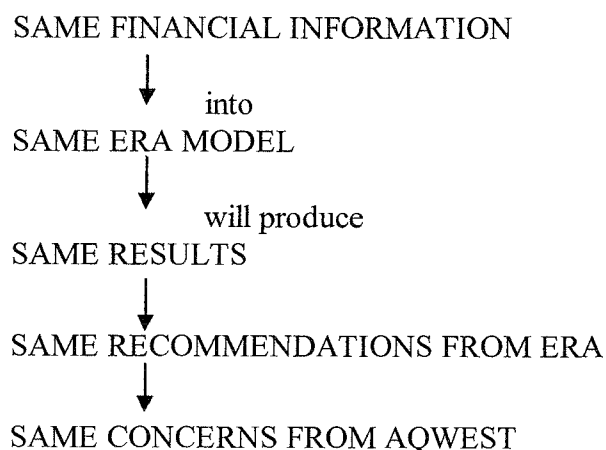
Response: Aqwest has no opinion on this matter at this point in time.

How should the Authority treat developer contributions in its financial modelling of water utilities?

Response: Developers contributions are quarantined for a particular purpose and should not be included in any financial modelling of water utilities. Water utilities should be sustainable and provide a suitable return on assets based on their operational revenue only, i.e. supply fees, consumption charges etc.

Are there any issues specific to each utility that warrant particular attention?

Response: 1) If the following scenario is repeated in the current pricing review then very little change will be achieved:



- 2) Sustainable use of the resource is of paramount importance. There is an increased risk of saline intrusion if abstraction from the aquifer is increased. Investigations completed by the Department of Water (DoW) indicate that most of the groundwater sub areas in the Bunbury area to be at or near their maximum sustainable allocation. There is less than 1% available for future allocation in the Yarragadee aquifer (Ref: Department of Water – South West Groundwater Areas Water Management Plan – Allocation February 2008). This science reinforces the view that water in the South West is very much a finite resource.
- 3) In conclusion, the following matters are reiterated:
- The Board will fully participate and actively engage in the pricing review.
 - Retention of current water level tariff tiers which includes the retention of high charges at high levels of consumption to encourage water conservation and penalise those customers who waste water is essential.
 - Aqwest has long term financial plans and these should not be compromised by the Pricing Review.
 - (i) Pricing must be adequate to ensure long term business sustainability including sufficient operating profit.
(ii) Pricing must be adequate to ensure long term resource sustainability and minimising or eliminating any potential long term environmental impacts.
 - It is highly desirable that a sustainable fixed rate of return be established on “new” and “old” assets.

Thank you for the opportunity to provide feedback on your Issues Paper.

Yours faithfully

Brad Bevis
CHIEF EXECUTIVE OFFICER