



INFORMATION

Inquiry into the Efficient Costs and Tariffs of the Water Corporation, Aqwest and the Busselton Water Board

NOTICE ON DRAFT REPORT

Introduction

On 25 September, the Economic Regulation Authority (Authority) released its [draft report](#) into the efficient costs and tariffs of the Water Corporation, Aqwest and the Busselton Water Board. This Notice has been prepared to clarify some matters surrounding the Authority's recommendations relating to wastewater tariffs for Water Corporation customers living in the Perth metropolitan area.

Background

If implemented, the tariff recommendations contained in the Authority's draft report will bring about a reduction in the aggregate payment that is made by most households in the Perth metropolitan area. The reduction is the result of an increase in the charges for water services which, for most households, is offset by a decrease in charges for wastewater services.

In the draft report, the Authority provided the example of an average household in the Perth metropolitan area with water consumption of 250 kilolitres per year. Were the Authority's recommended tariffs implemented, such a household would face a \$20 increase in its 2013/14 water bill and a \$148 decrease in its 2013/14 wastewater bill (relative to 2012/13). In net terms, the aggregate water and wastewater bill payable by such a household would reduce by \$128 in 2013/14.

The Authority's recommendations on wastewater charges are discussed in further detail in the sections below.

The Structure of Wastewater Tariffs

Residential wastewater tariffs are currently set as a fixed charge each year based on estimated property Gross Rental Values (GRVs). The higher the GRV of a property, the higher will be the wastewater charges that apply.

In the draft report, the Authority recommended that this charging structure be abolished and that wastewater charges be levied as a single and equal fixed charge payable by all customers.

As the Authority has argued in its past two water inquiries (2005 and 2009), GRV pricing is an inefficient method of recovering revenue. Specifically:

- there is little, if any, relationship between the GRV-based price charged and the cost of the service. Under the current GRV pricing approach, the wastewater charges levied on high GRV customers are more than three times the charges that are levied

on low GRV customers yet all else being equal there is no difference in the cost of service provision to these two customer groups;

- the Authority is not aware of reliable evidence to support the view that there is a strong correlation between property values and income.¹ Customers on fixed or low growth incomes who live in areas with high property price growth are unfairly penalised under a GRV pricing approach, so too are customers on low incomes who live in high-value properties; and
- there are administrative costs associated with property value-based pricing. The Water Corporation estimates that the annual cost of maintaining its property value database and regularly recalculating tariffs is between \$3 million to \$4 million.²

The Water Corporation also supports the case for a shift away from GRV pricing on the grounds that it can be inequitable and is inefficient to administer.³

The recommendation to shift away from GRV pricing is not the reason for the reduction in recommended wastewater tariffs. Rather the recommended reduction in wastewater tariffs is a direct result of the Authority's estimate of the revenue requirement for wastewater services that needs to be recovered through tariffs.

The Level of Wastewater Charges

In this inquiry, the Authority calculated the level of wastewater tariffs by deriving the Water Corporation's efficient revenue requirement for wastewater services for the 2013/14 to 2015/16 period. Tariffs were then set such that the Water Corporation can recover this revenue requirement over the same period, with some additional allowance for catch-up from under-recovery in previous periods.

The Authority determined that the revenue requirement for the Water Corporation's metropolitan wastewater services for the period 2013/14 to 2015/16 is lower than the revenue requirement for the previous pricing period (2010/11 to 2012/13). The decrease in the revenue requirement is the reason for the recommended decrease in the average level of wastewater charges.

The reasons for the decreased revenue requirement are discussed in detail in the draft report but broadly they are the result of:

- A decrease in the rate of return – in the 2009 inquiry, the Authority applied a real pre tax rate of return of 6.62 per cent. In this inquiry, an effective real pre tax rate of return of 4.03 per cent was applied. The main reason for the relatively low rate of return is that the nominal risk free rate is currently at a low level.
- An adjustment to the Water Corporation's 2005 initial asset value to remove developer contributions. It is not appropriate for the Water Corporation to earn a return on assets that have been already paid for by developers, hence the Authority

¹ The available evidence on the relationship between income and property values in Western Australia is very limited. In fact, there appear to be few studies of this issue generally. A recent review of the correlation between income and home values undertaken for the Local Government Association of South Australia does not support the idea of a strong correlation. Indeed they find that the simple correlation is weak, both for Australia and Adelaide. South Australian Centre for Economic Studies. (2004). "The Correlation Between Income and Home Values: Literature Review and Investigation of Data." SA Local Government Association.

² Water Corporation, 2012, Personal communication (email), 25 May.

³ Water Corporation, 2012, *Submission in Response to the Issues Paper*, p. 32.

reduced the Water Corporation's revenue requirement by about \$422 million (relative to the asset base containing the gifted assets).

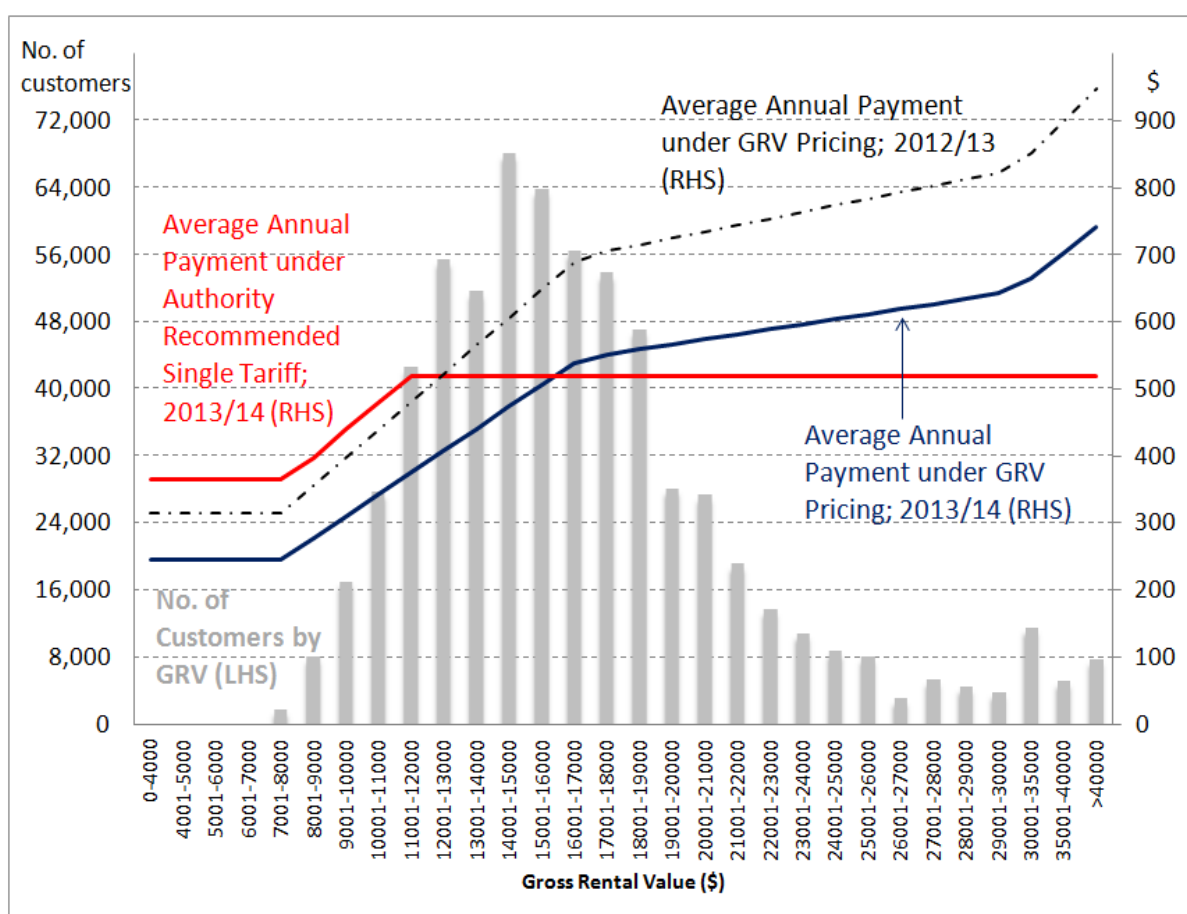
The Authority estimates that the Water Corporation's total efficient revenue requirement for the 2013/14 to 2015/16 period to be recovered from metropolitan wastewater services at \$1,438 million.⁴ This is \$239 million (nominal) lower than the revenue requirement of \$1,677 million that the Authority applied for the 2010/11 to 2012/13 period.

Conclusion

A scenario whereby GRV pricing is maintained will result in the exact same average decrease in wastewater charges for metropolitan residential customers (\$148 in 2013/14). This is because regardless of the approach used to apply tariffs, the same total revenue requirement still needs to be recovered by the same number of customers.

While the basis for determining wastewater charges does not have a bearing on the aggregate level of charges (as seen in the average charge) it does have a bearing on the payments that are made by specific customers. This is demonstrated in the chart below, which shows the amount payable in 2013/14 by different customers under a continuation of GRV pricing and also under the Authority's recommended single charge. As a reference point, the chart also shows the amount payable under the existing tariffs in 2012/13.

Comparison of Impacts of GRV Pricing versus Authority Recommended Single Tariff



Under the existing GRV method for charging, customers on high GRV properties pay higher wastewater charges than do customers on low GRV properties. In effect, the high GRV

⁴ Note, some of this revenue requirement is recovered through metropolitan commercial customers.

customers subsidise customers on low GRV properties under the current GRV pricing arrangements. For this reason, a move away from GRV pricing will inevitably result in winners and losers as existing cross subsidies are unwound.

A move to a single fixed tariff from GRV would result in customers with properties that have a GRV of less than \$16,000 (\$307 per week) paying more than they would under a GRV pricing approach. As part of its modelling of recommended tariffs, the Authority has implemented a transition period for customers facing an increase in wastewater payments. For households facing an increase in charges between 2012/13 and 2013/14 (estimated to be about 97,700), the Authority has modelled tariffs such that these customers do not face an increase of more than \$50 per year in wastewater charges.

The Authority notes that this transition path proposal has been included to provide some indication about how the shift away from GRV based pricing can best be managed. The final decision about whether a transition arrangement is necessary (and if so how it would be implemented) is one that can be made by Government.

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