AQWEST SUBMISSION TO ECONOMIC REGULATION AUTHORITY DRAFT REPORT

INQUIRY INTO THE EFFICIENT COSTS AND TARIFFS OF THE WATER CORPORATION, AQWEST AND THE BUSSELTON WATER BOARD

Aqwest is pleased to provide this submission to the Economic Regulation Authority (the Authority) regarding the Draft Report for the *Inquiry into the Efficient Costs and Tariffs of the Water Corporation, Aqwest and the Busselton Water Board*. This submission focuses only on those elements of the Draft Report that require further consideration by the Authority.

REDUCTION IN DEMAND

Although the Authority has noted that the average consumption from Aqwest customers for the period 2010/11 to 2012/13 (254 kilolitres) was only slightly different to the consumption forecast in 2009 (257 kilolitres), further analysis has revealed that the composition of that consumption has changed significantly.

Due to the significant change in revenue, Aqwest has analysed the breakdown of consumption across each consumption tier. The analysis reveals that consumption in the lower tiers has increased slightly, while consumption in the higher tiers has fallen significantly. Table 1 demonstrates the change for consumption in 2011/12.

	2009 forecast	Actual	Difference
0-150 kL	1,948,187	2,051,631	5.3%
151-350 kL	1,364,152	1,243,359	-8.9%
351-500 kL	429,328	316,493	-26.3%
501-700 kL	214,289	131,469	-38.6%
701-1000 kL	81,497	44,999	-44.8%
Over 1000 kL	50,929	25,862	-49.2%
Total	**4,088,382**	**3,813,813**	**-6.7%**

Table 1: Forecast versus actual consumption for 2011/12 by consumption tier

The reduction in consumption in the higher tiers has resulted in significantly lower revenue than originally anticipated because consumption at the higher tiers is charged at a significantly higher price than consumption in the lower tiers.

The change in the consumption profile prompted Aqwest to undertake a review of consumption trends over time. Figure 1 demonstrates the change in consumption by tier since 2005.

Aqwest anticipates that growth in the future will continue to drive consumption in the lower tapers but ongoing water efficiency and smaller block sizes will reduce consumption at the higher tapers. The dashed line in Figure 1 represents an extrapolation of the current trends over the next three years.

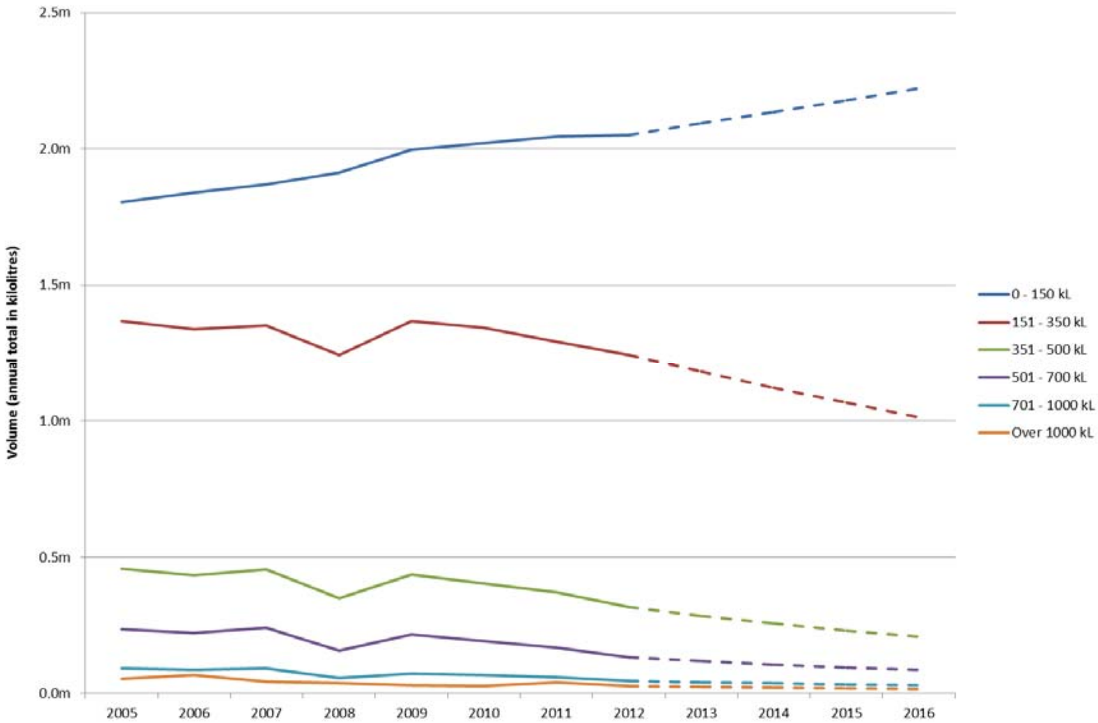

Figure 1: Change in consumption by tier

As consumption at the higher tapers is charged more than consumption at the lower tapers, the redistribution of consumption has the effect of increasing the prices required to achieve the same level of revenue.

Based on the revised estimates of consumption in each taper, Aqwest estimate that prices will be required to increase by an additional 5.74% per year beyond the estimates in the Draft Report.

OPERATING AND CAPITAL EXPENDITURE BUDGET REVISIONS

A number of budgetary changes have occurred since Aqwest's original submission to the Authority in March. In particular:

1. In April 2012, the Treasurer announced a further efficiency dividend requirement for Government Trading Enterprises. Aqwest has included reduced expenditure in this submission as per the reduction targets required by government.

2. On 1 July 2012, following an audit recommendation, Aqwest aligned its asset capitalisation threshold policy with Treasurer's Instruction 1101. This has meant that from 1 July 2012 only assets over $5,000 are now capitalised, whereas

previously, all assets over $100 were capitalised. This has shifted a large amount of capital expenditure into operating expenditure (refer Table 3).

3. Since Aqwest's March 2012 submission, Aqwest has run a number of budget reviews and has obtained more accurate data on projected expenses and revenue in some areas. For example, Aqwest's current electricity provider Perth Energy has highlighted a significant expected increase in electricity prices on the expiry of Aqwest's current contract in October 2012 that was not accounted for in the March 2012 submission.

4. Aqwest has also included the adjustments to operating costs noted in the Authority's Draft Report, which most notably includes the removal of business development costs.

5. Since Aqwest's March 2012 submission, the capital expenditure program has also been reviewed. Table 3 shows a significant increase in expenditure in 2013/14. This mainly represents the deferral of the full cost of construction of the Glen Iris Water Treatment Plant into the 2013/14 financial year, whereas in the March submission, this cost was split over the 2012/13 and 2013/14 financial years.

The impact on operating expenditure is shown in Table 2 and the impact on capital expenditure is shown in Table 3.

Operating Expenditure (Nominal $)	**2013-2014 $**	**2014-2015 $**	**2015-2016 $**
Submission March 2012	6,936,113	7,042,588	7,504,473
Revised Submission October 2012	7,166,443	7,247,209	7,827,126
Difference	230,330	204,621	322,653
Changes comprise of:			
Removal of Business Development Manager Staff Costs	(314,487)	(324,707)	(332,825)
2012-2013 State Government Efficiency Dividend Savings	(181,806)	(264,071)	(307,764)
Changes to Asset Capitalisation Threshold	652,272	653,631	687,253
Budget Revisions	74,351	139,768	275,989
Difference	**230,330**	**204,621**	**322,653**

Table 2: Changes in operating expenditure

Table 3: Changes in capital expenditure

Capital Expenditure (Nominal $)	2013-2014 $	2014-2015 $	2015-2016 $
Submission March 2012	5,972,443	2,794,103	3,941,194
Revised Submission October 2012	8,150,011	2,231,990	3,144,478
Difference	2,177,569	(562,113)	(796,716)
Changes comprise of:			
Changes to Asset Capitalisation Threshold	(652,272)	(653,631)	(687,253)
Budget Revisions	2,829,841	91,518	(109,463)
Difference	**2,177,569**	**(562,113)**	**(796,716)**

In the Draft Report, the Authority removed the business development manager staff costs and some of the other budget revisions. However, Aqwest estimates that the remaining changes will require an additional price increase of approximately 2.9% per year.

CORPORATISATION EXPENDITURE

As noted in the Draft Report, the '*Authority holds the view that should Aqwest be corporatised then it will be because of a decision made by the State Government in its capacity as owner of Aqwest and that presumably such a decision would be made because it were in Aqwest's interests. There is no reason that Aqwest customers should be required to bear the costs incurred as a result of such a decision.*' On this basis, corporatisation costs were excluded from the cost of service in the Draft Report.

Aqwest objects to the removal of the following corporatisation costs:

Year	**Amount**
2012/13	$131,400
2013/14	$150,000
Total	**$281,400**

The Water Services Legislation Amendment and Repeal Act 2012 was assented to on the 3 September 2012. The Water Services Act 2012 was assented to on the same date. The development of Regulations is well advanced. It is therefore highly likely that Aqwest will become the Bunbury Water Corporation (trading as Aqwest) on 1 July 2013.

A decision to corporatise has numerous benefits as indicated at Appendix 1 "Explanatory Memorandum, Water Services Legislation Amendment and Repeal Bill".

BUSINESS DEVELOPMENT REVENUE

In Aqwest's March 2012 submission, business development costs were included in forecast operating expenditure.

Aqwest has no objection to the removal of business development costs as per the Draft Report, however, we note that the benefits associated with business development were also included in the March 2012 submission in the form of additional business development revenue. Aqwest included a revenue stream to exactly offset this Business Development expenditure, thus having a neutral effect on water tariff pricing. In this revised submission, Aqwest has removed both the revenue and expenditure relating to future business development opportunities.

In addition, minor adjustments to other non-tariff revenue have also been made to reflect changes in budget forecasts since the March submission.

The changes in 'Other Revenue' are shown in Table 4.

Other Revenue (Nominal $)	**2013-2014 $**	**2014-2015 $**	**2015-2016 $**
Submission March 2012	1,397,373	1,392,026	1,472,390
Revised Submission October 2012	1,184,347	1,189,011	1,280,613
Difference	(213,025)	(203,015)	(191,777)
Changes comprise of:			
Removal of Business Development Revenue	(312,964)	(320,788)	(328,807)
Budget Revisions	99,938	117,773	137,031
Difference	**(213,025)**	**(203,015)**	**(191,777)**

Table 4: Changes in Other Revenue

The changes in other revenue result in an additional price increase of approximately 0.98% per year.

TAXATION

The Authority has opted to incorporate taxation in the current inquiry, which affects both costs and the required rate of return.

Aqwest has no objection to the inclusion of taxation, but notes that the Authority must accurately recognise the impacts of taxation, particularly for new revenues and expenditures. The taxation arrangements included in Authority's current pricing model do not include the tax that must be paid by Aqwest on capital contributions and gifted assets, nor do they include the value of the those assets for the purposes of calculating tax depreciation.

Although capital contributions and gifted assets are excluded for the purposes of determining regulatory revenue, the value must be included as a revenue item and as an addition to the asset base for tax purposes.

Although the Authority has not explained in detail their assumptions regarding the calculation of tax, it appears from the models provided to Aqwest that the Authority's intention is to calculate the tax that would be paid by a standalone business with the Authority's assumed financial profile (e.g. 60% gearing, an initial capital base equal to the initial regulatory capital base). Therefore, for the calculation of tax, we propose:

- including new capital contributions and gifted assets as a revenue item for tax purposes;
- including new capital contributions and gifted assets in the asset base for the purposes of calculating tax depreciation;
- setting the initial asset base for tax purposes equal to the regulatory asset base, reduced in proportion to Aqwest's actual asset base for taxation (approximately $56 million) compared with Aqwest's statutory asset value ($105 million).This reduction reflects the fact that the value of the assets for tax purposes is less than the statutory accounting value as the assets are depreciated based on historic cost for tax purposes. In addition, we propose to add the assets that have been contributed since the regulatory asset base was initially determined in 2008.

Modifying the tax calculation based on the above proposal adds an additional 0.32% per year to the required price increase.

TARIFF CAPS

The Authority has proposed capping the highest usage charge at the highest usage charge recommended for the Water Corporation $3.11 per kilolitre). Aqwest does not support capping tariffs based on the prices charged in the Perth metropolitan area. These caps do not relate to the cost of service to Bunbury customers nor to the opportunity costs for water supply. The Authority has previously argued that water could be supplied to Perth, however this argument ignores the additional costs that would be incurred in servicing Perth, the fact that Aqwest has an obligation to service customers within their operating area before considering supplies to third parties, and the fact that the opposite argument could equally be made, i.e. that Perth tariffs could be limited to Aqwest's tariffs.

Linking Bunbury prices to those of the Water Corporation appears to be based on a desire for consistency rather than soundly argued policy and we do not believe that artificial caps of this nature would apply in an environment of light handed regulation. Therefore, we strongly urge the Authority to abolish any link between the prices in Perth and Bunbury. While the impact on prices is small at this stage, it may become more significant in the future as more tariffs increase to reach the cap. When this occurs, the cap on higher tapers will imply that lower tapers will be required to bear the full burden of any further price increases, a situation we consider untenable.

CONCLUSIONS

The charges recommended in the Authority's Draft Report imply that prices would increase by 9.09% in real terms for each of the years from 2013/14 to 2015/16. The changes proposed in this submission would, if applied over three years, result in a price increase of 18.90% over the same three year period.

Therefore, Aqwest proposes to smooth the price increase over both the next three years and the four years immediately following. This time period would reflect the full 10 year phase-in of prices envisaged in the Authority's previous pricing inquiry (i.e. 2010/11 to 2019/20). We also propose that the annuity for under-recovered revenue recommended by the Authority on page 87 of the Draft Report also be fully recovered over the same time period.

After accounting for all of the adjustments in this submission, the final price increase for the years 2013/14 to 2015/16 would be 10.13% per year.

A summary of the pricing changes is shown in Table 5. A full spreadsheet outlining the changes has been provided separately to the Authority.

Item	**Impact**	**Price increase 2013/14 to 2015/16**
Price increase proposed in Draft Report		9.09%
Revised consumption profile	+5.74%	
Revised operating and capital expenditure	+2.94%	
Removal of business development revenue	+0.98%	
Revise taxation calculation	+0.32%	
Remove price caps	-0.17%	
Price increase required before smoothing		18.90%
Price increase smoothed over 3 + 4 years		10.13%

Table 5: Summary of pricing impacts

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CHIEF EXECUTIVE OFFICER
19/10/2012

WATER SERVICES LEGISLATION AMENDMENT AND REPEAL BILL 2011

EXPLANATORY MEMORANDUM

The primary purpose of this Bill is to repeal the *Water Boards Act 1904* and amend the *Water Corporation Act 1995* to enhance the operations of the Busselton and AQWEST-Bunbury Water Boards. This will enable the Boards to provide the same range of services and operate under the same governance arrangements as the Water Corporation.

This Bill will implement the legislative reforms recommended by the 1999 *National Competition Policy* (NCP) *Legislation Review of the Water Boards Act 1904* and the 1999 *Busselton* and *AQWEST-Bunbury Water Boards Competitive Neutrality Reviews*. The recommendations of those reviews were endorsed by Cabinet in December 1999 and in February 2004.

The key legislative amendments recommended in the Reviews and embodied in this Bill are as follows:

National Competition Policy Review of the *Water Boards Act 1904;*

- enable the Water Boards to provide services outside their water area;
- allow Water Boards to provide a full range of water services (including sewerage, drainage, and irrigation);
- enable the Water Boards to make a profit;
- enable the Water Boards to enter into business arrangements;
- facilitate the adoption of a more commercial approach to service provision consistent with the principles of competitive neutrality; and
- enable the provision of CSO (Community Service Obligations) payments to Water Boards where applicable.

Competitive Neutrality Reviews of Busselton and AQWEST-Bunbury Water Boards

- prepare annual statements of corporate intent and strategic development plans;
- provide concessions to senior and pensioner customers;
- pay dividends to government with the dividend payments to be negotiated annually;
- earn a return on assets with the rate to be negotiated annually; and
- remain exempt from local government rates and charges.

The NCP Review of the *Water Boards Act 1904* noted when that Act was passed, the operation of public utilities along commercial lines was not envisaged. As a consequence the Act provides for the establishment of organisations capable of providing services to the community in a non-competitive environment. The existing Act covers the functions and responsibilities of the Boards in considerable detail, all are highly prescriptive and not in keeping with the Water Corporation Act which would allow the Boards to act in a more commercial and competitive manner in the new competitive water industry environment. Another impediment to competition is that the *Water Boards Act* relates only to water supply impeding the Boards' opportunities to fully participate in the water industry.

The *Water Corporation Act 1995* on the other hand, is a modern government trading enterprise Act. It establishes the Water Corporation as an entity with a significant degree of independence and sets it a commercial focus. Ministerial oversight of the operations of the Corporation is provided through the Minister's approval of Statements of Corporate Intent and Strategic Development Plans developed by the Water Corporation.

Accordingly, it was determined that new enabling legislation for the Boards was necessary and would best be achieved by amending the *Water Corporation Act 1995* to cover the operations of the Boards. The Water Corporation and the Boards will all be 'corporations' for the purposes of the Act. This will mean that the Boards will have the same powers as the Water Corporation and can operate on a level playing field with the Corporation and other private providers in competing for the provision of services in the water industry. This will encourage competition and efficiencies for the water industry as a whole.

The secondary purpose of the Bill is to amend other pieces of legislation to ensure all legislation is consistent with the new water legislation regime which will commence with the Water Services Bill 2011. These amendments mainly involve removing old terminology and replacing it with terminology used in the Water Services Bill 2011. References to legislation which is no longer relevant in the new regime will also be removed. It is due to these additional amendments that it is necessary for the Water Services Legislation Amendment and Repeal Bill 2011 to come into force on the same day as the Water Services Bill 2011.