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17 March 2006

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Dear Lyndon

Please find attached a copy of the Corporation's Response to the Economic Regulation Authority's *Draft Report: Inquiry on Country Water and Wastewater Pricing in Western Australia.*

Yours sincerely

J.I. Gill
CHIEF EXECUTIVE OFFICER

Submission to the Economic Regulation Authority's Draft Report: Inquiry on Country Water and Wastewater Pricing

17 March 2006

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Introduction

This paper is the Water Corporation's response to the Economic Regulatory Authority's (ERA) draft report on pricing in country regions, as called for in the ERA's *"Draft Report: Inquiry on Country Water and Wastewater Pricing in Western Australia"* (31 January 2006).

Original Submission – Response the ERA's Country Issues Paper

This paper follows on from the Corporation's *"Submission to the Economic Regulation Authority's Inquiry on Country Water and Wastewater Pricing"* (13 January 2006) which was responding the ERA's initial issues paper in December 2005.

In our January 2006 submission, the Corporation detailed the history of pricing for water and wastewater services in the country. In addition, the submission highlighted the following key issues that underlie the pricing for country water and wastewater services:

- Country charges are a decision for the State Government, with country tariffs supported by Community Service Obligation (CSO) arrangements. These arrangements ensure that the underlying commercial performances of the Corporation's country operations are met.
- Prior to 1985, water and wastewater services were provided by two State- owned utilities – the Metropolitan Water Authority and the country water supply division of the Public Works Department. Some of the remaining differences between metropolitan Perth and country tariffs are due to their origins being in different organisations.
- Due to the generally higher and diverse range of unit service costs in the country (compared to metropolitan Perth) there are differences in tariff structures.
- The following principles in combination have governed changes in tariff structures:
    - Simplicity, to avoid excessive administration cost and to facilitate ease of customer understanding.
    - Customer acceptance, by taking into account the social impacts of the pricing structure.
    - Economic signals through user pays with pay-for-use volumetric charges and pay-for-service annual charges replacing charges based on property valuation.
    - The State-wide uniformity of prices.

Current Submission – Response to the ERA's Draft Report

This paper does not intend to repeat the information detailed in the Corporation's original submission. It is assumed that this submission is read in conjunction with the previous one.

The intent of this submission is to respond to the findings in the ERA's draft report. Accordingly, the paper first details each of the ERA's findings as numbered in their draft report followed by the Corporation's response.

RESIDENTIAL WATER PRICING

Section 2.3 Objectives Underlying the Current Country Water Pricing Approach

1) There is no formal policy statement that sets out the social objectives of the uniform pricing policy. However, the social objectives currently underlying the uniform pricing policy can be discerned from observing country prices and appear to include: the provision of water for basic needs at a uniform price; the provision of an average amount of water at a location at a uniform price; and the provision of water to customers who use up to 150 kL/year more than the average at a particular location at a discounted price to the charge that applies in Perth.

While the uniform pricing policy has not been formally recorded as a policy statement, the objectives of the uniform pricing policy can be inferred by reference to the pricing decisions made by successive State Governments.

Uniformity between metropolitan and country charges has been the guiding principle behind tariff changes that have been applied to:
- Residential water (uniform service charge, uniform volumetric charges to 350kL);
- Non-residential water service charges (uniform service charge but differentiated volumetric charges);
- Non-residential wastewater charges (uniform service charges, uniform volumetric charges).

Decisions were specifically made to apply non-uniform charges for:
- Residential water consumption above 350kL (town classes, climate allowance);
- Non-residential water consumption charges (town classes);

It should also be noted that the differentiated charges based on town classes for both residential and business customers do not reflect the full cost of service provision.

For residential water, a decision was made to apply uniformity up to 350kL.
- The further discount for an additional 200kL in the north is a deliberate reflection of the impact of climate on consumption, and a specific decision was made since 1985 to extend this concession to towns with similar climatic conditions.

- The lower relative charge for the 100kL between 350kL and 450kL in the country is a reflection of a historic difference between metropolitan and country tariffs and does not reflect a deliberate Government decision to provide an additional concession.

The current differential charges for residential sewerage reflect the long-standing Gross Rental Value tariff structure that was in place before the 1985 metropolitan/country merger, and therefore doesn't necessarily reflect an expression of the uniform pricing policy.

From the above, it is clear that the social objectives of the uniform charging policy go beyond the provision of specific water volumes at uniform prices. Decisions since the combination of the metropolitan and country services in 1985 have generally been based on uniformity of charges being the primary driver, with the exception being some volumetric water charges where there is a view to encourage water conservation.

Section 2.3.2 What Would Efficient Country Water Prices Look Like?

2) ***Application of economic principles on a town-by-town basis without reference to the uniform pricing policy would almost certainly result in significantly different usage charges and fixed charges between towns with higher payments being made in total by customers in the country systems.***

In the absence of other distorting factors, the application of economic principles would lead to cost reflective charges based on the Long Run Marginal Cost (LRMC) of supply. Leaving the cost and practicality of metering and cost estimation aside, the charges would reflect the various marginal costs associated with a customer's service requirement and annual, seasonal and daily demands.

This would certainly result in charges that would be significantly different to the current prices and would generally be much higher in the country. There would be exceptions in areas of stagnant or declining population.

It should be noted that the discussion of peak prices on page 8 of the ERA Draft Report understates the peak cost of supplying Kalgoorlie. The price provided ($4.65/kL) represents the average cost for a customer taking water uniformly throughout the year. The cost of providing peak summer demand is considerably higher. Consideration should be given to which marginal cost (annual or summer peak) should be targeted for a simplified cost reflective tariff structure.

3) ***In order to achieve more efficient water pricing, the Corporation would need to develop better systems to differentiate commercial and residential costs and to identify the forward-looking supply costs for towns or groups of towns that are approaching capacity and need to increase their water supplies.***

The Corporation agrees with the ERA that the decision as to whether it is worthwhile to develop more "efficient" water pricing will be a balance between the benefits and the costs of developing more complex systems.

However, the issue goes beyond the expense of developing better costing systems. The basic problem lies with the uncertainty associated with assumptions such as growth projections, environmental conditions and future service standards that underlie country cost estimates. There is a degree of uncertainty with the Perth cost projections, and even greater uncertainty associated with country schemes.

The ERA has raised the need to better differentiate residential and commercial costs in the past. However, there is no fundamental difference in costs as each receives the same service. Residential and commercial services are provided using common infrastructure, with the cost of service provision largely based on the respective proportion of the usage by each customer type. Differences will occur between customers to meet peak capacity requirements, and these requirements differ significantly both between and within customer groups (eg high rise apartments vs. houses with gardens, hotels vs. factories).

The Corporation has information systems capable of differentiating revenue and costs on a scheme by scheme basis.

With regards to identifying the forward-looking supply costs for towns, the Corporation previously raised its concern over the application of LRMC in its response the ERA's issues paper.

For the purpose of completeness, those comments are repeated:

"Moving to marginal cost for country schemes is problematic with the greatest difficulties being the complexity of the calculation required for each of the Corporation's 236 schemes, coupled with the instability of the result due to the uncertainty of growth.

These difficulties need to be further weighed against the administrative costs of using a marginal cost approach and the fact that price differentiation applies only to consumption in excess of 350kL, being 28% of the total country consumption. The Corporation currently has the systems in place for calculating the average cost for a scheme" (p.11)

The ERA has suggested a LRMC approach could be adopted for towns experiencing growth. The Corporation prepares a planning report for each of its country water schemes. These are reviewed every 5 years at a minimum. Examination of these planning reports indicated that approximately 30 towns (~ 12%) are growing. Determining the LRMC is a complex exercise, administratively demanding with the results often subject to significant variability due to the inherent uncertainty of scheme requirements.

Care should also be taken not to mix the appropriate price signal for customers with the appropriate price signal to assess the value of alternative sources. The suggestion that the availability of forward looking prices would encourage alternative providers is contrary to the Corporation's recent experience. Proponents of alternative supplies are often seeking to provide a substitute for existing sources of supply. These proponents generally want the certainty of replacing existing known demand. The appropriate pricing for these projects is the avoidable costs associated with their project, not the forward looking marginal costs appropriate for setting customer charges.

It should be noted that the Corporation has actively tried to facilitate the provision of alternative sources in the hope of lowering the cost of providing loss making country services and encouraging the broader regional benefits these project may provide.

The issue with these projects is not about competition (for loss making business), but the costs and risks of the alternative sources relative to the Corporation's avoidable costs. These issues need to be dealt with on a project specific basis. Using customer prices, or the forward looking marginal cost of expanding schemes, can lead to an unrealistic view of the viability of an alternative, and lead to inefficient expenditure and resources being applied to their investigation.

Section 2.3.3 Can Greater Efficiency be Achieved for Country Pricing Within the Constraint of Uniformity?

4) The commitment to and the specific implementation of uniformity limits the options available to use price as an incentive to achieve greater efficiency. Setting the threshold differently across groups of towns, at say the average water use for the group, would ensure that a similar percentage of households in each group exceed the threshold and pay cost reflective prices. The usage charge below the threshold and fixed charge could be adjusted to achieve the average payment (which could be set, say, at the average payment for Perth). This would allow the usage charge above the threshold to be set in relation to LRMC, where

appropriate, thereby introducing an efficiency incentive for above average users.

As detailed in the Corporation's response to Finding (1) above, the definition of the uniform pricing policy can be inferred from the pricing decisions made by government.

This inference for water services suggests that the uniform price policy means the same price for the same quantity of water up to a reasonable level of consumption. The ERA's proposal is a redefinition of what uniformity means.

The Corporation has the following concerns in relation to a tariff that results in the same charge for an average volume of water used in each town (where that average differs from town to town):

i) Each town would have a different volumetric charge up to their average consumption. There would be very little uniformity associated with pricing as there is not really an "average user". Most households have different attributes. Unintended consequences would be that customers living in units would benefit in towns with a hot climate and/or houses with large gardens, and large families would be particularly penalised if they were in towns with low average consumption.

ii) Such an approach would effectively reward towns who have consistently used a high volume of water by providing them at a lower unit water price. A more practical alternative would be to base the uniform charge volume on a behaviourally independent factor such as the climate.

iii) This approach may be contrary to the Corporation's Waterwise initiatives. Towns that have a low average use (particularly those who have been subject to significant demand management initiatives) would effectively be penalised with a higher unit price for their low use. This would ignore the costs incurred by customers in reducing consumption.

iv) Administratively, such a policy would require determining a separate rate for each town. Determining and applying this average, as well as determining how this rate might change over time as consumption patterns change bears consideration. In addition, the policy is unlikely to be well understood by customers, and could result in additional complaints from customers on the wrong side of the average for reasons other than the "inefficiency" of their use eg large families.

The Corporation would support an assessment of whether the current tariff should be uniform up to 350kL across the state. Consumption has generally reduced since this threshold was introduced, and it may now be appropriate to reduce the volume up to which uniformity applies. Uniform prices up to 300kL (with an additional 200kL at concessionary prices in the north) could be achieved by simply reducing the second pricing taper from 200kL to 150kL, so that it applies from 150kL to 300kL, rather than from 150kL to 350kL.

Section 2.3.4 Allocation of Country Towns to Classes

5) ***Grouping of towns should ideally be based on forward looking cost of providing water services and additionally account for non-health related aspects of water quality and differences in weather conditions between groups of towns. Whilst***

such a classification is dependent on data that is not readily available from the Corporation, it is the case that the current classification needs to be reconsidered to ensure that a reasonable balance is achieved between efficiency and social objectives.

6) ***Grouping towns that are approaching the need to increase their water supplies would allow (possibly imprecise) estimates of LRMC to be applied while the usage charge above the threshold for towns that are unlikely to need to increase their water supplies could be set to at least recover the avoidable costs of providing water services and, where appropriate, also make a contribution to the Corporation's return on its investment.***

Country towns are currently segregated into 2 classes (Country North and Country South) based on climatic conditions. Within these 2 categories, towns are further split into 5 classes based on a rolling 3 year average of the average historical cost of supply.

The current grouping of the towns has little impact on the balance between efficiency and social objectives. This balance is dependant on the level to which uniformity is applied (350kL) and the rate at which differential charges are increased towards cost above this level. With only a gradual increase in residential charges above 350kL, there is not a strong efficiency argument for refining the basis of allocating towns to classes. However, this could change if fully cost reflective pricing were applied to large enough volumes to make the cost of doing so worthwhile.

The current choice of 5 classes helps in the administration of the tariff. While theoretically each town could have a different tariff, this would complicate:

- the billing system;
- provision of information to customers on their charges;
- the publishing of by-laws.

The use of LRMC for country water is problematic. This was discussed above under Finding (3).

While economic price signals are one objective of a tariff structure, another is equity between customers. As an example, a purely economic price signal may result in very high charges to cover the forward costs on a small scheme for a disadvantaged town in a harsh climate where the only source of water available is of poor quality. While some would see the resulting high charges as economic price signals and equitable (as customers should pay the costs incurred in providing the service), many would not (as charges should reflect ability to pay or the standard of service provided or the volume required for essential water use). Some customers would regard the recovery of the historical costs of service provision as equitable (why should a customer in town which was very expensive to service but is not growing pay less than a customer in a lower cost town with a higher marginal cost?). If prices are not going to fully reflect long-run marginal cost, the price signal will already be diminished and these other issues need to be addressed in tariff design.

The Corporation would seek that the ERA carefully considers the costs as well as the benefits associated with any change to the basis of allocating towns to cost classes. The Corporation acknowledges the potential for benefits to outweigh costs for some schemes, but seeks consideration be given to the overall cost of introducing change, and the perception of equity between customers.

Section 2.3.5 Concessions

7) ***There are various options for restructuring existing country water pricing arrangements including basing the threshold below which concessions apply on a value such as average consumption for a group of towns to help achieve clearly specified objectives.***

8) ***The concession arrangements may require further consideration by Government. Any such review might consider, among other things, the objectives of the policy, criteria for eligibility, the options for providing assistance, and the consistent treatment of those appropriately considered eligible for assistance.***

As noted in the Corporation's response to the ERA's inquiry paper, the Corporation acknowledges there is an inconsistency between the concessions offered to country and metropolitan residential customers. This inconsistency is a by-product of the different concessions offered prior to the merger of metropolitan and country services in 1985.

Concessions provided by the Corporation are supported by CSO payments from the State Government, and any change in policy is a decision for Government. There are numerous options available that would result in a uniform approach, but these either result in a cost to State Government revenue or an increase in charges for some customers.

The draft paper includes some views that concessions should be increased. The ERA should give consideration to the fact that any increase in concessions would be a direct cost to Government, and this funding may well be far better targeted providing other types of welfare benefit. Would welfare groups chose to apply an increase in the welfare budget to metropolitan pensioners using between 150kL and 550kL or are there other better targeted priorities?

COMMERCIAL WATER PRICING

Section 3.3.1 Uniformity and Cost Reflectivity

9) ***Commercial water charges appear to be only weakly related to costs – the fixed charge is uniform and usage charges are not specifically linked to estimates of LRMC.***

As noted in the response to Finding (1) above, a Government decision was made to introduce uniform water service charges across the State. This decision can be used as an indicator of the application of the Government's uniform pricing policy.

Usage charges are related to the town cost classes, but were never intended to be fully cost reflective.

A decision to implement fully cost reflective charges for commercial water users would therefore be a significant change in the Government's approach to uniform pricing.

It should be noted that industrial and mining customers whose peak requirement exceeds 49kL per day enter into major consumer agreements that include charges that reflect the location specific cost of providing the service. Prices reflect the cost of upgrading peak capacity and ongoing operating costs. These price signals ensure major consumers face the correct price signals when they are choosing the location and/or production process for their projects.

A more targeted approach to LRMC pricing could be to apply similar agreements to smaller customers. In considering the level at which agreements would apply, consideration should be given to location specific factors (eg capacity constraints, the difference between LRMC and the by-law charge). Again, care should be taken that the benefits of these agreements outweigh the cost of implementation. There are significant costs in calculating the prices for major consumers, negotiating agreements and for ongoing administration.

10) ***It is not clear that it is the Government's intention in its uniform pricing policy to provide discounts to commercial users. In the absence of residential and commercial cost information by scheme it is not possible to conclude the extent to which the CSO payment is benefiting commercial customers rather than residential customers.***

11) ***The Corporation would need to further develop its cost databases for a more accurate assessment of the current commercial pricing structure to be made.***

As noted in the response to Findings (1) and (9) above, the Government has made a clear decision to introduce uniform charges to commercial users. This was based on the overall approach to pricing and impact on revenue, not a decision to provide individual customers with a particular level of subsidy.

The CSO payment is for maintaining the overall tariff structure for both residential and commercial customers. The benefits of the CSO payment to particular customer groups are an outcome, not an objective.

Additionally, as noted in the response to Finding (3), there is no fundamental difference in the cost of providing services to residential and commercial customers as they are serviced from the same infrastructure. The costs of servicing these customers jointly are considerably less than the cost of stand alone schemes.

If the ERA needs to progress beyond the allocation of costs to commercial customers based on their relative use of a scheme, charges can equitably be in a range between avoidable costs and stand alone costs. These are not issues associated with the need to development the Corporation's cost databases, but require a more fundamental assessment of costs. This work should only be undertaken on the basis that the benefits from changes to the tariff structure would exceed the costs.

Section 3.2.2 Water Usage Threshold

12) ***Water for commercial use is a business input; the argument that water should be treated like any other input appears to be warranted. The current commercial usage charge threshold is an impediment to efficient water pricing, which reduces the extent of cost-reflective pricing.***

The level of subsidy for country commercial charges is a matter that is determined by the Government's pricing decisions. There is currently a compromise between cost based prices and making services available to business at an affordable price. As a result, commercial usage charges are not cost reflective for either the first 300kL consumption taper or for consumption above this level, although the charge above 300kL is closer to the cost of supply.

This charging policy may viewed as assisting small country businesses.

As discussed in the response to Finding (9) above, there may be benefits in targeting the charges to larger users through a review of the major consumer threshold, rather than modifying the general by-law tariff.

RESIDENTIAL WASTEWATER PRICING

Section 4.3.1 GRV-Based Pricing

13) Under GRV-based pricing, customers within towns, and in different towns with identical wastewater costs, pay different amounts for the same wastewater service.

GRV-based pricing is not cost reflective for individual customers.

The Corporation has previously proposed moving to a fixed service charge for sewerage as this would improve customer understanding of the basis for our charges and reduce the cost and complexity of administration.

The Corporation does not support the halfway step proposed in the ERA's Urban Pricing Inquiry as it creates serious inequities around the step points in the tariff structure. The structure would also create broadening inequities in the longer-term as relative valuations changed and charges were not updated.

If this tariff was intended as a halfway step to a uniform service charge, the Corporation believes there are more equitable phase-in strategies.

The Corporation notes that State Government has reconfirmed its preference for GRV-based pricing in its response to the ERA's Urban Pricing Inquiry, based on the impact any change would have on customers of low socio-economic status.

Section 4.3.2 Cost Reflectivity

14) While the current approach allows for wastewater charges to reflect costs on a town-by-town basis (subject to a cap for towns with expensive wastewater systems) actual charges show no relationship to actual costs, despite a policy since 1993 to gradually align charges with costs.

Subject to the revenue cap and maximum charge, the intent of the Corporation is to recover the total cost of the wastewater service from each wastewater scheme. The extent to which this can be achieved is influenced by a number of factors including:

i) The relatively slow adjustment mechanism to align charges with costs. For many schemes the adjustment is just 2.5% per annum above the General Price increase.

ii) Scheme's inherited from the Corporation's predecessors and/or other organisations (eg. private operators, local shires) were generating revenue significantly below costs.

iii) Increasing costs driven in part by new, higher wastewater treatment standards may increase at a rate higher than the allowable increase in revenue.

iv) The Government's decision to place a cap on an individual customer's charge, in addition to a cap in the overall rate in the GRV dollar.

The lack of cost reflectivity in the current sewerage rates reflects the constraints on the rate of change in charges. There would be even less correlation if the adjustments since 1993 had not been made.

15) The cap on the recovery of costs from an individual town (currently $0.12 per dollar of GRV) is applied for affordability reasons but is inconsistent with the principle of cost-reflective pricing.

The decision to place a $0.12 per dollar of GRV was a Ministerial commitment. The associated legislation has a cap of $0.20 per dollar.

16) Cost-reflective prices for wastewater services would provide important information to alternative service providers who may be considering offering wastewater services, particularly in new developments.

There is a difference between cost reflective prices and avoidable costs that are appropriate to assess alternative service providers (see the response to Finding (3)).

Sewerage schemes are efficiently designed to meet future capacity requirements. These cost need to be recovered through customer prices and/or CSO payments. Care should be taken to base alternative servicing proposals on the actual costs avoided rather than these prices.

17) Cost-reflective pricing of residential wastewater services would require the Corporation to develop more detailed data on the costs of service provision, including differentiation between servicing residential and commercial customers.

Information on the total cost of each scheme is already available.

As with water, wastewater services are provided to both residential and non-residential customers predominately using the same infrastructure. For "regular" waste (that is, non-industrial waste), the cost of providing the wastewater to different customer groups is largely proportional to their respective use of the total system.

Identifying the extent to which customers use the wastewater service would necessitate some measurement of their discharge to the sewer. This could be approximated by utilising the commercial discharge volumes and an assumed discharge for residential customers.

This measure would give a broad allocation of costs to customer groups. However, given the current GRV based residential charges and uniform non-residential charges, there is currently no use for this information. The Corporation would be interested to understand the benefit the ERA sees in the availability of this information.

Section 4.3.3 Caps on Individual Wastewater Charges

18) The effect of the cap on individual country residential wastewater charges is to shift the relative contribution from customers in high-value properties towards customers in low-value properties. In fact, country customers in low-value properties pay, on average, higher wastewater charges than customers in the same value properties in Perth. This is inconsistent with the principles of the uniform pricing policy. However, the individual cap serves to spread wastewater payments more evenly between households in a town, and results in more cost-reflective pricing because the costs of wastewater provision do not differ significantly between households. The Authority is not suggesting that the cap be removed but is particularly interested in the views of interested parties on this matter.

As discussed in the response to Finding (1), there has been no fundamental decision by the Government since 1985 associated with residential sewerage charges that can be taken as revealing the Government's intention related to the uniform pricing policy. With the exception of the introduction of the maximum country residential sewerage charge, the tariff structures are largely unchanged since 1985.

The suggested effect of the impact of the cap on individual wastewater charges is more theoretical than actual. As discussed in the response to Finding (14) above, the constraints make changes in rates so gradual that the actual impact on uncapped customers' bills would be minimal.

There are two differences between the metropolitan and country regions which influence the charging for wastewater services:

i) In general, it costs more per household to provide the service to country customers; and
ii) Metropolitan customers tend to have a higher GRV than country customers (average metropolitan: $8,508; average country: $7,172 (2004/05))

Whilst the wastewater charges for both metropolitan and country customers are based on GRV-based pricing, the actual structure of the two systems differs. Metropolitan customers are charged using a tiered band structure without a price cap (the rate cap is unnecessary as costs are less than $0.12 per dollar GRV). For country customers, a separate rate is calculated for each scheme and applied to all properties regardless of their value. However, caps in the GRV rate and the overall charge are applied.

COMMERCIAL WASTEWATER PRICING

Section 5.3.1 Cost Reflectivity

19) Current commercial wastewater charges are not cost reflective because charges do not vary across towns whilst costs vary significantly.

In 2002 the Expenditure Review Committee requested that the Minister for Government Enterprises establish a working group to examine alternative charges for (among other things) country commercial wastewater charges.

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In November 2002, the Joint Working Party considered a number of alternative options for country commercial wastewater pricing and recommended that it was most appropriate to introduce the metropolitan model for country customers. It was acknowledged that this was not cost reflective. The rationale behind the recommendation was largely based on a preference for state-wide uniform charging, and to address complaints from country businesses that they were disadvantaged relative to metropolitan businesses by the previous valuation based charges.

20) ***There is an inconsistency between the approaches to commercial and residential wastewater pricing. Uniform pricing for commercial users coupled with a cost-recovery pricing approach for residential users means that residential users in towns with high wastewater costs currently have to pay more relative to commercial users. The Authority's preliminary view is to recommend cost reflectivity for commercial customers.***

As noted in Findings (19), a Joint Working Party has previously considered alternative pricing structures for commercial wastewater charges, including cost reflective pricing. The preference for the current structure reflects the State Government's desire for state-wide uniform prices.

As noted in the response to Finding (18), the other constraints on charges means that the impact on residential customers bills due to uniform commercial charges would be minimal. This minor impact could also be completely removed by a minor modification to the rates adjustment calculation.

Section 5.3.2 Other Issues

21) ***The potential for competition in wastewater service provision might be compromised by uniform commercial pricing across schemes.***

As discussed in the response to Findings (3) and (16), customer prices should not be relied on by alternative service providers as an indication of the avoidable costs associated with their proposals.

COMMUNITY SERVICE OBLIGATION (CSO) PAYMENTS

Section 6.2 Analysis

22) ***The CSO policy influences the design of country water and wastewater pricing. CSOs could either be calculated as whatever is needed to ensure the uniform pricing policy and other policies are achieved or specified at a certain level, which would result in prices being established to make up the Corporation's shortfall in revenue.***

The CSO recognises the cost of implementing country water and wastewater pricing. The Government considers the impact on revenue and the CSO payment for each change in country pricing policy.

A significant benefit of the CSO policy is that it makes the financial impact of government

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decisions transparent. This transparency applies not only to pricing decisions, but extends to the provision of changes to any service level or standard provided in the country.

It would not be practical to constrain service delivery to meet a CSO payment budget, particularly at the level of a scheme or customer class, as much of the expenditure is required to meet increasing regulatory standards. Setting a price to meet a forecast cost shortfall would therefore be problematic.

23) CSOs are not clearly related to specific policy objectives. Although used primarily to fund the uniform pricing policy, CSOs are also used to fund residential wastewater customers and are likely to be benefiting commercial customers.

The total CSO payment to the Corporation is the sum of:

i) Losses on Country Services (incl. new CSOs and improvements in standards);
ii) Payment for losses on the Infill Sewerage Program; and
iii) Payment for revenue concessions.

The objective of the CSO arrangements is to compensate the Corporation for undertaking non-commercial activities.

The CSO approval processes insures that the expenditure and pricing decisions underlying the CSO payments are specifically approved by either the Minister for Water Resources or Cabinet.

This approval process has covered the change in revenue and impact on individual customers' bills of all the tariff reform decisions associated with country commercial tariff reforms.

24) As currently understood, the uniform pricing policy applies to residential water pricing. Yet, other aspects of pricing such as the imposition of caps on individual wastewater charges appear contrary to the social objectives underlying uniform pricing. The Authority's preliminary view is that the uniform pricing policy would benefit from being clearly defined and documented.

Please refer to the Corporation's response to Finding (1) in this paper.

25) CSOs could be made more transparent at the town level. The benefit of doing so would be to provide the opportunity for competitive tenders for water and wastewater services.

The objective of the CSO payment is to recognise the costs incurred in providing country services to aid decision making, not to provide a competitive quote for the cost of ongoing operations of an existing scheme.

While the CSO payment is calculated at a town level, there are many shared costs (eg billing systems) that are allocated in this process. Additionally, the payment is based on the depreciation and a rate of return on past investments and these costs could be largely sunk costs if replaced by an alternative provider.

The CSO payment does not reflect the forward looking avoidable costs associated with the provision of existing services. It would therefore be inappropriate to assess alternative service providers against the scheme by scheme CSO payment. The projected CSO payment for a new scheme could be used as an indication of costs against which to assess potential competitors. However, care should be taken to recognise potential economies of scale within the Corporation, and to recognise the additional cost placed on regulators associated with an additional industry participant.