

**AQWEST – BUNBURY WATER BOARD  
SUBMISSION – AUGUST 2004**

**INQUIRY ON URBAN WATER AND WASTEWATER PRICING  
(THE INQUIRY)**

The Economic Regulation Authority (ERA) has invited submissions on any matter raised in the Issues Paper and/or the Terms of Reference relating to the Inquiry.

The Board of Management of Aqwest – Bunbury Water Board considered this matter at its meeting held 11 August 2004 and approved items for inclusion in the submission as follows:

**GENERAL**

Aqwest appreciates the opportunity provided by the ERA to provide comment on the conduct of the Inquiry.

In general terms Aqwest is concerned that the Inquiry is being conducted without a set of defined, measurable objectives or any form of performance assessment.

Of particular concern is that the Inquiry appears to cut across the decision making responsibility and accountability of Aqwest Board Members. Board Members have responsibilities as set out in the Water Boards Act and the Statutory Corporations Liability of Directors Act yet the basic responsibility of determining prices and raising revenue is being taken away.

This raises the question that if there is a recommendation of the ERA approved by the Government and acted upon by the Board (directed by the Minister) that proves to be detrimental to the business, who then is responsible? The situation relating to Epic Energy is a case in point.

There is also a general concern about the model of pricing regulation that is being used as the basis of this Inquiry. The concern is that the incentives and basic drivers for Community / State owned utilities are completely different to those that exist in the real commercial world such as those administered by OFWAT.

In the Public Sector in which Aqwest operates the directors, managers, and staff do not directly benefit as they might in the Private Sector (profit sharing, bonus share issues etc) and they are subject to for greater public scrutiny and high accountability levels by the customers, regulators, government, and the media. There is not a share value attached to the agency, its performance cannot be measured by its share price and there are no public shareholders to hold the Board accountable.

Further in this regard there is considered to be a far greater issue as it relates to the basic constitution of Aqwest under the terms of the Water Boards Act 1904 (the Act). The application of normal commercial assessment of Aqwest's activities is not considered possible or reasonable because of the restriction of the Act. Legal advice has shown that the intent of the Act did not envisage normal commercial activities such as profit making, profit sharing, taxation, joint ventures, contracting out, contracting in, sponsorship, and normal commercial incentives for Board Members and Staff. Despite nine years of effort Aqwest has been unable to gain the necessary support for the Act to be changed.

## **ISSUES PAPER INTRODUCTION**

The following comments are provided in relation to the matters listed by dot point in the Introduction (page 1) of the Issues Paper.

- **The efficient cost of providing water and sewerage services.**  
No comment.
- **The standards of service that apply, including standards of quality, reliability and safety.**  
There is an existing set of standards as identified in our operating licence and these should be used for this project as its first inquiry and not muddy the waters by trying to fix something that is not necessarily broken.
- **The need to encourage investment in the water industry.**  
By whom and for what purpose? The state urban water areas are covered by existing exclusive licences and the licensees have a responsibility to ensure adequate investment. This makes this aspect of the inquiry superfluous. The Act would need to change and Aqwest would need to be allowed to do things that Private Sectors can, eg form joint ventures etc. The Water Corporation hold licences for the majority of the State and external investment is thereby restricted.
- **Water supply demand management.**  
No one size fits all model is applicable and Aqwest for its area of responsibility are best positioned to carry out appropriate demand management at the appropriate time in the cycle of availability of resource and infrastructure development. It is suggested that Managers be left to manage demand.
- **The protection and development of future water sources.**  
This is a State responsibility and is considered outside scope of the inquiry. In accordance with COAG this function should not be the responsibility of service provider utilities. This function should be funded by taxpayers as the utilities do not control the activities and should not be responsible for raising the funds.
- **Ecological sustainable development.**  
No comment.

- **The social impact of the recommendations.**

No comment. (The existing pricing structure and Board accountability to local community and social groups is more likely to ensure they are considered in their decision making.)

- **The need to promote regulatory outcomes that are in the public interest.**

Aqwest have a direct responsibility to customers. Customer needs are researched, addressed and formal reporting mechanisms exist.

- **The long term interests of consumers in relation to the price, quality and reliability of goods and services provide in the relevant markets.**

As above. The local ownership as applicable to Aqwest, with Board Members appointed from its customer base is considered to be the best assurance that this will happen.

- **The need to encourage investment in relevant markets.**

See previous comments. Aqwest is restricted by its legislation in this regard.

- **The legitimate business interests of investors and service providers in relevant markets.**

The Water Boards Act is quite specific about the Boards activities and this has no relevance to them without changes to the Act.

- **The need to promote competitive and fair market conduct.**

The Water Boards Act prevents any reasonable direct competition by the Boards. Aqwest involvement in Benchmarking provides a basis for competition by comparison which is considered more appropriate.

- **The need to prevent abuse of monopoly or market power.**

The Inquiry model may apply where private companies are involved in water supply but not public utilities.

- **The need to promote transparent decision making processes that involve public consultation.**

The Inquiry raises concern regarding the responsibility of the utility Board Members and what is already an extremely transparent process involving scrutiny by Customers, Boards, Ministers, Auditors, and Parliament. What happens to this scrutiny if the inquiry makes recommendations that are adopted and later turn out to be in gross error? Who is then responsible? The existing system provides a high level of transparency and accountability.

## SPECIFIC ISSUES RELATED TO AQWEST

Matters of specific interest to Aqwest are as follows:

- **Changes to the Water Boards Act.**  
The Act stifles any level of commercial activity by Aqwest and the application of the principles of pricing as set out in the Issues Paper has little relevance to Aqwest. It would be a desirable outcome that the inquiry strongly supported the immediate need for changes to the Water Boards Act to allow Aqwest full participation in the Water Industry of WA.
- **Industry Structure.**  
The inquiry should be encouraged to analyse the effect of the reform of the WA industry compared to the Victorian industry and to recommend structural reform to improve the performance of the WA water industry. The matter of the Water Corporation gaining the licence to supply Dalyellup and spending millions of dollars to access the basic resources where it was a simple extension of Aqwest's system and the fact that Dalyellup residents pay approx 25% more for their water is an illustration of the failure of the existing structure.
- **Wastewater.**  
The lack of involvement of Aqwest in wastewater is a severe restriction to Aqwest's ability to apply a Holistic approach to the management of the entire water cycle. This restricts pricing comparisons being made in this state for a total water / wastewater agency. Involvement in both activities would enable Aqwest to provide a better level of comparative competition and thereby total pricing comparison with other agencies in Australia.
- **Public Utilities.**  
It is considered that the issue relating to the difference in drivers for public utilities compared to privately owned utilities as mentioned previously should be considered. The nearly 100 years of continuous provision of appropriate services to the community of Bunbury is a supporting argument.
- **Accountability.**  
The issue relating to accountability for price setting needs to be raised. In particular the responsibility of the ERA compared to Board Members needs to be clarified. Price is a key tool, which allows the Board to better meet the needs of the Community it services in relation to social values and demand management and price setting would be a restriction in this regard.
- **Structural Reform.**  
The essential service and health impacts of the water industry should be considered by the Inquiry as a driver for structural reform, in particular the need for a senior level Water Minister.

▪ **Headworks.**

The treatment of Headworks fees as taxable income is considered inappropriate on the grounds as follows:

- The value of the income is diminished by the impact of taxes and dividends (where applicable). The income should not be taxed nor be included in dividend calculations.
- The income is not raised as a result of the utilities capital investment and should not be included in Rate of Return calculation.
- The utilities have no control over this form of revenue and yet it can have a significant impact on reported performance.

▪ **Dividends.**

Aqwest does not pay a dividend to the State and there is a lot of recorded evidence and argument that supports that position. Aqwest would strongly resist any move to change that situation. With that in mind the level of Rate of Return on Assets should be treated differently from the Water Corporation.

**ISSUES PAPER QUESTIONS**

The Issues Paper poses a series of unanswered questions. These questions which are highlighted (boxed) in the report will be commented on using the page number followed by a number starting from the top of the page as follows:

**PAGE 21 – NO. 1**

**What level of security should be incorporated into future supply (i.e. what level and frequency of water restrictions is acceptable?) What is the most efficient future water source option for meeting the projected demand?**

It is considered that addressing levels of security and water source options is beyond the terms of reference and outside of the expertise available to this inquiry. Water resources issues should be managed by the Water Resources Regulator on a State-wide basis.

**PAGE 24 – NO. 1**

**Is it appropriate to use water pricing to achieve all of the purposes that are outlined above? Would it be more efficient to use other approaches to achieve these purposes?**

Water services should be priced to reflect the cost of providing the service and achieving a reasonable rate of return as per the COAG principles but they should not be used to provide social or environmental benefits outside of regulatory compliance. The utilities have no control over the expenditure or need for these funds and should not be publicly accountable for raising them.

**PAGE 26 NO. 1**

**How can pricing policy be used to give water service providers incentives to achieve efficiency gains?**

Public utilities have entirely different performance incentives to the Private Sector. Board Members do not benefit, employees do not benefit and there is no share price to set benefits to shareholders. In essence the model being discussed has little relevance to the water utilities in WA. As an example in Bunbury if you increased shareholder benefit at the expense of the customer it would have no relevance as they are the same.

**PAGE 26 NO. 2**

**How far ahead should prices be set?**

As this is an initial inquiry 2 – 3 years maximum is suggested. With allowance for changing circumstances.

**PAGE 27 NO. 1**

**How should unexpected revenue variations be shared between customers and shareholders?**

What is the difference as it applies to Aqwest between shareholders and customers and what is the value to the organisation in increasing profits, unless the profits occurred from other sources, where these could be used to subsidise costs of service to local Customers.

**PAGE 27 NO. 2**

**How can water pricing be used to give water service providers incentives to achieve improvements in service standards?**

Increased or decreased profits are of no benefit or dis-benefit to public utilities. The OFWAT comparisons are not appropriate because those companies have real shareholders and share prices.

**PAGE 28 NO. 1**

**Should the price setting approach that is applied to Aqwest and Busselton Water be different to the approach applied to the Water Corporation?**

Aqwest and Busselton must be treated separately on the basis that they don't pay dividends they don't receive CSO's, their customers and shareholder are one and the same and they are held accountable by the Community through its Board members.

**PAGE 30 NO. 1**

**How should the value of initial regulatory asset bases be set taking the COAG pricing principles into account?**

National Competition Council has accepted the use of AASB 1041 for Aqwest. No change is suggested.

**PAGE 31 NO. 1**

**How should the regulatory asset base be rolled forward and in particular how should depreciation be valued?**

Use of the accounting standards to achieve AASB 1041 is recommended for Aqwest.

**PAGE 32 NO. 1**

**What gearing ratio should be used?**

Difficult to gauge as Aqwest has been debt free since 2000. The industry statutory for utilities of 60% is considered appropriate.

**PAGE 32 NO. 2**

**What cost of debt margin should be used?**

Difficult to gauge as Aqwest has been debt free since 2000. Recommend the lower end of the scale, 90 basis points for statutory utilities.

**PAGE 33 NO. 1**

**What are the pros and cons of adopting a pre-tax versus post tax approach? If pre-tax is recommended, which tax rate should be used (an effective tax rate or the statutory tax rate?)**

Historically, Aqwest has used the pre-tax approach to determine performance indicators such as return on assets.

The pros of adopting a pre-tax approach, as stated in the Issues Paper, are that it is simpler because there is no need to estimate the projected tax payments, the con being that the tax rate needs to be determined.

Aqwest would recommend pre-tax approach.

**PAGE 33 NO. 2**

**What are the pros and cons of adopting a real versus nominal approach?**

Real return approach would be preferred as it shows real return after inflation. Easier to compare similar organisations.

**PAGE 33 NO. 3**

**What risk free rate should be used?**

The risk free rate that should be used is the 10 year Commonwealth Bond Rate (5.87% @ 30 June 2004).

**PAGE 34 NO. 1**

**What level of market risk premium should be used?**

The market risk premium (the difference between the return on the market portfolio and the risk free rate) should be uniform among providers for greater comparability. The rate of 6% as quoted in the Issues Paper appears high in the water supply market. A lower rate would more closely represent the risk associated with the market.

**PAGE 34 NO. 2**

**What level of equity beta should be used?**

Otherwise known as "systematic" risk. Risk cannot be diversified away by increasing the number of assets because it depends upon factors that affect the whole market in a rising market, but fall faster than the market in a falling market. Assets with a beta value < 1 are "defensive" because their returns vary less than the return on the market. AT the extreme (where a business holds the market), the business is subject only to market (systematic) risk as all unsystematic risk has been removed.

Aqwest's "systematic" risk should be set to the lower end of the Water Industry range as shown in the Issues Paper as 0.65.

**PAGE 34 NO. 3**

**What financial indicators should the Authority use in assessing the ongoing viability of each water service provider?**

The Issues Paper recommends 3 cash flow indicators. Of these, 2 indicators relate to debt. As Aqwest has no debt these indicators would be of little value.

The third indicator (Ability to Finance investment from internal sources), for example:

$$\text{Internal Financing Ratio} = \frac{\text{Net Profit after tax} - \text{capital contributions} + \text{depreciation} - \text{dividends}}{\text{Net Capital Expenditure (Capex - Contribs)}}$$

Or

$$\text{Net Cash Flow/Capital Expenditure} = \frac{\text{Funds from Operations} - \text{dividends}}{\text{Net Capital Expenditure (Capex - Contribs)}}$$

Would be a much better indicator for our business as no debt is included.

**PAGE 35 NO. 1**

**Is the level of the Water Corporation's dividend payout ratios and gearing ratio appropriate?**

Aqwest should not be required to pay a dividend to Government and an agreement to this effect is in place. There is considerable recorded justification and agreement in this matter.

**PAGE 39 NO. 1**

**Are the standards of service in the operating licences appropriate?**

The existing Operation Licence sets the standard and no great public concern over them has been identified. In fact equally the question could be asked, would customers pay less for lower standards? As this is the first inquiry it is suggested that the existing standards be accepted and the inquiry proceed in that basis.

**PAGE 40 NO. 1**

**Are there any issues not already identified in relation to the management of water resources in environmentally sensitive areas that should be considered by the Authority in this inquiry?**

It is a non pricing issue and is best left to Water Resource Regulators to manage.

**PAGE 41 NO. 1**

**Are there any matters for consideration by the Authority relating to the standards that are required in licences issued by the CEO for the Department of Environmental Protection?**

There needs to be an allowance for flexibility should any externally imposed standards or regulation be changed. These agencies / regulators responsible for the imposition of standards should be made aware of the impact of changing a standard and should take into account the cost of implementing that change.



**PAGE 43 NO. 1**

**How efficient are each of the water service providers operations?**

The basis of comparison needs to be clarified to ensure a fair comparison is made. This could be the entire basis of the inquiry made on a national and international comparison level.

**PAGE 45 NO. 1**

**Are the capital expenditure programs of each service provider appropriate?**

It is considered that this question is beyond the technical capacity of this inquiry and best known and managed by the Utility. Performance is measured in accordance with Operating Licence requirements and reflects adequate investment.

**PAGE 46 NO. 1**

**What other matters should the Authority consider in making recommendations on required revenue?**

The Authority could consider the following:

- Structure of the Industry by comparison to other states particularly in relation to price movements.
- The place of Aqwest in the scheme of the things and the restrictions of the Water Boards Act on its ability to act commercially.
- The synergies of Water and Wastewater services and the ability of Aqwest to apply a Holistic approval.
- The opportunity of Aqwest to expand its activities to provide a better basis of competition by comparison in the Victorian style and the effect of this on prices.

**PAGE 49 NO. 1**

**Should prices play a greater role in reducing demand when water is in short supply?**

When water is in short supply varied Demand Management initiatives should be employed and managed by the utility. Pricing is one small part of this.

**PAGE 50 NO. 1**

**Should the water usage charge make up a greater amount of the total water bill?**

That is the case at present for Aqwest.

**PAGE 50 NO. 2**

**Should the number of steps in the progressive tariff scale be reduced?**

No reason is seen for the number of pricing steps issue to be included in the inquiry. There are a variety of systems used in both Australia and the rest of the world and most are set by the Utilities as appropriate to their circumstances. These are theoretical arguments and the serious question of accountability arises.

**PAGE 51 NO. 1**

**Should water prices be charged on a seasonal basis?**

The difficulties in this outweigh the benefits. Has this issue been researched and is there any data to support the need for this? As a simple alternative perhaps the Utilities billing regime could be amended to make the final read for the year ending in March. As it is

the customer does not get the message until the consumption period is over anyway. It is considered that targeted diverse conservation programs are more effective.

**PAGE 54 NO. 1**

**Is the low rate for the first 150kl of usage effective? If not, how could a discount to low water using households be delivered more effectively?**

The first 150kl for average sized household is considered non discretionary and is provided at the least possible cost over the fixed costs recovered through the service charge. This is why Aqwest has endeavoured to maintain its service fee at the lower end of the scale

**PAGE 55 NO. 1**

**Can the approach to charging residential customers for wastewater services be improved? If so, how?**

No comment on wastewater charges.

**PAGE 56 NO. 1**

**To what extent should water pricing involve cross-subsidies?**

No comment on cross-subsidies.

**PAGE 56 NO. 2**

**What other matters should the Authority consider when making recommendations to pricing structures?**

The issue of accountability is one that needs serious consideration as any pricing recommendations undermine the position and responsibility of the Board of Management. The resolution of this issue would require the Boards to be directed, which would then shift accountability to the Government which is considered highly undesirable.

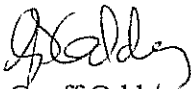
**PAGE 58 NO. 1**

**How should the Authority assess the impact of the pricing recommendations on social outcomes; environmental outcomes; the level of government funding; borrowing, capital and dividend requirements; and inflation?**

This asks the question that is the basis of the creation of the ERA and the conduct of the inquiry. It is considered too open ended to be able to provide a response.

Aqwest – Bunbury Water Board would like to reiterate its previous comment that while understanding the time constraints of the Inquiry it has constraints of its own and would appreciate early advice of any requirements for it to provide information.

The level of consultation provided to date is greatly appreciated.



Geoff Oddy

**CHIEF EXECUTIVE OFFICER**

26 August 2004