

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

Dear Sir/Madam

DEPARTMENT OF WATER SUBMISSION: DRAFT REPORT OF THE ECONOMIC REGULATION AUTHORITY INQUIRY ON TARIFFS OF THE WATER CORPORATION, AQWEST AND BUSSELTON WATER

Please find attached comments from the Department of Water (DoW) on selected issues and recommendations of the draft report of the Economic Regulation Authority (ERA) inquiry on tariffs of the Water Corporation, Aqwest and Busselton Water (Attachment 1).

The DoW welcomes the draft report and supports most of its recommendations.

In particular, the DoW offers general support for:

- The scope of proposed water use tariffs, including some support for the inclusion of an externality premium to account for the impact of groundwater abstraction.
- Replacement of wastewater charges based on Gross Rental Value with charges based on estimated wastewater discharge volumes.
- Flat charges for residential drainage and drainage charges for commercial customers based on property size.
- Replacement of the uniform pricing policy with a tariff cap policy and the lowering of the volume threshold at which cost reflective water use charges commence.
- The alignment of future reviews of prices and service standards.

The DoW expresses concern with the specifics of some of the report's views and recommendations, in particular:

- The report's approach to setting an externality premium may have limited impact and supporting basis.
- The basis on which the report has used ERA's wholesale water market model to calculate the short run value of water and thus to set some tariffs is unclear and may not be correct.
- The Inquiry could include more discussion of the practicality of possible options for mitigating the impacts of its recommendations on tenants, particularly for low-income households.

- The feasibility of unlinking fixed charges in country areas from those in Perth should be considered.

This letter and the attached comments are the current views of the DoW only, for the purposes of encouraging further consideration of issues related to the Inquiry. The final position of the Government will be considered following the Inquiry's final report.

Should you have further enquiries please contact Mr Warren Tierney, Principal Policy Officer, Policy and Planning, the Department of Water on telephone 08 6364 7146.

Yours sincerely

Kim Taylor
DIRECTOR GENERAL

20 May 2009

Att

Inquiry into tariffs of Water Corporation, Aqwest and Busselton Water: Department of Water comments on draft report

Water usage charges

Externality pricing

- In its draft report, the ERA advised that water usage charges for Perth should include an externality premium for the environmental impacts of groundwater abstraction.

In-principle support for proposed approach to externality charges

Based on available knowledge and current circumstances, the Department of Water supports the draft report's proposal for an externality premium. The proposal is better than the status quo and better than delaying action.

The Department believes that it would probably be possible, with time, to further understand the evidence of externalities, the basis for their calculation and the structure of externality charges through both improved modelling and improved information on sustainable groundwater abstraction levels.

This may lead to either upwards or downwards revision of charges. Revenue requirements and tariffs can be adjusted in future regulatory periods as knowledge is refined. The repair of the environment at a later date would be less straightforward.

The draft report's recommended approach is consistent with the precautionary principle. The precautionary principle is well established in Australian environmental and natural resources legislation¹. A balanced assessment must include the risks of delay, not just prefer delay based a one-sided assessment of the risks of early action.

Water costs are sensitive to the amount of groundwater available for use and there is uncertainty about the sustainable level of abstraction from Perth's groundwater sources particularly in a drying climate. Thus the draft report's examination of a range of possible abstraction assumptions and the impact of these assumptions on prices is prudent.

The specific Perth tariffs recommended by the draft report are not excessive, even with the proposed externality premium included. They are no more than the report's maximum estimate of the cost of alternative sources. They appear to include a significant externality premium only in the top consumption tier, and it

¹ Weier, A and Loke, P. 2007, *Precaution and the precautionary principle, two Australian case studies*. Productivity Commission

appears that the majority of users would not consume enough water to face this premium. The structure of charges is unchanged, only the amount is adjusted.

Given the drying climate, there is minimal risk that ERA's proposed charges are too high. On balance, the draft report's proposal for an externality premium is more likely to result in net public benefit than in net costs when compared with the status quo.

Possible limitations of proposed approach to externality charges

Despite the Department's support for the draft report's proposal for an externality premium, it sees some limitations with the proposal.

- The draft report does not address whether externality pricing is the most effective and efficient means practicably available to internalise any externality arising from groundwater abstraction.
- It is unclear if the draft report's proposal would substantially improve environmental outcomes or reduce risks of environmental damage. The report's recommendation for an externality premium does not appear to provide a significantly stronger demand-side price signal, and it only appears to impact upon a small number of high volume users. It may not significantly reduce the consumption of groundwater.
- The proposal does not appear to provide any supply-side price incentive in preference of non-groundwater sources or to increase investment in alternative sources.
- If groundwater abstraction externalities constitute a basis for a price premium, a more direct means of applying this premium could be upon the 'wholesale' abstraction of groundwater, rather than upon retail water use from all water sources.

The Department supports the draft report's proposal. However it is open to improved alternative proposals for internalising environmental externalities so long as these can be practicably implemented during the regulatory period of this inquiry.

Short term value of water

- The draft report examined the short term value of water in detail.

Increasing the understanding of the value of water has the potential to improve price signals and efficient water management. The Department supports the report's examination of the short term value of water.

The department also agrees that there is little risk of overpricing water. It agrees that conceptually, setting price based on short run marginal cost (SRMC) may be appropriate where it is higher than long run marginal cost. This would be subject

to the customer impacts of price fluctuations being acceptable, particularly for domestic tenants.

However the draft report recommended that the middle consumption tier for water use charges be at the upper level of SRMC, while the upper and lower tiers be based on the upper and lower estimates of long run marginal cost (LRMC).

It is unclear whether the draft report is merely attempting to propose a reasonable charge for the middle tier that also happens to be supported by the SRMC calculation, or whether the report is proposing that the SRMC should form the specific basis for calculation of the middle tier. This should be clarified. In the absence of additional explanation and evidence, the choice of SRMC for the middle tier and LRMC for other tiers appears arbitrary.

The ERA's SRMC model is complex, and the Department is not able to make substantial comment on its technical validity. One possible limitation of the model is that it is unclear if the short run marginal cost of each source includes the foregone future option value to the seller (opportunity cost) of storing the water to sell in future years.²

Wastewater

- The draft report recommended that charges based on Gross Rental Value (GRV) be replaced with charges based on estimated wastewater discharge volumes.

The Department supports the inquiry's investigation of estimated volumes for wastewater charges and the proposal to phase out charges based on GRV.

Estimated volumetric charges could offer improved efficiency if changes in wastewater discharge volumes significantly influence costs in the short or long term. They also would offer customers increased control over their total bills, which benefits price sensitive customers.

The report also highlights several practical obstacles to estimated volumetric charges particularly with regard to the use of winter consumption as the basis for estimating the level of usage of the wastewater service. The Department acknowledges that these issues would need to be resolved.

Another potential issue with the use of winter water consumption is that it could result in strategic behaviour, where customers disproportionately reduce only their winter water consumption in order to reduce their total wastewater bill. It may be necessary to use some component of the water consumption volume as measured across all billing periods.

² For further explanation, see

Freebairn, J (2003) *Principles for the Allocation of Scarce Water* Australian Economic Review

Brennan, D (2007) *Missing markets for storage and their implications for spatial water markets* 51st Annual Conference of the Australian Agricultural and Resource Economics Society

Ng, Y (1987) *Equity, Efficiency and Financial Viability: Public-Utility Pricing with Special Reference to Water Supply* Australian Economic Review

If the challenges of implementing estimated volumetric wastewater service charges are found to be overly burdensome, then the effect of changes in water consumption upon wastewater costs should be incorporated in water use prices as far as it is efficient to do so.

If the impact of water consumption on wastewater costs is significant and no allowance is made for it, then the draft report's comment that there is little risk of overpricing water becomes even stronger.

Drainage

The draft report's recommendations include:

- Flat residential charges, and charges for commercial customers based on property size
- In future, any expenditure on drainage quality be recovered on all of the Water Corporation's water customers in the scheme.

The Department supports in-principle a system of flat rate and land area based charges to replace GRV charges for drainage.

The Department also supports the view that it would be fairer if all Perth residents were to share those costs of drainage systems that provide genuine public benefits, and that a levy may be an appropriate means of doing this.

However, assessing the efficiency of any proposed drainage water quality expenditure would need to determine whether the proposed measures are the best for achieving desired outcomes. This would need to consider:

- cost-effectiveness relative to all realistically available options
- that some available options may not be directly related to the Water Corporation's drains
- the contribution on both water quality and stormwater management outcomes, which may be best addressed through combined measures, especially in greenfields developments
- the other measures in a catchment that may also be needed for the proposed measure to achieve its outcomes.

The Department supports in-principle the draft report's specific recommendation number 14 that in future, any expenditure on drainage quality be recovered from all of the Water Corporation's water customers in the scheme, but the following matters would need to be considered:

- Local governments already spend varying degrees of ratepayer revenue to provide drainage services and improve water quality, particularly outside main drainage areas. The fairness of spreading Water Corporation drainage water quality expenditure across customers outside main drainage areas cannot be assessed without regard to who pays for existing local government expenditure
- It is unclear if there is a significant correlation between the boundaries and costs of a water scheme and the boundaries and costs of each local and/or main drainage scheme. The spatial distribution of the beneficiaries of water quality drainage expenditure also does not necessarily correlate with water

scheme boundaries. A simple statewide levy on all Water Corporation customers (or all ratepayers) may be arguably as fair or fairer than scheme-based charges.

The management of drainage is an issue of significant interest to many of the Department's stakeholders. The Department believes that more detailed information on projected revenue and expenses should be published to make it available to drainage customers and other stakeholders. For example, the proportions of the Water Corporation's revenue requirement driven by the return on drainage assets and/or by drainage operation and maintenance costs should be reported, as well as some outline of cost drivers during the regulatory period.

Impacts on low-income tenants

- The report's recommendations with respect to usage charges have the potential to affect tenants disproportionately
- Tenants pay water usage charges, while fixed charges are paid for by property owners. As a result, there are currently limits on the extent to which tenants can be compensated for the increases in water use charges that result from the need to expand water supplies and from any externality premium of volumetric wastewater charges that may be implemented.

The water use price signals that appear necessary to address the cost of expanding supplies and reducing groundwater abstraction, the volumetric wastewater charges and the shift away from GRV drainage charges proposed by the draft report all shift a greater share of burden onto tenants. More landlords may exercise existing rights to pass on costs as these costs increase.

Ideally, a means to directly compensate water users instead of land owners would be the most effective way to address these impacts. The Department notes that practical issues exist with this proposal and that it is ultimately a matter for government. Nevertheless the Department would welcome discussion in the final report of more direct measures to address impacts on tenants.

Country pricing

- The draft report recommended that the uniform pricing policy be changed to a tariff cap policy, where water use prices are cost reflective, up to a certain price limit
- It also canvassed the possibility of lowering the volume threshold at which cost reflective water use charges commence.

The Department supports that these proposals because they would improve price signals and water resource management, as well as being fairer on the customers of low cost schemes.

In addition, options for unlinking fixed charges in country areas from those in Perth should be considered in the final report. The linking of country fixed charges to Perth charges means that changes in Perth costs automatically affect unrelated country prices.

For example, the ERA inquiry into developer charges recommended a decrease in developer charges in Perth. This would increase fixed charges in Perth, thus also unfairly increase fixed charges in the country. Price reforms driven by Perth scheme costs that affect country fixed charges may be difficult for Governments to support and to explain to country customers.

The intent of unlinking of charges would not be to increase or decrease country fixed charges, only to prevent these charges from being driven by the costs of the Perth system.

A number of alternative methods for calculating country fixed charges could be conceived. A simple option could be to index country fixed charges at current levels.

Service standards

- The draft report recommended that service standards be aligned with price reviews.

Decisions about the level of service standards and the level of prices are directly linked. The Department supports the draft report's recommendation.

For example, water supply reliability is an important driver of customer charges as well being at the core of customer satisfaction with water services. The Department would support the development, implementation and public reporting of auditable service standards for water supply security.

This is particularly important in smaller schemes where

- significant planning and resourcing challenges exist
- market-based approaches such as those proposed in the ERA competition inquiry have not been advocated
- customer choices between price and service level may be necessary.