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Our Ref:

Colin Reid
Director, Water and Transport
Independent Pricing and Regulatory Tribunal
PO Box Q290
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NSW 1230

15/11/02

Dear Colin,

Re : Review of Metropolitan Water Agency Prices

Please find following this letter a submission from the Public Interest Advocacy Centre to this review. We trust it will assist the Secretariat and the members of the Tribunal.

PIAC looks forward to the chance to discuss our views further at the public hearing. As always, we are happy to receive any requests for clarification or further information.

Yours sincerely
Public Interest Advocacy Centre

Jim Wellsmore
Policy Officer

1. Introduction

The Public Interest Advocacy Centre (PIAC) is an independent, non-profit legal centre based in Sydney. Established in 1982 it strives to foster a fair and just society by empowering disadvantaged citizens, consumers and communities through strategic legal and policy intervention in public interest issues.

PIAC has established the Utility Consumers' Advocacy Program (UCAP) with funding from the NSW Government.

The main aims of the project include:

- developing policy;
- advocating on behalf of residential consumers of gas, electricity and water services;
- identifying systemic problems with utility service providers;
- ensuring that consumer protection mechanisms work effectively; and
- facilitating the development of partnerships between stakeholders in utility service provision.

A community based Reference Group supports the development of policy by UCAP.

2. Price and service

The Tribunal has sought the views of stakeholders on the practicalities of introducing incentives for the water supply businesses to provide a higher standard of service to their respective customers. In particular, the notion of discreet price/service trade-offs has been raised as an option for mediating between the desires of customers for higher standards and the capacity of the businesses to provide these. PIAC notes that the retail water agencies generally have displayed little interest in such an option.

Sydney Water has proposed that discussion on a price/service trade-off be deferred to the next determination. Hunter Water has suggested that the impact of weather on service levels overall means that efforts to deliver higher standards for some customers would be so complex as to not be viable. In effect, the effort needed to sustain higher standards for some or all customers could outweigh any benefits.

PIAC does not believe that it is desirable for the community to pursue higher standards of service through economic incentives for the agencies. An important obstacle would be determining the willingness of the community as a whole, or some groups of customers, to trigger these incentives. The Tribunal previously has commissioned research on the question of 'willingness to pay' which highlighted many of the methodological questions in judging the desire of customers to capture better service in return for higher costs. Then, too, we are mindful that the willingness to pay on the part of some customers may not match the capacity of others.

Hunter Water has pointed out that the obligations imposed through operating licences already provide for an appropriate level of service to their own customers and those of Sydney Water. While Gosford City and Wyong Shire councils do not operate with similar

obligations we consider it to be an open question as to whether the service levels they provide are significantly inferior to those of the more regulated retail water agencies.

It might be suggested that the large metropolitan agencies shy away from discussion about incentives for higher standards because they have no interest in providing them. On the other hand, if there is a widespread view that service performance improvements are needed then it is appropriate that these be pursued through the mechanism of the operating licences. This should not preclude consideration of the costs associated with any improvements. Indeed, the public processes employed by the Tribunal in determining the terms of the operating licences would ensure open discussion not only about the desirability of certain improvements but ability of all consumers to contribute to funding these.

3. Period of price path

The arguments raised in support of a new determination for only two years appear sound. We acknowledge the concern of the Tribunal that too short a determination period might not provide a desirable level of certainty about future costs for customers and revenue for the agencies. A succession of determinations of only two years duration would not be appropriate. However, at this time a single determination with a two year term undoubtedly would serve the public interest.

In particular, the demand management efforts of Sydney Water currently are the subject of a major review. This is expected to provide a number of options by which Sydney Water may achieve compliance with the per capita consumption targets imposed through its Operating Licence. Consideration of these options will be assisted by the collection of more detailed information on per capita consumption which was proposed by Montgomery Watson Harza in their recent review of the Sydney Water Operating Licence undertaken for the Tribunal.

Our understanding is that none of the likely options for achieving compliance with demand targets will impose costs that Sydney Water would need to recover through higher prices. However, a two year price path would allow for future reviews of Sydney Water's licence and prices to be performed concurrently. This would present the community with the opportunity to consider what is appropriate in terms of demand management as well as the extent to which improved performance in this area should be funded through increased prices.

4. Operating expenditure

While supporting the general use by the Tribunal of incentive based regulation and the CPI-X approach PIAC recognises that there are limits to how far cost reductions can be driven. Accordingly, we see some validity in the argument made by Hunter Water in its

submission that the major gains in cost reductions already have been squeezed out of the businesses. Consumers support operating expenditure being limited to that which is prudent and would welcome what additional reductions in costs can be achieved. However, given the lack of resources available to PIAC and our colleagues in the community sector we must leave it to the Tribunal and the businesses to resolve the question of what further efficiencies might be identified.

It is noteworthy that in the case of Wyong Shire Council there continues to be a steady growth in forecast OPEX costs. This is a concern especially when this growth is contrasted with the forecasts submitted by the Gosford City Council. Moreover, it appears that the forecasts submitted to the Tribunal contain allowances for a number of activities and acquisitions which are non-recurrent in nature. The question must be asked as to whether these are prudent expenditures and appropriate to be treated as OPEX costs.

5. Capital expenditure

Regulatory oversight of capital expenditure should protect consumers by ensuring expenditure is both prudent and sufficient for the long-term viability of a supply system. During its 2001 review of the Sydney Water customer contract the Tribunal held a public hearing at which the Corporation argued that supervision by the regulator is preferable to controls such as penalties for poor performance of its current assets. Though mindful of concerns that giving too much latitude in CAPEX provides an invitation to the agencies to 'gold plate', PIAC is equally motivated to support a level of expenditure which over the longer term will ensure a reliable and quality water supply system. The problem of information asymmetry which afflicts all regulatory systems makes it difficult for the Tribunal to strike an appropriate balance.

We note that Halcrow Management Services in 1999 commissioned report suggested that Sydney Water has been undertaking only a modest level of capital investment in recent years. On the other hand, from the data supplied by Sydney Water for this determination it is apparent that the completion of the Northside Storage Tunnel has released a significant level of funds for use in other areas of the water supply network after 2002/03.

One notable activity not discussed by Sydney Water in its submission is the Corporation's new Customer Information and Billing System (CIBS). Given the difficulties encountered with the introduction of this new system and the likelihood of significant additional costs being incurred by Sydney Water it is of particular interest to consumers to know whether these costs will be passed through to final bills.

PIAC notes also the commitment by Sydney Water to spend \$130 million on future residential developments in western Sydney housing developments. It is not clear, however, whether this expenditure is to be funded by charges on developers or recovered from the larger customer base.

Of concern also is the apparent continued growth in CAPEX by Hunter Water. It is noted that this has risen steadily throughout the current determination period and has been

forecast to continue rising at least until the beginning of the 2005 price path. Notwithstanding our comments on the need for capital outlays to maintain the viability of the supply system, PIAC would be concerned if this rate of growth in CAPEX at Hunter Water was to be sustained beyond this next regulatory period. We would appreciate clarification as to the intended duration of Hunter Water's waste water program.

6. WACC

We assume that the proposal by Sydney Water to defer consideration of the rate of return and the weighted average cost of capital to the 2005 determination process indicates satisfaction with the 7% WACC allowed by the Tribunal for the current price path. The fact that both Sydney Water and Hunter Water are seeking CPI-only price rises for the next price path would support this view.

Rates of return and the level of the WACC have implications for final prices and thus are of interest to PIAC and the consumers for whose interests we advocate. PIAC is not able to nominate a specific value for the rate of return and the WACC. However, we previously have argued there is an appropriate level for these regulatory building blocks in the case of monopoly firms operating in utility industries. While the individual agencies have a legitimate interest in ensuring that pricing determinations protect their long-term commercial viability, the large degree of subjectivity in the debates over these regulatory components lends itself to an exercise in maximising revenue.

Accordingly, we look forward to discussion of the value of these building blocks at the time of the 2005 determination.

PIAC also is concerned about the future impact on prices of the 'recoverable amount test' described by Hunter Water in its submission to the Tribunal. While Hunter Water has not proposed significant price rises on this occasion, we argue that customers should not be faced with price increases designed solely to allow compliance with an accounting construct. This is especially the case when the accounting tool is to be applied by a statutory public monopoly.

7. Customer prices

One issue for consideration in the setting of prices for water and sewerage is the balance in customers' bills between fixed and volumetric charges. Many household users of utility services such as water and sewerage prefer the fixed component of bills to be as low as possible. PIAC is mindful, on the other hand, that the significant level of price inelasticity characteristic of residential consumption means that there are limited opportunities for households to reduce consumption as a response to 'price signals' inherent in volumetric charges.

A related issue is whether or not the use of water and sewerage services can be distinguished by being either essential or discretionary. The community benefits at least as much as the agencies from reduced per capita consumption. The difficulty arises in trying to encourage less consumption of a discretionary nature. Specifically, it is not possible to measure or issue bills for each type of consumption.

We make these comments as a general response to the attempts by several of the retail water agencies to 'fine tune' the weighting of the fixed and consumption based components of their prices. There remains within the agencies some interest in having water and sewerage priced so as to provide 'signals' to the community. Given the evidence of the limited impact on demand of volumetric pricing, continued support for 'user-pays' pricing of water and sewerage services can scarcely be expected to provide any public benefit.

PIAC intends to apply this critique also to the concept of seasonal pricing for water, which we note, has been raised once more within the current determination process.

In the matter of water services, we are concerned at the seemingly inexorable rise of prices being charged by Gosford City Council and Wyong Shire Council. Doubtless there are valid reasons for adjusting prices to bring about uniformity in prices for consumers in the wider Sydney metropolitan area. It is noted, also, that the pensioner rebate for water bills continues to be available to customers in these areas. We remain concerned, however, about the extent to which the discourse of 'commercial returns' has influenced the movement of prices for these consumers and whether sufficient allowance has been made for affordability.

PIAC is pleased that Gosford City Council has indicated it will make greater efforts to encourage those of its customers facing difficulty with water prices to access the Council's 'hardship committee'. It is hoped that the work undertaken by Sydney Water in relation to its 'financial hardship policy' will be of benefit to the Council.

It is important to note that in some instances the impact of the combined prices for water and sewerage proposed has been calculated in relation to households with 'average' consumption. In the case of Hunter Water, for example, it is clear the proposed new prices will create both 'winners' and 'losers'. This is to be expected of an approach to pricing which emphasises the characteristics of a market.

Gosford City Council has not produced 'winners' amongst its customers since its proposal is for the increase in final bills to grow from 3% for the lowest consuming households to as much as 10% for those with the largest consumption. If 'user-pays' is the chief criteria there is little to argue about with this proposal. However, regrettably, the level of consumption in a particular household cannot be used as a guide to the capacity to pay higher prices.

The impact of proposed price rises for Gosford is all the greater since the Council is seeking to adjust its prices to make allowance for added costs arising from purchases of 'green energy' and certain 'consultancies'. PIAC questions whether it is appropriate for the Council to seek to recover these costs from its customers or to do so through the next price path.

A further consideration raised by the Council in support of its proposed prices is the desire to reduce its current level of debt. The Council has expressed this preference for lower debt in the past. The response from PIAC remains the same - relying on some debt to finance necessary capital investment is an appropriate way to share the burden of funding between current and future customers of a monopoly water agency. In any event, the Council now proposes to negate any falls in prices through a reduction in debt by the introduction of an asset replacement charge to customers' bills. We remain to be convinced that the net effect of these changes will provide any benefit to customers.

For their part, Wyong Shire Council are pursuing a significant 'real' increase in prices for the first year of the next regulatory period followed by CPI-only changes the next. PIAC would be interested to learn of the arguments against a smoother price path. We also would be anxious to learn more about the distribution of costs between Wyong and Gosford of the several joint initiatives they plan to undertake over the next two years. Given their different pricing proposals, consumers would look for an assurance that the different pricing proposals advanced by the two Councils reflect an appropriate sharing of costs arising from prudent investment.

Both Council agencies have argued that water restrictions and the resultant reduction in volume of sales should be taken to support higher prices. While PIAC understands the crude effect of restrictions on revenue we are uncertain as to the impact on the network assets of a lower level of utilisation and whether this in turn delivers a benefit to the Councils. A further issue is the impact on total revenue for future years from population growth. More importantly, we regard price rises in response to reduced demand as a perverse outcome. Unquestionably it sends an inappropriate price signal for households to see that less consumption can result in higher prices.

The relationship between demand and revenue is an issue also for Sydney Water. Past variations between forecast and actual consumption have been noted by the Tribunal as providing Sydney Water with a significant level of 'surplus revenue'. PIAC agrees with Sydney Water that such differences are inevitable. We diverge from the Corporation on the point of subsequent price paths taking account of such surpluses. Price paths cannot be overly sensitive to future fluctuations in demand lest they be afflicted with the same forecasting errors. However, regulatory price paths provide a mechanism for the return to consumers of some windfall revenue in a manner which does not increase the volatility of revenue received by the utility. Consumers would expect that the next price path should take up the opportunity to address the issue of surplus revenue earned by Sydney Water.

In relation to sewerage charges alone, PIAC supports the proposal by Hunter Water to continue with weighting its charges towards a fixed, service component. We note that many household consumers prefer less emphasis in prices on fixed components. However, given the very different approaches to sewerage charges used by Sydney Water and Hunter Water, it is difficult for us to offer the Tribunal a strong case that either fixed or volumetric charges are preferable.

Nor does consideration of equity factors provide a clear case. A greater reliance on a volumetric component would seem to favour low volume, wealthy customers at the expense of high volume, poor households whereas weighting costs towards a fixed

component likely will favour large volume, poor households as against small volume, wealthy families.

PIAC believes there is value in achieving consistency between the two major metropolitan retail water agencies. We also note the view of Hunter Water that this simplifies the charging for sewerage use in the case of unmetered properties. Finally, as the Tribunal has noted, reliance on usage charges necessarily brings about some volatility of revenue for the supplying agency.

8. Demand management

As noted above, PIAC is prepared to consider support for future demand management programs which would require greater revenue from customers. Indeed, the same qualified support was given to a similar proposal in our submission to the last determination of prices for the metropolitan retail water agencies. Whether or not future demand management programs will require additional revenue remains to be seen. However, it is disappointing that already Sydney Water have indicated they are not prepared to commit additional funds from within their current income from customers to an enhanced water conservation effort. This is given the results of the review of Corporation's operations undertaken for the Tribunal by Montgomery Watson Harza. This also limits the range of options available for future efforts. Further, the suggestion that conservation based price rises inevitably will be sought in the future appears less than reasonable when Sydney Water arguably has additional resources to commit from those funds over-recovered through its existing prices.

It should be understood that PIAC does not support the use of price itself as a mechanism for achieving improved demand management or water conservation performance. The evidence is strong that price signals for residential consumers are greatly muted by inelasticity of demand. As the Tribunal's analysis shows, the size of price rises needed to impact on the consumptive behaviour of the wealthier (and apparently higher volume per capita users) would have serious impacts on social equity and the affordability of water for the majority of households.

Hunter Water has passed comment on the signalling effect of prices in its submission to the Tribunal. Yet, they also make the point that the 'sustained reduction in (per capita) consumption' by Hunter Water customers has been brought about by a number of factors of which price might be only one. We note with interest the inference by Hunter Water that commercial use of water necessarily is 'legitimate' and that price signals might not be appropriate for such customers. We expect that this should not be taken to imply that residential users, by contrast, tend to have less usage which is legitimate or deserves to be quarantined from price signals.

9. Block tariffs

PIAC believes more discussion is needed before block tariffs could be supported by the community. We share the concern of the Tribunal that since block tariffs operate according to the level of consumption they pose challenges for equity insofar as they are not sensitive to affordability of water for households of varying size.

Indeed, our understanding is that in many overseas jurisdictions block tariffs have been used not to address issues of overall demand but to facilitate the extension of supply to communities who had been denied a reticulated water supply. In many cases this situation has arisen through market failure or problems of affordability. Block tariffs, then, have been introduced as a lifeline measure for poor communities living in small dwellings with several families sharing a single tap. An explicit component of this approach has been the introduction of cross-subsidies in favour of those without a water supply.

Clearly these circumstances are unlikely to be encountered in NSW where access to water and sewerage services is supported by pensioner rebates and the Payments Assistance Scheme provided by Sydney Water.

In terms of demand management, block tariffs are no more than a different approach to providing price signals to customers which encourage efforts to reduce consumption. Our views on price inelasticity have been expressed elsewhere in this submission. To the extent that block tariffs attempt to direct price signals only to larger volume customers it might be possible to limit concerns over the equity impact by, for example, imposing higher prices only on the largest users. An obvious target, then, might be non-residential customers. We note, however, that Hunter Water was given permission for the current price path to charge not more but less per unit of consumption to its largest commercial and industrial customers.

10. Step pricing

As a means to drive greater efforts in demand management by Sydney Water there is some attraction in the proposal for step pricing. PIAC sees this as having important parallels with the scheme for abating of greenhouse gas emissions imposed on NSW electricity retailers. We would be happy to pursue discussion of step pricing as a water conservation measure at such time as Sydney Water and the expert panel release the range of available options for an enhanced future demand management program.

11. Miscellaneous charges

PIAC remains opposed to the use by all utilities of miscellaneous charges. In our view the costs these charges are claimed to recover have never been adequately substantiated by the providers. In some cases the substantive arguments offered for these charges relate more to the behaviour of non-residential customers, yet these

charges continue to be levied against household users. Further, in many cases the effect of these fixed charges being levied on customers is a further reduction in affordability of essential services such as water and sewerage.

In illustration of our concern over proper substantiation of costs we note the differences in fees proposed by Hunter Water and Sydney Water for dishonoured payments. Hunter Water seeks substantial increases in this charge and the ability to levy different levels of penalty on customers depending on the payment method they have chosen. It is not surprising that costs to the agencies would vary between methods of payment. However, Sydney Water appears able to absorb these costs within a single flat charge of \$20 (though this involves a considerable rise for direct debit failures). Hunter Water seeks to impose charges of between \$16 and \$31.

We are aware of anecdotal evidence that the methods by which some utility providers collect direct debit payments for bills has had a multiplier effect on these 'dishonoured payment' charges. In some cases it appears that systems for electronic transfer have continued to pursue payment from a credit card or bank account after the first transaction has failed for insufficient funds. When a customer is unaware that payment is being sought against insufficient funds the effect of repeated attempts to secure payment can result in multiple charges to the point that the penalties levied on a customer can be larger than the original bill. Our anecdotal evidence does not include any of the NSW metropolitan water agencies but we would appreciate reassurance that each bill would only incur a single such charge.

The charges proposed by Hunter Water for restriction or disconnection following non-payment of bills also compares unfavourably with Sydney Water. Our understanding is that Hunter Water are seeking to impose on customers facing difficulty in paying their bills a charge of \$8 for a phone call; a further \$24 to attend the property to effect the restriction or disconnection' and a further \$32 to restore full supply - a total of \$64. Sydney Water, on the other hand, charge \$30 for reconnection of a customer but our understanding is that this response to non-payment is rarely invoked with preference given to restriction.