

SUPPLEMENTARY SUBMISSION TO IPART'S REVIEW OF METROPOLITAN WATER AGENCY PRICES



caring for our
community and the
environment


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Supplementary Submission for
Medium Term Price Path
2005/06 to 2008/09

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GLOSSARY

AAV	assessed annual value
AIR	annual information return
DEC	Department of Environment
DR	disaster recovery
EP	equivalent population
IFRS	International Financial Reporting Standards
SC	service charge
SIR	special information return
WWTW	wastewater treatment works

1 INTRODUCTION

The Independent Pricing and Regulatory Tribunal (IPART) has stated its intention to make a price determination to commence 1 July 2005 for the NSW metropolitan water agencies. To address IPART's interests and Hunter Water objectives, the Corporation provided IPART with a submission in September 2004. That submission dealt with the matters raised in IPART's 2004 *Review of Metropolitan Water Agency Prices Issues Paper*.

Hunter Water recognises that the price review process is one of the most important parts of the regulatory arrangements in which it operates. While Hunter Water makes its best efforts to capture its forward planning and budgetary projections at the time it makes its price submission, all the Corporation's forward planning does not centre on the pricing process. Rather, much of its forward planning is on-going and continuous, meaning that it is continually being developed and refined. For example, forward capital expenditure is based on a range of investigations from population studies, options studies, strategy reviews and concept plans. It is simply not practical or pragmatic to time all this investigation works so it is completed at a single point in time in order to frame a capital expenditure program for the price process. The economy, community and environment in which the Corporation operates are dynamic and new and changed demands emerge daily. To be responsive to these changes, the Corporation needs to be flexible and its planning needs also to be ongoing. As a result, a number of elements of the submission and annual information return provided in September 2004 have changed. Some changes have come about because the Corporation has done further work on changes in train during September 2004, such as the transition to new accounting standards under the International Financial Reporting Standards that will come into effect from 1 July 2004. Others, in the capital expenditure area, have come about due to completion of further studies or strategy reviews of planned works that indicate a change to costs or to timing of works.

The Corporation's approach in 2000 when facing a possible 4 year price path was to develop supplementary submissions to provide IPART with further information and costs that was not available earlier. IPART took this information into account when setting prices in its determination.

This supplementary submission is provided to update IPART for completeness on a number of key changes and developments that alter elements of Hunter Water's September 2004 submission. For a number of areas this submission provides further data in response to the Atkins Cardno Capex, Asset Management and Opex Review of the Corporation. This supplementary submission provides revisions to:

- projected revenue
- operating expenditure
- the forward capital expenditure program
- revised price cap
- the proposed stormwater charges

The relevant sections of the Annual Information Return (AIR) and Special Information Return (SIR) have also been updated to reflect these revisions. The specific details of these changes have been provided separately to IPART.

2 REVISIONS TO REVENUE

In the September 2004 pricing submission, Hunter Water factored in an increased level of developer activity and therefore an increased level of applications for Miscellaneous Charges. The additional developer activity will result in increased revenue of approximately \$1.36m (2004\$) over four years, however this increase was not included in the AIR. This omission has now been rectified. The continuing high level of growth is also reflected in the significant capital expenditure over the price path period.

3 REVISIONS TO OPERATING EXPENDITURE

3.1 International Financial Reporting Standards

New International Financial Reporting Standards (IFRS) will require reclassification of some cost items traditionally treated as capital expenditure to operating expenditure. There will be **no difference in outlays** but only a difference in the accounting treatment.

The main area of reclassification is “research”. One of the main types of research in Hunter Water are studies and investigations on how best to accommodate growth. Traditionally, this work has been treated as capital expenditure and recovered through developer charges. Under IFRS rules this type of research will need to be treated as operating expenditure.

IFRS will become operative from 1 July 2005. Under the new Intangible Assets standard (AASB 138), expenditure that is research in nature does not meet the definition of an asset and as such cannot be capitalised.

Research is investigation undertaken with the prospect of gaining new knowledge, and often occurs prior to development. Examples of research include feasibility studies, servicing strategy studies, inflow and infiltration studies, evaluation and selection of alternative upgrade strategies.

Development expenditure will continue to be capitalised. Development (design and construction of assets) usually follows from successful research (investigation/option studies) and is distinct from research. Development is the application of knowledge to produce a single plan or design for new or improved processes, systems, products or services before the start of commercial production or use.

There are **two paths** forward and Hunter Water seeks some guidance on the preferred direction from the Tribunal.

The first option is to include all research expenditure (for growth and non-growth activities) in annual operating expenditure and recover this through annual charges. This would mean that, over the price path, there would be an additional \$9.0m operating expenses to be recovered from annual charges with an offset reduction of \$9m in capital. In 2004\$ terms, this would result in a net \$5m over the operating cost projections provided in the AIR which included \$1.0m per year for the additional operating costs arising from IFRS.

The second option is to continue to recover research expenditure related to growth via developer charges. This would mean that of the \$9.0m quoted above, \$3.8m would be recovered through annual operating costs and \$5.3m through developer charges.

Adopting this second approach will mean there will be a difference in the operating costs reported in the AIR and those reported in Hunter Water's statutory accounts. For example for 2005/06, the full \$3.7m would be shown in the statutory accounts while only \$2.19m (for non-growth research) would appear as opex in the AIR. If this approach is followed, there is a case for adding a separate balancing entry to the AIR so that the differences each year are clear. Note that this option is not illustrated in the tables in this Supplementary Submission.

Hunter Water would welcome the Tribunal's consideration of the treatment of research expenditure as it relates to both IFRS and the cost reflectivity of annual charges and developer charges.

3.2 Growth – Water

The Atkins/Cardno review flagged that, although some additional growth in water supply was included in the demand projections in the initial price submission, the associated operating costs of this additional supply (e.g. chemicals and electricity) were not included in the AIR. This was a point raised by the consultant. This increase has now been factored into the AIR as an additional \$0.57m (2004\$) over the proposed price path period.

3.3 Electricity

The initial pricing submission included an allowance for an electricity price increase in the order of 10% in 2007/08 (when Hunter Water's current contract expires). As part of the Atkins Cardno review Hunter Water provided the original advice received from the Corporation's supplier about likely increases in 2007/08 based on trend increases in contract electricity prices. Further, in October 2004, Hunter Water obtained separate verification of likely increases from an external energy consultant, who provided written advice that the price increase is likely to be in the order of 16%. This increase has now been factored into the AIR as an additional \$0.54m (2004\$) over the proposed price path period.

3.4 Additional Costs Associated with Developer Activity

Some miscellaneous charge costs were omitted from the AIR submitted in September 2004.

As noted above, the Corporation has factored in increases in revenue from developer activity. This brings with it an increased level of applications in establishing the miscellaneous charges relating to developer applications. Initially, this increase is being serviced by engaging additional resources on a contract basis.

However, the additional labour required to service this higher workload was not factored in to the operating costs projected in the AIR. This increase has now been factored into the AIR as an additional \$0.4m (2004\$) over the proposed price path period.

3.5 Disaster Recovery Centre

The initial pricing submission allowed for \$0.12m pa for a disaster recovery centre. Since September 2004, Hunter Water has settled on a preferred option for an off-site disaster recovery centre. This involves leasing space within the recovery centre of another major Newcastle business. Having advanced to this point, the leasing costs and costs of necessary communication links have been more precisely defined and are now projected to be \$0.20m pa (i.e. an \$0.08m increase).

4 REVISIONS TO THE FORWARD CAPITAL PROGRAM

4.1 Background

A small number of capital projects included in the September 2004 submission and SIR have changed since last September. These changes are the result of additional information coming to hand. An example is the completion of studies that were underway last September on the completion of trunkmain condition assessment as agreed with IPART in order to meet operating licence standards over the long term

As pointed out in the introduction, much of Hunter Water's forward planning is on-going and continuous, meaning that it is continually being developed and refined. For example, forward capital expenditure is based on a range of investigations from population studies, options studies, strategy reviews and concept plans.

The following information provides details of changes to the capital program since last September. This section follows the format used for providing capital project information to Atkins/Cardno and IPART, where the consultants requested specific project information.

As outlined in the Corporation's December 2004 and January 2005 comments on the draft reports prepared by the consultants, Hunter Water's capital programs are built up from a process involving:

- capacity reviews and upgrade strategies (treatment works) or servicing strategies (reticulation). These include assessment of population growth and capacity of existing assets to deliver services in line with regulatory requirements
- concept design and environmental assessment
- detail design
- procurement and construction

Hunter Water believes this detailed process produces sound capital programs that are best value for money to deliver desired regulatory performance. Descriptions of the capital projects involved are included in Table 1.

Table 1 Capital Program Revisions – Total Costs (04/05 to 08/09)

Project	2004/05 \$'000		Reason
	Initial *	Supplementary	
Belmont WWTW Upgrade Secondary Treatment Plant	\$12,000	\$16,000	Concept and detailed design work has significantly progressed
Morpeth WWTW Stage 2 Upgrade	-	\$7,160	Additional study information on growth brought this project forward into the price path period
Boulder Bay WWTW Stage 2 Upgrade	\$3,375	\$6,625	Additional study information on growth brought this project forward into the price path period
Newcastle Stage 1 Wastewater Transport System Upgrade	\$27,600	\$31,310	Concept and detailed design work has progressed significantly
Trunk Watermains Replacement	\$1,520	\$4,020	Improved condition information from assessment reports
Disaster Recovery	-	\$500	Preferred option finalised and costed

* September 2004 Price Submission

4.2 International Accounting Standards

The transfer of research costs to operating expenditure as a result of the adoption of the IFRS (refer to section 2.1) requires an equivalent adjustment to capital expenditure. The adjustments required for the option of transferring all of the research expenditure to opex have been made to the SIR.

4.3 Summary of Capital Program Changes

The impact of the changes described above is shown in Table 2 below. Over the course of the proposed price path period there would be an increase in the capital works program of \$20.6m over the Corporation's September 2004 submission. The total adjustment to the capital program in the SIR depends on the treatment of the IFRS adjustment of research expenditure (refer to section 3.1). The table below shows the effect if all the expenditure is reallocated to opex. The Corporation awaits the Tribunal's advice on this matter.

Table 2 Changes to the Capital Program

	(2004/05 \$'000)				
	05/06	06/07	07/08	08/09	Total
Projects	\$7,846	\$6,200	\$1,414	\$5,660	\$20,620
IFRS adjustments *	-\$3,697	-\$2,235	-\$1,594	-\$1,532	-\$9,058
Total adjustment to the SIR	\$4,149	\$3,965	-\$180	\$4,128	\$11,562

* Assuming adjusting for the total amount (refer to section 2.1 above)

5 REVISED PRICE CAP

Given the changes to the operating and capital expenditure outlined above, Hunter Water has recalculated the required price adjustments for the price path.

Hunter Water's submission in September 2004 proposed a staged approach to achieving a rate of return consistent with the weighted average cost of capital (WACC) over the next eight years. Hunter Water's financial modelling now indicates that an annual adjustment of prices by 3.2% real (ie CPI+3.2% annual adjustment) would deliver a real pre-tax rate of return on Hunter Water's rolled-forward 2003 regulatory asset base of around 5.6% by 2009. This rate is short of the mid point of the assessed appropriate WACC range at this time of 6.1% to 7.5% but appropriate in a move towards achieving more realistic returns in the medium term.

The fact that the data in this submission derives an "X" factor of 3.2% reinforces Hunter Water's original position that a real annual price adjustment of around 3.0% is appropriate. In determining prices, Hunter Water would like the information provided in this supplementary submission to be considered by the Tribunal along with the Corporation's comments on the final Atkins/Cardno reports and material to be presented at the public hearing on 10 March.

6 REVISIONS TO THE STORMWATER PRICING PROPOSAL

6.1 Background

As noted in the Corporation's September 2004 submission, an ongoing theme in stormwater drainage pricing has been the removal of the last vestiges of valuation-based charges. The proposal continues to address this objective and, further proposes a revised service charge structure. Under the proposal, service charges for non-residential customers are differentiated into small, medium and large properties. As the property-value based charge is removed, service charges increase and a mechanism to protect customers from price shocks is provided. This mechanism is based on maximum allowable increases (price caps) for each year. The details of the proposal are provided in Chapter 6 of Hunter Water's September submission.

In essence, the steps to determine a stormwater customer's bill under the proposal are as follows:

1. Define the stormwater category (minimum charge, small, medium or large) based on the stormwater customer's property area.
2. For any particular area category the stormwater charge will be equivalent to:
 - a. The service charge (SC) for that category
plus
 - b. The assessed annual value (AAV) component, if applicable (i.e. for customers prior to March 1991). The AAV valuation is determined at the rate (cents/\$AAV) specified for that time period.
3. If the increase from year to year is greater than the price increase limit that is deemed reasonable i.e. price cap, then the price cap is applied
4. If the increase from the previous year is less than the price cap, the charges stand as defined.

The application of the process defined above leads to a number of outcomes depending on the:

- the size of the property
- the existing basis of the bill SC or SC + AAV charge
- the magnitude of the AAV in the case of the SC + AAV charge basis
- the decay in the AAV rate over the four-year proposed price path
- the assumed service charge starting point for each property category e.g. it is proposed that the medium property charge in 2005/06 is \$100
- the maximum allowable increase per property (the cap) applied in the case of existing SC only customers

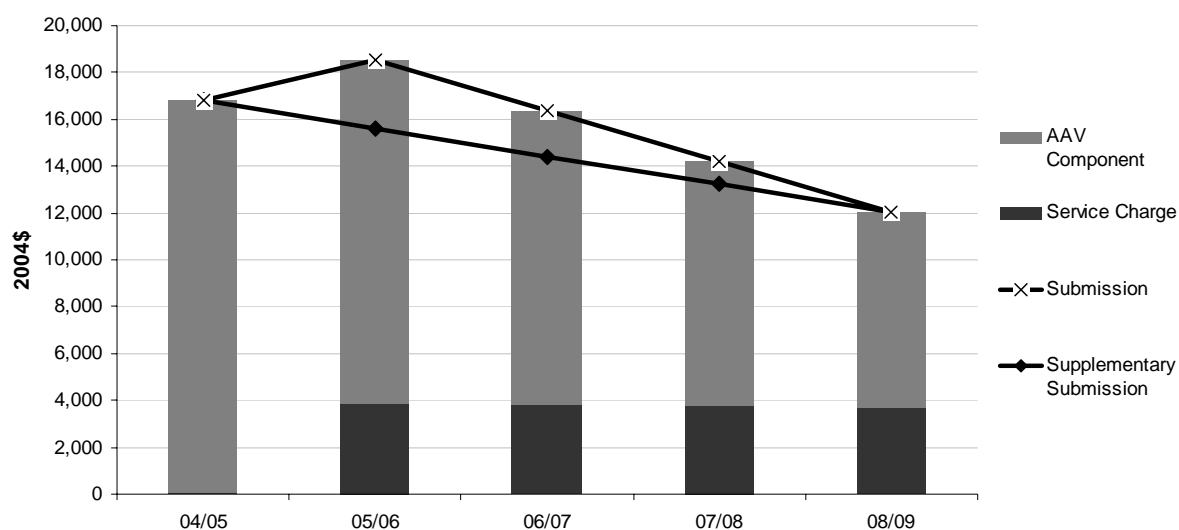
6.2 Revisions

In most cases, charges will increase. However 891 (25%) of the stormwater properties will see a decline in their charges over the proposed four-year price path. As outlined in the September submission, 2,575 properties have an AAV component and the submission proposed the halving of the AAV rate in this proposed four-year price path.

Of the properties that will experience a decline in charges over the proposed price path, a proportion of them would experience an initial increase in stormwater charge in 2005/06 if the proposal is adopted as set out in the September submission. This is due to the fact that, for some customers, the decline in the AAV component is more than offset by the increase in the service charge.

The proposal put forward in this Supplementary Submission is that this anomaly be removed and these customers be charged on a straight line basis to the 2008/09 charges. An example of this proposal is shown in Figure 1 below.

Figure 1 Illustration of the Adjustment to a Stormwater Bill



The loss in revenue imposed by the “straight-line” approach to the target 2008/09 charge is made up in the modelling through an increase in the residential rate as shown below in Table 3.

Table 3 Revised Residential Stormwater Service Charges (2004/05\$)

	Current 04/05	05/06	06/07	07/08	08/09
Submission	\$42.31	\$42.96	\$43.63	\$44.30	\$44.98
Supplementary	\$42.31	\$43.03	\$43.77	\$44.52	\$45.28
Increase	-	\$0.07	\$0.14	\$0.22	\$0.30