



ICRC

independent competition and regulatory commission

**Information Paper
Prices for Water and
Wastewater Services**

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The Independent Competition and Regulatory Commission (the Commission) was established by the *Independent Competition and Regulatory Commission Act 1997* (ICRC Act) to determine prices for regulated industries, advise government about industry matters, advise on access to infrastructure and determine access disputes. The Commission also has responsibilities under the Act for determining competitive neutrality complaints and providing advice about other government-regulated activities.

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Foreword

The Independent Competition and Regulatory Commission (the Commission) is responsible for determining the tariffs that ACTEW Corporation (ACTEW) applies for the provision of water and wastewater services in the Australian Capital Territory (ACT). In order to determine these charges, the Commission undertakes a comprehensive inquiry into ACTEW's water and wastewater business on a regular basis, typically once every four or five years. Each inquiry results in the determination of a price path to apply for the length of the subsequent review period. The most recent review determined a price path to apply for the four years from 1 July 2004 to 30 June 2008.

In preparation for the next price inquiry, which will determine water and wastewater tariffs to apply in the ACT from 1 July 2008, the Commission will release a series of discussion papers. These papers, and any comments made in response, will form the basis of the regulatory approach to be adopted by the Commission in conducting the inquiry. The Commission intends to release five discussion papers between September and January 2007.

This information paper outlines the context within which the upcoming price inquiry will take place, including the roles of the Commission, ACTEW and the ACT Government. This information paper also provides an overview of the 2004–08 price determination and developments since the 2004–08 price direction was finalised, and a discussion of the Commission's recent inquiry into incentive mechanisms and how it relates to the upcoming water and wastewater inquiry.

The importance of water management, including water and wastewater pricing, has been brought to public attention in recent years as a result of the drought which has affected the ACT and much of south-eastern Australia. In the ACT, the increased prominence given to water management and, in particular, to the security of water supply culminated in a debate surrounding the possible construction of a new dam. It was in this context that a pipeline between the Cotter and Googong catchments was constructed, increasing the ability of ACTEW to store water previously lost from the Cotter catchment. In addition, the ACT Government introduced water restrictions during the drought, and Permanent Water Conservation Measures were introduced in the ACT in March 2006.

The Australian Government and state governments have identified water management as a significant issue. The National Water Initiative, signed by all members of the Council of Australian Governments (COAG) in 2004, builds upon the 1994 COAG framework for water reform. In addition, the Australian Government has recently implemented the Australian Government Water Fund, which provides funds for projects that invest in water infrastructure and improve water management techniques.

The attention being given to water management issues by governments, as well as the increasing public awareness of water management issues, is an indication of the importance of water resources. As such, the task of the Commission in completing the 2007–08 price review and approving water and wastewater tariffs for the following years, while having regard to government policies and relevant social, economic and environmental considerations, is an important step in any national water management strategy.

As always, the Commission believes that a crucial part of the regulatory process is community involvement. The Commission will seek submissions from the ACT community on matters relating to water and wastewater pricing and the level of service that consumers expect to receive for the price they pay.

Based on the discussion paper series, and any submissions made in response to the discussion papers, the Commission will release a working conclusions paper in the first half of 2007. As the initial step in the formal price inquiry process, the paper will detail the Commission's approach to the 2008 price determination. The Commission expects to release a draft decision by October 2007 and a final decision by March 2008. The Commission will seek comments from interested parties, and intends to hold a public hearing, between the releases of the draft and final reports.

Paul Baxter
Senior Commissioner
August 2006

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1 Introduction

In March 2004, the Independent Competition and Regulatory Commission (the Commission) released its *Final Report and Price Direction: Investigation into Prices for Water and Wastewater Services in the ACT*. This determined the tariffs to be charged by ACTEW Corporation (ACTEW) for water and wastewater services in the Australian Capital Territory (ACT) from 1 July 2004 to 30 June 2008.

The Commission expects to commence its next review of the pricing of water and wastewater services in 2007. That inquiry will determine tariffs to apply once the current price direction expierese reports are provided below.

This paper outlines the Commission's approach to the inquiry, and the context within which the inquiry will be conducted.

This chapter summarises the intended inquiry process.

Chapter 2 provides an overview of:

- the role of the Commission
- the role of ACTEW
- the water and wastewater network
- the need for regulation of ACTEW's water and wastewater tariffs
- ACT Government policy as it applies to water and wastewater.

Chapter 3 provides an overview of the current price direction.

Chapter 4 discusses developments since the current price direction was issued.

Chapter 5 outlines the conclusions of the review of incentive mechanisms that the Commission completed during 2005, and describes how the conclusions of that review apply to the inquiry.

Chapter 6 explains how interested community members or groups may contribute to the inquiry.

1.1 Discussion papers

During 2006 the Commission will publish five discussion papers, providing an overview of the Commission's approach to the following aspects of the regulatory process:

- Technical regulatory issues—The first discussion paper will discuss technical issues related to the length of the regulatory period, the form of regulation, the building-block methodology, the determination of the regulatory asset base, the potential use of productivity measures, and the calculation of the 'X factor'.
- Forecasting issues—The second discussion paper will examine the forecasting of customer numbers, customer demand, and operating and capital costs.
- Incentives for efficiency improvements and service standards— This discussion paper will build on the issues raised in the previous two discussion papers, with reference to the issues examined in the Commission's *Final Decision: Review of Efficiency and Service Standard Incentive Mechanisms* in December 2005. Although that decision rejected both a formal incremental incentive carryover mechanism and a service standard scheme, the Commission

will continue to explore how the design of the regulatory process provides positive incentives for regulated businesses to improve efficiency and maintain high levels of service quality.

- Pricing principles—The fourth discussion paper will discuss water, wastewater and recycled water tariff structures, the annual price reset methodology, the use of pass-through mechanisms., and other issues related to the pricing of water and wastewater services.
- Weighted average cost of capital—The final discussion paper will explore issues related to the calculation of the weighted average cost of capital, which is the return the business earns on its invested capital.

The Commission will call for submissions in response to each of the discussion papers.

1.2 Other reports

Following on from the discussion papers, and taking into account all submissions received, the Commission will release a working conclusions paper in the first half of 2007. This document will detail the Commission's approach to the regulatory process. The working conclusions paper will include the Commission's preferred methodology for calculating the 'X factor', forecasting methodology, pricing principles and any incentive mechanisms. The Commission will seek submissions in response to the working conclusions document.

In late 2007 the Commission will release its draft pricing decision. The Commission intends to hold a public hearing, as well as inviting written submissions, to gather feedback in response to the draft decision.

The draft decision will be followed by the final decision and price direction in early 2008.

1.3 Inquiry timetable

The Commission's planned timetable for the water and wastewater inquiry process is set out below.

Event	Date
Release of information paper	August 2006
Release of discussion paper 1	September 2006
Release of discussion paper 2	October 2006
Release of discussion paper 3	November 2006
Release of discussion paper 4	December 2006
Release of discussion paper 5	February 2007
Close of submissions on discussion papers	March 2007
Release of working conclusions paper	April 2007
Close of submissions on working conclusions paper	July 2007
Release of draft report	October 2007
Close of submissions on draft decision	December 2007
Public hearing	December 2007
Release of final report	March 2008

2 Overview of water and wastewater issues

In conducting the review of water and wastewater services, the Commission must be conscious of:

- its roles and responsibilities
- ACTEW's corporate structure and the nature of the network it operates
- ACT Government water management policy, and its likely effect on the efficient cost of operating the network.

2.1 Role of the Commission

The *Independent Competition and Regulatory Commission Act 1997* (ICRC Act) established an independent commission to regulate pricing, access and other matters in relation to industries involved in the provision of electricity, water and sewerage services, and other services, and to investigate competitive neutrality complaints and government-regulated activities.

Under the ICRC Act, the minister issues references to the Commission directing it to undertake inquiries as required. The Commission expects that in 2007 the minister will direct the Commission to undertake a review of ACTEW's water and wastewater services and determine prices to apply from 1 July 2008.

2.2 Description of ACTEW

ACTEW is wholly owned by the ACT Government and is the water and wastewater service provider in the ACT. It was established as a corporation on 1 July 1995, at which point its role was to provide electricity, and water and wastewater services.

In 2000, ACTEW and the Australian Gas Light Company (AGL) entered into a joint venture creating ActewAGL. Under this joint venture, ACTEW's electricity network was combined with AGL's gas network in an equal partnership. ACTEW retained ownership and control of the water and wastewater network, although ActewAGL operates and maintains the water and wastewater network under a service contract agreement with ACTEW.

As ACTEW is 100 per cent government owned, profits are returned to the ACT Government. However, the ACT Government has no role in the day-to-day management of ACTEW, which operates as an independent corporation: that is, under the direction of a board of directors and under the management of an executive management team.

2.3 Description of ACTEW's water and wastewater network

The water catchment infrastructure in the ACT consists of three dams on the Cotter River to the west of Canberra and one dam on the Queanbeyan River to the east of Canberra. To the west of Canberra, the Corin, Bendora and Cotter dams jointly provide approximately 87 gigalitres of storage. To the east, Googong Dam provides approximately 125 gigalitres of storage.

Water from these dams is treated and reticulated to households and businesses within the ACT. ACTEW also provides water to the Queanbeyan City Council. The pricing of the bulk water supplied to the Queanbeyan City Council by ACTEW through its treatment works and reticulation network will be explored in the discussion paper on pricing.

Wastewater is collected by ACTEW via the wastewater network and treated at the Lower Molonglo Water Quality Control Centre (LMWQCC).

Each year, approximately 65 gigalitres are taken from the dams and approximately 35 gigalitres are treated at the LMWQCC and returned for use downstream.¹

2.4 Need for regulation

The water and wastewater reticulation network operated by ACTEW exhibits the characteristics of a natural monopoly. That is, due to the economies of scale that exist in the construction, maintenance and operation of the water and wastewater network, it would be unprofitable for another business to duplicate the network and enter the market.

Given the natural monopoly characteristics, and consequent lack of competitive pressures to constrain the prices charged by ACTEW, there is a need to regulate the provision of water and wastewater services to prevent any possible extraction of monopoly rents by ACTEW.

In simple terms, the Commission regulates the pricing of the services provided by ACTEW by determining the efficient and prudent cost of providing the services and calculating water and wastewater tariffs to cover these costs. The first discussion paper will provide a detailed description of the approach to regulation.

The Commission typically undertakes a major inquiry every four or five years to determine a new price path for the subsequent period. Built into these price paths are annual price resets which adjust tariffs annually to allow for inflation, efficiency gains, and changes in other aspects of the operation of the network that have been foreshadowed in the price path determination. These annual price resets also allow the opportunity to adjust tariffs to take account of unforeseen events, such as droughts or unexpected capital construction activity, as occurred during 2004–05 and 2005–06. A discussion of these unforeseen events is contained in Chapter 4.

Since the establishment of the Commission in 1996, it has undertaken four price inquiries into the services provided by ACTEW.² The first covered the 1997–98 financial year and the second the 1998–99 financial year. The third review was for a period of five years, from 1 July 1999 to 30 June 2004, and the most recent review determined prices to apply from 1 July 2004 to 30 June 2008.

2.5 ACT Government policy

The upcoming inquiry will take place in a different policy context to that of previous reviews. Following the release of the current price direction in March 2004, the ACT Government released

¹ ACT Government, *Think Water, Act Water*, Canberra, 2004, p. 21.

² The Commission was initially called the Electricity and Water Pricing Commission with the name subsequently being changed to the Independent Competition and Regulatory Commission.

Think Water, Act Water (TWAW) in April 2004.³ TWAW outlines the ACT Government's water resource management strategy until 2050.

The aims of the TWAW strategy are to:

- increase the efficiency of water usage in the ACT
- provide a long-term, reliable source of water for the ACT and region
- develop a cross-border (ACT–New South Wales) water supply agreement
- protect the water quality of the ACT and surrounds
- incorporate water-sensitive urban design principles into urban, commercial and industrial development
- promote and provide for community involvement in the management of ACT water resources.

Included under the goal of increasing the efficiency of water usage are targets to reduce per capita consumption of mains water by 12 per cent by 2013 and 25 per cent by 2023. A target of increasing reclaimed water use from 5 per cent to 20 per cent by 2013 is also included.

As part of the strategy to provide a long-term, reliable source of water for the ACT and surrounding region, ACTEW has been required to provide recommendations to government on the options for a new water source. In response to this direction ACTEW has undertaken the Future Water Options project. The project is discussed in more detail in Chapter 4.

The ACT and New South Wales governments have also entered into a memorandum of understanding (MOU) regarding cross-border water supply. The MOU is aimed at establishing a framework under which the region will have access to ACT-controlled water. The MOU will assist the New South Wales Government to make decisions regarding new developments in the region.

In response to the extended period of drought, from 2003 to 2006, and the consequent water restrictions applied in the ACT and Queanbeyan, the ACT Government has implemented a policy direction entitled Permanent Water Conservation Measures. These measures, which came into effect from 31 March 2006, were introduced in recognition of the goals set under the TWAW initiative and are aimed at reducing annual water consumption by 8 per cent. The impact of the Permanent Water Conservation Measures will need to be taken into account when determining demand forecasts to apply to the next water and wastewater pricing period. The Commission intends to explore this issue in the discussion paper on forecasting issues.

³ *Think Water, Act Water* and related documents are available from Environment ACT or from the TWAW website, at www.thinkwater.act.gov.au.

3 Overview of the current price direction

The current price direction for water and wastewater services applies from 1 July 2004 to 30 June 2008 and determines the price path to apply to both water and wastewater tariffs.

The price path allows average revenue per customer to grow annually by the increase in the Consumer Price Index (CPI) plus 2.5 per cent for water customers and CPI plus 1 per cent for wastewater customers. This price path was determined using the cost building-block methodology. Under this methodology, tariffs are calculated to recover the efficient costs incurred in operating and maintaining the water and wastewater network as well as granting a return on the value of capital stock and depreciation of this capital stock.

Apart from setting the price path to apply from 1 July 2004 to 30 June 2008, major features of the price determination included:

- the restructuring of water tariffs
- the implementation of a capital monitoring program
- the inclusion of pass-through provisions
- a commitment to consider some form of incentive mechanism.

3.1 Restructuring of water tariffs

Prior to the implementation of the current pricing structure, water tariffs consisted of a fixed annual charge and a two-tiered volumetric charge, centred on annual consumption of 175 kilolitres. This pricing structure resulted in the average price of water falling as consumption increased.

To have the price of water fall as consumption increases is seen as a perverse outcome in a situation where security of water supply is a concern. To address this problem, in the 2004 direction the Commission sought to restructure water tariffs such that the average price of water exhibited a ‘U shape’. That is, the average price of water falls per kilolitre consumed over a certain range of consumption, then increases if consumption continues. The Commission considered that adopting a U-shaped average price of water would help to balance the need to allow for non-discretionary water use while encouraging water conservation at higher levels of discretionary consumption.

A U-shaped average price was achieved by reducing the fixed annual charge applying to the connection of water to a property and adjusting the volumetric tiers. The fixed charge was set at \$75 per annum for the length of the price direction, and three volumetric tariff tiers, 0–100 kilolitres, 101–300 kilolitres, and greater than 300 kilolitres, were introduced. The price per kilolitre of each tier was subject to adjustment on an annual basis over the length of the regulatory period to account for inflation and unforeseen events. The prices for the three tiers were initially set at \$0.515, \$1.00 and \$1.35 per kilolitre respectively.

3.2 Wastewater pricing

The Commission's 2004 price determination left the structure of wastewater pricing fundamentally unchanged. However, ACTEW proposed during the inquiry that it would undertake a consultative program to review the structure of wastewater tariffs. The Commission accepted this offer and expects that ACTEW will provide the Commission with a proposal for reform of wastewater tariffs in 2006–07.

The wastewater tariff structure attracts much less public comment than the water tariff structure does, but for the average residential customer the wastewater bill exceeds the water bill. Residential customers' wastewater charges are in the form of a fixed annual charge that is levied quarterly. This charge does not vary with the level of water usage. Commercial customers are also charged a per fixture fee.

3.3 Capital monitoring program

In the most recent price inquiry the Commission identified a need for ACTEW to formalise its capital planning processes; as a result, the current price direction requires ACTEW to report annually to the Commission on its capital management program. The Commission has been pleased with ACTEW's reporting, and considers that the processes put in place and information gathered will assist ACTEW in forecasting its future capital works programs and provide useful information for the upcoming inquiry.

3.4 Pass-through provisions

The current price direction includes a provision for the recovery of costs that could not be foreseen at the time the direction was made. This 'pass-through' mechanism allows a degree of flexibility in the price path whereby unforeseen costs can be included in prices during the regulatory period without conducting a full price inquiry. The trigger events that may allow a pass-through event are:

- a change in taxes event
- an act of terrorism
- a major natural disaster
- a subvention payment event
- a service standard event
- or
- an augmentation event.

These events are all subject to a materiality threshold to ensure that only significant events are included in any adjustment to the price path.

To date, ACTEW has claimed the pass through of costs in relation to a major natural disaster and an augmentation event. These claims and the Commission's responses are discussed in Chapter 4.

3.5 Incentive mechanisms

As part of the price determination, the Commission committed to working with ACTEW to discuss the possible implementation of an efficiency carryover mechanism and/or service incentive scheme for future use in regulating prices in the ACT. This commitment lead to the release by the Commission during 2005 of a series of reports exploring the introduction of one or both of these schemes. These reports are discussed in greater detail in Chapter 5.

4 Recent developments

In both 2004–05 and 2005–06 there were a number of unexpected developments for which ACTEW sought to recover costs via the pass-through mechanisms set out in the Commission’s 2004–08 price direction.

4.1 Developments in 2004–05

As part of the application of the price path adjustment to apply in the 2005–06 year, ACTEW made a claim for the recovery of additional costs incurred in operating the drought taskforce above those granted in the current price direction. ACTEW also made a claim for revenue forgone due to water restrictions as a result of the drought during 2004–05. These claims were made under the major natural disaster event pass-through mechanism incorporated in the Commission’s 2004–08 price direction.

As part of the adjustment for 2005–06, the Commission allowed ACTEW to recover revenue forgone because of reduced water consumption that resulted from the Stage 3 water restrictions applied by the ACT Government during 2004–05. The Commission recognised that the forecasts upon which the price direction’s tariffs had been based did not foresee Stage 3, or greater, water restrictions.

In establishing prices as part of the annual price reset, the Commission had two options. One option was to forecast of likelihood high-level water restrictions and their impact on water demand when determining prices. This would have resulted in higher prices than the Commission ultimately charged. Indeed, if water restrictions had been factored into prices but no water restrictions had been implemented, ACTEW would have over recovered revenue and consumers would have been over charged for the water they consumed.

The other option was for the Commission to allow ACTEW to recover foregone revenue after the water restrictions had been imposed and the exact revenue foregone was known. The Commission in adopting this option believes that over the course of the price direction, the revenue received by ACTEW will accurately reflect the recovery of efficient costs. In effect, the methodology adopted by the Commission ensured that only actual revenue forgone would be recovered. On that basis, the Commission allowed revenue forgone during 2004–05 to be recovered during 2005–06 and 2006–07, as actual revenue data became available.

The need to adopt this approach to setting prices was a function of the limited data on forward demand projections. As part of the next review of pricing, the Commission will be considering how best to forecast future consumption and whether or not to continue with this form of pass-through arrangement. This issue will be explored in the discussion paper dealing with the Commission’s approach to forecasting.

In addition to forgoing revenue because of the application of Stage 3 water restrictions, ACTEW was required by the ACT Government to establish and operate a drought taskforce for the ACT. The Commission allowed for the recovery of actual costs associated with this taskforce, once they had been incurred.

4.2 Developments in 2005–06

As part of the annual price reset for the 2006–07 year, ACTEW made a series of claims for the recovery of additional costs incurred during 2005–06. These costs related to the:

- Future Water Options (FWO) project
- augmentation works associated with the Cotter–Googong Bulk Transfer scheme
- remediation of the Lower Cotter Catchment
- additional pumping and treatment costs incurred to utilise water from the Lower Cotter Reservoir
- deferral of recovery for a proportion of costs incurred in previous years.

4.2.1 Future Water Options project

The FWO project was undertaken by ACTEW in response to a direction from the ACT Government. ACTEW was required, as part of the TWAW policy direction, to provide recommendations to government on the options for a new water source for the ACT. As a result, ACTEW undertook several studies and delivered of a series of reports to the ACT Government.⁴

Under the 2004–08 price determination the Commission adopted the approach of allowing ACTEW to claim a pass-through event to recover costs incurred in the implementation of new government policy. Therefore, the Commission allowed ACTEW to recover the costs of the FWO project in setting the price for 2006–07.

However, in making this decision, the Commission was conscious that this could create a precedent whereby the government could shift the costs of policy changes onto ACTEW with the knowledge that ACTEW would be able to recover these costs from its sales of water and wastewater services. For example, the ACT Government is responsible for the management of the water catchment areas that supply water into the Cotter and Googong storage facilities. These costs are currently recovered by the Water Abstraction Charge (WAC).⁵ It is conceivable that the government could, by way of a policy review, transfer this responsibility to ACTEW.

Based on its current approach of allowing ACTEW to recover the costs of government policy requirements, the Commission would normally allow ACTEW to recover the catchment management costs through increased water tariffs. This would not necessarily lead to an overall increase in costs to consumers, if the WAC was decreased at the same time as the costs were transferred to ACTEW. But, if the WAC was not adjusted or used to fund some of the related activity, consumers could find themselves paying for the same service twice.

The Commission is concerned that an approach such as this may lead to a transfer of functions from government to ACTEW, resulting in ACTEW undertaking functions that would more appropriately be carried out by government. However, the Commission notes that ultimately

⁴ The Future Water Options reports are available from the ACTEW website, at www.actew.com.au/futurewateroptions.

⁵ A statement from the Chief Minister's Department on the relationship between the Water Abstraction Charge and costs in 2005–06 is available from the Commission's website, at www.icrc.act.gov.au/waterandsewerage under the heading 'Water and Wastewater Annual Price Reset 2006-07'.

consumers should pay for the provision of these services, regardless of whether they do so through water and wastewater tariffs or through the funding of government expenditure.

4.2.2 Augmentation works

The final recommendations ACTEW made to the ACT Government in April 2005, based on the FWO project, were to:

- transfer water from the Cotter Catchment to Googong Dam via pre-existing water pipes
- pump water from the Murrumbidgee River at Angle Crossing to Googong Dam via Burra Creek (this was later revised to recommend pumping water from the Cotter Pump Station)
- undertake additional technical analysis for each of the dam options.

Given the severe drought the ACT was experiencing at the time, and acting under its own powers to ensure security of water supply, the ACTEW Board took the decision to begin work on the transfer of water from the Cotter Catchment to Googong Dam in mid-2005.

The Cotter–Googong Bulk Transfer (CGBT) scheme transfers excess water from the Cotter Catchment west of Canberra to Googong Dam in the east. In a typical year, water is spilt from Cotter Dam because it is full, while Googong Dam has unused capacity. The intent of the CGBT is to transfer the water which would ordinarily be spilt to Googong Dam for storage. The water may be taken from either Bendora Dam or Cotter Dam. Rather than being simply reticulated within the ACT and Queanbeyan, it is piped across to Googong Dam.

As part of the 2006–07 water and wastewater tariff reset, ACTEW requested that the CGBT scheme costs be recovered via the augmentation event pass-through provision.

The Commission determined that the costs incurred by ACTEW in completing the CGBT would be treated as capital costs and included in the regulatory asset base (RAB) from 2006–07.⁶ The Commission considered it appropriate to treat the costs as capital costs, given the investment in infrastructure undertaken in completing the works. However, the Commission intends conducting a review of these costs as part of the 2007–08 price inquiry, to ensure only prudent and efficient costs are being recovered.

4.2.3 Remediation of the Lower Cotter Catchment

The Cotter Catchment was severely damaged during the 2003 bushfires. This damage to the catchment directly affected the quality of water in Cotter Dam, and increased turbidity levels reduced the volume of water available from Cotter Dam.

Historically, water has been drawn from Bendora Dam rather than Cotter Dam because of the higher elevation of Bendora Dam (and consequent lower cost of pumping). ACTEW has recently refurbished the pumping capacity from Cotter Dam as a means of optimising the usage of Cotter Dam during periods of severe drought and uncertainty concerning future rain patterns.

⁶ By including the assets in the regulatory asset base, ACTEW each year earns a return on the value of capital as well as an allowance for depreciation. This issue will be explored in the discussion paper on technical regulatory issues.

The ACT Government has committed to a remediation program aimed at restoring the Cotter Catchment. These remediation works include revegetation of impacted areas, road drainage and culvert works, and other rehabilitation activities. The program undertaken by the ACT Government was intended to take place over approximately 10 years and involved an extended period of natural and seeded growth which would ultimately return the Cotter Catchment to its previous high-quality condition as a water catchment area.

However, ACTEW identified a need to fast-track the ACT Government's remediation works in the Lower Cotter Catchment. ACTEW's works are aimed at more swiftly improving water quality in Cotter Dam, enabling a greater potential usage of the Cotter Dam as a water source. Effectively, the works provide a means of achieving a greater degree of water security for the ACT and Queanbeyan than would have otherwise been possible.

As part of the 2006–07 water and wastewater price reset, ACTEW submitted that the costs it had incurred should be recovered via the augmentation event pass-through mechanism. In approving the recovery of these costs, the Commission received advice from the ACT Government that all of the insurance monies received to compensate for losses incurred as a result of the 2003 bushfires and all funds collected via the WAC were already being expended in catchment management projects.⁷ The accelerated expenditure proposed by ACTEW was to augment these sources of funding so as to bring the Cotter Catchment back to full utilisation more quickly than would have otherwise occurred. Therefore, the Commission considered that ACTEW was entitled to recover the prudent and efficient cost of undertaking the remediation works.

The Commission elected to consider the costs incurred by ACTEW in undertaking the remediation works in the Lower Cotter Catchment as capital costs and include them in the RAB, given the period over which the works will provide a benefit. As with the recovery of costs related to the CGBT scheme, the Commission will conduct a review of the prudence and efficiency of these costs as part of the 2007–08 price inquiry.

4.2.4 Additional pumping and treatment costs

During the height of the drought in 2004–05, ACTEW considered it necessary to pump and treat water from the Cotter Dam to provide greater security for water supply. As part of the annual price reset for the 2006–07 year, ACTEW submitted to the Commission that these pumping costs should be recovered under the major natural disaster event pass-through mechanism. The Commission considered the costs and concluded that they were prudent, given the need for ACTEW to provide a secure water supply for the ACT. As such, the pumping and treatment costs incurred from December 2004 to July 2005 are to be recovered during 2006–07 via water tariffs.

4.2.5 Deferral of cost recovery

In an attempt to lessen the impact of the above pass-through claims, ACTEW submitted to the Commission that it would defer the recovery of a proportion of costs from 2006–07 until 2007–08.

⁷ The documents provided to the Commission detailing these expenditures are available from the Commission's website, at www.icrc.act.gov.au/waterandsewerage under the heading 'Water and Wastewater Annual Price Reset 2006–07'.

The Commission accepted the proposal, given the steep increase in water tariffs that would have occurred had the full cost recovery been included in 2006–07 water tariffs.

However, the decision to defer the recovery of a proportion of these costs from 2006–07 until 2007–08 raises the matter of how to correctly inflate the deferred amount to compensate ACTEW for forgoing the revenue for 12 months.

A possible approach would be to inflate the deferred amount by the increase in CPI for the 12-month period. The Commission has previously adopted this approach to inflating costs which are recovered at a later point in time. An alternative approach would be to inflate costs by CPI plus the weighted average cost of capital (WACC).⁸ Inflating by CPI allows ACTEW to recover the costs in real terms while inflating by CPI plus the WACC compensates ACTEW for the opportunity cost of these funds. The Commission has yet to make a decision on the appropriate methodology to use to adjust the recovery of the costs already incurred by ACTEW. This matter will be resolved as part of the 2007-08 annual price reset.

⁸ In the current determination, the Commission adopted a pre-tax real WACC. The issue of the most appropriate form of WACC will be addressed in discussion paper 5.

5 Overview of the incentive mechanisms review

In the final report and price direction released in March 2004, the Commission committed to investigating the possible introduction of an efficiency carryover mechanism and/or service incentive scheme.

In March 2005, the Commission released a discussion paper on these two incentive mechanisms. The Commission released a draft decision in August 2005, and a final decision in December 2005.⁹

In relation to the introduction of a service incentive scheme, the Commission concluded that no evidence existed that indicated an adjustment to the current arrangements was necessary. The Commission also concluded that the costs of establishing and maintaining a service incentive scheme were likely to outweigh any benefits.

In regard to an efficiency carryover mechanism, the Commission identified a range of perverse outcomes stemming from the mechanistic nature of schemes implemented in other jurisdictions. The Commission was therefore not convinced of the benefits associated with implementing such a mechanism.

However, the Commission also identified a need to review the manner in which forecast operating and capital costs are determined in price directions made by the Commission, so as to ensure that the ‘efficiency incentive’ characteristics of the current ‘CPI minus X’ pricing mechanism are fully achieved. The Commission committed to the releasing a discussion paper on this issue in the second half of 2006, and making a final decision in early 2007. The Commission stated that this review would provide clear guidance to ACTEW on the way in which the Commission will assess and determine forward projections of operating and capital costs, as part of the upcoming regulatory review, to ensure that the desired efficiency incentive purposes of the price determination mechanism are achieved.

This commitment to assess the manner in which forward projections of operating and capital costs are determined is, in part, the reason for the series of discussion papers accompanying the water and wastewater price inquiry. The Commission has taken the opportunity to expand the matters to be considered beyond the question of operating and capital cost forecasts. To examine thoroughly the effects of the price determination mechanism, the series of reports will include discussions of technical regulatory issues, pricing principles and the WACC, as well as cost forecasts.

⁹ Copies of these reports and the submissions received are available from the Commission’s website, at <http://www.icrc.act.gov.au/waterandsewerage> under the heading ‘Report 6 of 2006’ on the Water and Sewerage page.

6 Community involvement

The Commission seeks to achieve the widest possible level of dissemination of information and community involvement in the review process to support the water and wastewater price inquiry.

Chapter 1 provides details of the discussion papers the Commission will be publishing during 2006, and the reports leading up to the final decision and price direction. At this point, the Commission is not seeking submissions on any of the particulars to be examined in the discussion papers.

The Commission does, however, wish to engage the community in the process from this point. The Commission encourages any member of the community, including residents, businesses, community groups, business organisations and any other interested parties, to contact the Commission and ask to be included on the water mailing list. Individuals and organisations on the Commission's water mailing list will receive copies of the discussion papers and reports.

To be included on the water mailing list, please contact the Commission by telephone on 6205 0799, by email at icrc@act.gov.au, or by mail to Independent Competition and Regulatory Commission, PO Box 975, Civic Square ACT 2608.

Glossary and abbreviations

ACTEW	ACTEW Corporation
AGL	Australian Gas Light Company
Commission	Independent Competition and Regulatory Commission
CGBT	Cotter–Googong Bulk Transfer
CPI	consumer price index
FWO	Future Water Options, ACTEW project
ICRC Act	<i>Independent Competition and Regulatory Commission Act 1997</i>
LMWQCC	Lower Molonglo Water Quality Control Centre
RAB	regulatory asset base
TWAW	<i>Think Water, Act Water</i> , ACT Government water resource strategy
WAC	Water Abstraction Charge
WACC	weighted average cost of capital
X factor	The number representing the real change in either prices or revenue each year, used in the formula applied to adjust prices in each year of a price direction