ACTEW

CORPORATION

Response to the Draft Price Direction

Water and Wastewater Services

Regulatory period commencing
1 July 2004

Submission to the
ACT Independent Competition
and Regulatory Commission

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ACTEW
CORPORATION

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Executive summary

In March 2004, the Independent Competition and Regulatory Commission (the Commission) will deliver its final decision for the price paths to apply to water and wastewater services in the Australian Capital Territory (ACT) from 1 July 2004.

ACTEW Corporation Ltd (ACTEW) is the licence holder under the *Utilities Act 2000* for the provision of water and wastewater services in the ACT and the owner of the water and wastewater network, storage and treatment infrastructure, and associated assets. Since October 2000, the ActewAGL Distribution partnership (ActewAGL), a joint venture of ACTEW and the Australian Gas Light Company Ltd (AGL), operates the water and wastewater business and maintains the infrastructure under a service contract agreement with ACTEW.

The Draft Decision

On 3 December 2003, the Commission released a *Draft Report and Draft Pricing Direction* (the draft decision) on the pricing review.

In the main, the draft decision falls well short of the proposals in ACTEW's submission. In particular, the following areas remain of significant concern to ACTEW:

- In rejecting a revaluation of ACTEW's water and wastewater businesses to a level closer to the real value of the infrastructure used, the Commission is denying a proper return on its investment to ACTEW's owner, the ACT Government. ACTEW believes that recognition of the importance of water resource management in the current environment means that a regulatory asset base (RAB) closer to the true underlying value of the assets, which signals the true cost of the services provided, can be sustained.

- ACTEW is not properly compensated for the risks of running its water and wastewater businesses. The Commission allowed a real pre tax return of 7.1 per cent on ACTEW's asset base; lower than ACTEW's proposed weighted average cost of capital (WACC) of 7.5 per cent. The lower figure is despite the Commission requiring ACTEW to bear risks of events outside its control, such as costs arising from changes to legislation, to a greater degree than is accepted elsewhere.

- While the draft decision accepts ACTEW's forecast capital program for the next regulatory period, it does not allow a *performance fee* to be paid to the ACTEW's contractor, ActewAGL, for undertaking the capital program. The performance fee provides incentive for the contractor to deliver an efficient capital program and incorporates the contractor's margin. The return allowed to the contractor is an inherent cost of an efficient capital program. The overall margin is modest and consistent with normal commercial contractual arrangements. While not accepting the Commission's disallowance of the performance fee from legitimate capital expenditure, ACTEW seeks to ensure

that, at the very least, the margin payment made to its contractor is included in its allowed capex.

- The draft decision proposes unrealistic and unsustainable reductions in operating and maintenance expenditure, based in part on a misunderstanding of the functions being performed. The Commission's draft decision reduced projected operating expenditure for the forthcoming regulatory period by an average of 7 per cent per annum over five years. ACTEW's operating expenditure projections reflect what is required to effectively operate and maintain the water and wastewater networks in the current environment. In the next regulatory period, the network environment will continue to be dramatically impacted by the recent drought and bushfire, evolution of ACT water policy, proposed changes to the ACT spatial plan, changes in Government policy on renewable energy targets and effluent reuse targets, and environmental considerations, including requirements from the Murray–Darling Basin. These factors, together with a continually growing and ageing network, place additional cost pressures on ACTEW in developing appropriate strategies and delivering expected service requirements. If the Commission's proposed operating expenditure level were implemented, it would seriously affect ACTEW's ability to deliver effective and reliable water and wastewater services in the short and long term.

- The Commission has proposed a capital review and audit regime that would not only require significant amounts of documentation to be provided to the Commission on each and every capital project, but that would also require audit of that documentation by a Commission-nominated person. A certain level of monitoring is acceptable in a regulated environment and ACTEW would be keen to discuss the nature of information required to reassure the Commission. However, ACTEW rejects the extent of intervention proposed by the Commission, which verges on making judgements and decisions that direct ACTEW's business activities. These decisions should be left to ACTEW, given its knowledge of the water industry, the ACT environment and its customers.

- The Commission proposes to shorten the next regulatory period to only four years. ACTEW believes that, in order to achieve efficiency gains, the regulatory control period must be long enough for management initiatives to be implemented and to take effect. The longer the business is able to retain the benefits of increased efficiency through higher profits, the greater the incentive to pursue those initiatives. The costs of a price review can be very significant both for the regulated business and the regulator. The Commission's assertion of "a number of uncertainties impacting on medium-term water usage"[1] is inconsistent with its diluting of ACTEW's proposed cost pass-through provisions. Approving these provisions in full as to their extent and materiality, in line with regulatory decisions in other jurisdictions, would address concerns about uncertainty without having to resort to a shortening of the regulatory period, with the consequent loss of incentives for efficiency.

[1] ICRC 2003, p 27.

Therefore it is ACTEW's view that the regulatory period should be maintained at five years.

- ACTEW's experience in the current regulatory period has highlighted the significant risk it faces as a result of unexpected increases in costs outside of its control. Cost increases of this type have included the costs of complying with changes in legislative and regulatory requirements, as well as sharply increased insurance costs. The Commission's draft decision in relation to pass-through arrangements is inconsistent with the arrangements allowed by other utility regulators. The Commission rejected pass-through arrangements for service standard events and insurance events. Both of these types of event have been recognised as allowed pass-through events by other regulators, for example the Australian Competition and Consumer Commission and in Victoria. It is anticipated that there will be a range of costs that are yet to be quantified arising from the significant policy and research work associated with the reform of the water industry. In addition, the Commission's proposed materiality threshold for allowing cost pass-throughs is substantially higher than that adopted by other regulators, requiring ACTEW to carry increased risk, uncompensated by a higher WACC.

The overall result of the Commission's draft decision has been to reduce ACTEW proposed revenue requirement by $96 million[2] over the five years of the review.

Pricing of Services

Water

The Commission has developed options for the structure of water prices in the ACT in response to the ACT Government's need to meet specified consumption targets. One of these options involves a second price step and a reduced fixed charge. In light of the Commission's request for assistance in this area, ACTEW has developed an improved demand management pricing option for consideration. This involves a reduced fixed charge of $80 per annum (from $125) with a second price step at 500 kilolitres (kl) per annum[3] at $2.50/kl, aimed at improving the efficiency of water use on gardens and lawns in the warmer months. In doing so, ACTEW notes that it has previously provided the Commission with a pricing proposal[4], but that this was developed in the context of normal climatic events and involved a managed price path in accordance with its established pricing principles.

Wastewater

ACTEW notes the Commission's support for a proposed review of the fixtures based charge for wastewater. During the early stages of the next price path ACTEW will focus on gathering information and consulting with its customers. During this time fixtures based charges would be retained. ACTEW is currently reviewing the findings

[2] This figure is the nominal dollar difference between ACTEW's August 2003 and the Commission's draft decision revenue requirements.

[3] On a daily basis.

[4] ACTEW 2003b.

of a study into wastewater charging which shows the cost of wastewater services to residential customers to be somewhat higher than the cost contribution of this group. If it is found appropriate, ACTEW will therefore propose to increase the residential charge by at least ten per cent over the next regulatory period (two to three per cent each year) before adjustments to wastewater prices in line with the price path.

Trade waste

The Commission has encouraged ACTEW to continue to negotiate trade waste charges with consumers, and has stated that where the additional treatment or maintenance costs imposed by trade waste are material, "these higher costs should be passed through to the relevant customers".[5] ACTEW intends to use the cost information gathered throughout the first two years of the price direction in negotiating cost reflective trade waste charges with consumers. ACTEW supports the Commission's foreshadowed *light-handed* approach to regulating prices for trade waste services.

[5] ICRC 2003, p 172.

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1 Introduction

1.1 Purpose of the submission

In March 2004, the Independent Competition and Regulatory Commission (the Commission) will bring down a final price direction for water and wastewater services in the Australian Capital Territory (ACT) for the regulatory period commencing 1 July 2004. The price review is being undertaken according to terms of reference issued by the ACT Government under the *Independent Competition and Regulatory Commission Act 1997* (the ICRC Act). The Commission released its *draft report and draft price direction*[6] for the review (the draft decision) on 3 December 2003.

ACTEW Corporation Ltd (ACTEW) is the license holder under the *Utilities Act 2000* for the provision of water and wastewater services in the ACT and the owner of the water and wastewater network, storage and treatment infrastructure, and associated assets. Since the formation of a joint venture with the Australian Gas Light Company Ltd (AGL) in October 2000, the resulting ActewAGL Distribution partnership (ActewAGL) operates the water and wastewater business and maintains the infrastructure under a service contract agreement with ACTEW.

Over the course of the current pricing investigation, ACTEW has provided its views on pricing to the Commission in two major submissions, in May and August 2003.[7] This submission responds to the Commission's draft decision, seeking to address issues of concern in relation to the Commission's approach and conclusions.

1.2 The Commission's draft decision

The overall result of the Commission's draft decision has been to reduce ACTEW proposed revenue requirement by $96 million[8] over the five years of the review.

ACTEW's proposals were for real annual increases in prices of 6.0 per cent for water and 5.3 per cent for wastewater in the face of significant additional costs in security, insurance, wages and salaries, the impact of the Canberra bushfires, and the requirement for a more realistic return on its asset base.

In contrast, the Commission is proposing a lower increase in prices of 2.4 per cent for water and 0.5 per cent for wastewater in each year over four years.

1.3 ACTEW's proposals

This submission presents a pricing proposal from ACTEW which is a considered response to the Commission's views in the draft decision. Table 1.1 provides a summary of ACTEW's price path proposal.

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6 ICRC 2003.

7 ACTEW 2003a and 2003b.

8 This figure is the nominal dollar difference between ACTEW's August 2003 and the Commission's draft decision revenue requirements.

Table 1.1 Proposed price paths over the regulatory period 2004-2009

	2004-05	*2005-06*	*2006-07*	*2007-08*	*2008-09*
	CPI + X per cent				
Water					
ACTEW revised proposal	5.4	5.4	5.4	5.4	5.4
ICRC draft price direction	2.4	2.4	2.4	2.4	
Wastewater					
ACTEW revised proposal	4.2	4.2	4.2	4.2	4.2
ICRC draft price direction	0.5	0.5	0.5	0.5	

Note: ACTEW's proposals are based on its revenue requirement smoothed over its proposed five-year regulatory period, where the Commission has calculated ACTEW's revenue requirement over four years. See the discussion on the length of the regulatory period at Section 8.2 of this submission.

The major elements of ACTEW's proposal are:

- opening RABs, consistent with ACTEW's August 2003 proposal, of $459.3 million for water and $475.6 million for wastewater, based on economic valuations, which correct for the transitional nature of prices incorporated in the cashflow assumptions of the previous economic valuations on which the Commission's preferred roll-forward of the asset bases would be based;
- a WACC of 7.53 per cent. The Commission's WACC contains parameter inconsistencies, and fails to provide for asymmetric risk in the absence of a more comprehensive treatment of cost pass-throughs;
- removal of the requirement for a return on working capital;
- a reduced contractor's margin of $0.5 million per annum for capital expenditure;
- acceptance of some proposed efficiencies in operating expenditure; and
- a regulatory period of five years to retain incentives for efficiency.

The details of these proposals are provided in the succeeding chapters. ACTEW's revenue requirements for the period, based on the case outlined above, are shown in Table 1.2 (water) and Table 1.3 (wastewater).

Table 1.2 ACTEW's revised revenue requirement—water

	2004/05	*2005/06*	*2006/07*	*2007/08*	*2008/09*
	$m	*$m*	*$m*	*$m*	*$m*
Operating Costs	30,741	31,405	32,576	33,977	35,463
Return of capital – depreciation	10,867	11,367	11,732	12,131	12,483
Return on regulated asset base	35,873	37,485	38,033	38,573	39,139
Return on working capital	-	-	-	-	-
Revenue requirement	**77,481**	**80,257**	**82,341**	**84,681**	**87,085**
Reduction from ACTEW's August proposal [a]	915	913	828	1,787	1,886

Notes: [a] Difference between this proposal and the revenue requirement proposed in ACTEW's August 2003 submission to the Commission for the price review.

Table 1.3 ACTEW's revised revenue requirement—wastewater

	2004/05	*2005/06*	*2006/07*	*2007/08*	*2008/09*
	$m	*$m*	*$m*	*$m*	*$m*
Operating Costs	36,172	35,776	37,501	39,415	41,009
Return of capital – depreciation	10,946	11,569	12,056	12,585	13,055
Return on regulated asset base	36,393	37,391	38,309	39,384	40,379
Return on working capital	-	-	-	-	-
Revenue requirement	**83,511**	**84,736**	**87,866**	**91,384**	**94,443**
Reduction from ACTEW's August proposal [a]	1,754	2,146	2,414	3,712	4,045

Notes: [a] Difference between this proposal and the revenue requirement proposed in ACTEW's August 2003 submission to the Commission for the price review.

2 Regulatory asset base

2.1 The case for revaluation

In the current price direction, the Commission observed that:

> The inclusion of costs related to the capital base recognises the owner's investment in the regulated utility, and the capital-intensive nature of infrastructure businesses. Failure to include adequate capital costs as part of the revenue requirement of the utility risks an inappropriate reduction in investment in the industry. This could ultimately lead to reductions in coverage, service levels, and reliability.[9]

Under the *Territory-Owned Corporations Act 1990*, the ACT Government requires maximisation of the sustainable yield on its investment in ACTEW. Determination of the RAB is a key factor in the achievement of this objective.

As part of the price review process, ACTEW commissioned an asset revaluation by Meritec Pty Ltd (Meritec). Meritec's valuation as at 1 July 2002 showed substantial increases in the depreciated optimised replacement cost (DORC) value of ACTEW's water and wastewater assets.

Under the guidelines for determining the relevant regulatory value of infrastructure assets established by the Council of Australian Governments (CoAG), the applicable valuation is to be, in normal circumstances, the lesser of the DORC and economic value (recoverable amount). Because of the large variation now apparent between the rolled forward RAB and DORC valuations of the water and wastewater businesses, ACTEW undertook an updated calculation of the economic value of the water and wastewater businesses. ACTEW's August 2003 submission proposed the resulting economic values of $459.3 million for water and $475.6 million for wastewater as appropriate opening RABs for the next regulatory period. These are higher than the Commission's roll forward opening RABs based on the 1999 economic values.

In the draft decision, the Commission characterises its 1999 RAB decision as one which "*effectively said* that the asset valuation made at that time was a 'line in the sand' for the purposes of setting the value in future years",[10] and that the 1999 decision "was presented as a 'line in the sand'…".[11] ACTEW rejects this view and contends that the valuation adopted by the Commission in its 1999 determination was neither *locked in* nor established as a *line in the sand* by implication or otherwise, and therefore never precluded a subsequent revaluation.

ACTEW expressed its concerns in 1999 in response to the Commission's draft price direction for the current period, that the economic valuation derived by the Commission was based on undervalued prices:

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9 IPARC 1999, p 38.

10 ICRC 2003, p 52 (*emphasis added*).

11 ICRC 2003, p 54.

> … ACTEW is concerned that the Commission's RAT [recoverable amounts test] valuation undervalues ACTEW's asset base [since] … the RAT valuation proposed by the Commission is based on the projected earnings for 1998/99. The revenue projections for this year are based on the current pricing structures which substantially undervalues [sic] the services provided—this has effectively been acknowledged in the Commission's Draft Price Direction in respect of water, in particular through the proposed revenue path of CPI+3 for five years. The Commission's RAT is based on 1998/99 revenues with no allowance made for price increases in future years. Consequently, the application of a rate of return to an asset base estimated by the Commission's RAT model effectively locks in the current underpricing of ACTEW's services.[12]

ACTEW believes that recognition of the importance of water resource management in the current environment means that a RAB closer to the true underlying value of the assets, which signals the true cost of the services provided, can be sustained.

The Commission contends that, to allow regular revaluation of the RAB would increase uncertainty and decrease ACTEW's incentives to invest. However, the Commission has acknowledged its ability to draw *a line in the sand* or *lock-in* a valuation. ACTEW would be prepared to discuss with the Commission the possibility of locking in a future RAB with the aim of increasing future regulatory certainty.

2.2 The Commission's roll-forward methodology

The general construction of the roll-forward approach adopted by the Commission in the draft decision is:[13]

Opening RAB + CPI – DEP + CAPEX = Closing RAB

where:

Opening RAB	equals closing RAB in previous year. The initial RAB is taken from the Commission's 1999 economic valuation;
DEP	Depreciation given in the previous ICRC decision, adjusted for actual CPI;[14]
CAPEX	Actual CAPEX which was considered prudent;[15] and
CPI	CPI compensation (change in CPI*(Opening RAB + ½ CAPEX)).

While ACTEW disagrees with the use of a roll-forward RAB, it agrees that, if a roll forward approach were to be used, that the Commission's general approach would be appropriate with exception of the treatment of the *performance fee* paid by ACTEW to

[12] ACTEW 1999, p 31.

[13] Implied from ICRC 2003,Tables 5.4 and 5.5, pp 63-64.

[14] ICRC 2003, p 62.

[15] ICRC 2003, pp 57-62, while 2003/04 is based on ACTEW's latest estimates.

ActewAGL for managing the capital program. The performance fee element should not be deducted from the value of prudent investment being rolled-in.

ACTEW notes that this fee covers both an appropriate return to the contractor and an incentive payment element.[16] Under normal commercial contract arrangements, the payment of both a contractor's margin and any incentive payments for cost reductions form part of the cost of prudent investment. In the absence of these payments, the costs of the investment would be higher.

The Commission has determined that ACTEW's investment in the previous regulatory period was prudent.[17] However, it has then deducted the performance fee element in calculating the roll-forward of the asset base.[18] ACTEW considers that the *entire* prudent cost of investment should be incorporated into the asset base. Once incurred, performance fee payments form part of the prudent cost of actual investment and as such should be incorporated into the RAB.

ACTEW also notes that the published figure for the RAB roll-forward differs from the figure used in the Commission's model subsequently provided to ACTEW. ACTEW understands that the figure used in the model is the intended value.

[16] This is discussed further in Section 4.1 of the submission.

[17] ICRC 2003, p 58.

[18] ICRC 2003, p 59 and Table 5.4 p.63.

3 Return on capital

3.1 Weighted average cost of capital

In its draft decision, the Commission recognised the importance of determining a rate of return on capital that would avoid both over-investment and unnecessarily high prices for consumers, and setting incentives and rewards for investment too low, placing at risk future investment in the network.[19]

ACTEW would not be properly compensated under the Commission's draft decision for the risks of running its water and wastewater businesses. The Commission allowed a real pre tax return of 7.1 per cent on ACTEW's asset base; lower than ACTEW's proposed WACC of 7.53 per cent. The lower figure is despite the Commission requiring ACTEW to bear risks of events outside its control, such as costs arising from changes to legislation, to a greater degree than is accepted elsewhere.

3.1.1 Additional risks faced by ACTEW

ACTEW noted in its earlier submissions to the Commission that it believes that the most appropriate approach to addressing the risk associated with changes to external cost drivers is through the introduction of pass-through mechanisms, rather than through adding a component to the allowed return to address asymmetric risk. As a result, ACTEW's proposed WACC of 7.53 per cent did not include a component to address asymmetric risk.

The Commission has indicated in its draft decision that it proposes to allow cost pass-through events for a *narrower* range of external cost drivers than has been approved for other regulated businesses. Specifically, the Commission has excluded *Insurance Events* and *Service Standard Events* from the categories of allowed pass-through events. These have been approved as pass-through events for other regulated businesses.

ACTEW's response to the Commission's proposed approach to pass-through events is discussed in Section 8.1.

3.2 Return on working capital

ACTEW notes that the Commission has not allowed ACTEW's proposal for the inclusion of a return on working capital in its revenue requirement.

The Independent Pricing and Regulatory Tribunal (IPART) allows NSW metropolitan water businesses a return on working capital[20] and the revenue requirement modelling conducted for the NSW water businesses is the same as the Commission's model for ACTEW.

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[19] ICRC 2003, p 83.

[20] See, for example, IPART 2003, Appendix 8, p 65.

Nevertheless, in view of the Commission's position in the draft decision and in light of what ACTEW considers to be more fundamental issues regarding the RAB and allowed WACC, ACTEW has not incorporated a requirement for working capital in the revised revenue requirement proposed in this response.

3.3 Sustainability of revenues

The Commission's draft decision includes analysis of the implications of the derived revenue requirement on ACTEW's financial position. The Commission refers to Standard & Poor's (S&P's) United States utilities rating criteria for 1995 and the NSW Treasury's 1994 report *The Capital Structure for NSW Government Trading Enterprises* as the basis used in determining the indicative credit ratings for ACTEW.

Using a purpose built credit ratings model,[21] ACTEW has identified the following issues in relation to the Commission's financial viability ratios included in the draft decision:

- The analysis is inconsistent with the WACC assumptions used in the remainder of the Commission's draft decision; and
- The credit rating criteria used by the Commission have been superseded by more up to date information.

The implications of each of these issues on the conclusions reached by the Commission in it draft decision are discussed below.

3.3.1 Inconsistency with the WACC

In its draft decision, the Commission determines a regulatory WACC to apply to ACTEW's regulated water business. This WACC is determined using an assumed gearing ratio of 60 per cent. However in the financial viability analysis, the draft decision reverts to ACTEW's actual gearing ratio of 31 per cent. Thus the assumption made by the Commission in calculating the WACC is inconsistent with that used in analysing ACTEW's financial viability.

ACTEW contends that the Commission should either adjust the draft WACC so that it reflects ACTEW's forecast gearing ratio of 29 per cent, or adjust its financial analysis so that it is based on the WACC assumptions. To prescribe a return through the WACC based on one capital structure and then apply another capital structure in the financial analysis is inconsistent.

ACTEW's suggested approach outlined above is consistent with that adopted by the former Office of the Regulator-General, Victoria when undertaking financial viability analysis which included the following guidelines:[22]

- Use of the forecast regulatory asset value;

[21] Based on ACTEW forecasts and notional balance sheets.

[22] ORG 2000, pp 166-167.

- Use of the benchmark capital structure in the regulatory WACC as in the financial viability analysis;
- Annual interest costs are assumed to be the same as those used in determining the regulatory WACC; and
- All other costs and revenues should be consistent with those from the regulatory decision.

Adjusting the financial viability analysis to reflect the regulatory WACC parameters reduces the indicative credit rating for the water business over the next regulatory period to BB (S&P 1995) or to BB+ (NSW Treasury), which are indicative credit ratings bordering on *speculative grade* (as opposed to *investment grade*) and below the indicative credit rating of regulated water and wastewater businesses of BBB to A.[23]

3.3.2 Out of date information

There is scope for the information used by the Commission in its draft decision analysis of financial viability to be updated. The Commission used the S&P Corporate Finance Criteria for 1995, when S&P's *Corporate Ratings Criteria* for 2003 is publicly available. These criteria are updated regularly to reflect current market conditions.

Using the S&P criteria for 2003, the indicative credit rating falls to a consistent BB across the next regulatory period, indicating that the business is *speculative grade* (below *investment grade*) and below the expected indicative credit rating for a regulated water business.

[23] ORG 2000, pp 297-301.

4 Capital expenditure

4.1 Performance fee

The Commission's draft decision accepts ACTEW's forecast capital program for the next regulatory period, but has excluded the *performance fee* cost paid to ACTEW's contractor (ActewAGL) for undertaking the capital program. The Commission states that it "will not allow a separate additional 'performance fee' cost"[24] to be included in allowed capex.

ACTEW does not agree with the argument put forward by the Commission for excluding the performance fee from ACTEW's allowed capex for the next regulatory period.

The Commission's consultant, Halcrow Pacific Pty Ltd (Halcrow), has characterised the performance fee as consisting of two components:

- an appropriate return on the cost to the contractor in managing the capital program; and
- an incentive mechanism which would be paid to the contractor if it were able to produce specified outcomes at a lower than expected rate.

This characterisation of the performance fee is consistent with the current agreement between ACTEW and its contractor. The current performance fee is approximately 5 per cent of the efficient capital program, which is consistent with industry standards. This performance fee covers both a return on ActewAGL's costs in managing the capital program, and an incentive payment for efficiencies.

The Commission acknowledges that the first component of the performance fee is an acceptable cost for inclusion in allowable capital costs. However, the Commission mistakenly concludes that the return to the contractor is already accounted for in the management and project planning costs included in the capital projections, and that a separate allowance via the performance fee is not required.

> … the inclusion of the 10 per cent to 15 per cent margin in the projected capital works costs for ActewAGL management and project planning purposes would appear to be consistent with industry benchmark standards and therefore the commission will allow this cost.[25]

Contrary to the Commission's apparent understanding, the management and project planning costs included in the projected capital expenditure for projects are the actual costs of either internal staff or external resources in undertaking management, design and other activities for each construction project. There is no element of return to the contractor included. As a result, the element of the performance fee related to the

[24] ICRC 2003, p 76.

[25] ICRC 2003, p 75.

return to the contractor for managing the capital program needs to be incorporated in the capex requirement.

In relation to the incentive component of the performance margin, the Commission expresses the view that this should not be incorporated in projected capex costs, as the cost should be funded from the capex savings achieved during the regulatory period. ACTEW is prepared to accept this position.

As a result, ACTEW has reduced the amount of the performance fee it has included in its cost projections to reflect only that element of the fee relating to the appropriate return to the contractor. As noted above, this cost is not already included in other elements of projected capex costs for the period and is a legitimate business cost incurred by ACTEW.

As advised to the Commission, the extent of and basis for determining the performance fee in the forthcoming regulatory period is uncertain as the *Utilities Management Agreement* (an arm's length contractual arrangement to be put in place between ACTEW and ActewAGL from later in 2004) has not been finalised. At this stage, therefore, the breakdown of the performance fee between the return to the contractor and any incentive payment is uncertain. ACTEW has reduced the amount of the performance fee it has included in its cost projections by approximately $500,000 per annum, to reflect the return to the contractor. This amount represents 50 per cent of the total performance fee.

ACTEW's revised capital expenditure projection, incorporating a contractor margin of $0.5 million per annum, is shown in Table 4.1.

Table 4.1 ACTEW's revised capital expenditure proposal

	2004/05	*2005/06*	*2006/07*	*2007/08*	*2008/09*
	$'000	*$'000*	*$'000*	*$'000*	*$'000*
Water	31,822	7,120	3,272	4,651	3,093
Wastewater	17,372	12,942	11,102	10,927	9,352

Note: Figures shown are in real 2002-03 dollars.

ACTEW notes that acceptance of the Commission's position that the incentive element of the performance fee should not be incorporated in the capex projections does not imply acceptance of the position that the incentive cost element should be excluded from the cost of investments when those investments are rolled into the regulatory asset base at the time of the next review. Payment of both a margin and some further incentive for the contractor to deliver an efficient capital program is an inherent part of the cost of prudent investment and consistent with normal commercial contractual arrangements. In incorporating investment into the asset base at the time of the next review, ACTEW therefore expects the Commission to roll-in the *total* cost of all prudent investment, including any incentive payments made.[26]

[26] Discussed in Section 2.2 of the submission.

4.2 Intrusive capital review and audit regime

The Commission has proposed a capital review and audit regime that would not only require significant amounts of documentation to be provided to the Commission on each and every capital project, but that would also require audit of that documentation by a Commission-nominated person. A certain level of monitoring is acceptable in a regulated environment and ACTEW would be keen to discuss the nature of information required to reassure the Commissions. However, ACTEW rejects the extent of intervention proposed by the Commission, which verges on making judgements and decisions that direct ACTEW's business activities. These decisions should be left to ACTEW, given its knowledge of the water industry, the ACT environment and its customers.

ACTEW also notes that as part of its improved asset management processes, from 2004/05 ACTEW will be subjecting its contractor's submitted capex program to very extensive audit reviews, covering all facets of the capex program, at the beginning of each year. ACTEW considers that this review process would already provide an appropriate level of scrutiny to ACTEW's capex program.

4.3 Proposed mini-hydroelectric plants

The Commission stated in its draft decision that it is prepared to accept the inclusion of mini-hydroelectric plants (mini-hydros) in ACTEW's capital expenditure projections for the forthcoming regulatory period, but that these would be included in the RAB at the start of the subsequent regulatory period only where ACTEW demonstrated each project to be economic or justifiable on other grounds at the time of the investment.[27,28] The Commission is reminded that *other grounds* in this context include ACTEW's *principal objectives* specified in the *Territory Owned Corporations Act 1990*, which include requirements to:

> (c) exhibit a sense of social responsibility by having regard to the interests of the community in which it operates; and
>
> (d) where its activities affect the environment—conduct its operations in compliance with the principles of ecologically sustainable development.[29]

Before undertaking a capital project, ACTEW assesses the economic viability and other factors surrounding the proposal. The project proceeds where it is demonstrated to be the most effective way of meeting the requirements of the water and wastewater networks in the context of the business environment in which it operates.

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[27] ICRC 2003, p 72.

[28] ACTEW notes that the Commission has included in its draft decision (ICRC 2003) a summary of its analysis in Chapter 5 that is contradictory to the detailed analysis on page 119. The Commission states that ACTEW would need to provide additional information to the Commission on mini-hydros before the capital expenditure would be included in the final decision. ACTEW has assumed that the Commission's position is, as stated in the detailed analysis, that the projected capital expenditure is accepted, but would be reviewed at the end of the next regulatory period before it would be able to be included in the asset base for the period following.

[29] *Territory Owned Corporations Act 1990* (ACT), Schedule 4 *Modifications in relation to ACTEW Corporation Limited*, Section 2, substitution of Section 7.

Appropriately, the incentive-based regulatory regime rewards ACTEW for prudent investment decisions.

4.4 Effluent reuse

The Commission states in its draft decision that:

> ... the commission has allowed expenditure on effluent reuse projects in the current regulatory period to enter the RAB at 30 June 2004. However, the commission intends to remove this expenditure in the actual roll-forward of the RAB for the regulatory period commencing 1 July 2008 unless ACTEW can clearly demonstrate that the proposed projects were the most effective and cost efficient schemes in terms of meeting the ACT government effluent reuse objectives and minimising ACTEW's costs.[30]

This statement suggests that, unless ACTEW is able to justify expenditure that has *already taken place in the current regulatory period*, it would be removed from the regulatory asset base in 2008. This is a curious approach and one that is inconsistent with the general roll-forward principle.

It might be reasonable to require ACTEW to demonstrate at the *next* regulatory review that *new* assets connected with effluent reuse were economic or justifiable on other grounds at the time of the investment before they can be included in the RAB.[31] However, ACTEW does not accept that projects that have occurred *already* should be subject to further review at the time of the next regulatory review.

ACTEW is also concerned the Commission appears to have prejudged that recycling water from LMWQCC for consumptive use "may prove to be a more economically efficient means of meeting the reuse targets".[32] The Commission has noted the uncertainty that exists in the water and wastewater environment at present driven by fire, drought, ACT Government decisions on water supply use and reuse, and on implementing the Canberra spatial plan. ACTEW will, therefore, develop the most effective approach to effluent reuse in the light of information available at the time decisions are to be made.

In making the assessment of the capital expenditure to be included in the RAB at the time of the next regulatory review, the Commission must only consider the context and information available at the time the decision was made, not whether, with hindsight, a different decision might have been made.

4.5 Omitted capital expenditure

At the Commission's request, ACTEW has provided updated information on the latest projected capital and operating costs of the Googong Water Treatment Plant and the Stromlo Filtration Plant. ACTEW notes that the Commission included the revised operating costs, which were lower than ACTEW's preliminary projections, but that

[30] ICRC 2003, pp 73-74.

[31] ICRC 2003, p 72.

[32] ICRC 2003, p 73.

higher capital expenditure on the projects was not included in the capital expenditure shown in the draft decision. This has since been discussed with the Commission and the Commission has confirmed its intention for this capital expenditure to be fully incorporated.

4.6 Capital contributions

In its August 2003 submission to the Commission, ACTEW signalled its intentions regarding to the acceptance of capital contributions over the next regulatory period and sought assurances from the Commission over the treatment of developer-initiated works.[33]

Under the *Utilities Act 2000*, ACTEW is able to levy a *capital contribution charge* on developers for the development or augmentation of its network. However, to levy such a charge, ACTEW would be required under the Act to develop a *capital contributions code*.

ACTEW believes that the administration of a capital contributions code for water and wastewater sector assets would be a resource-intensive and expensive exercise. Given expectations that the value of developer-initiated capital works will be low over the next ten years, and mainly limited to infill projects where costs are not easily attributed to a particular project, administration of a capital contributions code would not be cost effective over this period.

As a result, ACTEW proposes not to proceed with the development of a capital contributions code during the term of the forthcoming price determination and to continue to internally fund required development.

ACTEW is concerned, however, that the Commission not differentiate capex that might otherwise have been contributed and seeks to ensure that it receives a return on these assets where investments have been prudently made. A forecast $3.5 million of sewer augmentation work falls into this category in the next period.

In the absence of a commitment by the Commission to allow ACTEW a commercial return on its development expenditure, ACTEW might be forced to reconsider its position and adopt the less cost effective option of developing and administering a capital contributions code.

[33] ACTEW 2003b, p 55.

5 Operating expenditure

5.1 Overall reduction in projected operating expenditure

The Commission has not accepted ACTEW's projected efficient operating costs in its draft decision, stating that they do not reflect the efficient costs of providing water and wastewater services to customers in the ACT.[34] The Commission states that it has come to this conclusion by reference to the information provided by ACTEW and from the report and analysis undertaken for the Commission by Halcrow Pacific Pty Ltd (Halcrow). The Commission's draft decision[35] refers to the efficient operating plan cost path which is Halcrow's lower boundary, but does not refer to the range suggested by Halcrow, which has as its upper boundary the projected costs submitted by ACTEW.

The Commission has reduced overall projected operating expenditure from ACTEW's revised estimates as shown in Table 5.1:

Table 5.1 Commission's revisions to projected operating expenditure

	2004/05	*2005/06*	*2006/07*	*2007/08*	*2008/09*
	$'000	*$'000*	*$'000*	*$'000*	*$'000*
ACTEW's August revised projections	65,089	64,106	64,705	67,427	68,501
Allowance by the Commission	61,676	60,176	60,482	61,939	62,653
Commission's Reduction	3,413	3,930	4,223	5,488	5,848

Note: Figures shown are in real 2002-03 dollars.

The Commission's draft decision reduced projected operating expenditure for the forthcoming regulatory period by an average of 7 per cent over five years. ACTEW's operating expenditure projections reflect what is required to effectively operate and maintain the water and wastewater networks in the current environment. In the next regulatory period, the network environment will continue to be dramatically impacted by the recent drought and bushfire, evolution of ACT water policy, proposed changes to the ACT spatial plan, changes in Government policy on renewable energy targets and effluent reuse targets, and environmental considerations, including requirements from the Murray–Darling Basin. These factors, together with a continually growing and ageing network, place additional cost pressures on ACTEW in developing appropriate strategies and delivering expected service requirements. If the Commission's proposed operating expenditure level were implemented, it would seriously affect ACTEW's ability to deliver effective and reliable water and wastewater services in the short or long term.

The Commission has recognised additional costs in direct maintenance and operating activities, including moving to national standards of maintenance and the additional cost of operating the new water treatment plants. In this respect, the Commission has accepted ACTEW's projected Asset Management Plan (AMP) expenditure for the operation and maintenance of the water and wastewater networks. The Commission

[34] ICRC 2003, p 122.

[35] ICRC 2003, Table 7.3, p 107.

has however reduced non-AMP operating expenditure to a level that would severely limit ACTEW's ability to manage service delivery of water and wastewater services, as well as respond to the significant strategy and planning requirements.

ACTEW disagrees with the basis of the Commission's proposed reduction in projected efficient operating expenditure for the next regulatory period and is concerned with the impact on customers and the business in both the short and long-term from adopting lower than required operating and maintenance expenditures.[36] Moreover, since its August submission, ACTEW has provided the Commission with information based on more up to date estimates and a general saving, revising its total projected operating costs down by $6.4m (in real 2002/03 dollars over five years). Yet in the draft decision, the Commission has imposed a *further* $22.9 million or 7 per cent reduction. Such a reduction would be unachievable and unsustainable

The major areas of concern in relation to operating expenditure are as follows:

- The Commission's proposed reductions include cutting projected Asset Management and Planning and Project Management costs by 20 per cent in a period when the Commission has itself recognised greater uncertainty considering the impact on changes to the ACT water strategy and spatial plans;

- The Commission has made no allowance in the *Service Provision to ACTEW* costs for supporting new management systems implemented over the current regulatory period aimed at improving asset information and processes and works management information; and

- The Commission has double-counted potential efficiency savings by only allowing salary cost increases in line with inflation whilst imposing a 2 per cent efficiency cut to reflect productivity improvements from 'significant' real wage increases.

The Commission has also not taken account of revisions to ACTEW corporate costs of approximately $0.9 million (in real 2002/03 dollars) advised in November 2003. ACTEW requests that these be included in the final price determination.

5.2 Reduction in non-AMP operating expenditure

The Commission makes reference to the level of non-AMP operating expenditure in 2002/03 and reduces the projected costs for the forthcoming regulatory period to the levels achieved in that year. The overall costs for 2002/03 for these items, excluding fire and drought-related costs, were $28.9 million (real 2002/03 dollars). The Commission has proposed to reduce this amount to $27.2 million for 2004/05 and to $26.8 million for 2005/06 (both in real 2002/03 dollars), even after accepting projected increases of approximately $1.5 million in total in insurance and additional occupational health and safety (OH&S) requirements. The Commission is therefore

[36] The draft decision showed different amounts allowed for operating expenditure in the Executive Summary and in Chapter 7. Based on additional information provided by the Commission, ACTEW understands that the operating expenditure shown in the detailed analysis in Chapter 7 is the Commission's proposed amount and consequently the analysis in this section is based on the figures presented in Chapter 7.

proposing a real reduction between 2002/03 and 2004/05 of $1.7 million or approximately 6 per cent. Over 2005/06 and 2006/07, a further real reduction of $0.6 million is proposed. These reductions are unrealistic and unattainable.

In arriving at the projected non-AMP operating expenditure, the Commission appears to have accepted all estimates where ACTEW has projected a decrease in costs and rejected all areas where ACTEW has projected an increase, with the exception of insurance and OH&S. The Commission has also proposed an efficiency cut on all costs in this area, including those where ACTEW has projected a decrease. This approach appears unreasonable.

Efficiency measures required over the past few years have already reduced staff numbers performing these non-AMP work functions to levels where, in some cases, only one staff member with a specific expertise now exists. Any further reductions due to funding cuts will seriously affect the ability of ACTEW to perform the key functions included in asset planning and management and some key project management and strategic areas.

Key components of the Commission's analysis and subsequent efficient operating expenditure conclusion are discussed in detail in the following sections.

5.2.1 *Asset Planning and Management* and *Project Management* costs

As part of the Commission's reductions to operating expenditure, it proposes to reduce ACTEW's forecast *Asset Planning and Management* costs from the projected levels in 2004/05 and beyond of $5.3 million (in real 2002/03 dollars) to the level incurred in 2002/03 ($4.2 million in real 2002/03 dollars). At the same time, the Commission has accepted ACTEW's projected reduction in *Project Management Labour* costs from $3.6 million in 2002/03 to $2.1 million in 2004/05 (2002/03 real dollars).

The two items cannot be looked at in isolation. The costs predominantly represent the efforts of specific teams. As previously highlighted to the Commission, a new works management system, which will provide information on a more activity-based footing going forward, was implemented in late 2002/03. In implementing the system and moving into the 2003/04 year, project and activity types were changed to better reflect the activities being undertaken. This has impacted the comparability of costs from 2002/03 to later years. That is, the teams involved in *Asset planning and management* and *Project management* have been reallocated between categories between those two years.

When the relevant activity groups and costs are combined, the result shows that ACTEW has proposed a reduction in costs to reflect efficiencies in *Asset Planning and Management* and *Project Management* as shown in Table 5.2.

Table 5.2 ***Asset Planning and Management*** **and** ***Project Management*** **costs**

	2002/03	*2004/05*
	$ '000	*$ '000*
Asset planning and management costs	4,195	5,259
Project Management Labour Costs	3,610	2,062
Total	**7,805**	**7,321**
ACTEW projected efficiency		**484**

Note: Figures shown are in real 2002/03 dollars.

In addition to ACTEW's proposed reduction of 6 per cent, the Commission proposes a further reduction of $1.1 million (in real 2002/03 dollars), which is a total 20 per cent reduction compared to the 2002/03 level. This reduction is unrealistic and would not enable ACTEW to meet its responsibilities in responding to the impacts of changes in government policy on water strategy and other changes expected in the near future. ACTEW's projected level of costs is required to meet the following asset planning and management issues:

- Providing input and responses to the ACT Government in the development of the ACT Water Policy, in particular in relation to:
  - The development and assessment of options for new water supply sources for the ACT;
  - The assessment of water supply risk and the realistic timing for new sources, including impact of demand reduction targets, historic uncertainty, climate change, and environmental flows;
  - The setting of effluent reuse targets and how to achieve them, including the need for and costs of any new assets required;
  - Associated economic and social impacts together with any technical issues involved; and
  - Cross-border water supply issues and their impacts on the ACT's water supply;
- Liaising with and responding to the ACT Planning and Land Authority (ACTPLA) in relation to proposed land-planning changes associated with the Draft Spatial Plan. These proposed changes have significant impacts on the requirements for and timing of new assets, as well as the utilisation of existing assets and their expected economic lives. These impacts have major capex and opex implications for ACTEW. The planning changes relate to:
  - New development proposals for Kowen, Molonglo Valley and Stromlo; and
  - Significant changes to the land release program in Gungahlin.
- Liaising with and responding to the Non-Urban Land Inquiry in relation to proposed development of the Cotter catchment, Cotter, Tidbinbilla and Tharwa regions, and the re-development of the area adjacent to the suburb of Duffy, including:
  - Advice on management of the Cotter catchment;

- New development proposals for Pierces Creek, Uriarra, Cotter and Stromlo settlements; and
- Alternative water and sewerage options for all these locations.

- Advice on all aspects of the current drought, including:
  - Forward projections of dam levels;
  - Bushfire impact on water yield from the Cotter catchment;
  - Monitoring the impact, and likely future impact, of water restrictions;
  - Monitoring and modelling the impact of different environmental flow regimes and different operating scenarios (for example, use of lower Cotter Dam) on current and future dam levels; and
  - General advice on water use options, including reuse options;

- Advice on all aspects of water resource management, including:
  - Current review of environmental flows; and
  - Technical aspects of ACTEW's new licence under the *Water Resources Act 1998*.

These activities are in addition to ongoing planning and management required for the existing network as it ages; planning for ongoing augmentation as a result of growth; development and management of major maintenance programs; and managing the network to ensure it is able to meet environmental and safety standards.

ACTEW proposes that the costs of *Asset Management and Planning* and *Project Management* be accepted at the projected level, which already includes a proposed reduction from the 2002/03 level.

5.2.2 Reduction in *Service Provision to ACTEW* costs

Under the *Water and Sewerage Managing Contractor Alliance Agreement* (WSMCAA), ACTEW pays its contractor, ActewAGL, for the provision of water and wastewater maintenance and operational services. Part of the cost of providing these services is management of the WSMCAA arrangement and any corporate costs incurred by ActewAGL in delivering these services. ACTEW projected these costs to increase from $12.0 million in 2002/03 to $14.7 million in 2004/05 (and subsequent years) (all in real 2002/03 dollars) primarily due to:

- increases in insurance costs;
- increases in OH&S requirement costs;
- inclusion of the cost of depreciation and support of newly implemented corporate systems utilised by ActewAGL; and
- increases in salaries costs in corporate areas above inflation.

The Commission has explicitly accepted the first two increases but implicitly disallowed all other increases by holding the cost, in real terms, to the 2002/03 base

cost. In addition, the Commission has also applied an efficiency saving of 2 per cent to the total of these costs, including the increased insurances.

Cost of supporting new corporate systems

ACTEW has implemented new systems to gather and improve information on network operations and assets, including condition and asset maintenance information, that are consistent with better practice and expected by the Commission and its consultants. Halcrow criticised ACTEW in relation to the quality of information and systems. ACTEW has taken steps to improve systems during the current regulatory period, for example, by implementing WASP, the works management system. ACTEW is planning to further improve systems and processes in the forthcoming regulatory period. It is therefore inappropriate for the Commission to expect ACTEW to invest in better systems, yet not be entitled to recover either the cost of the investment or the ongoing support costs.

Salary increases

Salary increases are projected to be above inflation, consistent with the current Enterprise Agreement and current industry benchmarks. These real cost increases should therefore be allowed as part of the efficient operating expenditure level. By holding service provision costs constant, in real terms, to 2002/03 levels, the Commission has in effect only permitted wage increases in line with inflation. The Commission has also imposed a 2 per cent efficiency cut in the light of the "forecast of significant wage increases".[37] The Commission has thus double-counted potential efficiency gains (as described further below). If the Commission wishes to impose a 2 per cent efficiency cut, then it should also allow the real increase in wages under the *Service Provision to ACTEW* costs.

Revised Service Provision to ACTEW costs

ACTEW acknowledges the Commission's comments in relation to holding the *Service Provision to ACTEW* costs at a constant level, but still requires adjustment for those costs, including additional information systems costs and salary increases above inflation, that cannot be avoided. While not agreeing that its projected *Service Provision to ACTEW* costs are inefficient, ACTEW has revised its estimates to include additional costs as identified above while holding the balance of the *Service Provision to ACTEW* costs at 2002/03 levels.

The revised estimates represent a $4.0 million reduction over five years—some 5 per cent of costs projected in ACTEW's August submission.

5.2.3 Double counting of required efficiencies

In establishing the need for an efficiency reduction, the Commission argues, "a forecast of significant real wage increases without the expectation of efficiency improvements is not consistent with industry best practice".[38] As a consequence, the Commission identified a potential efficiency saving of 2 per cent on non-AMP

[37] ICRC 2003, p 121.

[38] ICRC 2003, p 120-121.

operating expenditure. However, the costs allowed by the Commission in this category, including *Asset Management and Planning, Project Management Labour* and *Service Provision to ACTEW* costs, do not include any increase above inflation for wages growth. That is, the Commission has not incorporated any real wage increases into these cost projections.

The Commission is effectively proposing a 2 per cent efficiency reduction, *plus* a further 2 to 3.3 per cent efficiency reduction (compounding) depending on the projected inflation rate, and therefore has double-counted the potential efficiency reductions.

ACTEW acknowledges the need for efficiencies to be built into business operations, but is only prepared to accept a 2 per cent efficiency target, providing it is not double-counted as described above.

5.2.4 Revised non-AMP operating expenditure

Based on the above discussion on non-AMP operating expenditure and incorporating the Commission's approach to include efficiencies and hold costs constant ACTEW has revised the projected non-AMP operating expenditure as shown in Table 5.3.

Table 5.3 Revised Non-AMP operating expenditure

	2002/03	*2004/05*	*2005/06*	*2006/07*	*2007/08*	*2008/09*
	$'000	*$'000*	*$'000*	*$'000*	*$'000*	*$'000*
Base level (net of efficiencies)	28,907	28,206	28,483	28,951	29,285	29,827
Agreed increases for insurance and OH&S items	-	1,506	1,486	1,486	1,486	1,486
Revised non-AMP operating expenditure	**28,907**	**29,712**	**29,969**	**30,437**	**30,771**	**31,313**

Note: Figures shown are in real 2002-03 dollars. Figures exclude fire and drought costs.

5.3 Revised efficient operating expenditure

Based on ACTEW's assessment and response to the draft report as outlined above, ACTEW proposes a revised efficient operating expenditure plan as indicated in Table 5.4.

Table 5.4 ACTEW's revised efficient operating expenditure

	2004/05	*2005/06*	*2006/07*	*2007/08*	*2008/09*
	$'000	*$'000*	*$'000*	*$'000*	*$'000*
Commission's efficient operating plan – total [a]	61,676	60,176	60,482	61,939	62,653
ACTEW August revised forecast [a]	65,089	64,106	64,705	67,427	68,501
ACTEW revised proposal					
Asset management plan (AMP) projects	32,964	33,339	33,927	34,673	35,215
Drought and fire costs	1,514				
Non-AMP operating expenditure (including efficiencies)	29,712	29,969	30,437	30,771	31,313
Total ACTEW revised proposal	**64,190**	**63,308**	**64,364**	**65,444**	**66,528**

Note: Figures shown are in real 2002-03 dollars. **Source:** [a] ICRC 2003, Table 7.5 p124.

The revised efficient operating expenditure proposed in Table 5.4 represents a 2 per cent saving on average compared to the previously revised efficient operating cost plan. It would allow ACTEW to meet a maintenance and operations level

commensurate with the age, condition and expected performance of the water and wastewater networks, while holding non-AMP expenditure levels relatively constant in real terms after allowing additional costs imposed for insurance and OH&S requirements.

6 Service standards and demand forecasts

6.1 Service standards

In its draft decision, the Commission requested more detailed information from ACTEW on the service standards it intends to meet for the next regulatory period.[39]

Expenditure projections presented in ACTEW's August submission stated, "The expenditure projections presented are based on a continuation of the current service performance of the network".[40]

ACTEW proposes continuation of the current service standards, as outlined in Table 6.1, for the duration of next regulatory period. These performance measures are achieved through the operations of the Joint Venture partnerships. Specific measures are the subject of contractual requirements, while other measures relate to compliance requirements of the Consumer Protection Code and other codes under the Utilities Act 2000. ACTEW has consistently met or exceeded these targets.

Table 6.1 ACTEW Corporation key service targets

Service	Performance Measure	Target
Wastewater	Disruptions per 1000 properties	< 62.5 pa
	% disruptions corrected within 5 hours	> 90%
Water	Interruptions per 1000 properties	< 80 pa
	% interruptions corrected within 5 hours	> 95%
Contact Centre	% of calls answered in 20 secs or less	> 80%
	% of calls abandoned	< 5%
Staff Safety	Lost time injury frequency rate / million hours worked	<6.8 with a 20% annual reduction
Wastewater treatment	LMWQCC Effluent Discharge licence compliance	100%
	Southwell Park Water Reuse licence compliance	100%
Water Quality	Meet the requirements of the Australian Drinking Water Guidelines for aesthetics	95%
	Meet the requirements of the Australian Drinking Water Guidelines for health	100%

6.2 Demand Forecasts

The Commission has stated in its draft decision that it has concerns over the growth rate in customer numbers for the period 2002-03 to 2003-04 because:

> … the growth rates of 1.35 per cent and 1.25 per cent for water and wastewater customers respectively are below the growth rates experienced in the prior years, and those forecast in the subsequent years.[41]

[39] ICRC 2003, p 38.

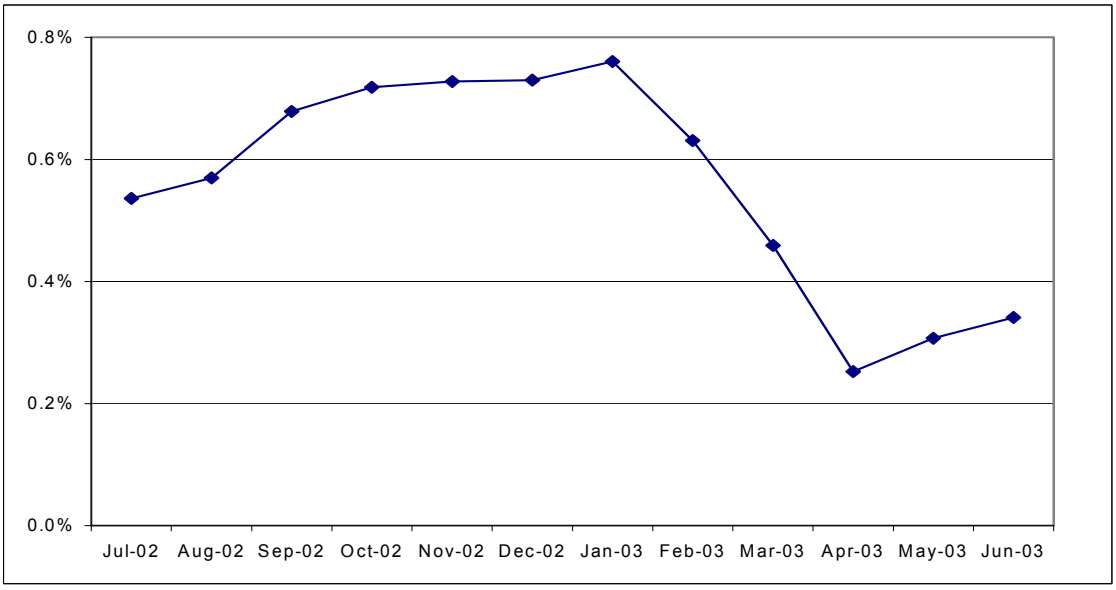
[40] ACTEW 2003b, p 74.

ACTEW considers that this forecast *dip* in customer growth is justified. Since providing the Commission with customer forecasts in May, ACTEW has become aware of the potential crowding-out effect that the post-bushfire rebuilding effort may be having on new customer growth. ACTEW believes that applying a customer growth rate of 1.57 per cent (and 1.47 per cent for wastewater) in 2003/04, as used by the Commission in its modelling, will overstate the number of new customers coming online because some of this growth will represent existing customers who are rebuilding their houses and therefore reconnecting to the network.

In July 2003, ACTEW had 377 fire-affected properties on its books. Removing these customers from the 1.57 per cent (1.47 per cent) customer growth in 2003/04 (in order to avoid double-counting) reduces growth in that year to 1.28 per cent (1.17 per cent). ACTEW decided to take the more conservative view that around 75 per cent of the affected properties would *crowd-out* new customer growth. The resulting customer growth rate in 2003/04 is therefore projected at 1.35 per cent (1.25 per cent).

The Commission has stated that until it can "satisfy itself that there is a downturn in new customer number growth in 2002-03 it will require ACTEW to adjust its customer number forecasts for 2003-04 … ".[42] Figure 6.1 shows the growth over six months for the *houses* customer group, which makes up around 75 per cent of all ACTEW customers. It clearly shows the downturn in new customer growth that occurred after the bushfires.

Figure 6.1 Growth in the *houses* customer group



Note: Figures shown represent half-yearly growth on a 3-month moving average.

This analysis of customer growth in the wake of the January 2003 bushfires justifies ACTEW's customer number forecasts for 2003/04. A downward revision, as proposed by the Commission, is not necessary.

[41] ICRC 2003, p 47.

[42] ICRC 2003, p xvii.

7 Pricing proposal

7.1 Water tariff structure and billing

ACTEW provided the Commission with a tariff structure proposal in its August 2003 submission. This option proposed a managed increase in the volumetric charge, to improve price signals, and a reduction in the price step to around 130 kilolitres per annum by the end of the regulatory period. ACTEW also advocated the introduction of *daily pricing* from 1 July 2004.

This tariff structure was developed as a preferred approach to water pricing in the context of ongoing reform consistent with ACTEW's pricing principles. It provides for managed prices increases towards an efficient level and is consistent with ACTEW's ongoing commitment to water resource management.

However, in the circumstances of the current climatic events, the Commission has "been encouraged by the ACT Government to consider the role of pricing as a water use efficiency measure".[43] In this regard, the Government has proposed a 12 per cent reduction in per capita usage of water by 2013, and a 25 per cent reduction by 2023 has caused the Commission to investigate alternative pricing structures.

The Commission outlined a price structure in its draft decision (*Proposal A)* which would require a change to the current billing arrangements as it incorporates a second price step and a reduced fixed charge.

This structure places greater emphasis on the volumetric component of the tariff structure with the intention of influencing the consumption behaviour of customers that consume above a certain level.

ACTEW had previously advised the Commission that a more aggressive pricing approach would hasten the reduction in per capita consumption as targeted by the ACT Government in its draft water strategy:

> In the context of the ACT Government's focus on this issue and the need for ACTEW to support the Government's policy initiatives for a proposed reduction in per capita water consumption, ACTEW will be advising the Government on pricing options that will help ensure these targets are met. These options will necessarily be more aggressive than the pricing proposal being put to the Commission for the purpose of this inquiry, as they need to focus on achieving a target reduction in per capita demand.[44]

Given that the Commission has sought comments on its proposal "and other related pricing options,"[45] ACTEW is eager to assist with this process and has provided comment on the proposal.

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[43] ICRC 2003, p 153.

[44] ACTEW letter to the Commission, 29 August 2003.

[45] ICRC 2003, p 167.

7.1.1 The Commission's *Proposal A*

The price schedule for *Proposal A* is:

- $70 fixed charge;
- $0.50/kl for first 100kl consumed per annum;
- $1.00/kl for the next 200kl consumed per annum; and
- $1.50/kl for consumption in excess of 300kl per annum.

Due to the relative price inelasticity of demand for water, ACTEW believes that the increase in the top price step needs to be markedly higher than $1.50, in order to more quickly achieve demand management objectives. ACTEW believes that the top step price could be around $2.50/kl to better achieve this objective.

The primary focus for such a demand management charge should be to ensure efficient outdoor water use. The aim needs to be to manage the amount of water used on lawns and gardens in summer. Recent evidence on Sunday night sprinkler use confirms the extent to which this form of demand contributes to the high levels of water use in the warmer months.

ACTEW believes that a demand management charge should target this component of water use as a matter of principle. However, a number of administrative issues arise in setting such a demand management charge. For example, the charge should not penalise non-domestic customers using water as a legitimate part of their business. However, some non-residential and government water use would also fall into this category of demand, where water is used on lawns and gardens essentially for ornamental purposes.

7.1.2 ACTEW's demand management option

Commensurate with ACTEW's proposed price path of CPI+5.4 per cent per annum for the duration of the regulatory period 2004/05 to 2008/09, ACTEW's indicative 2004/05 prices for a demand management option are in Table 7.1. This is based on the best estimate of the likely demand response to the price change.

Table 7.1 Indicative 2004/05 water prices

	Current (2003/04)	*ICRC Proposal A*	*ACTEW proposal (2004/05)*
Fixed charge ($ pa)	125	70	80
Usage charge ($/kl) [a]			
Up to the first step	0.43	0.50	0.72
In excess of the first step up to the second step	1.05	1.00	1.10
In excess of the second step	1.05	1.50	2.50 [b]
First step (kl pa)	175	100	175
Second step (kl pa)	–	300	500 [b]

Note: [a] Exclusive of the water abstraction charge.
[b] Based on application to residential customers only

An increase in volumetric prices across the consumption range will improve demand management signals for all customers, providing all customers with a greater financial incentive to use water more efficiently. The fixed charge would fall to $80 per annum.

ACTEW would also retain a degree of revenue certainty via an increase in the first tier price. This is because consumption charged at this price (up to 175kl per annum) is relatively unaffected by climatic events.

This option would maintain the first step at 175kl per annum (0.4795kl per day) for a period of two years to accommodate the introduction of daily pricing. As stated in ACTEW's August submission, this will "allow customers to understand the pricing implications and to provide time to adjust to the new arrangements."[46] In addition, maintaining the step at 175kl for two years will help avoid potential customer confusion that might result from the introduction of a second price step. ACTEW would progressively increase the price of water to around $1.50/kl for customers using up to 500kl per annum, thereby sending all customers an appropriate signal about the cost of water.

The top (demand management) price step would be set at a level to influence consumption behaviour and the efficiency of outdoor water use. Taking the price elasticity of demand for water into consideration, ACTEW believes that a price of $2.50/kl would send a stronger demand management signal and provide a stronger incentive for reducing this form of water consumption over a shorter time frame.

Around 13 per cent of households use more than 500kl per annum, but these households are responsible for 30 per cent of overall residential water use.

But, it is important to note that around 36 per cent of households would exceed this threshold on a daily basis in the warmer months.

ACTEW believes that setting the threshold at this level (500kl per annum) would mean that the impact on larger families would be minimised. Based on the Commission's analysis, indoor use for a family of six would be around 342kl per annum (or around 86kl per quarter). ACTEW's demand management option would ensure these families' living standards were not compromised.

It must be emphasised that ACTEW has developed this pricing option in the context of the Commission's proposal for options to meet the Government's consumption target. ACTEW's demand management option is designed to guide and progress the Commission's thinking in this important area. This option is *revenue neutral* for ACTEW. The relative size of the fixed charge being reduced in response to higher volumetric charges to allow ACTEW to remain within its revenue cap.

7.1.3 Tariff Impacts of ACTEW's demand management option

The following analysis assumes that the demand management charge is applied only to residential customers.

[46] ACTEW 2003b, p 18.

Table 7.2 shows the impact on residential customers of the indicative changes to prices under ACTEW's demand management option in 2004/05. The impact of daily pricing (including pro-rata billing) has not been included in this analysis.

Table 7.2 Impact on Residential Customers

Consumption (kl)	*2003/04 bill*	*2004/05 bill* [a]	*Nominal difference*	*% change (real)*
0	$125.00	$80.00	-$45.00	-37.6%
50	$146.50	$116.00	-$30.50	-22.8%
100	$168.00	$152.00	-$16.00	-11.7%
150	$189.50	$188.00	-$1.50	-3.2%
200	$226.50	$233.50	$7.00	0.6%
250	$279.00	$288.50	$9.50	0.9%
280	$310.50	$321.50	$11.00	1.0%
300	$331.50	$343.50	$12.00	1.1%
350	$384.00	$398.50	$14.50	1.2%
400	$436.50	$453.50	$17.00	1.4%
500	$541.50	$563.50	$22.00	1.5%
700	$751.50	$1,063.50	$312.00	38.1%
1,000	$1,066.50	$1,813.50	$747.00	65.9%
5,000	$5,266.50	$11,813.50	$6,547.00	118.8%

Note: [a] Does not include the impact of daily pricing or pro-rata billing. Shaded row represents average household consumption.

Customers that use very little water would receive real decreases in their water bill, while customers that use significantly more than 500kl per annum would receive large real increases as a demand management incentive.

Table 7.3 shows the impact on commercial customers of the indicative changes to prices under ACTEW's demand management option in 2004/05.

Table 7.3 Impact on Commercial Customers

Consumption (kl)	*2003/04 bill*	*2004/05 bill* [a]	*Nominal difference*	*% change (real)*
0	$125.00	$80.00	-$45.00	-37.6%
50	$146.50	$116.00	-$30.50	-22.8%
100	$168.00	$152.00	-$16.00	-11.7%
150	$189.50	$188.00	-$1.50	-3.2%
200	$226.50	$233.50	$7.00	0.6%
250	$279.00	$288.50	$9.50	0.9%
280	$310.50	$321.50	$11.00	1.0%
300	$331.50	$343.50	$12.00	1.1%
350	$384.00	$398.50	$14.50	1.2%
400	$436.50	$453.50	$17.00	1.4%
500	$541.50	$563.50	$22.00	1.5%
700	$751.50	$783.50	$32.00	1.7%
1,000	$1,066.50	$1,113.50	$47.00	1.9%
5,000	$5,266.50	$5,513.50	$247.00	2.1%

Note: [a] Does not include the impact of daily pricing or pro-rata billing.

Commercial customers using up to 150kl per annum would receive a significant real decrease in their water bill, although these customers represent only 2 per cent of

commercial water consumption. The majority would face a real increase in their annual water bill.

Figure 7.1 shows the impact of ACTEW's indicative prices for its demand management option on residential customers' annual water bills over a range of consumption. The impact of daily pricing (including pro-rata billing) has not been included in this analysis.

Figure 7.1 Impact of ACTEW's proposal on residential water bills

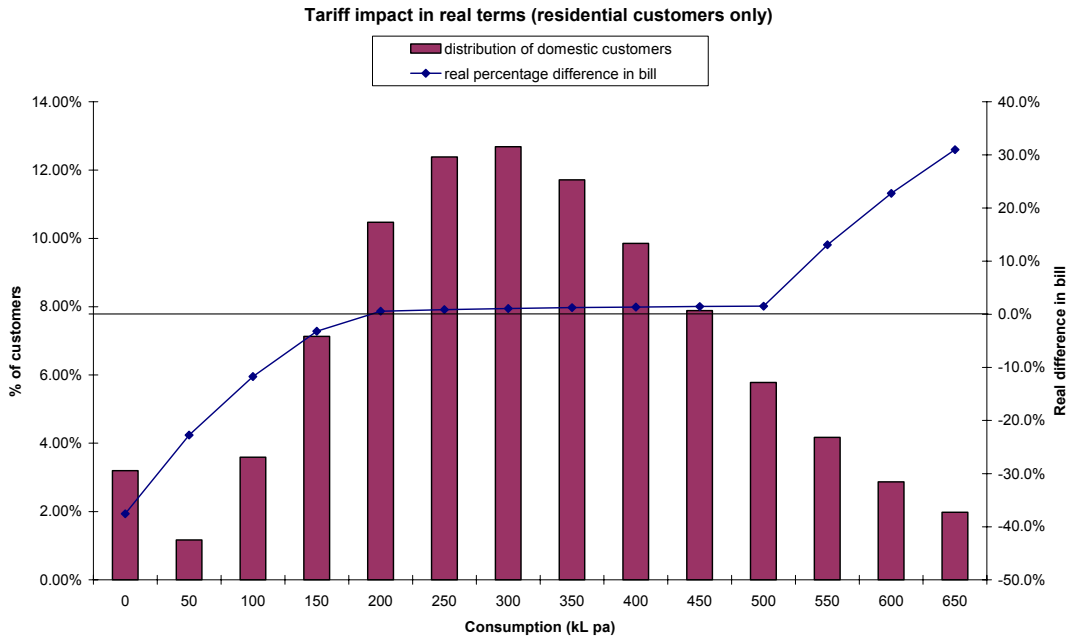

Figure 7.1 indicates that many residential customers will face a reduction or a small real increase in their water bill under ACTEW's demand management option. However, customers that consume more than 500kl per annum could potentially face very large bill increases. This would provide a financial incentive to use water more efficiently.

7.1.4 Other water tariff and billing issues

Daily pricing

In its August submission to the Commission, ACTEW proposed the introduction of *daily pricing*. ACTEW continues to support the adoption of daily pricing.

In its draft decision, the Commission highlighted three issues that it considered to be *drawbacks* of daily pricing. ACTEW does not agree with the Commission on any of these issues. Firstly, the two billing effects (increased bills for those who consume above the effective quarterly step in at least one quarter and below it in at least one other, and decreased bills for almost all customers because some of the consumption on the first quarter bill will be charged at the previous year's prices) would be taken into account when ACTEW sets its water tariffs. ACTEW also believes that these two effects would improve the price signals to customers and should not be viewed as drawbacks of the adoption of daily pricing. Secondly, ACTEW agrees that the presentation of information on customers' bills is important. ACTEW will investigate

the possibility of presenting water bills in the same manner as ActewAGL presents electricity and gas bills.

ACTEW notes that the improved price signals resulting from the introduction of daily pricing could result in customer confusion and be less effective if implemented concurrently with other changes to the price structure. For this reason, ACTEW proposed in its August submission:

> … to retain the consumption step at an effective 175kl per annum (0.4795kl/day) for the first two years of the introduction of quarterly pricing in order to allow customers to understand the pricing implications and to provide time to adjust to the new arrangements.[47]

Unmetered properties

The Commission is seeking feedback on its proposed alteration to billing arrangements for flats. This would involve "moving to a similar approach to that used for strata title home units, whereby metered consumption is used to determine bills."[48] Presently, flats are charged according to a deemed consumption rate of 175 kilolitres per annum.

In proposing changes to the charging of flats, the Commission would need to consider the requirement to change ACTEW's billing systems and conduct consultation with affected customers. Providing this can be achieved within the necessary timeframes, such a change could be implemented for the next regulatory period.

Any side constraint determined by the Commission for the next regulatory period would also need to allow for the potential impacts of this change. Over the current price path, the introduction of a volumetric charge for flats would not have been possible as some customers' bills would potentially have been outside the side constraint set by the Commission.

Seasonal tariffs

ACTEW notes that the Commission agrees there is not a strong case for the introduction of seasonal tariffs in the ACT.

As stated in its August submission, ACTEW believes that any costs that are driven by seasonal factors are minor and would not outweigh the costs of implementing a seasonal pricing scheme. This finding is supported by a Dixon and Baker study into seasonal pricing quoted in a report by the Industry Commission, which stated that "the cost differential of providing winter and summer water for Melbourne is only 5 cents/kl" and that implementing seasonal pricing would result in an increase in costs.[49]

As stated in ACTEW's August submission, and noted by the Commission in its draft decision, the daily allocation of the price step threshold that would occur under daily

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[47] ACTEW 2003b, p 18.

[48] ICRC 2003, p 172.

[49] Industry Commission 1992, p 68.

pricing will discourage seasonal peaks in consumption. Therefore, the introduction of daily pricing will achieve the key objective of seasonal pricing.

Concessions

In its draft report, the Commission has recommended a review of concession arrangements in the ACT.

A change in tariff structure may require a review of the concessions offered by the ACT Government in order to compensate certain groups of customers. However, with reference to the Commission's proposal that the "Government should give consideration to changing the eligibility requirements such that home ownership is not a prerequisite to receiving a concession rebate",[50] the Commission must take into account that it is the owner of a property who bears the liability for water and wastewater charges. This is provided for under section 94 of the *Utilities Act 2000* which states:

> (1) The owner of land where water is supplied under a standard customer contract is liable for an amount payable by the customer under the contract.
>
> (2) The owner of land where sewerage services are provided under a standard customer contract is liable for an amount payable by the customer under the contract.

As water and wastewater concessions are passed through to customers via the bill, it would not be possible to provide a rebate to persons who are not homeowners.

7.2 Structure of wastewater tariffs

ACTEW notes the Commission's support of a proposed review of the fixtures based charge for wastewater. As proposed in its August submission, during the early stages of the next price path ACTEW will focus on gathering information and consulting with its customers. During this time the fixtures based charge would be retained.

The Commission has stated that it:

> ... will seek additional information from ACTEW identifying the cross-subsidy between residential and non-residential consumers of wastewater services in the ACT and how ACTEW intends to address this cross-subsidy, given the revenue settings in this draft price direction.

A report by the Centre for International Economics (CIE) into charging options for wastewater in the ACT found that the cost contribution per residential customer is between $386 and $393. This is about 14 per cent higher than the sewerage charge currently applied to these customers, which suggests that the residential sector is supported, to a small extent, by the non-residential sector.[51]

As stated in its August submission, ACTEW proposes to:

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[50] ICRC 2003, p 193.

[51] CIE 2003, p 44.

> ... review this finding closely and, if it is appropriate, to impose a managed increase in the sewerage charge to residential customers by at least ten per cent to better allocate costs from a pricing perspective.[52]

ACTEW is currently reviewing the CIE report finding in detail and will inform the Commission of the outcome. If it is found to be appropriate, ACTEW will increase the residential wastewater charge by at least ten per cent over the period of the new price path (two to three per cent each year) before making adjustments to wastewater prices in line with the price path.

7.3 Trade waste

The Commission has stated that it "supports ACTEW's proposed review into whether a trade waste tariff will produce improvements in allocative efficiency and expects to be kept informed with the progress and outcomes of this review".[53]

The Commission has encouraged ACTEW to continue negotiating trade waste charges with consumers and has stated that where the additional treatment or maintenance costs imposed by trade waste are material, "these higher costs should be passed through to the relevant customers".[54] ACTEW intends to use the cost information gathered throughout the first two years of the price direction in negotiating cost reflective trade waste charges with consumers, and it appears that the Commission would be supportive of this approach.

In response to ACTEW's request that the Commission establish the contestability of trade waste services, the Commission has stated, "it does not intend to formally deem trade waste services to be contestable or otherwise".[55] However, the Commission has stated that trade waste services will be indirectly regulated in that the costs of providing this service will form part of the revenue requirement, but the revenue generated will be excluded from the calculation of the revenue cap.[56]

ACTEW supports the Commission's foreshadowed *light-handed* approach to regulating prices for trade waste services.

7.4 Side constraints

The Commission has stated that it "would like to avoid using side constraints if at all possible, as they have the potential to create anomalies in the tariff structure."[57] ACTEW agrees with the Commission and, points out, in addition, that side constraints could potentially hinder efforts to adapt the tariff structure "to suit the particular circumstances faced by ACTEW and the ACT community."[58] For example, a side constraint similar to that used for the current price path might prevent the

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52 ACTEW 2003b, p 29. Prices would be subject to further adjustments in line with the proposed price path.

53 ICRC 2003, p xxxiii.

54 ICRC 2003, p 172.

55 ICRC 2003, p 171.

56 ICRC 2003, p xiv.

57 ICRC 2003, p 175.

58 ICRC 2003, p xxvii.

implementation of aggressive demand management options, daily pricing or any possible move to charging flats by volume.

Implications of the Water Abstraction Charge

The Commission released the final report of its review into the ACT's Water Abstraction Charge (WAC) in October 2003. The review was conducted under a separate part of the terms of reference for the water and wastewater review. The final report presented the Commission's advice on the appropriate level for the WAC, as well as on an appropriate methodology for the calculation of the charge in future years. The Commission's decision on the WAC also has the potential to impact on the formulation of side constraints on water prices.

In its WAC final report, the Commission agreed with ACTEW's August 2003 proposal regarding the interaction between the water abstraction charge and side constraints, stating, "the WAC should sit outside of any side constraints applied by the Commission to general prices for water and wastewater services through its price direction process".[59]

Importantly, however, the Commission has rejected ACTEW's proposal to pass-through the effects of the WAC on ACTEW revenue. The Commission notes, "that the WAC may have some implication for demand,"[60] but believes that "the change can be taken into account in the forecasts of demand provided in the annual tariff review (if the second option discussed in Section 8.6 is adopted)."[61] This option would require ACTEW to base its revenue forecasts on 'fresh' demand forecasts each year. Should this approach be adopted, then the current side constraint, "… for the same level and pattern of consumption of water",[62] would clearly need to be amended to accommodate revised demand forecasts each year.

As discussed in section 8.3.4 below, ACTEW believes that the use of an indicative typical year is the most appropriate method for forecasting demand for water each year. Although the Commission discusses this as an option, it has not proposed how the impact of the WAC on ACTEW's revenue would be addressed in the event that this approach is adopted.

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[59] ICRC 2003, p 11.

[60] ICRC 2003, p 143.

[61] ICRC 2003, p 144.

[62] IPARC 1999, Appendix 1.

8 Other regulatory issues

8.1 Cost pass-through

ACTEW's experience in the current regulatory period has highlighted the significant risk it faces as a result of unexpected increases in costs outside of its control. Cost increases of this type have included the costs of complying with changes in legislative and regulatory requirements, as well as sharply increased insurance costs.

ACTEW proposed in its earlier submissions to the Commission that this risk would be most appropriately addressed by the adoption of a cost pass-through mechanism. ACTEW's August submission proposed that pass-through arrangements be put in place for the following four categories of events:

- A change in taxes event;
- A service standard event;
- An insurance event; and
- An unforeseen external event.

These pass-through items relate to external events beyond ACTEW's control, which result in a material change in the costs incurred by ACTEW.

In its draft decision, the Commission has accepted the concept of the inclusion of pass-through mechanisms in the regulatory regime. However, it proposes to limit pass-through arrangements to the following events:

- Changes in taxes;
- Terrorism and major natural disasters;
- A subvention payment event: and
- An augmentation event.

The Commission also proposes to introduce a materiality threshold of $1.5 million in any one year relating to cost pass-through.

The Commission's draft decision in relation to pass-through arrangements is much stricter than the arrangements allowed by other regulators for comparable utility businesses. The Commission rejected pass-through arrangements for service standard events and insurance events. Both of these types of event have been recognised as allowed pass-through events by other regulators. In addition, the Commission's proposed materiality threshold is substantially higher than that adopted by other regulators, requiring ACTEW to carry increased risk, although this is not compensated by a higher WACC.

The Commission has argued that cost pass-through provisions are not consistent with the proposed length of the regulatory period, which, at four years rather than five, reduces the risk of unanticipated events. However, in the event that the Commission's proposal for a four-year regulatory period were to be adopted in its final decision, ACTEW sees no reason why this should prove incompatible with a cost pass-through regime. Where additional costs have been foreseen by ACTEW they have been included in cost forecasts. Pass-through events are designed to remove the risk of major unforeseen events. If none of these events occurs within the four years, then a pass-through event would simply not be activated.

8.1.1 Service standard events

The electricity distribution business in South Australia and the gas distribution businesses in Victoria have pass-through provisions to address the costs associated with mandatory changes in service standards. The ACCC has also recognised the risk that regulated businesses face as a result of changes in external requirements that impact the number or scope of service standard requirements.[63]

The Commission's rationale for not allowing service standard events is firstly that ACTEW would only have to bear any higher costs until the end of the regulatory period and, secondly, that changes in service standards are likely to be known well in advance of coming into effect.[64]

Cost pass-through arrangements are proposed precisely to deal with changes in costs that occur *during* the regulatory period. ACTEW therefore considers that the Commission's first point is out of place in this context. The Commission acknowledges that ACTEW will face a risk from external cost changes during the regulatory period, but then uses this to argue that there is no need to introduce a pass-through arrangement to mitigate this risk.

ACTEW also disputes the Commission's assertion that regulatory and service standard changes that impose external costs will always be known in advance. ACTEW's experience in the current period has been that such changes in external service standards have occurred during the regulatory period. Specifically, changes in costs have resulted from the *Utilities Act 2000*; the *Public Health Act 1997*; annual drinking water licensing fee; the *Water Resources Act 1998*; and compliance with Occupational Health and Safety standards. Moreover, to the extent that changes in service standards are known well in advance, and are incorporated into the expenditure projections at the start of the regulatory period, they would not then be subject to a pass-through application. In these cases, a cost pass-through provision for service standard events would simply not be used.

ACTEW continues to believe that the Commission should allow a pass-through for service standard events, consistent with the practice of other regulators. If the Commission excludes service standard events, ACTEW would require an increase in the WACC it receives as a result, to compensate it for the additional risk borne.

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[63] See ACCC 2002b, pp 81-85.

[64] ICRC 2003, pp 116-117.

8.1.2 Insurance events

Provisions for the pass-through of unexpected changes in insurance costs have been incorporated into pass-through arrangements approved by the ACCC for SPI PowerNet, GasNet, Powerlink and Murraylink.

The Commission's rationale for the exclusion of insurance events as a pass-through category is that it considers that given recent increases in insurance premiums, the potential for further increases is probably less than it has been in the current period.[65] ACTEW does not find this a compelling argument for excluding insurance events as a pass-through category. If insurance premiums do not rise materially from forecast levels in future, then the pass-through provision would not be activated. If they do change materially, then the proposed pass-through provisions would address the risk this imposes for the business.

The Commission expressed concern that allowing pass-throughs for external insurance costs may distort ACTEW's decisions regarding whether to seek external insurance or to self-insure. However, this is not problematic in ACTEW's proposed definition of insurance events, which clearly relates such events to external drivers, such as the *non-availability* of insurance.

ACTEW therefore continues to believe that the Commission should allow insurance events as a category of cost pass-through. If the Commission excludes insurance events then ACTEW will require an increase in the WACC it receives as a result, in order to compensate it for the additional risk it would bear.

8.1.3 Materiality threshold

ACTEW proposed that cost pass-through events should be triggered by material changes in costs that fall within the scope of the pass-through categories.

The Commission has proposed an explicit materiality threshold of $1.5 million in any one year. ACTEW notes that no other regulator allowing cost pass-through provisions has adopted an explicit threshold. Indeed, the Essential Services Commission in Victoria (ESCV) explicitly rejected the concept of specifying a value for the materiality threshold.

> … the [ESCV] believes that the current statement of materiality is sufficient … and that it is not necessary or desirable to specify a threshold amount as part of the definition of a [pass-through] amount.[66]

Rather, regulators have referred to *material* changes and have defined materiality as being when the cost of the event outweighs the administrative costs associated with evaluating the pass-through application.[67] The $1.5 million threshold proposed by the Commission is clearly significantly above the administrative costs that would be associated with the pass-through application.

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[65] ICRC 2003, p 117.

[66] ESCV 2002, p 234.

[67] ESCV 2002, p 234.

Setting the materiality threshold at $1.5 million per annum means that ACTEW will continue to bear the risk associated with external cost changes below this level. ACTEW will therefore need to be compensated for bearing this risk via an increase in the rate of return it receives. If the Commission still sees merit in setting a material threshold for cost pass-throughs, ACTEW believes that it should be no higher than $0.5 million per event per year.

8.2 Term of the regulatory period

The Commission proposes to shorten the next regulatory period to only four years because of what it sees as uncertainties impacting on medium-term water usage; fluidity in ACTEW's longer term operating and capital expenditure projections; the potential for a major new water source; and to separate the timing of the water and wastewater review from the electricity distribution price review.

There is a trend amongst regulatory bodies to do as the Commission did in its current price direction and utilise a five-year regulatory period in order to provide a level of regulatory certainty and to ensure a minimum period for incentives to become effective.

In order to achieve efficiency gains, the regulatory control period must be long enough for management initiatives to be implemented and take effect.

In terms of incentives more generally, the longer the business is able to retain the benefits of increased efficiency through higher profits, the greater the incentive to pursue those initiatives.

ACTEW believes that five years is the appropriate regulatory period.

The significant cost associated with a detailed distribution price review process is also a key consideration. Such costs can be very significant both for the regulated business and the regulator. Where the regulatory regime is soundly based there are unlikely to be significant net benefits from having a short review period and undertaking a fresh, comprehensive review. In addition, the form of regulation of water and wastewater in the ACT, as confirmed in the Commission's draft decision (a average revenue cap on a per property basis) minimises the potential for a decoupling of revenues and costs which would be accentuated over a longer regulatory period in other jurisdictions.

The Commission's assertion of fluid and uncertain circumstances is inconsistent with its watering-down of ACTEW's proposed cost pass-through provisions. Approving these provisions in full as to their extent and materiality, in line with regulatory decisions in other jurisdictions, would address concerns about uncertainty without having to resort to a shortening of the regulatory period, with the consequent loss of incentive for efficiency.

Administrative convenience should not alone, or even primarily, form the rationale for reducing the regulatory period. ACTEW also contends the commencement of new national regulatory arrangements for energy will remove the impact of sectoral overlap from the Commission.

8.3 Form of regulation

8.3.1 Miscellaneous fees and charges

The method of regulating miscellaneous fees and charges proposed in the Commission's draft decision does not provide ACTEW with any incentive to provide the services for which these fees are charged. Under the proposed form of regulation, ACTEW's revenue is unaffected by whether or not it provides these services while it must incur additional costs to provide them.

ACTEW proposes that, in order to alleviate this problem, miscellaneous fees should be tied to a standard number of service deliveries rather than to the number of service deliveries in the previous year.

8.3.2 Consumer price index

The Commission indicated that the consumer price index (CPI) figure that it will use for the calculation of prices would be the "All groups index number for the weighted average of eight capital cities as published by the Australian Bureau of Statistics".[68]

ACTEW believes that the cost structure relevant to the ACT is the Canberra CPI, and other capital cities' price indices have little or no bearing on its costs. Over the last five years, revenue would have increased 5 per cent more on the Canberra index (15.9 per cent) than they would have on the average capital cities index (15.2 per cent).

ACTEW has also pointed to inconsistencies that should be addressed between the Commission's use of the eight capitals index for pricing and the Canberra index for revenue. The Commission has undertaken to investigate and rectify these inconsistencies.

8.3.3 Setting the average revenue cap

The Commission's draft report details the formula to be used for setting the average revenue cap[69]. ACTEW wishes to point out that sales volumes are not relevant at this stage for setting prices for wastewater services as these prices are currently not tied to volumetric usage. ACTEW therefore assumes that the formula specified relates to water services only.

8.3.4 Demand forecasts for annual compliance

The Commission has stated that it is seeking comments on "the demand forecasting methodology the Commission should employ in determining annual compliance with this price direction."[70]

ACTEW believes that the use of an indicative or typical year is the most appropriate method for forecasting demand for water each year. The Commission has indicated

[68] ICRC 2003, p 97.

[69] ICRC 2003, p137.

[70] ICRC 2003, p 138.

that ACTEW will need to provide proposed tariffs to the Commission by 1 March each year. Therefore demand forecasts will be developed during January and February prior to the beginning of the financial year. Water consumption in a particular financial year will be highly dependent on climate, which cannot be forecast with sufficient accuracy at that point in time. As climate factors are the biggest impacts on demand, ACTEW does not see the merit in providing updated forecasts each year and prefers to use an indicative year adjusted for certain factors for its forecasting purposes.

ACTEW disagrees with the Commission's assertion that this methodology "may not be able to cater for changes in the tariff structure, nor reflect changes in consumer behaviour over time or short term issues such as water restrictions or changes in the level of the Water Abstraction Charge (WAC)."[71] For some time, ACTEW has used its estimate of the elasticity of demand for water to update its indicative consumption profile for changes in tariff structure and the level of prices including the WAC. ACTEW would continue to do this in addition to regularly reviewing the indicative consumption year in order to take account of changes in consumer behaviour over time.

ACTEW does not believe that presetting the relative share of sales volumes falling into each band is practical. This could potentially hinder efforts at tariff reform "to suit the particular circumstances faced by ACTEW and the ACT community"[72] by essentially determining, from year to year, the level of any price step thresholds. ACTEW believes that the level of price step thresholds should be tied to pricing principles, not dictated by a constraint such as this. Potentially, as the indicative consumption profile is updated each year, the level of any price step thresholds may become volatile. This would send inconsistent price signals and cause confusion amongst customers.

ACTEW believes that the second approach outlined by the Commission would essentially involve the same forecasting methodology as the first approach, but would involve a more heavy-handed involvement by the Commission. As noted by the Commission, this approach would be more costly for both parties. ACTEW believes that these additional costs are unnecessary, and that they significantly outweigh any benefits of this approach.

8.4 Reset principles and incentive regulation

8.4.1 Benefit sharing

ACTEW notes the Commission's position of support in principle for the introduction of an efficiency carryover mechanism that would apply to efficiency gains in the next regulatory period.

ACTEW would be pleased to work with the Commission to determine the appropriate form of efficiency carryover mechanism to be applied in the ACT. ACTEW supports

[71] ICRC 2003, p 138.

[72] ICRC 2003, p xxvii.

the Commission's view that it is essential for arrangements for efficiency sharing to be established before, or as early as possible within, the regulatory period in question, so that both the regulator and the business know the rules that will apply. This will have the maximum impact on business incentives, whilst ensuring that any benefit sharing mechanism is not applied retrospectively.

8.4.2 S-factors

The Commission states in its draft decision that it will work with ACTEW and the community during the first year of the next regulatory period to develop the reporting information required for an S-factor. The Commission then intends to review the costs and benefits of introducing an S-factor before confirming its introduction as part of the adjustment mechanism for the regulatory period commencing in 2009.

ACTEW reaffirms its willingness to work closely with the Commission in examining the introduction of an S-factor arrangement.

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