



# Tariff Review 2016

A submission to the Independent  
Competition and Regulatory Commission in  
response to the draft report

28 November 2016

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## Summary of Icon Water's views

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Icon Water is supportive of some of the thinking set out by the Independent Competition and Regulatory Commission (ICRC) in its draft report.

- Icon Water agrees with the views of the ICRC that the water tariff structure is no longer cost-reflective and does not present an accurate price signal to consumers about the costs of using water. Icon Water also agrees that a rebalancing of the fixed and variable components of the water tariff would benefit the community as a whole. At its current level, the Tier 2 usage price provides incentives for large customers to invest in alternative water sources that are more costly than supply by Icon Water (uneconomic bypass). Unless the Tier 2 usage price is reduced and uneconomic bypass is avoided, the overall level of prices will need to increase to spread Icon Water's predominantly fixed costs across lower usage and/or fewer customers.
- Icon Water agrees that a long transition period of up to ten years should apply to any significant tariff structure reform.
- Icon Water agrees with the finding that pricing reform for sewerage services should focus on the introduction of a trade waste charging regime, since the current tariff structure is not reflective of the costs imposed by discharge of liquid trade waste.

However, Icon Water is concerned about the extent of rebalancing in the water tariff structure proposed by the ICRC. Evidence from our community engagement to date indicates a majority of residential customers are opposed to rebalancing to that extent. Discussion with our Community Consultative Forum has suggested that view is driven by concerns over water security, environmental impacts, impacts on low-income households and fairness. While some of these concerns may be unfounded, Icon Water's view is that concerns over fairness are a valid consideration in the tariff setting process.

Consideration should be given to alternative tariff structures that would be considered fairer by the community. These alternatives could include:

- separate residential and non-residential fixed supply charges
- supply charges that vary according to customer characteristics, such as meter size
- setting the usage price above marginal cost.

## Introduction

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This submission presents Icon Water's response to the Independent Competition and Regulatory Commission (ICRC) draft report on its review of tariff structures for water and sewerage services in the ACT.

The ICRC has set Icon Water's tariff structures since 2004. Over that time, the water tariff structure has changed substantially. The top tier usage price has increased by roughly 400 per cent since 2004, while the fixed supply charge has decreased. As a result, the cost of the major water security investments undertaken during the Millennium Drought has been borne by larger users.

The last substantive review of Icon Water's water and sewerage tariff structures was undertaken in the midst of the Millennium Drought in 2007 as part of the 2008-13 price investigation process. The region's water security situation has changed dramatically since that time and a review of tariff structures is certainly warranted.

Icon Water made submissions in response to the ICRC's issues paper and technical papers on 4 January 2016 and 14 July 2016. This submission builds on the views and evidence provided in those earlier submissions. Icon Water is continuing to engage with the community on tariff structure issues and will be guided by the outcomes of this tariff structure review when developing its regulatory proposal for the period commencing 1 July 2018, which is expected to be due for submission to the ICRC in mid-2017.

## ICRC draft report

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The ICRC's Draft Report indicates a preference for a substantial rebalancing of the fixed and usage components of the water tariff. The ICRC's preferred option would involve a 10-year transition to a lower usage price, aligned with long-run marginal cost (LRMC), currently estimated at \$1.74 per kilolitre, and a higher fixed supply charge around \$600 per year. In relation to sewerage tariff structures, the ICRC's preference is to limit changes to the introduction of a trade waste charging regime. The report also stated the ICRC's preference for a revenue cap form of control under which Icon Water would develop tariff proposals subject to principles set by the ICRC.

### The ICRC's draft assessment framework

The ICRC's draft assessment framework for developing the alternative tariff structure comprises an objective and nine pricing principles (see Table 1).

**Table 1: Draft assessment framework used in the Draft 2016 Tariff Review report**<sup>1</sup>

#### **Economic efficiency**

*Economic regulation objective: To promote the efficient investment in, and efficient operation and use of regulated services for the long term interests of consumers in relation to the price, quality, safety, reliability and security of the service.*

*Pricing principle 1: Tariff structures and prices should promote the economically efficient use of Icon Water's water and sewerage services infrastructure, and in the case of water should also encourage economically efficient use of the water resource.*

*Pricing principle 2: Any change from an existing to a more efficient tariff structure should only be undertaken if the efficiency benefits are greater than the costs of the change.*

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<sup>1</sup> ICRC 2016 Regulated water and sewerage services, Tariff Review 2016: Draft report, Report 5 of 2016, September 2016, p.xxi.

*Pricing principle 3: For each tariff class, prices should lie on or between an upper bound reflecting the stand-alone cost of serving customers in that class and a lower bound reflecting the avoidable cost of not serving those customers.*

### **Financial viability**

*Pricing principle 4: Tariff structures and prices should reflect the full recovery of the prudent and efficient costs of providing regulated water and sewerage services to ensure business viability.*

*Pricing principle 5: Tariff structures and prices should facilitate the recovery of Icon Water's allowed revenue over the regulatory period.*

### **Community impact**

*Pricing principle 6: Tariff structures should be robust enough to promote the economically efficient use of Icon Water's water and sewerage services infrastructure over a reasonable period of time.*

*Pricing principle 7: Any change to the structure of tariffs and prices that will have substantial customer impacts should be phased in over a transition period to allow customers reasonable time to adjust to the change.*

*Pricing principle 8: Tariff structures should be simple for customers to understand and straightforward for the utility to implement.*

*Pricing principle 9: Tariffs should be set using a transparent methodology and subject to public consultation and scrutiny.*

This assessment framework incorporates an updated economic objective that aligns with recent amendments to the ICRC Act.<sup>2</sup> It is important to recognise that the ICRC has adopted a conventional interpretation of economic efficiency, which is concerned with total welfare and effectively places an equal weighting on the outcomes for each individual.<sup>3</sup> This interpretation is useful because it allows objective analysis of efficiency to be separated from ethical value judgements about fairness. Those types of value judgement are captured in the assessment framework under a separate stream of pricing principles relating to community impacts. The ICRC's principles cover issues of stability, gradual implementation, simplicity and transparency, but they do not explicitly cover issues of fairness or affordability of the long-term goal for tariff structures.

### **The draft report in a national context**

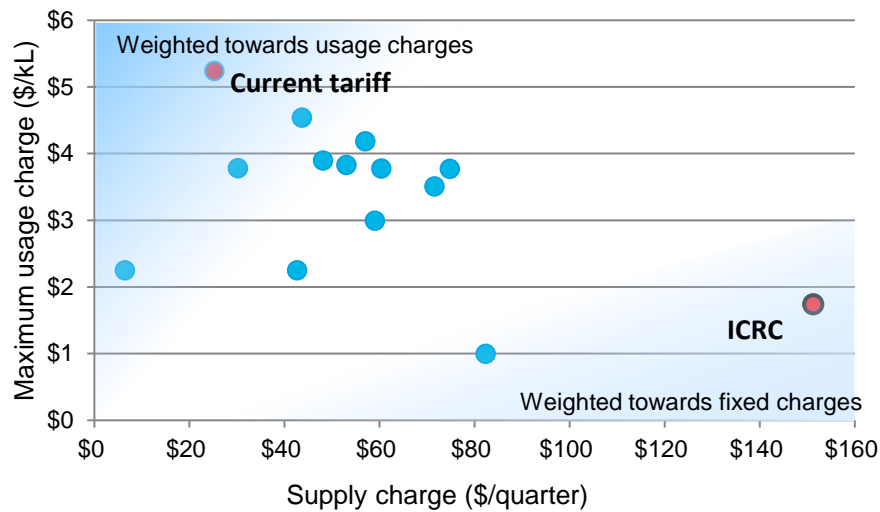
Among major Australian water utilities with more than 100,000 customers, Icon Water's top tier water usage price is the highest, while our fixed supply charge is the second lowest. Some rebalancing of Icon Water's charges towards higher fixed charges and lower usage charges would be consistent with pricing structures used by other major utilities in Australia. Figure 1 shows that, for residential customers, the ICRC's preferred water tariff structure would re-position Icon Water at the other extreme as the utility with water tariffs most weighted towards fixed charges.

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<sup>2</sup> Section 19L of the *Independent Competition and Regulatory Commission Act 1997*.

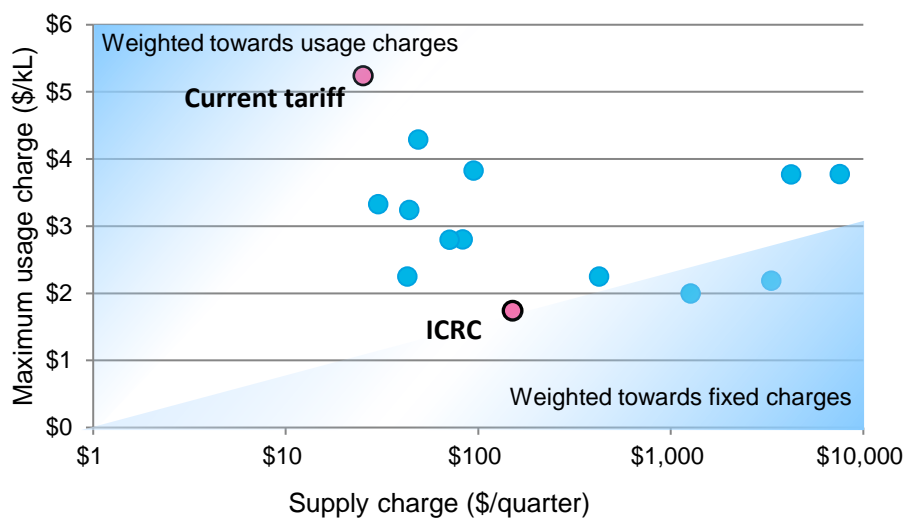
<sup>3</sup> For example, Harberger, A. C 1971 Three Basic Postulates for Applied Welfare Economics: An Interpretive Essay, *Journal of Economic Literature*, Vol. 9, No. 3 (Sep., 1971), pp. 785-797.

**Figure 1: Balance between fixed and variable charges for residential customers - major water utilities**



The majority of the largest water utilities in Australia have separate residential and commercial charges, and many of these large water utilities have supply charges based on meter size for non-residential customers. Figure 2 illustrates that Icon Water has the lowest supply charge and the highest top tier usage charge for non-residential customers. The balance between usage and supply charges in the ICRC’s draft preferred tariff structure would be within the range applied at other major water utilities.

**Figure 2: Balance between fixed and variable charges for large non-residential customers - major water utilities**



## Icon Water’s response

### Water tariffs

As noted in our past submissions, Icon Water agrees that current price signals are not cost-reflective and that some re-weighting would be warranted. At its current level, the Tier 2 usage price provides incentives for large customers to invest in alternative water sources that are more costly than supply by Icon Water (uneconomic bypass). Icon Water believes that the role of tariff structures in discouraging uneconomic bypass represents a key issue requiring attention in this review.

Uneconomic bypass would lead to higher water prices as Icon Water's predominantly fixed costs are spread across less usage and/or fewer customers. To provide a sense of the potential order of magnitude, prices would need to increase by around 11 per cent to maintain cost recovery if the ten largest consumers no longer sourced water from the primary network. Icon Water has already expressed the view to the ICRC that the Tier 2 charge needs to be reduced to discourage this bypass, at least for non-residential customers, while maintaining full cost recovery.

Icon Water also agrees that a transition of up to ten years would be needed for any tariff rebalancing, depending on the extent of the reform. Community views expressed through Icon Water's engagement activities are supportive of a gradual transition. However, the community is less supportive of the ICRC's preferred long-term goal (i.e. the end point of the 10-year transition discussed above).

#### Community views on the long-term goal

Icon Water's recent community engagement activities include an online survey held in May-June 2016 (the results of which were reported in Icon Water's submission to the ICRC of 14 July 2016) and three meetings of the Community Consultative Forum (CCF) held in May, August, and October 2016. The most recent two meetings have focused almost solely on tariff structure issues.

The CCF is still in the process of assessing information and consulting with the groups it represents on what is a complex issue. Ongoing feedback from the group will be received in advance of Icon Water's submission to the broader 2018 price review process. Based on discussions in the meetings to this point, it is clear there is a spectrum of views in the community.

Both the survey and CCF discussions have indicated a preference for having separate tariffs for residential and non-residential customers. While there is a willingness to accept some rebalancing of fixed and usage charges, there is significant resistance to rebalancing to the extent preferred by the ICRC in its draft report. This view appears to be driven by a number of factors, including:

- water security
- environmental impacts
- impacts on low-income households
- fairness.

The CCF is supportive of potable water conservation for a variety of reasons, including, but not limited to, water security and environmental sustainability concerns.

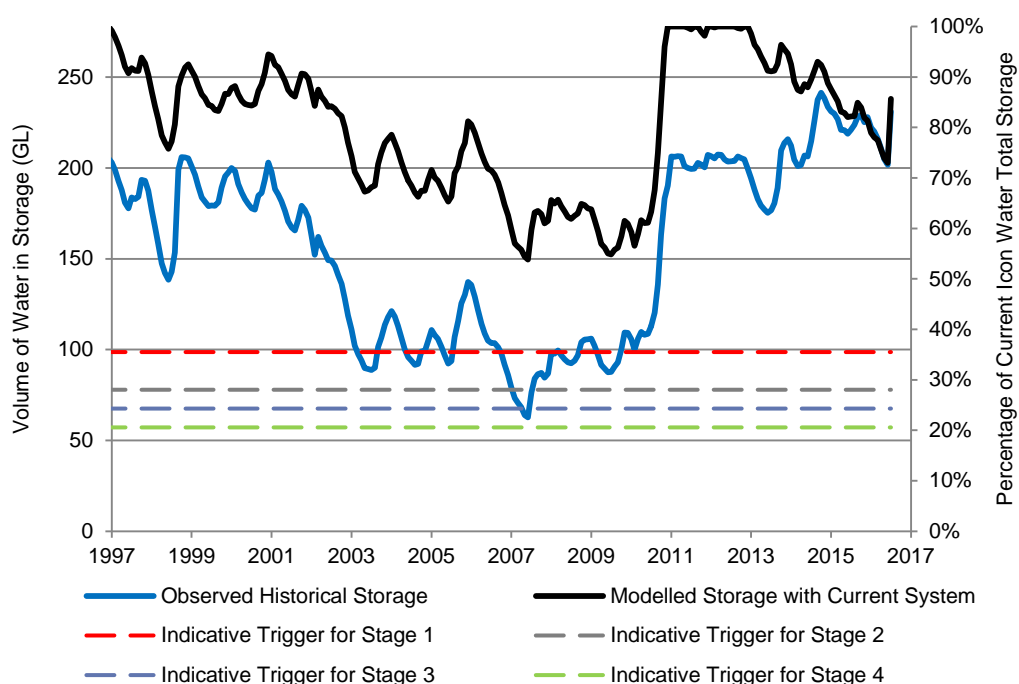
#### Icon Water consideration of community views

Icon Water remains engaged in a discussion with the community on the concerns listed above. The following section outlines our current thinking in relation to the implications of these concerns for the tariff structure.

#### *Water security*

The ACT has strong water security. There is more water in storage now than at any time in our history, with all of Icon Water's dams, including the new Enlarged Cotter Dam, at 100 per cent storage levels. Future investments required to meet the ACT Government standard of 1/20 years under water restrictions are at least 20 and probably more than 40 years in the future. Icon Water modelling shows that, if the Millennium Drought happened again now, water storage levels would not fall below 50 per cent and, based on current trigger levels, temporary water restrictions would not be imposed (see Figure 3).

**Figure 3: Water security – Scenario modelling results for water storage**



Icon Water’s view is that water security concerns are taken into account in the estimated LRMC and, as long as the usage price is set at LRMC or higher, there is no reason to be concerned about the influence of price on water security.

*Environmental impacts*

Water use can have positive environmental benefits. The use of water to improve vegetation and ground cover in the urban landscape reduces the potential for erosion and sedimentation to cause turbidity and pollution of waterways. This in turn leads to improved water quality and amenity for the community. It also improves Canberra’s bushfire resilience.

Icon Water’s responsibility for urban water management extends to strict environmental flow requirements, which safeguard river health. During 2015–16, Icon Water released a total of 36 gigalitres from the Cotter Dam into the Murrumbidgee River and 75 gigalitres from Googong Dam into the Queanbeyan/Molonglo Rivers in environmental flows. Icon Water releases more environmental flows from its dams than it abstracts for water supply to the community. These flows take place regardless of the structure of tariffs or the level of water usage.

It is also important to consider the environmental impacts of the alternative non-potable water sources that large customers will increasingly seek unless the current Tier 2 usage price is reduced. Large water users adopting alternative sources are unlikely to fully manage or cover the costs of environmental impacts, including on lake water quality.

Icon Water’s view is that any net environmental costs of urban water use are already reflected in the Water Abstraction Charge, which forms part of LRMC.

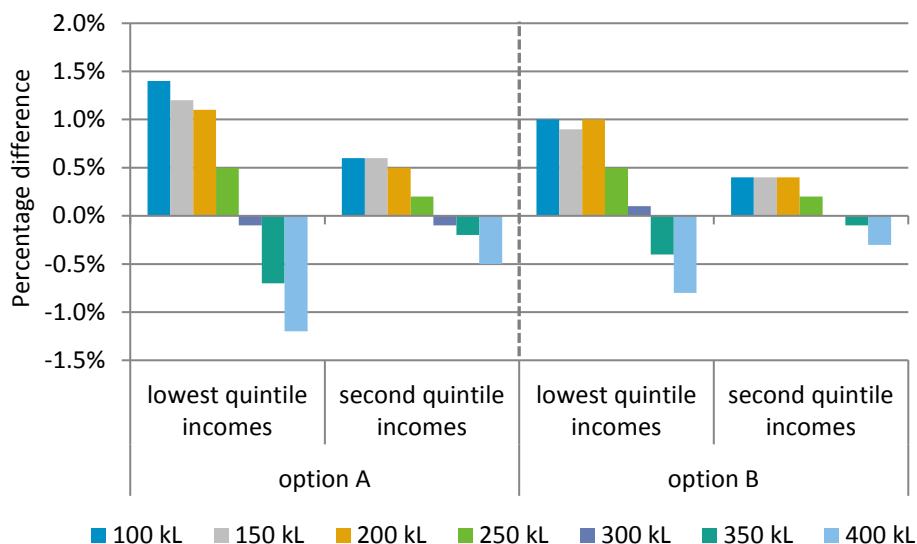
*Impacts on low-income households*

Customers holding pensioner, Healthcare card, or life support concessions are identified in Icon Water’s billing data as *Utilities Concession* customers. As outlined in our submission of 14 July 2016, around 40 per cent of *Utilities Concession* customers use more than 200 kilolitres annually and pay the Tier 2 water usage price. There are just as many *Utilities Concession* customers using more than 200 kilolitres per year as there are using less than 150 kilolitres per year. The consumption patterns of this group of customers are very similar to those of other residential customers.



Around 85 per cent of Utilities Concession customers use less than 300 kilolitres and would be worse off under the ICRC's preferred tariff structure. The bill increase as a proportion of income would be in excess of 1.0 per cent for small users in the lowest income quintile (see Figure 4). For small users in the second income quintile, the bill increase would represent around 0.5 per cent of their income. Larger users would not be adversely affected.

**Figure 4: Water and sewerage bill as a percentage of income – percentage difference of Option A and Option B from the 2016/17 tariff**



Notes: Water and sewerage bill as percentage of lowest quintile (\$29,588 pa) and of second quintile (\$70,928 pa) of gross household income.

Source: ABS Statistics, 6523.0.

Icon Water's view is that the impact on low-income households is a valid consideration and notes that concession arrangements are a better-targeted tool than the water tariff structure for managing these impacts.

*Fairness*

A usage charge set at LRMC would cover roughly 40 per cent of Icon Water's revenue requirement. Under the ICRC's draft preferred tariff structure, the residual costs, which make up roughly 60 per cent of the revenue requirement, would be recovered as an equal amount from each customer. A large commercial swimming pool would make the same contribution to residual costs as a small household.

Icon Water's view is that fairness is a valid concern that should be taken into account when setting tariffs – not only in relation to the transition path, but also in relation to the long-term goal.

Icon Water's view on water tariffs

Consideration needs to be given to alternative ways of sharing residual costs, whilst ensuring there is no economic cross-subsidy (that is, ensuring individual customer bills are between avoidable and standalone cost in accordance with the ICRC's Pricing Principle 3). These alternatives could include one or more of:

- separate residential and non-residential fixed supply charges
- supply charges that vary according to customer characteristics, such as meter size
- setting the usage price above marginal cost.

Varying arrangements for supply charges would be the preferred approach, given it would minimize distortion of consumption decisions. However, the extent to which residual costs can be shared on the basis of customer characteristics other than usage is limited and consideration may need to be given to

setting the usage price above marginal cost, particularly given the community view appears to be that usage is the fairest way of sharing residual costs. This consideration need not be considered a trade-off between equity and economic efficiency objectives. It could be considered part of the social welfare approach the ICRC has indicated it intends to take,<sup>4</sup> if the weight placed on individual welfare is assumed to vary over individuals or if individuals are assumed to hold preferences about equity.<sup>5</sup>

### **Sewerage tariffs**

Icon Water agrees with the ICRC finding that pricing reform for sewerage services should focus on the introduction of a trade waste charging regime. There would be limited economic efficiency benefits from introducing a sewerage usage charge, but there may be significant impacts on individual customer bills.

A charging regime for liquid trade waste, in contrast, is likely to improve economic efficiency by signaling the costs imposed by trade waste and providing an incentive for customers to undertake pre-treatment where it would reduce overall costs. This may help avoid sewer blockages, premature network degradation (reduced asset lives), sewer collapse and workplace safety risks. The detail of the scheme, including transition arrangements, will need to be developed in consultation with customers and other stakeholders.

### **Price setting arrangements**

In the Draft Report, the ICRC has stated a preference for a revenue cap control mechanism, where Icon Water would set tariffs subject to principles and, potentially, constraints set by the ICRC<sup>6</sup>. Icon Water remains keen to resolve the issue of form of regulation at the earliest possible stage, but notes that careful consideration will need to be given to this issue as part of the broader 2018 price review, taking account of a range of matters including 'unders and overs' mechanisms, constraints on annual price changes, annual compliance processes, the role of customer engagement, and demand forecasting arrangements.

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<sup>4</sup> ICRC 2016, *Draft report Tariff Review 2016 Regulated water and sewerage services*, Report 5 of 2016, September, p. 8.

<sup>5</sup> For an empirical example, see Scarborough, H & Bennett, J, 2012 *Cost-Benefit Analysis and Distributional Preferences: A Choice Modelling Approach*

<sup>6</sup> ICRC 2016, pp. xxii,16.