Unitywater Submission Long-Term Regulatory Framework and Pricing Principles

Unitywater

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1. Introduction

This submission represents Unitywater's response to the QCA's Long-Term Regulatory Framework (LTRF) and Pricing Principles Position Papers released in February and March 2014 respectively. These papers were prepared pursuant to the Ministers' Direction Notice (the Direction) signed by the Treasurer and Minister for Trade (The Hon Time Nicholls) and the Attorney-General and minister for Justice (the Hon Jarrod Bleijie).

This submission is structured around the following sections:

a. Discussion of the Direction;

b. The role of regulation;

c. Discussion of the LTRF paper:

   i. Regulatory options considered in the LTRF Paper;

   ii. LTRF Paper conclusions and Unitywater views; and

   iii. LTRF Paper recommendations and Unitywater views.

d. Discussion of Pricing Paper:

   i. General issues and relationship of Pricing Paper to LTRF Paper;

   ii. Impact of water supply value chain on pricing;

   iii. Need for cost benefit analysis;

   iv. General comments on Pricing Paper; and

   v. Unitywater response to Pricing Paper Recommendations.

Objective reference: A2347337

2. The Ministers' Direction Notice

Unitywater is of the view that the Direction is potentially subject to divergent interpretation due to the manner in which it is drafted. This issue is also recognised by the QCA with the LTRF Paper noting the lack of definitive guidance provided in the Direction in terms of establishing the appropriate form of regulation. Specifically, that some requirements such as the need to address the treatment of aggregate annual revenue under/over recoveries are associated with direct forms of regulation while other elements such as facilitating the move to more light-handed prices oversight suggest an indirect approach

In interpreting the Direction, Unitywater notes that the Direction is structured around four sections:

a. Referral: a high level direction outlining the broad requirements of the exercise;

b. Conduct: this section is in three parts and outlines:

   i. The over-arching principles that should be considered in developing the framework;

   ii. A list of regulatory parameters for which recommended treatment is to be included; and

   iii. A list of supplementary regulatory objectives to be considered.

c. Consultation: sets out the requirement to consult broadly; and

d. Timetable: sets out the 30 September 2014 date for the QCA to report to the Ministers.

In terms of the QCA interpretation of the Direction, Unitywater notes that in the Executive Summary of the LTRF Paper and Section 1.1 of the Pricing Paper, the QCA lists the objective of the Ministers' Direction Notice as (underlined words have been added by QCA, words in brackets have been deleted from the Direction Notice):

> *…to protect the long term interests of the users of SEQ water and sewerage services by ensuring that the prices of these services reflect prudent and efficient costs, while promoting efficient investment in and the use of these services, having regard to their (service) reliability, safety and security over the long term.*

The LTRF Paper goes on to paraphrase the Direction as requiring a long-term framework which (S3, pg 8):

a. Protects the long-term interest of the users of SEQ water and sewerage services by ensuring the prices of these services reflect prudent and efficient costs having regard to service reliability, safety and security;

b. Ensures appropriate levels of customer engagement, co-ordination with other regulatory processes, promoting whole of sector solutions, and incorporates incentive mechanisms and service quality performance monitoring (including specific information);

c. Assists customers understanding of how the costs of water and sewerage services influence prices;

d. Incorporates aggregate annual revenue under/over-recoveries in relation to core water and sewerage services in a manner that balances the interests of the SEQ entities and their customers;

e. Is administratively cost-effective; and

f. Reflects the risk of misuse of market power and different characteristics and size of the entities.

The QCA is also required to facilitate the transition to more light-handed prices oversight over time.

Unitywater is concerned that in paraphrasing the Direction, the QCA does not mention the requirement at point 1.a) of the Direction that the first principle to be considered in development of the framework should be to:

> *Ensure the costs of implementing the regulatory regime do not exceed the benefits*

Unitywater is of the view that cost/benefit analysis should be central to any consideration of the form and application of regulation or associated reporting requirements.

The use of cost/benefit analysis is critical to any attempt to ensure that government regulation is in the interests of consumers and has a positive net impact on the economy as a whole. The use of cost/benefit analysis in assessing regulation has been endorsed by COAG as being best practice (for example in COAG's 2007 Guide to Best Practice Regulation).

Further, Unitywater is concerned that the QCA paraphrasing of the Direction potentially fails to capture the structure of the Direction, in particular, the priorities which should be considered in developing the framework, for example, Unitywater considers that it is likely that the Ministers' intended the over-arching Principles in Section 1 to have greater priority and therefore weight than the supplementary regulatory objectives required to be considered.

Given the uncertainties over interpretation of the Direction, Unitywater is keen to ensure that the QCA clearly identifies the key economic issues underpinning the drafting of the Direction and that the regulatory processes recommended to be adopted are aligned to addressing the Ministers' likely concerns.

It is Unitywater's view that the Ministers' focus is likely to be the balancing of the costs of regulation with the desire to utilise the QCA's role as an independent economic expert in the price assessment process to address community concerns over the rapid increases in water and sewerage costs. Discussion of the potential issues that are likely to be successfully addressed by economic regulation is provided in the next section.

3. The Role of Regulation

Economic regulation of DRs is costly. For example, the QCA is spending $2.1M on SEQ DR regulation in 2013-14, while the businesses are likely to be spending the same or greater in direct costs with the addition of the unquantified impact of management distraction as significant senior management time is dedicated to understanding and managing the regulatory process. Unitywater considers that the total cost would be in the order of $5M per annum.

As such, the adoption of mandatory economic regulation should only apply in circumstances where there are identified failures compared to the ideal competitive market model and only where cost benefit analysis shows a clear benefit from the imposition of the specific regulatory approach.

It is Unitywater's view that the benefits from economic regulation of infrastructure businesses principally relate to three areas of concern, namely:

a. The primary driver for economic regulation of utility businesses is to ensure no monopoly pricing. Monopoly pricing (ie. where prices are above long run marginal cost not just above an annual MAR), is a problem as it creates economic inefficiency and distorts resource allocation and consumption. In this context, over the period 2010 to 2013 the QCA has undertaken annual reviews of DRs prices/revenues and costs to ascertain whether they were consistent with the QCA estimate of prudent and efficient costs. The QCA found no evidence of monopoly pricing. The QCA also proposed that water retailers would transition to light handed annual performance monitoring based on an assessment against certain criteria and depending on the outcome of the 2013-15 price monitoring investigation. The QCA has completed its Draft Assessment and considers that Unitywater, QUU, Gold Coast Water and Logan Water should immediately transition to long-term annual performance monitoring as from 1 July 2015.

b. A second order concern of economic regulation is to ensure prudent and efficient costs through the operation of an incentive regulation framework. This is only necessary where there are no other factors placing pressure on businesses to improve productivity. In this context, the legal and operating framework under which DRs operate ensures that these businesses do face continuous pressure to increase productivity. This is due to the fact that the DRs owners are in effect the DRs customers (that is, the residents within the relevant local government areas are both customers for the DRs and effective owners of the councils which in turn own the DRs). This alignment between owners and customers also mitigates concern over monopoly pricing as any monopoly profits achieved through charging excessive prices would flow back to the customers by way of participation returns (dividends) to the councils and therefore provision of council services (or reduced rate charges). Unitywater's focus on cost reduction and efficiency improvements is clearly evidenced in Unitywater's Corporate Strategic Plan which identifies the key strategic direction as the focus on those parts of Unitywater's value chain that drive down the 'total cost to serve customers' through: economies of scale; efficiencies in allocation of capital and other resources; and efficiencies in asset management and business processes. See **Appendix 1** for further discussion of the impact of ownership and operating structure on the incentive and ability to misuse monopoly power.

c. Another argument often used to support the application of regulation is that the regulator can act as an independent umpire providing information to consumers on the reasonableness of prices and service quality for utility services (especially in the face of concerns over increasing real utility charges as is occurring at present). However, relying on the regulator for this purpose is both inefficient (expensive and duplicating other activities) and generally unsatisfactory given the limitations of the regulators role and the information asymmetry between the businesses professional managers and economic regulators with limited knowledge of the business. This issue can be addressed more efficiently simply by all parties in the water and waste water value chain working together to provide a consistent and well-structured message on the cost elements of service provision and factors leading to price rises (including noting the role of return on investment in underpinning the provision of other council services). To the extent necessary this could include commissioning occasional independent assessment of the reasonableness of proposed prices.

On the basis of the above discussion, it is Unitywater's view that it is likely that the Ministers' focus is the balancing of the costs of regulation with the desire to utilise the QCA's role as an independent economic expert in the price assessment process to address community concerns over the rapid increases in water and sewerage costs. Therefore, any process implemented by the QCA should focus on achievement of this outcome.

4. Long Term Regulatory Framework Paper

This section of Unitywater's Submission specifically addresses the LTRF Paper.

4.1. Regulatory Options

Unitywater is concerned that the application of economic regulation through extensive reporting requirements risks creating onerous data acquisition, analysis, reporting and information requirements for DRs that cannot be justified in terms of economic cost benefit. As such, any consideration of the preferred long-term regulatory framework needs to consider all potential options. In this context, Unitywater considers that the potential regulatory options cover the continuum from self-regulation through some form of prices oversight to highly intrusive regulation, such as cost-of service price setting regulation. Moving along this continuum away from self-regulation will be associated with increasing imposts on both DRs and the regulator and as such should only occur where there is a clear net benefit from doing so.

Unitywater is concerned that the LTRF Paper does not clearly identify the full range of regulatory options that potentially could be applied to DRs and that this is likely to severely limit the Minsters' understanding of the implications of imposing the recommend form of regulation for eligible DRs. The starting point for any cost/benefit analysis of regulatory options should be a state-of-the-world absent regulation or with the lowest normally acceptable level of regulation.

Conceptually, for DRs this is likely to be represented by a self-regulation approach based on a level of information disclosure suitable to a publicly owned business operating in a largely non-contestable market. Unitywater considers that a self-regulation approach supported by a commitment to broad information disclosure and transparency in terms of pricing approaches, returns to owners and the use of those returns is likely to capture most of the benefits that might be attributable to economic regulation of SEQ DRs and as such any move to a more intrusive form of regulation would need to be balanced against clearly identified benefits.

Unitywater currently publishes extensive details on prices, costs and bill impacts for different usage patterns and is in the process of revising its pricing principles and guidelines to ensure they represent current best practice for water businesses. It should be noted that Unitywater considers the QCA's Pricing Principles Paper to be a valuable reference document that generally support the work Unitywater has already undertaken to reform the legacy tariffs inherited from Councils.

As noted above, Unitywater considers that the LTRF Paper only considered a limited range of regulatory options with the least intrusive of these being the QCA's recommended performance monitoring regime.

Unitywater would like to see a more comprehensive assessment of the regulatory options undertaken supported by comprehensive cost/benefit analysis.

4.2. QCA conclusions and Unitywater's view

QCA conclusion:

DRs have monopoly characteristics and therefore have market power. Where market power is exercised prices will be too high or quality too low. High prices may reflect inefficiently high costs rather than simply excessive profits. The LTRF Paper acknowledges that DRs have been subject to varying forms of price monitoring since 2008 and that these previous reviews have (with the exception of Redlands) not found any evidence of monopoly pricing, that is, total revenues (or prices) that are too high or any evidence of inappropriate quality for given prices. Further, the QCA has recommended that Unitywater, QUU, Gold Coast Water and Logan Water immediately transition to long-term annual performance monitoring from 1 July 2015.

Unitywater's view:

Unitywater is a statutory authority wholly-owned by the Moreton Bay Regional, Sunshine Coast Regional and Noosa Shire Councils providing commercial distribution and retail water and sewerage services.

This ownership structure means that Unitywater's water and sewerage customers (the property occupiers who elect councillors and are beneficiaries of council services) effectively own Unitywater thus ensuring full alignment of interests between customers and equity owners (further supported by Unitywater's Participation Agreement which ensures that each participating council receives a participation return paid out of net profits in proportion to each Councils share of Participation Rights).

It follows that even if Unitywater's prices were found to be at a level reflective of monopoly pricing (that is, above stand-alone-cost, which is not the case), the ownership structure would ensure that these monopoly profits were redistributed back to Unitywater's customers via the provision of Council services or rebates and therefore the economic impact would be effectively fully mitigated.

Further, this ownership structure places significant pressure on DRs to ensure costs are prudent and efficient, thereby minimising costs and prices. Unjustified prices are likely to be met by rate-payer discontent which is likely to be manifested in voting results at the next council election again ensuring an alignment of customer and DR interests. As noted above, Unitywater's Corporate Strategic Plan places reductions in the total cost to serve customers (ie. the price and the cost for the customer to engage with Unitywater) as a central aim for the business.

This emphasis is highlighted in the following charts. **Figure 1** shows the 12 month rolling average controllable operating cost per connection. Over the 21 month period shown on **Figure 1** controllable operating costs per connection fell by almost 15% in nominal terms or over 18% in real terms.

Figure 1 – 12 Month rolling average operating cost per connection

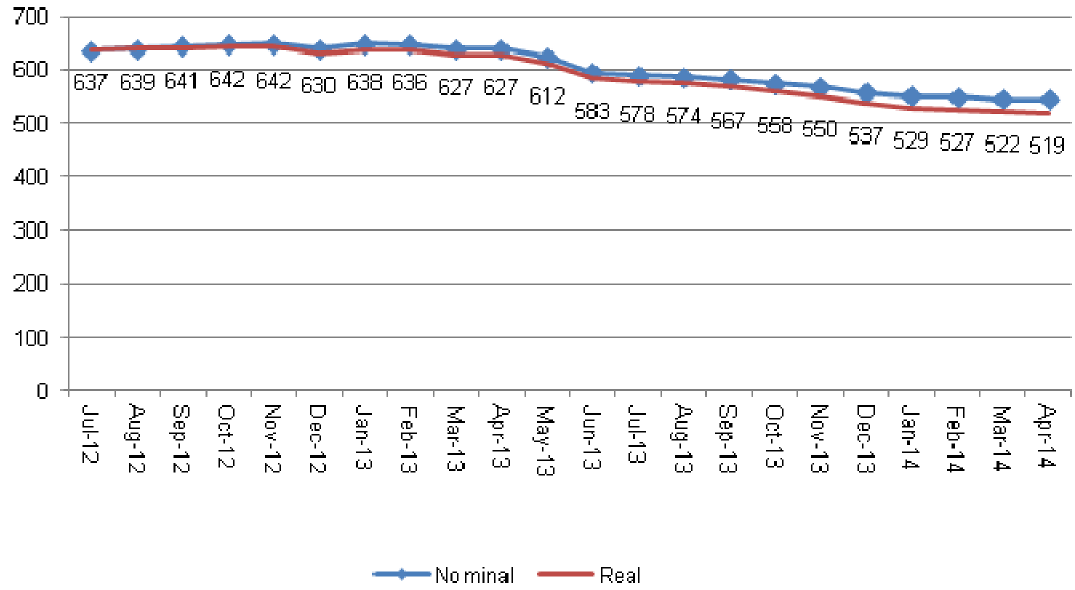
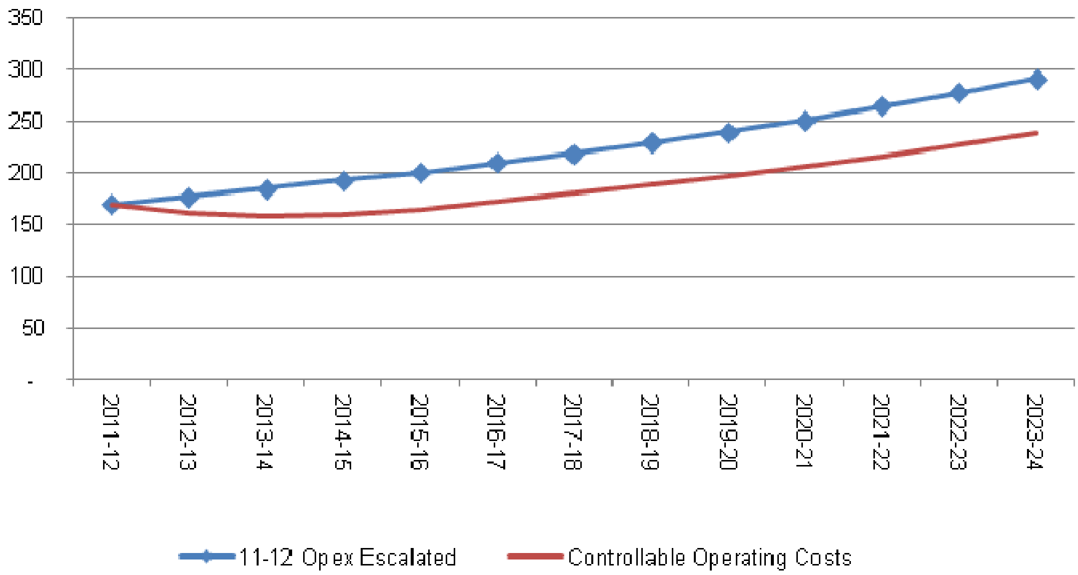


Figure 2 shows Unitywater's historical and forecast controllable operating costs. By 30 June 2014, Unitywater will have delivered around $40M (23%) in cumulative savings compared to 2011-12 and by 2018-19 expects savings generated in excess of $225M (110%).

Figure 2 – Forecast controllable operating costs (excludes depreciation and bulk water charges)



As such, the fact that Unitywater has monopoly characteristics is unlikely to be associated with actual monopoly pricing and therefore this argument is unlikely to justify the imposition of regulation.

QCA conclusion:

Significant savings were achieved by DRs compared to forecasts over the 2010-13 period of around $1.1B in capital expenditure and $127.4M in operating expenditure. This was in response to an environment which included price monitoring with that environment constraining entities from exercising market power.

The QCA estimated that total prudent and efficient costs across all entities are $77.5M million below those submitted by the entities over 2010-13 (in addition to the existing reductions identified above). The QCA claims this $77.5M could be saved as a result of suitable regulation and therefore is available to offset the QCA's annual regulatory cost for oversight of DRs of around $2 million.

Many of these savings were based on the QCA's view of expected cost escalation, cost growth (ie. electricity consumption by DRs), growth in customer demand and population growth. Actual outcomes may differ from forecast and therefore not generate the savings suggested.

The QCA sees future benefits resulting from further improvements to decision making processes, the adoption of regional investment perspectives, and attention to other limitations of past reviews (undefined) but indicates that the associated benefits cannot yet be quantified.

Unitywater's view:

The savings that have been achieved to date and the ongoing savings being sought by DRs are not attributable to the presence of economic regulation but rather are directly attributable to DRs ownership structure and the pressure being applied by customers to pricing. As noted above, Unitywater has adopted a focus on reducing cost to serve as a key business aim. Unitywater expects continued customer pressure to reduce costs and prices given that bulk water costs are projected to continue to rise over the medium term. As such, the savings identified in the LTRF Paper cannot be counted as a benefit of regulation under any cost/benefit assessment of the impact of regulation.

In addition, were the identified savings made, the benefits would not necessarily be reflected in lower prices but would be expected to flow to the owners given the DRs (with the exception of Redlands Water) were assessed as forecasting revenue below the maximum allowable revenue (MAR). That is, returns to equity holders are below the regulated return and any savings are expected to accrue to the equity holders in the first instance.

Further, the alignment of the interests of owners and customers under the SEQ DR structure, mitigates incentives for the misuse of market power, and means that even if market power exists and is used to raise prices and generate monopoly profits. This will simply result in a circular transfer of funds from customers to the business for the provision of services and back to customers as owners by way of profit repatriation. Under these circumstances there would be no benefit from regulation as there would be no net impact on customers as owners after offsetting profits against prices.

In Unitywater's view, the other unquantified benefits suggested within the LTRF Paper will be captured by current processes that are either already in place or are being developed and are not dependent on the presence of economic regulation.

QCA conclusion:

QCA forecasts that its' costs attributable to DRs will be around $2.2M in 2014-15 (to be recovered from the DRs) but that under a light handed price monitoring framework these costs will fall to around $0.5M with additional costs associated with any further work required such as additional data requests or a cost of service review levied on an ad-hoc basis.

Unitywater's view:

Given the uncertainty over the information requirements under the LTRF Paper's recommended performance monitoring arrangements, it is not clear what level of cost will be incurred by the QCA or DRs. However, Unitywater is concerned that the annual process proposed by the QCA and periodic major reviews will, on average, have similar or higher costs to the current annual price reviews. That is, average costs of perhaps $5M per annum or greater.

QCA conclusion:

The LTRF Paper rejected a formal price disclosure framework as an alternative on the basis that such an approach is "unlikely to disclose information capable of being critically reviewed by the majority of customers".

Unitywater's view:

Unitywater considers that a light handed appropriately specified price disclosure arrangement can address customer concerns over the efficiency and reasonableness of DR prices. Further, such an arrangement can potentially be implemented with significant cost savings compared to alternative more heavy handed regulatory arrangements.

Unitywater is committed to continuing to develop approaches that achieve greater transparency and understanding with respect to the manner in which prices are developed and structured. Unitywater believes that the LTRF Paper should not reject such approaches out of hand but should seek to analyse such options as potential viable regulatory approaches.

4.3. Recommendations of the LTRF and Unitywater's view

The key recommendations in the LTRF Paper include:

a. Use of public reporting and transparent QCA review as a key driver of continued performance improvement for DRs;

b. Transition to performance monitoring involving the QCA reporting on DRs' performance against a range of measures including prices, revenues, certain costs (currently undefined), certain procedures and policies, service quality standards and application of pricing principles (based on prices tracking a CPI-X benchmark) with potential for full cost of service review to be triggered where performance is considered inadequate;

c. Specific triggers for performance criteria will not be defined, however, before a full cost of service review is triggered DRs would be given the opportunity to explain deteriorations in performance;

d. Annual assessment of prices will occur against CPI-X targets based on annual information returns required to be provided by DRs. These returns are yet to be defined but initial information templates are to be developed;

e. The QCA is seeking amendment to the QCA Act to enable the QCA to automatically trigger a full cost of service review (without requiring Ministerial referral) where it considers DRs have breached their price monitoring guidelines; and

f. A cost of service review is also recommended to occur when an entities Netserv Plan is updated (ie every 5 years) where there are material changes to the plan.

Unitywater's view:

Unitywater is concerned that the LTRF Paper's recommendations fail to adequately take into account DRs ownership structure, operating environment and current management initiatives and have not been subject to proper cost/benefit analysis in order to ensure that the level of regulatory impost can be justified.

Further, there is considerable uncertainty over the how the recommended approach will be implemented and therefore what the implementation costs will actually be.

5. Pricing Principles Position Paper

This section of Unitywater's Submission specifically addresses the Pricing Principles Position Paper.

5.1. Context for establishing Pricing Principles

Unitywater would like to see any QCA Pricing Principles documentation recognise their inherent interrelationship with the form of regulation potentially to be applied. That is, as discussed in Section1.3, Unitywater expects that the form of regulation applicable to water businesses could vary along a continuum from self-regulation (or a price disclosure framework) where businesses can show they have little or no market power and no opportunity to extract monopoly rents from customers (as is the case for a council owned business such as Unitywater), to potentially being subject to some form of full revenue regulation for any element of the value chain where monopoly characteristics together with ownership structure, cost materiality and potential benefits would support full regulation.

This wide continuum of possible regulatory oversight suggests that a single suite of pricing principles may not be appropriate, rather, a hierarchy of principles may need to be established with a more limited set of principles applicable to businesses such as Unitywater (possibly on a voluntary basis where the business is not subject to external regulation) and a more comprehensive set of mandatory principles applied to businesses likely to be subject to greater regulatory oversight.

In this context, Unitywater notes that Recommendation 1.1 proposes that pricing of urban water, sewerage, trade waste, recycled water and stormwater re-use services provided by SEQ entities:

a. Promotes economic efficiency;

b. Ensures revenue adequacy;

c. Takes account of the public interest (including fairness and equity); and

d. Is transparent, predictable simple and cost effective to apply.

Unitywater is of the view that these general principles remain the key basis for setting prices for DRs and that more detailed or specific guidance as found in the Pricing Paper's extensive recommendations are of more use as guidelines rather than binding principles. Nevertheless, if the QCA considers that additional binding principles need to be put in place, Unitywater considers they should be limited in scope and matched to the form of regulation applying to a particular business.

For example, high level pricing principles can be established that could be used by all businesses irrespective of whether they are subject to any regulation at all (similar to those in Recommendations 1.1 and 1.3), while additional principles can be established to apply to businesses subject to greater levels of regulatory pricing oversight. These principles should be written in a concise and clear manner and should be supported by more detailed (non-binding) supporting guidelines outlining the practical application of the principles. That is, the Principles themselves should not seek to include unnecessary detail. The drafting of some of the current Recommendations is considered to be suitably concise for a statement of principles.

Where a customer owned DR is subject to light handed economic regulation, then the presence of pricing principles and associated guidelines that can support the DR's pricing decision making can still be highly valuable. These could form the basis of a reporting arrangement that could obviate the need for regulation through inclusion of a statement within the annual report concerning the businesses compliance with pricing principle guidelines.

In Unitywater's view, pricing principles are usefully structured at two levels (as the QCA has done in the Paper), firstly, an overarching aim of promoting efficiency and ensuring revenue adequacy (often satisfied by simply ensuring that revenue by broad customer group is cost reflective), with a secondary (more detailed) aim of sending price signals aimed at ensuring customers are faced by multi-part prices with a variable component reflecting forward looking supply costs on the basis that this will ensure efficient consumption decisions. This secondary aim needs to be assessed in light of the position of the business within the value chain.

The provision of urban water supply services to Unitywater customers involves both Unitywater as distributor retailer and Seqwater as bulk water supplier. Urban water customers are concerned about the provision of reliable high quality water and would not take Unitywater's distribution and retail services without also having Seqwater bulk water supply. Seqwater charges are following a price path to cost reflectivity by 2017-18 or possibly 2019-20 at which time bulk water will cost around $3.00 per kilolitre in 2014 dollar terms. Unitywater is required to pass through Seqwater bulk water charges on a $ per kilolitre basis. Given Unitywater current pricing for Moreton Bay Council customers of around $300 fixed per annum and $0.67 per kilolitre variable (up to 300 kilolitres consumption per annum), an average household with 150 kilolitres of annual water consumption would pay a water bill of around $850 per annum of which $450 (or some 53%) would be passed through to Seqwater. This Seqwater charge will swamp any price signal that may be implicit in Unitywater's forward looking variable water charge. This suggests limited if any information content or value from requiring a distributor retailer such as Unitywater to satisfy prescriptive detailed pricing principles.

It should be noted that Unitywater's customers have indicated a general preference for two part tariffs based around a fixed daily charge and a volumetric charge as this allows them to have greater perceived control over their utility bills (for both water and sewerage services). However, this preference, in and of itself, does not require Unitywater to undertake any detailed or complex economic analysis, rather, simply to establish a reasonable split of required revenues between a fixed and variable component reflecting Unitywater's assessment of revenue risk, costs, customer preferences and impact of price signals.

5.2. The need for cost/benefit analysis

Consistent with the discussion above, Unitywater is of the view that cost/benefit analysis should be central to any consideration of imposing binding pricing principles on DRs as some elements of the recommendations within the Pricing Paper have the potential to impose significant compliance costs on DRs with potentially little or no benefit to customers.

Unitywater recognises that the Pricing Principles document is only one element of the regulatory framework that the QCA has been tasked with assessing. However, as noted above in the discussion of the scope of the Ministerial Direction, Unitywater would like to see the Pricing Paper clearly acknowledge the impact of the form of regulation on the nature of pricing principles that should be applied to specific businesses and the extent to which any such principles are binding or voluntary and include an assessment of the impact of the proposals.

5.3. General comments on the Pricing Paper

Unitywater considers there could be significant benefit in restructuring the report to include:

a. Greater context of the role of pricing principles within other reform processes;

b. Development of a clear hierarchy of pricing principles related to potentially different levels of regulatory oversight;

c. Assessment of the impact of cost/benefit analysis; and

d. Separating out those elements of the report suited to being incorporated within supporting non-binding guidelines.

The following discussion covers Unitywater's general views on each section of the Paper. Unitywater's views on each individual Principle are provided in Section 5.4.

5.3.1 Section 1 General Pricing Principles

Unitywater fully supports the QCA's position expressed on page 3 that:

> *… unless otherwise directed by government, the QCA will treat economic efficiency as the primary objective of economic regulation.*

Unitywater is of the view that this is consistent with the utilisation of cost/benefit analysis in assessing the nature of pricing principles (or form of regulation) to be applied to DRs.

In general the recommendations within Section 1 are considered by Unitywater as a sound basis for a set of pricing principles and appear reasonable and logical although Unitywater would like to reiterate that the adoption of a fully developed LRMC approach to setting the volumetric water charge within a two part tariff for urban water services may not be justified on cost/benefit grounds depending on the availability of supporting systems and data. In this case a simpler approach based on available information and reflecting considerations including LRMC (to the extent possible given data and system constraints) and customer consultation is considered to be more appropriate.

5.3.2 Section 2 Pricing Principles for Urban Water

In terms of demand forecasting, Unitywater is of the view that this is not an area that needs to be mandated although it may be appropriate to include some discussion of possible approaches to forecasting within the pricing principles supporting guidelines. Unitywater is of the view that demand is unlikely to be volatile (other than in the presence of climate events which cannot be forecast anyway). Unitywater supports the QCA suggestion that a working group be convened including the QCA, to review demand forecasting practices and demand elasticities.

As drafted, the inclusion of recommendation 2.4 within a set of Pricing Principles would appear inconsistent with the possible range of regulatory outcomes that might be applied to different businesses (that is, for some unregulated or lightly regulated businesses this should simply be a recommended approach whereas it is currently expressed as a binding requirement). This is an example of the issue raised above of having a hierarchy of principles suited to the potential range of form-of-regulation outcomes.

Unitywater notes that the QCA has recommended against the use of inclining block tariffs (while noting that historic pricing approaches mean that such tariffs can be difficult to remove). Unitywater is of the view that while it is desirable that such tariff structures be unwound, this should not be mandated but rather recommended as desirable where practical and feasible to do so.

5.3.3 Section 3 Pricing Principles for Sewerage Services

Unitywater notes that the Sewerage Services Pricing Principles parallel the Urban Water Principles and as such the same comments generally apply. Further, Unitywater notes that it has adopted volumetric charging for sewerage services based on customer consultation which indicated a desire for greater control over the level of charges faced by sewerage customers. It is noted that this has been contentious with a small number of customers reflecting the inevitable reality that some customers pay less while others will pay more whenever changes are made to pricing structures and such concerns are also likely to be reflective of not fully understanding its application and the fact that for residential customers volumetric sewerage charging is capped at 270kL pa.

5.3.4 Section 4 Pricing Principles for Trade Waste Services

Unitywater notes that the Trade Waste Services Pricing Principles parallel the Urban Water Principles and as such the same comments generally apply. Unitywater considers that the recommendations in this section are otherwise non-contentious.

5.3.5 Section 5 Pricing Principles for Recycled Water

Unitywater supports the QCA's discussion of Pricing Principles for Recycled Water.

5.3.6 Section 6 Pricing Principles for Stormwater Reuse and Drainage

Unitywater supports the QCA's discussion of Pricing Principles for Stormwater Reuse and Drainage.

5.3.7 Section 7 Industry Wide Issues

Unitywater supports the QCA's discussion of Industry Wide Issues noting that the Section 7 Principles are generally guiding in nature rather than capable of strict application.

5.4. Unitywater's views on Pricing Paper Recommendations

1. General Pricing Principles

1.1. That pricing of urban water, sewerage, trade waste, recycled water and stormwater re-use services provided by SEQ entities:

a Promotes economic efficiency;

b Ensures revenue adequacy;

c Takes account of the public interest (including fairness and equity); and

d Is transparent, predictable simple and cost effective to apply.

Unitywater supports Principle 1.1 as a suitable high level statement of the over-rching aim of water and waste water pricing.

1.2. Entities initially establish that the pricing principles are being applied and subsequently advise of any departures, the reasons for the departure and provide relevant supporting analysis.

Unitywater considers that reporting on the nature of pricing principles adopted together with the manner in which they are implemented is appropriate although the nature of the reporting requirement should vary with the form of regulation applied.

For entities under a self regulation framework or a price monitoring framework, reporting would be voluntary and likely to occur through inclusion in their annual report.

For entities subject to direct regulation by the QCA, reporting to the QCA against the appropriate set of principles as discussed below will be appropriate.

1.3. Pricing reflects marginal cost, together with a two part tariff where necessary to achieve revenue adequacy.

Unitywater is of the view that pricing principles should be structured as a hierarchy of principles. In this context, draft recommendation 1.4 should have a higher priority than recommendation 1.3. Recommendation 1.3 should be used as a guide to setting prices but should not necessarily be binding where other considerations apply.

1.4. Prices be set between incremental (marginal) cost and stand-alone cost.

Unitywater supports Principle 1.4 as a Principle that should be binding and applied to all pricing decisions.

1.5. Prices reflect the LRMC of providing a particular service.

Unitywater supports Principle 1.5 as a non-binding recommended approach that should be used as a guide to setting prices but should not necessarily be binding where other considerations apply. In particular, Unitywater is concerned that mandating LRMC pricing could impose significant compliance costs with no real benefit, especially given that bulk water charges are likely to remain 100% volumetric and as such will swamp any price signal associated with DR LRMC based water prices.

1.6. Prices reflecting SRMC be considered when SRMC for a particular period significantly exceeds the LRMC (estimated for a longer period) for a particular service. This is sometimes referred to as scarcity charging.

While this should not be a significant issue for most DRs, Unitywater would be concerned about the practical implementation issues of this principle. As such, Unitywater supports Principle 1.6 as a non-binding recommended approach that should be used as a guide to setting prices but should not necessarily be binding where other considerations apply.

1.7. LRMC be estimated on the basis of the perturbation or AIC method.

Unitywater supports Principle 1.7 as the recommended approach to apply where LRMC is being estimated.

2. Pricing Principles for Urban Water

2.1. Long term forecasts used for capital planning be based on SEQ Water Strategy forecasts.

2.2. Short term demand forecasts be based on estimated water use per customer/connection and population forecasts (number of connections) and take account of any bounce-back effect as well as local circumstances.

2.3. Demand forecasting practices and alternative models (including demand elasticities) be reviewed by a working group including the entities, QCA and other relevant parties.

Unitywater does not support the inclusion of Draft Recommendations 2.1, 2.2 or 2.3 within any suite of binding Pricing Principles. Unitywater considers that Pricing Principles should not include detailed requirements on the approach to forecasting demand. To the extent that the QCA feels that guidance needs to be provided with respect to approaches to demand forecasting, this should be provided by way of non-binding pricing guidelines. Unitywater accepts the general content of these recommendations as useful input into Unitywater demand forecasting and considers there could be some value in a demand forecasting workshop.

2.4. The volumetric charge for urban water services should reflect LRMC.

> Unitywater supports Principle 2.4 as a non-binding recommended approach that should be used as a guide to setting prices but should not necessarily be binding where other considerations apply.

2.5. Where prices exceed average costs, short term over-recovery of revenues be addressed by ex-post rebates with adjustments made to the fixed charge.

2.6. Fixed charges for urban water services recover the maximum allowable revenue (MAR) not covered by the volumetric charge.

2.7. Charges not encourage customers to bypass or disconnect from the network.

> Unitywater supports Principles 2.5 to 2.7.

Inclining and declining block tariffs not be introduced, and where they are already in place be phased out over time to a single volumetric charge.

> Unitywater supports Principle 2.8 as a non-binding recommended approach that should be used as a guide to setting prices but should not necessarily be binding where other considerations apply. Specifically, Unitywater currently uses inclining block tariffs and may continue to do so where customer consultation indicates a desire for a continuation of this pricing approach.

2.8. Location-based charges for urban water services be applied where the location cost differences are material and where it is practical and cost effective.

2.9. Time of day or seasonal charges be considered for urban water services where there are identified economic efficiency benefits and where practical and cost effective.

2.10. Self-selecting tariff options be considered where there is sufficient information for customers to make choices, provided they do not result in cross-subsidies or introduce unmanageable revenue risks for the entity.

2.11. Price/service quality tariff options be adopted, where material cost differentials are associated with different levels of service.

2.12. Individual metering of flats and units be adopted where economic and practical.

> Unitywater supports Principles 2.9 to 2.13 as a non-binding recommended approach.

2.13. Where water is separately metered, and where practical, tenants be billed the fixed and variable charges for water and sewerage.

> Unitywater is concerned that there could be significant unforseen difficulties in implementing Principle 2.14 both in terms of legislative changes and possible unintended negative financial impacts on both tenants and DRs such as tenant requirements to pay these costs with no offsetting reduction in rents and increased retail costs on DRs. As such, this principle should remain an approach to be adopted at the discretion of DRs where legally able to do so.

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2.14. Customers with unmetered connections be charged a deemed amount for usage, reflecting average use for similar property types.

2.15. Customers with unmetered connections be given the option of paying for meter installation.

2.16. For vacant land where water services are available for connection, the water access charge that applies to connected properties (the relevant domestic or commercial charge) be applied.

2.17. Concessions and rebates:

a. Reflect a generally consistent approach between the entities;

b. Be set to apply to either the fixed charge or as a total direct adjustment to the gross invoice amount;

c. Be capped so as not to subsidise discretionary use; and

d. Be transparent with acknowledgement of the source of, and purpose for, particular concessions/rebates.

2.18. Concessions associated with excess water use caused by leaks, be determined by the entities in consultation with customers.

2.19. Hardship arrangements be consistent with legislative and operating requirements and avoid cross-subsidies where practical.

2.20. Meter-reading and billing be undertaken at least quarterly.

2.21. Tradeable urban water entitlements be considered only where the efficiency gains are sufficient to justify the administration and transactions costs.

Unitywater supports Principles 2.15 to 2.22 as a non-binding recommended approach.

3. Pricing Principles for Sewerage Services

3.1. Demand for sewerage services be based on forecast growth in connections, linked to population growth.

Unitywater does not support the inclusion of Draft Recommendation 3.1 within any suite of binding Pricing Principles. Unitywater considers that Pricing Principles should not include detailed requirements on the approach to forecasting demand. To the extent that the QCA feels that guidance needs to be provided with respect to approaches to demand forecasting, this should be provided by way of non-binding pricing guidelines.

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3.2. For residential customers:

a. Sewerage charges be based on a single part tariff with a fixed charge per customer or connection; and

b. Volumetric charges (based on discharge factors) be applied where the LRMC is significant and should be based on discharge or return factors linked to the LRMC of providing the water volumes.

> Unitywater does not support Principle 3.2 and believes that DRs should be able to bill customers using a two part tariff structure where customer engagement indicates a desire for such an approach. Further, while the volumetric component should take account of the LRMC as one factor, Unitywater considers that other considerations should also be able to be included such as ensuring a relatively steady pricing structure and ensuring that the volumetric component represents a proportion of the total bill consistent with customer expectations.

3.3. For non-residential customers:

a. Fixed sewerage charges be based on the impact of the customer on the system. In the absence of direct metering, water connection size is considered a reasonable proxy; and

b. If appropriate, volumetric charges be applied based on relevant discharge factors established by customer type. Customers should be able to negotiate a variation in the discharge factor.

3.4. Nodal pricing for sewerage services be applied where cost effective.

> Unitywater supports Principles 3.3 and 3.4.

4. Pricing Principles for Trade Waste Services

4.1. Where the customer base changes in line with growth, trend information be used to provide reasonable forecasts of demand for trade waste services.

4.2. Entities consult with large customers to monitor any step changes in demand for trade waste services.

> Unitywater does not support the inclusion of Draft Recommendations 4.1 or 4.2 within any suite of binding Pricing Principles. Unitywater considers that Pricing Principles should not include detailed requirements on the approach to forecasting demand. To the extent that the QCA feels that guidance needs to be provided with respect to approaches to demand forecasting, this should be provided by way of non-binding pricing guidelines. Unitywater accepts the general content of these recommendations as useful input into Unitywater demand forecasting.

4.3. Trade waste prices be based on the impactor pays principle.

4.4. Charges be based on the LRMC of transport, treatment and disposal of trade waste, with variable charges based on volume and contaminant load.

4.5. Specific charges for the management of trade waste services (inspection and monitoring) be applied on a cost reflective basis.

4.6. Charges be differentiated according to customer type and risk factors, and by location (as part of risk assessments) if considered cost effective.

4.7. Consistent with regulations, entities apply penalty charges for non-compliance and recover the efficient costs associated with breaches.

Unitywater supports Principles 4.3 to 4.7 as a non-binding recommended approach.

5. Pricing Principles for Recycled Water

5.1. The revenue requirement for recycled water services be based on the total additional cost of recycling less avoided costs and less developer contributions.

5.2. Direct and avoidable costs be allocated between relevant parties on a beneficiary pays basis.

5.3. Recycled water volumetric prices be based on LRMC for the established recycled water scheme where possible, less marginal avoided costs. Where the volumetric charge is then higher than the potable water volumetric charge, it may be necessary to reflect demand sensitivities to ensure demand clears supply.

5.4. If still required to ensure revenue adequacy, fixed charges in a two-part tariff be set to recover remaining revenues, also subject to willingness to pay.

5.5. If the revenue requirement is still not achievable, unrecovered amounts be allocated to potable and sewerage charges in proportion to avoided cost allocations.

5.6. Charges be periodically reviewed, as customer acceptance increases.

Unitywater supports Principles 5.1 to 5.6 as a non-binding recommended approach.

5.7. Charges for sewer mining be set on a case-by-case basis to reflect relevant direct costs, a share of sewerage system common costs, service costs for any returns, less avoided/avoidable costs.

Unitywater supports Principle 5.7 as a non-binding recommended approach.

6. Pricing Principles for Stormwater Reuse and Drainage

6.1. Stormwater reuse pricing be subject to the same pricing principles as recycled water.

6.2. Rate-based charges be used for recovery of stormwater drainage costs.

6.3. Charges for stormwater drainage be transparently identified on customer bills.

Unitywater supports Principles 6.1 to 6.3 as a non-binding recommended approach.

7. Industry-wide issues

7.1. The inclusion of externality prices be supported where material impacts can be valued accurately and cost effectively.

7.2. Prices incorporating estimates of externalities avoid duplication with other mechanisms and be transparent.

7.3. Licences and market mechanisms (where practical) be considered by Government where the benefits are considered to justify the costs.

7.4. Third party access prices be based on the cost of service methodology, and take account of relevant joint or common costs. Any departure from this methodology (such as applying the retail minus methodology) is to be justified.

7.5. Where retail prices are averaged across user groups (postage stamp tariffs) an adjustment apply to ensure that access prices do not result in increased costs of service delivery for remaining customers.

7.6. Common costs be allocated to services and customers on the basis of a causal relationship between the costs incurred and the water, sewerage, recycled water or other service performed.

7.7. If a causal relationship cannot be established between costs incurred and the relevant service, a reasonable cost allocator needs to be established.

7.8. Price paths be applied where there are substantial price increases, having regard to customers' ability to pay and the impacts on the service provider's financial viability.

7.9. Price paths be set on a revenue neutral basis.

Unitywater supports Principles 7.1 to 7.9 as a non-binding recommended approach.

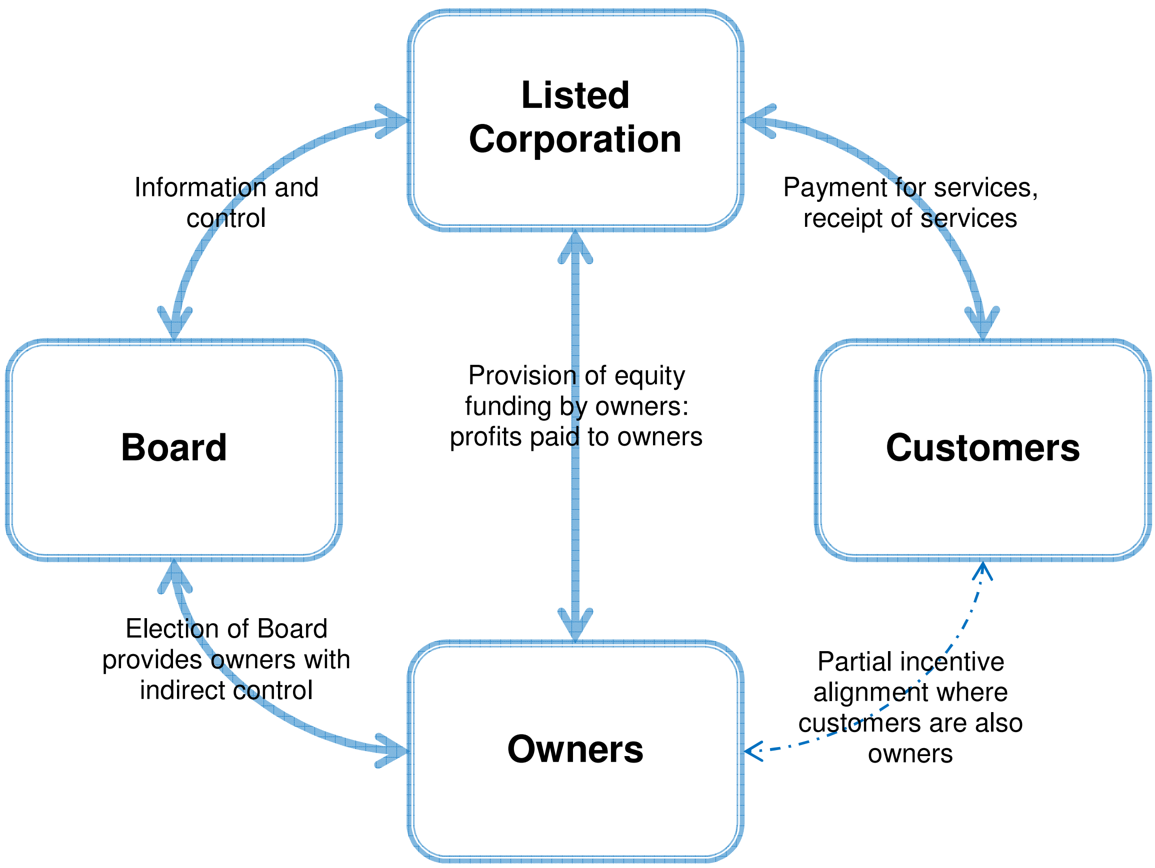
Appendix 1 - Incentives to Misuse Market Power

Economic regulation of utilities such as water or electricity distribution and transmission service providers has grown out of concerns that these businesses have natural monopoly characteristics. These characteristics include: significant investment in long life assets which have limited if any alternative use; and cost characteristics that mean services are most efficiently provided by a single business within a defined geographic area (generally a declining average cost curve). These characteristics convey potential market power on such a business compared to a business operating in a contestable, competitive market sector.

Businesses with market power may seek to set prices above those that would apply in a competitive market or restrict supply below the optimum level. In either case, consumer welfare will suffer and economic efficiency will be harmed. It is this impact that economic regulation is primarily tasked with addressing.

The incentive and ability to misuse market power under a standard, publicly traded, corporate structure is highlighted in **Figure 3**.

Figure 3 – Publicly Traded Company Structure



The key issue is that under a conventional publicly listed corporate ownership structure, there is:

a. A separation of ownership and management of the firm (where the managers of the firm are not generally the owners of the firm or at least not the sole owners of the firm). As such, managers cannot automatically be expected to act in the best interests of owners. The job of the Board and in particular, independent Board members, is to protect the interests of owners and ensure the strategic direction of the firm is consistent with owners interests.

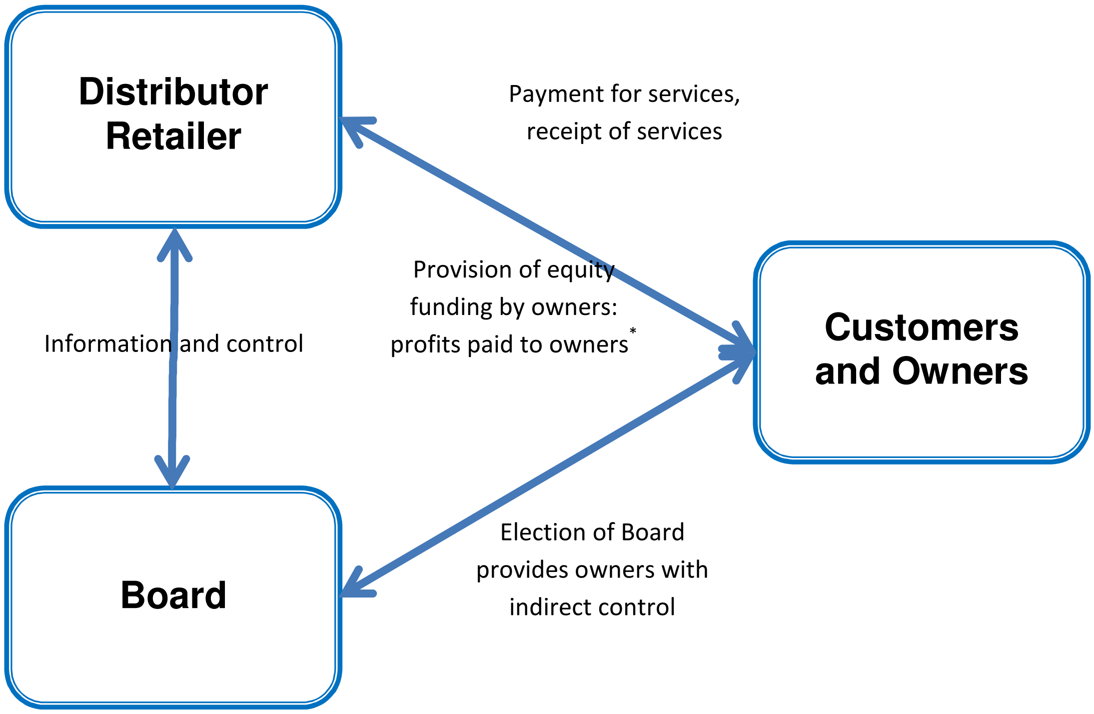
b. A disconnect between the incentives and goals of owners and customers (acknowledging that in some instances some customers may own some shares in the company they are purchasing services from). Nevertheless, generally owners will be concerned with maximising the profitability of the business and therefore returns while customers will be concerned with getting goods or services of defined characteristics at the lowest possible price.

Thus, at best, there is an indirect linkage between the interests of customers and owners. In a market that is effectively competitive, (that is, a market with multiple actual or potential suppliers and purchasers and low entry and exit costs), this disconnect between owners and customers need not disadvantage customers.

However, where a market is not competitive and has significant monopoly characteristics as exists with businesses providing essential utility services such as water and sewerage businesses, there may not be any competing suppliers and the presence of a monopoly service provider can potentially lead to prices significantly above those based purely on prudent and efficient costs. However, it is important to realise that monopolists are still constrained by the market demand curve and any factors limiting their misuse of market power.

One such factor impacting on Unitywater is the legal ownership and operating structure and associated incentives and ability to misuse market power and therefore justification for economic regulation. Unitywater is a statutory authority providing water and sewerage distribution and retail services to the Brisbane northern suburbs and Sunshine coast area (bounded by the Noosa Shire Council and Moreton Bay and Sunshine Coast Regional councils). These councils are also Unitywater's sole shareholders, while the business and residential occupants within the council boundaries are both Unitywater's sole customers and the council electors/owners and recipients of council services. The resulting relationship between the parties is highlighted in **Figure 4**.

Figure 4 – Council Owned Statutory Authority



Under the council ownership model, DR profits are paid to councils so that the final beneficiaries (people living, or businesses operating in the council area) only indirectly benefit from profits received. Nevertheless, they are the sole residual beneficiary and as such, there is no leakage of profits beyond the DRs customers.

The key characteristic highlighted by the above diagram is the alignment of customers and owners into a single group. This removes one of the two major issues identified with the standard publicly traded model outlined in Figure 3, namely, broad alignment between the interests of owners in having an efficiently run, profitable business and customers seeking value for money provision of services. The remaining issue regarding separation of ownership and management is addressed similarly to under the publicly traded corporate model, namely, by way of business oversight by an appropriately structured board.

While the alignment of owners and customers mitigates incentives for the misuse of market power, it also means that even if market power exists and is used to raise prices and generate monopoly profits, this will simply result in a circular transfer of funds from customer/owners to the business for the provision of services and back to customer/owners by way of profit repatriation meaning that under these circumstances there would be no benefit from regulation as there would be no net impact on customer/owners after offsetting profits against prices.

Under this ownership structure it is extremely difficult to envisage a competition (monopoly pricing) argument for economic regulation of UnitywaterDRs which would satisfy a cost/benefit test. Given this, the question is what concerns Government is seeking to address through continued regulation of DRs like Unitywater.

As discussed above, there has been no evidence of monopoly pricing after a sequence of QCA reviews and given the legal and operating structure that mitigates against the development or misuse of market power, it seems that the most likely issue being sought to be addressed by the Government is the perception of excessive price rises and concerns over utility businesses over-investing in assets and generation of associated returns (albeit those returns may simply be the minimum commercially required to support the investment).

However, there are other options for addressing such concerns and reliance on regulatory oversight by the QCA may not be the most efficient option. An appropriate integrated communication strategy involving key stakeholders such as Government, DEWS and DRs and Councils would be the first step in addressing these concerns in a cost effective manner.

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