

[REDACTED]

From: Richard Koerner [REDACTED]
Sent: Monday, 7 February 2011 16:06
To: Water (External)
Subject: Further information relating to 2010/11 price monitoring submission
Attachments: SEQmayorssub.pdf

Attn. Ms Cath Barker

Dear Ms Barker,

A recent public submission has been made to the Productivity Commission's Urban Water Sector Inquiry by the Council of Mayors (SEQ) that has relevance to the current QCA's invitation for public comment relating to 2010/11 water and sewerage price monitoring.

It is posted as Submission #77 on the Commission's list of submissions and is attached. Findings of Appendix "A" may be of particular interest.

Kind regards,

Richard Koerner

PS Below is a supplementary submission to the Urban Water Sector Inquiry relating to issues concerning determination of 2008 legacy asset RAB valuations in S.E.Qld.

----- Original Message -----

Subject: Further information relating to Submission#7

Date: Mon, 07 Feb 2011 13:19:15 +1000

From: Richard Koerner [REDACTED]

To: UrbanWater (Ex Email) [REDACTED]

Attn. Mr. Rick Baker

Dear Mr. Baker,

I note that the Commission is scheduled to issue its preliminary report soon and refer to attachments "N", "P" and "Q" of Submission #7.

The Commission should be aware that no further information has been provided by Qld. Treasury regarding the methodology used for determination of the June 2008 legacy regulatory asset base (RAB) now assigned to Unitywater and other SEQ fully owned monopoly service providers for capital recovery pricing purposes by the Queensland Government.

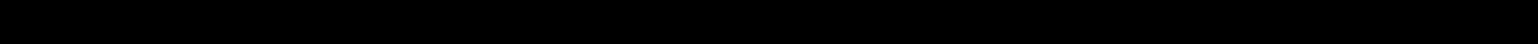
Appendix "A" to Submission #77 by the Council of Mayors (SEQ) endorses the use of the depreciated optimised replacement cost methodology for determination of legacy RAB valuations. However the report does not appear to have examined the basis for July 2008 legacy RAB determinations mandated by the Queensland Government that are accepted by the Council of Mayors (SEQ).

I contend such legacy RAB determinations are flawed and will continue capital revenue recovery by Unitywater and other SEQ retail entities

that are in excess of the maximum allowable revenue given information provided in attachment "N" to Submission #7, and the ongoing failure of the Treasurer's Office to respond to clarifications requested in attachment "Q".

Kind regards,

Richard Koerner



Submission to the Productivity Commission's Public Inquiry into Australia's Urban Water Sector

Council of Mayors (SEQ)
January 2011



Council of Mayors

South East Queensland

About the Council of Mayors (SEQ) Pty Ltd



The Council of Mayors (SEQ) was established in September 2005 as an independent political advocacy organisation to represent the interests of Australia's fastest growing region – South East Queensland (SEQ). It proactively seeks cooperation of Federal and State Governments to ensure the long-term sustainability and liveability of SEQ communities.

The Council of Mayors (SEQ) represents a region that is home to more than three million people (1 in 7 Australians) and generates one quarter of Australia's population growth and one fifth of the nation's economic growth. Five out of the six largest councils in Australia are from SEQ, which is no longer just a series of disparate geographic areas but a region that, in practical terms, now functions as a single metropolitan area.

Executive Summary

As the peak body representing South East Queensland (SEQ) councils, the Council of Mayors (SEQ) welcomes the opportunity to respond to the Productivity Commission's (the Commission) Public Inquiry into Australia's Urban Water Sector. As the level of government closest to people and with a long history of providing affordable quality water services to residents and businesses in the fastest growing region in Australia, SEQ councils possess a specialised knowledge in urban water policy.

Average rainfall in the last decade fell nearly 16 per cent compared with the previous 30 years.ⁱ This is generally consistent with natural variability experienced over the last 110 years, which makes it difficult to detect any influence of climate change.ⁱⁱ While SEQ is still recovering from its worst drought in living memory, it is now experiencing extreme rainfall events (flooding). With the immediate water supply crisis over, policy makers now have an opportunity to reflect on its unmitigated causes, as well as review the policy approaches taken to upgrade, manage and maintain a more secure and sustainable water supply. In this context, the SEQ experience provides an enduring example of how political interests can undermine proper planning and investment decisions and legitimate reform, including National Water Initiative (NWI) objectives, with consequent increases in supply risk and hardship for local consumers.

Ignoring the foreseeable and cumulative risk to water supply security in SEQ resulted in delayed and panic-hurried investments in water supply infrastructure from 2006, coupled with a poorly conceived institutional reform agenda that slavishly followed the State's electricity model. This now presents as another decade of increasing "cost of living" pressures for SEQ residents – higher and increasing household water and sewerage bills. There has been much 'reform' work done in SEQ's urban water sector in the last few years – most of it at a time of water supply crisis and much of it unnecessary. The Courier-Mail observed: *"The irony of it is impossible to ignore – the State Government spent nearly \$7billion drought-proofing the region just in time for the wettest summers on record...not only is the new water system exceedingly expensive but it is also extremely confusing. Perhaps that's just what the Government wanted, a way to spread the blame."*ⁱⁱⁱ

In October 2010, the Council of Mayors (SEQ) commissioned Dr David Cousins AM to conduct an independent review of price increases to SEQ water and sewerage bills. Attached as **Appendix A**, this review examined the basis on which SEQ water and wastewater charges set for 2010-11 had been determined including: an assessment of the formal legislative and regulatory requirements impacting on costs and prices; whether current prices were consistent with these requirements; the impact of the State Government Bulk Water charges, capital investment and establishment costs; dividend policies; and how SEQ water and wastewater prices compared with other metropolitan areas. Cousins (2010) found *"significant infrastructure spending has been undertaken by the State Government in order to drought-proof SEQ. This has had the inevitable effect of increasing bulk water prices significantly"*.^{iv}

The Commonwealth has again recognised drought (and a lack of drought-proof water sources) brought many urban regions, such as SEQ, to the brink of running out of water^v. The biggest issue now facing the urban water sector is how to pay for the reforms to water supply arrangements and the major investment decisions in non-climate dependent water sources. Importantly, major investments in urban desalination and recycled water projects will ultimately provide important long term insurance against a natural and recurring risk for urban water supply – climate (drought). In this context, policy actions to ensure continuity of supply necessarily involved investment in extra capacity (excess to business-as-usual requirements) as a safeguard against future disruptions or emergencies. Less about a commercial objective, this can be viewed as a national security response providing necessary water supply security against a future natural disaster (drought) for one in seven Australians.

High debt and borrowings carried forward on recent major investments in the urban water sector are directly linked to higher ongoing costs associated with drought mitigation and population growth. Moreover, recent price increases for urban water and sewerage services throughout Australia are as much about the lack of an appropriate – all-of-government – national response to urban water security, as it is about the relative incapacity of urban utilities to insure supply and capacity against high natural risks (drought) and population growth. It is also about finding the appropriate balance between national pricing guidelines and civil rights – access to safe, reliable and affordable water and sanitation services.

In 2009, the Queensland Government released an independent review of State Government Boards, Committees and Statutory Authorities (the Weller Review) which proposed using a Public Interest Map as a key tool in brokering a balance between what governments should do and in what form. This might assist the Commission in its consideration of national urban water reform. Recognising that State Governments need to control the supply and delivery of water either directly, or through authorities, the Weller Review found that, as a first preference, local services should be delivered at a suitably appropriate local level and there should be flexibility of form and process, depending on local conditions.^{vi} However, irrespective of what structure is ultimately adopted, the key issue for urban water reform across Australia is providing water service providers with incentives to continue to pursue efficiency gains and make the right investment decisions.^{vii}

The Council of Mayors (SEQ) submission raises issues and concerns in a format that is broadly consistent with the Commission’s template structure, while also speaking specifically about the SEQ water reform process. This submission is set out as follows:

- Section 1 – The Urban Water Sector in Australia
- Section 2 – South East Queensland: Politics of a water supply crisis
- Section 3 – Efficiency and other objectives
- Section 4 – Supply of wastewater services
- Section 5 – Consumption and pricing
- Section 6 – Scope for competition and contestability
- Section 7 – Tools and options for achieving reform
- Section 8 – Implementing reform

1.0 The Urban Water Sector in Australia

“Australians live on the driest inhabited continent in the world. Rainfall is variable and droughts are common. Water is essential to maintaining our health, to producing our food and to sustaining our quality of life.”

National Water Commission

On 28 July 2010, the United Nations General Assembly adopted a resolution recognising access to clean water and sanitation is a human right. While Australia abstained from the vote, it linked access to water and sanitation to a range of civil rights.^{viii} Although responsibility for managing natural resources is vested in State and Territory Governments, these civil rights are contained within the Australian Constitution (Section 100): *‘The Commonwealth shall not, by any law or regulation of trade or commerce, abridge the right of a State or of the residents therein to the reasonable use of the waters of rivers for conservation or irrigation’*.

For Australia, the risk to clean water and sanitation is as dependent on climatic and seasonal variations (drought and flood) – as it is on the infrastructure and technology that will make (desalination and recycled water), collect (waterways), store (dams), treat (water and wastewater treatment) and distribute (distribution and retail) clean water and sanitation services. Head (2010) argues the public interest objectives in Australia’s urban water sector are wide-ranging, and call for a comprehensive approach to protecting public health and safety, providing secure and reliable water services, having strong regard for environmental sustainability – and achieving these goals in an economically efficient way.^{ix} This highlights the need for all levels of government, including the Commonwealth, to play a greater role in ensuring all Australian have access to safe, secure and affordable water and sanitation services.

Drought policy in Australia dates back to 1866 with Henry Parkes offering loans of seed wheat to farmers, while later national policy action focused on attempts to “drought proof” agriculture through building dams and encouraging irrigation, as well as through direct Commonwealth funding for financial subsidies, grants, education/training and social support throughout the last 30 years primarily targeted at rural and regional communities.^x From an historic analysis, both climatic risk profiles - drought and flood - have long been linked as the extreme, albeit not infrequent, parts of the same climate-vulnerable national landscape. This is as relevant a consideration to the urban water supply network, as it is for most other water supply systems throughout Australia. In SEQ, for example, Wivenhoe Dam’s primary function is to provide a safe and reliable water supply (1.15 million megalitres) for the region, but it is also designed to hold back a further 1.45 million megalitres in the event of a major flood. In effect, Wivenhoe Dam has the capacity to reduce downstream flood levels by about two metres in a flood similar in magnitude to the 1974 Brisbane flood.

A reliance on lowest cost surface water dominated collection methods throughout Australia, especially dams, means a high reliance on rainfall and inflows. The main source of water for Australia’s major urban centres remains surface water: rainfall-

fed dams (Sydney, Melbourne, South East Queensland and Darwin), rivers (Adelaide, Hobart and Canberra) and groundwater (Perth). However, across Australia both rainfall and inflows have been generally below historical averages over the last decade or more.^{xi} This has meant all the nation's major cities have recently experienced increasing demand pressures, combined with lower inflows to surface water storages.^{xii} This water demand-supply imbalance triggered a mobilisation of investment in supply augmentation projects, with desalination plants and water recycling schemes emerging as a non-climate dependent alternative water supply for many of Australia's major urban centres. However, high capital costs, coupled with significant operational costs, especially energy use, mean desalination, wastewater treatment and recycled water processes are more expensive than dams.

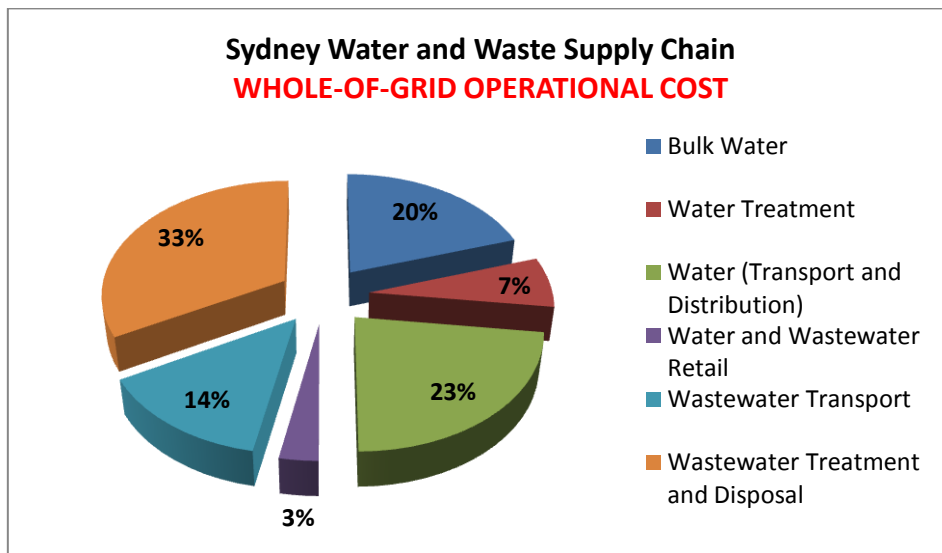
The role of the urban water sector

The Commission (2010) defines the role of the urban water sector as the provision of water and wastewater services to households, business and industry in metropolitan and regional urban areas. The supply of water and wastewater services to most of urban Australia is largely undertaken by government-owned water authorities that operate as regulated monopoly businesses.^{xiii} Services are provided under a variety of industry structures and with different mixes of state and local government ownership.^{xiv} The scale and structure of the supply chain varies across jurisdictions.

Energy is essential for the urban water and wastewater system and, across Australia, energy costs are a major operational cost for urban water utilities – with electricity prices increasing well above inflation. Sydney Water (2010) showed the Commission that its sewerage treatment (51.75 per cent) and water and wastewater pumping stations (39.45 per cent) accounted for more than 90 per cent (91.2 per cent) of its energy use.^{xv} While this did not include energy consumption for desalination plants, it does, nonetheless, highlight a higher level of vulnerability to electricity price shocks for the SEQ water retail-distribution companies than other parts of the supply chain because, in addition to distribution, it has responsibility for wastewater and sewage treatment. In context, Queensland electricity prices have increased by 13.29 per cent (2010-11); 11.82 per cent (2009-10); 9.06 per cent (2008-09); and 11.37 per cent (2007-08).^{xvi}

Sydney Water (2010) points out that what makes the urban water industry unique is that energy represents both a challenge and an opportunity. It is a challenge because of the future scope for price rises, and an opportunity because there is significant energy embodied in wastewater, which can be used (and is being used) to generate power.^{xvii} This innovative approach is consistent with integrated water cycle management (IWCM) principles, which are defined as 'a holistic multi-dimensional approach to urban water management where all water resources are used optimally based on the fit for use concept'.^{xviii} However, this is made more difficult in SEQ because the Queensland Government removed capital subsidies for water and wastewater infrastructure, which could act as a disincentive for SEQ retail-distribution entities to invest in infrastructure and innovation outside a commercial

risk profile. Additionally, Water Services Association of Australia (2010) observe that the absence of subsidies combined with the lower rate of return on certain ‘drought response’ assets act as a disincentive for SEQ’s newly formed distributor-retailer authorities to consider local wastewater recycling and potable substitution options even though they might be economic from a broader, whole-of-grid perspective.^{xix}



SOURCE: Productivity Commission (2010)

The water industry is more capital intensive than the electricity industry and the monopoly components comprise a more significant component of the industry’s costs.^{xx} From a whole-of-grid perspective, the Commission has provided a comparative tool for rationalising cost bearing functions for an average (\$1,000/year) Sydney Water consumer’s water and waste bill. This is replicated in the pie chart above noting that, for bulk water, cost is shared equally between dam and desalination supply. In SEQ, however, the cost of the Queensland Government Bulk Water charge represents significantly more than 20 per cent of the operational cost for the water and wastewater supply chain – almost double for Brisbane at 39.5 per cent and about 60 per cent of total increases for water and sewerage operational (distribution and retail) costs in 2010-11.

The pie chart above also highlights comparatively minor benefits for potential structural reforms to separate urban water and waste retail functions – about 3 per cent of the urban water supply chain. The risks in separating the retail component are: high establishment costs; reduced customer service satisfaction and compromised ‘tap to dam’ supply chain efficiency; and planning and investment decisions. Retail utilities will not be able to make bulk water purchases the way energy retailers can choose between generators because of supply and quality constraints.^{xxi} Additionally, retail functions can drive improvements up the value chain in the distribution functions that can increase customer satisfaction.^{xxii}

The political dilemma for the urban water sector (supply cost v supply security)

With unprecedented population growth in and around most urban centres, Quiggin (2010) points out that the scope to enhance urban water supply through new dams is limited or non-existent for most Australian cities. While this conclusion is primarily based on the availability and affordability of an appropriate site (location, geotechnical condition, size and environmental consideration), it is also about increasingly persuasive political interests. Until recently, expenditure on water infrastructure to service urban populations across Australia was relatively small.^{xxiii} This was due to a combination of capital/funding constraints (at least partially due to an inadequate cost recovery and pricing structure), as well as political constraints to the construction of new dams.^{xxiv}

The legacy of poor planning and investment decisions are evidenced through the growth of increasingly dangerous water supply “crisis” situations. In the SEQ context, for example, The Courier-Mail observed: “...*virtually every step of a process that began back in 2006, when then premier Peter Beattie realised he had to do something dramatic to address the previously unthinkable prospect of southeast Queensland running out of water, has been marked by a seeming indifference to the concept of value for money*”.^{xxv} Outside SEQ, the Independent Pricing and Regulatory Tribunal (NSW) found drought evidenced failures in institutional arrangements for balancing the demand for and supply of water services. The balancing of supply and demand had both a long term and a short term perspective.^{xxvi} Drought and a lack of drought-proof water sources brought many urban regions, such as SEQ, to the brink of running out of water.^{xxvii}

Many State Governments borrowed heavily to invest in non-climate dependent water sources during a time of water supply crisis (drought) and are now, through significant increases to the cost of bulk water, trying to recover some of this cost and pay down debt. Coupled with a recent memory of the hardship associated with a water supply crisis, the legacy of poorly planned and panic-hurried investment decisions now present as a 10-year long (or more) tail of “cost of living” pain for SEQ residents. This will mean significantly higher – and increasing – household water and sewerage bills over the next decade and beyond. An important consideration is the relatively minor role the Federal Government has so far played in providing a more secure, sustainable and affordable urban water system despite its national importance. In this context, Cousins (2010) argues, “*If income redistribution is an objective then funding infrastructure through taxation might be more effective given the existing approach of not discriminating in water pricing between different income groups.*”

Recognising the creation of a national water grid is not feasible because transporting water involves high transport costs (unlike electricity and gas), the goal of delivering long-term water security at an affordable price similarly does not fit well with a commercial decision-making framework. While water restrictions could play a major role in recalibrating future supply and demand imbalances, the longer term advantage for recent high cost investments in urban desalination and recycled water

projects are that this will add to capacity and reduce supply risk in a future time of water supply hardship (drought). Restrictions do not provide a solution to long term imbalances in demand and supply, but have strong community support as part of a drought response measure.^{xxviii} The 2007 Review of Water Restrictions conducted for the National Water Commission, for example, found that restrictions were effective in reducing water demand, with estimated savings between eight and 33 per cent across different restriction scenarios.^{xxix}

The Commonwealth’s recent Background Paper “Our Cities: The Challenge of Change” recognises water as an essential element of future sustainability and productivity of Australia’s cities. It also notes that urban water supplies are coming under increasing pressure from natural variability, changes in both temperature and rainfall and population growth.^{xxx} Council of Mayors (SEQ) strongly supports the development of a national urban policy that provides a robust basis for Commonwealth investment in identified national policy priorities in our cities. As the Commonwealth collect 82 per cent of the total government tax revenues (see below table), it has the greatest capacity to fund the major infrastructure needed to meet future urban challenges, such as the major measures taken to drought proof our cities. This could help ease the cost of living pressures for urban water users by removing from cost recovery principles the costs of ‘contingency infrastructure’ to meet future climate variability emergencies. During the 2007 crisis, the Queensland Government made a similar call: “*Solving the national water crisis will take more than rhetoric...the Howard Government need to stop talking and start delivering*”.^{xxxi}

AUSTRALIAN GOVERNMENTS							
TAX REVENUE 2003-04 TO 2008-09							
(\$M)							
	2003-04	2004-05	2005-06	2006-07	2007-08	2008-09	TOTAL
Commonwealth	209,560	229,131	245,223	261,998	285,672	278,002	1,509,586
<i>% of Total Tax</i>	81%	82%	82%	82%	82%	82%	82%
State Government	40,410	41,667	44,246	48,870	53,130	50,627	278,950
<i>% of Total Tax</i>	16%	15%	15%	15%	15%	15%	15%
Local Government (rates)	7,671	8,183	8,726	9,404	10,128	10,874	54,986
<i>% of Total Tax</i>	3%	3%	3%	3%	3%	3%	3%
TOTAL	257,641	278,981	298,195	320,272	348,930	339,503	1,843,522

SOURCE: ABS (2010), Catalogue No. 5506.0

Cousins (2010) argues consumption and investment decisions need to be guided by efficient price signals to ensure overall welfare of the community is maximised. “*On efficiency grounds it seems clear that water prices should reflect efficient supply costs over time. This is what all governments in Australia have formally agreed to under the National Water Initiative. On equity grounds, there does not seem a strong basis for departing from a user pays approach.*” However, a commercial price path for “water security” is seemingly beyond the affordability of many Australians and therefore beyond the capacity of many urban utilities. The Commission, for example, recognise actions taken to ensure continuity of supply may decrease measured productivity if they increase capital without any commensurate increase in output.^{xxxii}

In effect, policy actions to ensure continuity of supply may involve investment in extra capacity that may be excess to business-as-usual requirements but would be needed during disruptions or emergencies.^{xxxiii}

Queensland Government signals moving away from COAG NWI pricing principles

There is significant and increasing public anger over ‘cost of living’ pressures associated with Queensland Government policy decisions, particularly in respect of water, electricity and petrol. The State Government Bulk Water charge increases are the main driver of SEQ urban water price increases, contributing (in 2010-11) between 34.5 % (UnityWater), 61.7% (Allconnex) and 83.8% (Queensland Urban Utilities) of water price increases. Cousins (2010) observed *‘the State Government has shown every indication of wanting to distance itself from responsibility for large price increases associated with the new drought proofing investments. It has sought to stand behind the Queensland Water Commission (QWC) and, rather than point to the distributor-retailers, it has sought to ‘lay blame’ on local governments for not exercising restraint on retail prices’*.^{xxxiv} In effect, having made high cost investments in non-climate dependent water sources during the peak of a water supply crisis, now, with pre-reform water storage facilities (dams) full and overflowing, the Queensland Government is trying to re-define its commitment to the NWI.

Infrastructure Australia (2010) point to a confusing Queensland Government pricing policy, which caps the State bulk water price at a four per cent pre-tax target rate of return on newly constructed “drought” assets, while targeting a commercial rate of return on the majority of bulk water, which is sourced from existing assets and otherwise new capital.^{xxxv} This implies the Queensland Government is targeting a full commercial rate of return on pre-reform bulk water assets (highest demand and supply) and a capped rate of return on desalination and recycled water. And, with dams full, both desalination and recycled water sources have been placed on standby mode.^{xxxvi}

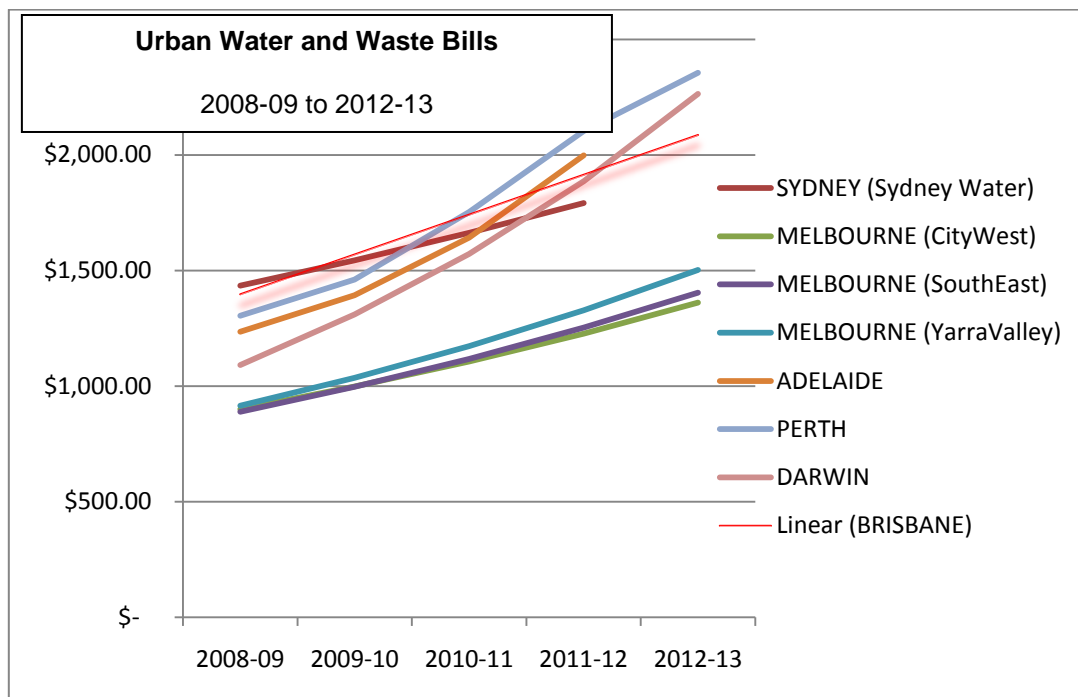
The Queensland Government’s political discomfort with NWI principles is evidenced by its pressure on SEQ retail-distribution entities to reduce water bills to a level already assessed as below the MAR requirement^{xxxvii xxxviii}; and on councils to directly subsidise water charges^{xxxix xl}. By contrast, The State Department of Infrastructure and Planning, in a recent submission to the Queensland Competition Authority, questioned the appropriateness of Local Government offering subsidies for water and sewerage services to local residents.^{xli} And, in passing new legislation, the Queensland Government argued: *“It is not considered appropriate that the SEQ local governments should be able to grant exemptions from water and wastewater charges for services now provided by the distributor-retailers”*.^{xlii}

The Queensland Government’s recent political attacks against NWI principles are inconsistent with its inter-government policy agreement and its directions to Queensland Parliament, local government and other subordinate agencies. Outside Queensland, the Independent Pricing and Regulatory Tribunal (NSW) has also

expressed its concern that full cost recovery was not being achieved due to subsidies from local, state or federal Governments that distort price signals.^{xliii}

Can Australians afford a fully “commercialised” urban water sector?

At the COAG meeting of 29 November 2008 it was agreed to adopt an enhanced national urban water reform framework to improve the security of urban water.^{xliv} COAG agreed actions included: finalising and adopting NWI pricing principles; reviewing consumer protection arrangements in relation to services provided by water utilities; and investigating possible enhancements to pricing reform. In SEQ all urban water distribution/retail entities continue to set prices below the MAR requirement. While adoption of NWI pricing principles would improve consistency of approach across the jurisdictions, consensus has not been reached on the best set of options for operationalising the principles.^{xlv} Infrastructure Australia argues greater national consistency and harmonisation in regulatory approaches could be achieved if States cede regulatory powers to a new single national water regulator - like arrangements for energy distribution/transmission.^{xlvi}

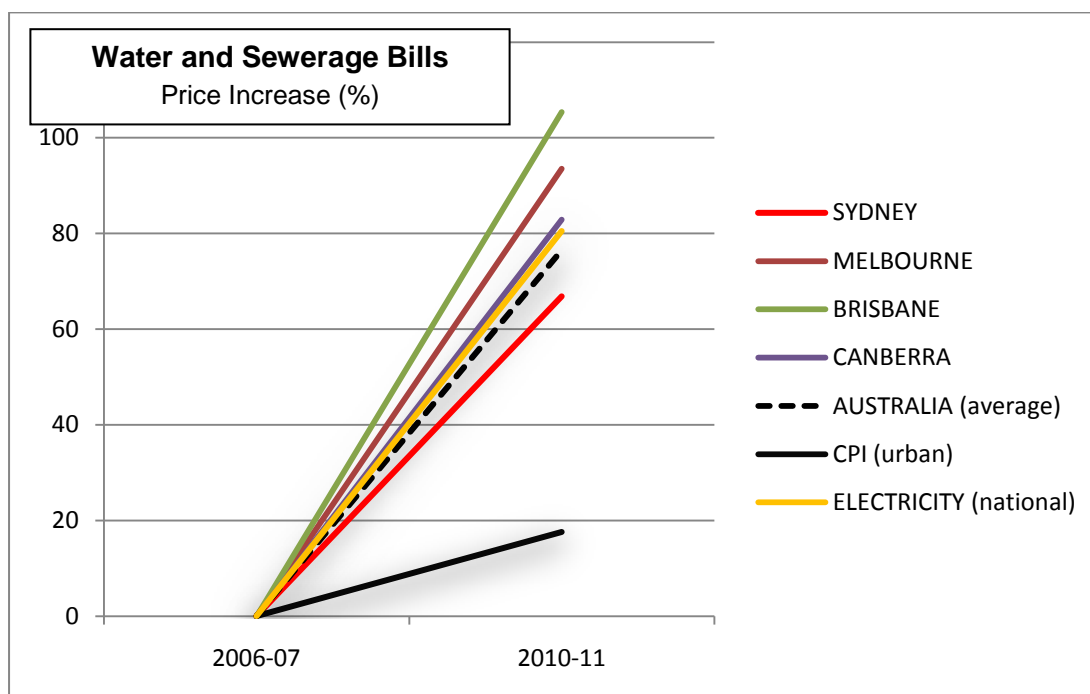


SOURCE: Engineers Australia (2010) and Australian Water Commission (2010)

The graph above shows that average urban household water and wastewater bills (based on 200KL water use) have continued to escalate in all capital cities since 2008-09. While Melbourne household bills are shown as lower than other capital cities, this is more likely due to Australia’s biggest desalination plant (150 ML/day) still in construction phase, and bulk water prices are set nearly double between 2009-10 and 2012-13.^{xlvii} From 1998 to 2010, water and sewerage charges have increased significantly in Canberra (131.2 per cent); Brisbane (128.2 per cent); Sydney (88.8 per cent); Melbourne (93.6 per cent) and Darwin (87.5 per cent). The smallest increases were in Perth (60.8 per cent), Hobart (68.4 per cent) and

Adelaide (72.7 per cent).^{xlviii} By comparison, the CPI (weighted average) for capital cities was 51.1 per cent for the same period.^{xlix}

These figures highlight the potential cost to the urban water sector if charges are capped at or below CPI without a significant subsidies for new capital investments. Capping would have an immediate short-term impact (negative) on urban water utilities and a cumulative adverse risk for both urban water supply and security of supply planning and investment decisions and the long-term economic viability of urban water businesses. In effect, without significant capital subsidies, this could re-create a similar political culture to that which was responsible for systemic water security policy failures in urban Australia. Infrastructure Australia, for example, found the past practice of setting prices below a commercial rate of return contributed to an underinvestment in water infrastructure over several decades and an unpreparedness to have an adequate supply buffer in times of drought.¹



SOURCE: Australian Bureau of Statistics 2010, Catalogue NO.: 6401.0 (September Quarter)

ABS data (above) show water and sewerage bills have increased significantly more than CPI. SEQ water prices will remain under upward pressure from a number of drivers, including:

- State Government bulk water charges, which represent about 39.5 per cent of the total operating cost of Brisbane’s water and waste supply operating costs in 2009-10ⁱⁱ, compared with about 20 per cent for Sydney, rising from around \$0.7/kl (2007/8) to \$1.52 (2010/11) to \$3.53 (2017/18);
- Big increases in electricity prices - 113.4 per cent between September 2000 and September 2010ⁱⁱⁱ;
- SEQ’s population growth at about twice the national average creating a massive need for investment in new infrastructure capacity. Significantly higher levels of Commonwealth infrastructure investment per capita is

required, relative to the nation as a whole, to maintain similar levels of service.^{liii};

- Queensland has above average unit costs to provide infrastructure and, because of the need for more infrastructure per capita to deliver the average level of service, Queensland also has above average depreciation expenses^{liv};
- The cost of capital works for SEQ urban water retail-distribution companies will increase significantly (about \$100million/year) because the Queensland Government has cut the water and sewerage capital subsidies program;
- Increased climate variability, with SEQ average annual rainfall in the last decade falling nearly 16 per cent compared with the previous 30 years. The 'best estimate' of projected rainfall change shows a decrease under all emissions scenarios.^{lv} Higher average temperatures will also reduce the yield for any given level of rainfall. This demonstrates the need for more expensive non-climate dependent bulk water supply sources; and
- Increased levels of service and environmental standards on waste water treatment.

Building “all-of-government” consensus on financing “water security” for major cities

Australian cities with populations of greater than 100,000 people contribute nearly 80 per cent of Australian Gross Domestic Product and employ nearly 75 per cent of its workforce.^{lvi} They are the principal location for about 70 per cent of Australian businesses, including 80 per cent of large corporations.^{lvii} Importantly, there is strong evidence that population growth is a major driver of State infrastructure spending, and States with rapid population growth must spend more to provide the average per capita stock of infrastructure required to deliver the average level of service.^{lviii}

The availability of reliable and affordable water is fundamental to maintaining a high living standard for all Australians and is a critical enabler of economic activity in Australia's metropolitan and regional areas.^{lix} As such, it would be consistent with the objectives of a national urban policy for all levels of government, especially the Commonwealth, to play a greater role in ensuring all Australian citizens, including the majority of Australians who live in urban areas, have access to a safe, secure and, more importantly, “affordable” urban water supply. This also points up the potential economic, social and environmental dividends for Commonwealth and State Governments through national urban reforms that link financial incentives for innovative local water and wastewater infrastructure investment to raising national efficiency, productivity and environmental outcomes.

In 1989, the Commonwealth Government found that ‘drought policy should be considered in a wider context than that of temporary relief and determined that *‘drought is considered a recurring, natural condition, and not a rare climatic aberration’*.^{lx} Implicit in this statement is recognition of the vulnerability of Australia's water supply to climatic variation and the need for a national drought policy response that would reduce the longer term impact of drought. It is also important to recognise that, notwithstanding recognising a foreseeable risk 20 years ago, the

Commonwealth have again recognised *'drought (and a lack of drought-proof water sources) brought many urban regions, such as SEQ, to the brink of running out of water'*^{lxix}. The recent 2005-08 water supply crisis was a particularly difficult time for SEQ residents and businesses, for which residents are still paying for through higher and increasing State Government bulk water charges.

It is difficult to reconcile the high cost (capital and operating) of "national security" urban water infrastructure like urban desalination and recycled water assets, within a commercial decision-making framework and an "affordable" cost-recovery price path. Cousins (2010) argues there seems to be a case to ensure prices set to cover high cost bulk supply sources relate more closely to the use of those sources. *'One approach could be to seek to recover most of the costs of the desalination plant when it was utilised at times of normal supply shortages. This would be somewhat analogous to the situation in the electricity industry when at peak load times higher priced gas fired plants come into operation. In the water industry, however, it may be necessary to recover the costs associated with maintaining operational capability of the desalination plant in normal bulk water prices'*.^{lxxii}

The Commonwealth Government has acknowledged that its population policy settings are major drivers of population growth in SEQ. Treasurer Wayne Swan acknowledged at the Growth Management Summit last year that: "Overseas migration has been the largest component of Queensland population growth since 2006."^{lxxiii} Dealing with climate change is also a major national priority. Policy measures to deal with the consequences of both major policy drivers needs to be as much a Commonwealth as a State and Local government responsibility.

In commissioning the Productivity Commission's recent inquiry into Australia's urban water sector, the Commonwealth Government recognise that, *"in recent times, the ability of our urban water systems to meet demand for water in our cities and towns has been challenged by severe droughts, climate change, increasing urban populations and ageing water infrastructure. Ensuring long term water security requires effective arrangements that encourage timely investment in diversified water supplies and improve the efficiency of water use"*. Notably, this is not dissimilar to the COAG 2003 Communiqué recognising a pressing need *"to increase the productivity and efficiency of water use, sustain rural and urban communities, and to ensure the health of river and groundwater systems"*. Taken together, the Commonwealth Government's historic and recent observations demonstrate its long consideration of productivity and efficiency reform in the national water supply sector, while also recognising natural and recurring risks to the security of the national urban water supply. Less evident, however, are quantifiable "security of supply" and "affordability" outcomes.

In 2007, SEQ faced the unthinkable prospect of possibly becoming a major city in the developed world that ran out of water. The economic costs to various industries

at the time (e.g. the nursery and garden industry, food production and even construction) were mounting, and would have become more severe if the crisis was not broken by long overdue rains in 2008.

In SEQ and in many other parts of Australia's urban water sector, the last drought has ended with UN meteorologists now identifying the immediate past and current period as 'the most powerful incarnation of La Nina in more than three decades – "producing one of Australia's wettest years".^{lxiv} This temporary end to the water supply emergency means the biggest issue now facing much of Australia's urban water sector, especially in SEQ, is how to pay the reform bill, especially the significant capital costs for diversifying water supply through building and maintaining expensive desalination plants and/or recycled water schemes. Having recognised drought as a significant and increasing national risk for urban water supply security – with consequent hardship for urban Australia – an adequate approach to national reform from the Commonwealth should not simply bespoke commercial principles for urban water companies and its customers, while leaving the massive bill for national drought mitigation action to subordinate levels of government.

In the context of the Commonwealth Government playing a greater role in affordable housing, it could (and does on a small scale) directly fund infrastructure to further its housing affordability objectives.

In the context of a pragmatic national environment and sustainability policy action, the Commonwealth could directly fund (and has through the National Water Fund) wastewater recycling and potable substitution options and wastewater treatment plant upgrades.

And, in the context of the national interests implicit in climate change and water security policies, and to further its own initiatives on reducing "cost of living" pressures, the Commonwealth could help retire State and Local Government debt on "drought proofing" infrastructure which is unlikely to comfortably fit into cost recovery mechanisms (such as desalination plants on standby mode).

2.0 SEQ: Politics of a water supply crisis

Consistent with natural variability experienced over the last 110 years, average rainfall in SEQ over the last decade fell nearly 16 per cent compared with the previous 30 years.^{lxv} Adding to identified naturally-recurring climate risk to SEQ's urban water supply, the region also experienced stronger population growth than other major capital city metropolitan areas. During 2007-08, for example, SEQ's population grew 10 times faster than other regional planning areas in Queensland – with about 70 per cent (69.2 per cent) of the State's population living in SEQ compared with 63.3 per cent in 1981^{lxvi}. In this context, Morton (2009) argued that with Queensland growing at about twice the national average for a lengthy period, significantly higher levels of infrastructure investment per capita was required,

relative to the nation as a whole, to maintain similar levels of service. This is particularly the case for the south east where about 75 per cent of Queensland's growth is taking place.^{lxvii}

From 2006 to 2008 SEQ dam levels fell below 20 per cent of capacity and Australia's toughest water restrictions were introduced. This natural disaster (drought) was made significantly worse because, despite strong population growth and increasingly limited water supply capacity, successive State Governments did not invest in additional new bulk water supply capacity. As discussed earlier, the scope to enhance urban water supply through building new dams is further limited by local and sectional political interests, as recently evidenced by the Wolfedene Dam (1989) and the Traveston Dam (2009).

Of great concern for Queensland residents, the regional water supply crisis occurred several years after State Government reports recommended the adoption of appropriate risk mitigation actions, especially more sustainable water use practices.^{lxviii} The severity of SEQ's water supply crisis was made worse by delayed State Government intervention, despite early – and regular – warnings from local government that SEQ urgently needed a new regional water supply plan.^{lxix} The Queensland Government's somnambulant approach to an emerging water supply emergency resulted in SEQ Councils spearheading further investigations into the Western Corridor Recycled Water and Gold Coast Desalination projects, as well as through other risk mitigation action like water restrictions, dam upgrades, aquifer projects, rainwater tank rebate schemes and other water conservation measures.

From the outset, it is important to recognise, while the SEQ water supply crisis acted as a catalyst for institutional reform for the region's water supply system, the crisis was primarily about capacity and demand issues – diminishing bulk water supply capacity, the lack of alternative water sources, wasteful water use practices and increasing demand from population and economic growth. In this context, it is not surprising that many people, including the local government sector, now view the Queensland Government's politically-charged takeover of bulk water supply assets as “*a cynical ploy to shift costs to councils and blame them for price hikes*”.^{lxx}

In 2006, Premier Peter Beattie declared that SEQ faced a water emergency and launched a massive SEQ water reform and infrastructure building agenda, including the establishment of the Queensland Water Commission (QWC), which was established to oversee water reform in SEQ and regional drought management strategies, including constructing a multi-billion dollar water grid to connect the region's major bulk water storages. Noting the QWC was not fully independent of government, Infrastructure Australia (2010) argue further review of the current arrangements would achieve more independent, transparent and objective decision-making for urban water supply planning in SEQ.^{lxxi}

While water and wastewater services in Queensland had traditionally been provided by Local Governments, the severe drought in SEQ and the significant expenditure on water supply infrastructure, such as the Tugun Desalination Plant and Water Grid, culminated in institutional reforms in the region during 2007–2008 with the Queensland State Government taking over responsibility (from councils) for bulk water assets.^{lxxii} While ‘compensation’ for these bulk water assets was made to SEQ Councils, strong concerns about the level of compensation remain. There has also been significant political controversy over water price increases, which has influenced the way people view the institutional and structural reforms to the SEQ industry.^{lxxiii}

The SEQ water supply crisis institutional reform process

Head (2010) argues water policy in many jurisdictions has been marked by crisis response rather than steady long-term planning which anticipates the need to cope with volatility, uncertainty and unpredictable variations.^{lxxiv} Queensland’s water policy experience over the last three decades has been strong evidence of this. In 2007, the Queensland Government announced an SEQ water reform model where the State Government would be accountable for water security and ensuring water supplies across the region (control the key water grid assets), while Local Governments would be responsible for the supply of treated water and the provision of sewerage services to households and business.^{lxxv} The State assumed control of bulk water assets (i.e. dams, water treatment, pipelines, desalination plants and the recycling scheme) as part of a new regional water grid. In securing Council-owned bulk water assets, the State Government split water storage from the rest of the water and wastewater supply functions, and further split the latter into ‘distribution’ and ‘retail’ entities. Quiggin (2010) argues these reforms were an “unthinking adoption of [a] structure modelled on electricity, despite the very different supply and demand characteristics associated with electricity (storable only at high cost, and transportable at low cost) and water (storable at low cost, but with high transport cost)”.^{lxxvi}

The key elements of the State Government’s final (2007) institutional reform model were^{lxxvii}:

1. **Ownership of SEQ dams/weirs** – rationalised to a single bulk supply entity owned the State Government by 1 July 2008 (future ownership of wastewater treatment plants considered after this);
2. **Manufactured water** – the Gold Coast Desalination Plant and Western Corridor Water recycling Scheme to be located within another State Government-owned entity from 1 July 2008;
3. **Bulk transport** (SEQ water grid) – major transport infrastructure, including that owned by Local Governments, to be moved to a single bulk transport entity owned by the State Government from 1 July 2008;

4. **Water grid management** – a Water Grid Manager will be established by the State Government to manage contracts between the bulk supply entities and the retailers, as well as to manage flow of water around the SEQ water grid;
5. **Distribution** – retail activities to be split from distribution from 1 July 2010 with all reticulation and sewerage pipes to be moved into a single regional entity from 1 July 2010; and
6. **Retail** – retail entities (three to 10) be established (independent from Councils).

The post-SEQ water supply crisis institutional reform process

In the pre-reform era in SEQ (up to 2007), one water entity (for example; Gold Coast Water) or two water entities (for example; Brisbane Water and SEQ Water) were involved in the water and wastewater supply chain in each local government area. This compares with seven water entities – each with its own overheads – in the period following institutional reform. For example, in addition to statutory and regulatory control by various State Government Departments, primarily the Department of Natural Resources, Mines and Energy, the SEQ water and sewerage supply chain also includes:

- Queensland Water Commission;
- Queensland Bulk Water Supply Authority (trading as SEQ Water);
- Queensland Bulk Water Transport Authority (trading as LinkWater)
- Queensland Manufactured Waster Authority (trading as WaterSecure);
- SEQ Water Grid Manager;
- Four (4) special purpose vehicles (SPV);
 - Southern Regional Water Pipeline Company Pty Ltd (trading as LinkWater Projects),
 - Queensland Water Infrastructure Pty Ltd,
 - South East Queensland (Gold Coast) Desalination Company Pty Ltd (trading as SureSmart Water); and
 - Western Corridor Recycled Water Pty Ltd.
- Three (3) independently managed water retail and distribution companies (owned by local government but structurally separated from Councils) with pricing-setting oversight for water and wastewater charges by the Queensland Competition Authority (QCA)
 - Central SEQ Distributor-Retailer Authority (trading as Queensland Urban Utilities);
 - Southern SEQ Distributor-Retailer Authority (trading as Allconnex Water); and
 - Northern SEQ Distributor-Retailer Authority (trading as UnityWater).

3.0 Efficiency and other objectives

On top of seven SEQ water entities – each with its own overheads - is a thick multi-layered bureaucratic maze, including the Department, the QWC and the State Government regulator – the QCA. While this is described in greater detail earlier (Section 2), the 2009 Weller Review seemingly recommends a move back to a similar urban water supply structure to that which, aside from a major supply-demand crisis during a prolonged drought, worked reasonably well in the pre-reform period.

The Weller Review (2009:86) argued that Governments “certainly” need to control the supply of and delivery of water, either directly, or through authorities. It then concluded that, as a first preference, local services should be delivered at a suitably appropriate local level and there should be flexibility of form and process, depending on local conditions.^{lxxviii} In this context, Yarra Valley Water (2010) argues that water utilities responsible for customers should hold the bulk water entitlements on their behalf and, where possible, these customer-focussed water utilities should manage their own water-supply demand balance in accordance with obligations reflecting central, larger scale plans.^{lxxix}

Sydney Water (2010) claim its ongoing efficiency gains in the last three decades were from the elimination of excess staffing (14,000 staff in 1980 to 2,978 in 2009-10), rationalising non-core business activities and increased private sector involvement, including extensive use of the private sector to deliver services. By way of contrast, the institutional reform approach to the urban water sector in SEQ was subject of direct and persistent political interference impeding the ability of water entities from achieving business improvement. For example, in September 2007, the Queensland Treasurer (Hon Anna Bligh MP) directed the following onerous pre-conditions for new retail and distribution companies in SEQ^{lxxx}:

- Reforms have not, and will not, be driven with labour savings as an aim;
- Staff and unions will be engaged throughout the implementation process;
- There will be no forced redundancies of staff employed under awards or Enterprise Bargaining Agreements;
- Workers’ entitlements and conditions will be protected;
- The terms and conditions of employment contracts will be honoured; and
- The State is aware of the need to protect staff from the Commonwealth’s Australian Workplace Agreements (‘Work Choices’) regime, and if necessary will enact legislation to ensure that employees transferring from Councils to the new State-owned and Local Government-owned entities are protected from Work Choices exposure.

While SEQ Councils argued the establishment of Corporations Act companies was the preferred model,^{lxxxii} the State Government adopted a political position that “*prospective employees of the water entities will not be subject to WorkChoices as a result of the implementation of these reforms within SEQ*”.^{lxxxii} In effect, these conditions for SEQ’s distribution/retail water entities now enshrine operational workforce inefficiencies – with efficiencies from greater economies of scale lost because the State Government insisted on three years of job guarantees (on top of

three years of job guarantees relating to forced council amalgamations). Additionally, there is still uncertainty over who will pay for water and sewerage infrastructure in State Government developments (e.g. ULDA areas).

4.0 Supply of Wastewater Services

Energy Prices

As highlighted in section 1, the highest operational and capital cost functions for SEQ's water supply chain remain with Council-owned water retail-distribution companies, while the State Government provides bulk water at an increasingly commercial price. These activities are particularly vulnerable to ongoing increases in energy prices. Sydney Water (2010) notes that, desalination aside, wastewater treatment accounts for just over 50 per cent of the energy used, while water pumping accounts for another 30 per cent and water filtration and sewage pumping accounts for more than 10 per cent.

In Queensland, for example, electricity prices have increased by 113.4 per cent in the last decade. In SEQ's post-reform urban water sector, the three Council-owned water retail-distribution companies – Queensland Urban Utilities, Unitywater and Allconnex – are most exposed to energy price shocks because of the high costs associated with sewerage treatment and water and wastewater pumping stations. Operational costs for the State Government-owned WaterSecure, because of its desalination and recycling activities, and LinkWater, because it transports water, are also highly vulnerable to state electricity prices increases. However, the State Government recently announced the energy intensive Tugun desalination plant would move to 'standby' mode and that Seqwater and WaterSecure would be merged in an effort to reduce costs.

Developer Charges:

As part of the 1994 COAG Strategic Water Reform Framework and the 2004 NWI, all efficient costs of water and sewerage activities should be recovered through a combination of developer charges, and fixed and usage charges.^{lxxxiii} However, the policy direction from the Queensland Government has not consistently pursued this objective. Current infrastructure charges for Queensland high growth councils recover only around 50-70 per cent of the cost of infrastructure.^{lxxxiv} Despite this, the Queensland Government is actively considering capping infrastructure charges at between \$20,000 and \$30,000, which is inconsistent with COAG and NWI commitments.^{lxxxv} The push by the State to have councils increase their subsidies on infrastructure charges comes just a year after the State announced the removal of its own 40 per cent capital subsidies on water and wastewater infrastructure, a decision that will cost councils around \$100 million a year.

Infrastructure contributions paid by developers are a significant part of the funding base for water utilities (around 20-30 per cent dependent on the level of

development) and have been under significant political pressure from the development industry. Capping of developer charges can have extremely negative impacts on both equity and efficiency. The equity aspects arise in that a greater burden of funding new development shifts to the broader taxpaying population rather than the developer and their subsequent purchases.^{lxxxvi}

From a cost recovery perspective, this masks the true cost of housing, particularly in fringe developments. Efficiency issues arise where the capping of charges results in investment being unfunded or deferred. This has been the case in some New South Wales local government areas in recent years. SEQ Councils have been in the process of developing detailed Priority Infrastructure Plans for approval by the Queensland Competition Authority which outline the detailed cost of infrastructure provision and form a robust and transparent basis for developer charges. As a general principle, cost recovery principles should continue to be applied to developer charges on a fully transparent and robust basis, with any public subsidies clearly identified.^{lxxxvii}

5.0 Consumption and Pricing

Engineers Australia and Infrastructure Australia have argued that under-investment in water infrastructure over a long period was a result of financing constraints. *“As a result there has been accumulating pressures on water supplies leading to water restrictions and ‘emergency’ decisions on new ‘insurance’ water supplies involving expenditure far more costly than otherwise may have occurred”*. In retrospect, the Queensland Competition Authority (1999) argued that underpricing will send misleading signals to customers about the real costs of supply and tend to encourage over-use of the resource. It is also likely to result in the business recovering insufficient revenue to ensure continued asset serviceability or sustainable business viability.^{lxxxviii} The QCA (1999) argued an objective, therefore, of any regulatory framework and associated principles for urban water pricing is to ensure that price/revenue levels are efficient in terms of preventing monopoly exploitation of customers while ensuring that the monopoly business is sustainable.^{lxxxix}

Sydney Water (2010) argue there are at least three other main drivers of increasing costs in the urban water and wastewater industry. These include: 1/. Catering for urban growth; 2/. Energy issues; and 3/ wastewater treatment plant issues. Providing, maintaining and replacing the additional water and waste infrastructure capacity required for a growing population also presents as an ongoing challenge, especially in high growth urban areas like SEQ. The Council of Mayors (SEQ) argue the Commonwealth Government because of its strong taxation base has the greatest financial capacity to ensure Australians have a reliable and affordable water supply. This is fundamental to maintaining a high living standard for all Australians and is a critical enabler of economic activity in Australia’s metropolitan and regional areas.^{xc}

Additionally, there is a symbiotic relationship between water supply and urban form and servicing requirements, and health of ecosystems – urban and rural.^{xcvi}

Engineers Australian (2010) argue a key aspect of the NWI (and the 1994 agreement before that) was for urban water prices to be set in accordance with commercial practice. However, this has not yet happened despite joint Federal-State (and Territories) agreement to principles for water prices through the COAG. Notwithstanding this, the Queensland Government is now leading a potentially damaging political campaign against NWI principles in SEQ, seemingly to minimise the political fallout from its own policy of increasing bulk water prices. This is evident in the Queensland Government's public advocacy for SEQ urban water distribution-retail companies to abandon cost-reflective pricing principles, as well as its calls on SEQ Councils to directly subsidise water services.

6.0 Scope for Competition and Contestability

The Consumer Utilities Advocacy Centre (2010) argue that, with specific regard to competition and contestability in the urban water sector, specific reforms often have few or no precedents either in Australia or internationally, which makes an evidence-based approach particularly difficult.^{xcvii} As shown in water and waste supply chains pie graph (Section 1) competition at the retail level is unlikely to produce substantial benefit, especially considering it accounts for about three per cent of operational costs. Retail utilities will not be able to make bulk water purchases the way energy retailers can choose between generators because of supply and quality constraints.^{xcviii} Further, the high capital cost of new metering systems to support full retail contestability would further negate the modest gains in terms of efficiency.

The recent experience in SEQ provides a timely warning for the Commission that national reforms aimed at structurally separating retail and distribution functions in the urban water sector would be a retrograde step. The Council of Mayors (SEQ) main arguments against this model as it was being developed by the State Government are presented in **Appendix B** for the consideration of the Commission.

The State Government revised its final institutional water reform model two years later, after considerable money was spent on transition planning and establishment costs. The Council of Mayors (SEQ) estimated the cost of implementing the single distribution entity and three retailers reform model would cost between \$200 million and \$320 million (depending on the nature of retail contestability).^{xcix} Over a five year price path, this would result in a 6.1 per cent increase in water charges in addition to the 147 per cent increase in prices (due to bulk water price increases). Clearly, in this case, the large capital cost of establishing retailers capable of retail contestability could not be justified in light of the limited efficiencies available.

The separation between distribution and retail has been rejected by all water service providers across Australia and it has not been implemented. This is because most policymakers now recognise that water is different from electricity because more of

the capital costs are tied up in the monopoly distribution role, leaving less scope for economies to be achieved in the contestable retail space.^{xcv} In the Queensland context, it is also important to recognise the public experience will not easily reconcile with any un-tested economic theory that greater competition reforms for urban utilities at the retail level will lead to cheaper utility bills. This is especially so because the Queensland Government promised its reforms to the State Electricity Industry would lead to greater competition and therefore cheaper electricity bills. Instead, household utility bills have – and continue to – increase by unprecedented levels, compared with the pre-reform periods for both electricity and water.

The retail-distribution model finally agreed by the Queensland Government after negotiations with the Council of Mayors (SEQ) resulted in three “economically efficient” retailers replacing ten council water businesses on 1 July 2010. A pricing oversight regime would apply on the basis that retailers would be permitted to pass through changes in wholesale costs through retail pricing and the future regulatory framework would allow for appropriate compensation for the risks faced by retailers, as part of achieving a reasonable profit margin on their operations.^{xcvi} SEQ Councils also proposed the development of a more rigorous service standard and customer protection framework to accompany the shift in accountabilities from councils to the new entities.^{xcvii}

While it is still early days, it is worth noting that the vertically integrated water utility that supplied Melbourne was split into three separate retail suppliers on a zonal monopoly basis. In this context, Yarra Valley Water (2010) argues that having three retailers competing through comparative performance has delivered many examples of innovative solutions at the state, national and international level.^{xcviii} However, IPART cautions that, while there are suggestions of significant improvement in efficiency as a result of the pressure on management to outperform neighbouring utilities, how expected efficiency gains from comparative competition outweigh the potential losses from the duplication of administration costs, and any scale efficiency loss should be quantified. However, as discussed in Section 3, potential efficiencies from greater economies of scale were lost in the SEQ distribution-retailer model because the State Government insisted on three years of job guarantees (on top of three years of job guarantees relating to forced council amalgamations).

7.0 Tools and options for achieving and implementing reform

Within Queensland there are several State agencies responsible for regulating or otherwise governing various aspects of the water business, which should be rationalised – subsumed within the Department of Natural Resources and Mines. Similar jurisdictional complexity is present at the national level resulting in significant probability of duplication, communication break-down and dysfunctional regulation.^{xcix}

For SEQ, the Council of Mayors (SEQ) argues there are now too many bodies to manage water supply which should now be rationalised – a view shared by the Weller Review, the Directors-General of its sponsoring departments and the Queensland Opposition. The Weller Review recommended the QWC, together with the four bulk water infrastructure bodies – Queensland Bulk Water Supply Authority, LinkWater, WaterSecure and the SEQ Water Grid Manager – should be abolished and its functions transferred into the Department of Natural Resources and Water.^c Additionally, it recommended the four SPVs should be abolished on completion of the specific project for which it was established.^{ci}

While few people would doubt in principle the critical importance of investing in a more secure and sustainable high quality national urban water sector, the high costs now realised by urban residents throughout Australia highlight the critical importance of “affordability” in the Commission’s inquiry. The Queensland Government (2007) argued if the Commonwealth helped fund drought-proofing infrastructure, it could “*drastically cut the impact of water prices on South East Queensland residents*”^{cii}. It is clear from an historic analysis that the Commonwealth has played major role in drought policy across Australia but less evident in recent history is its financial commitment to “drought-proofing” urban Australia, especially South East Queensland.

Governments across Australia have already agreed that water service prices should more closely reflect efficiency pricing principles^{ciii}. This has included endorsement of cost reflective pricing and the inclusion of the full opportunity cost of capital.^{civ} The relevant efficiency pricing principles have been articulated and confirmed on a number of occasions, but their application has been variable.^{cv} It would be reasonable to assume that, having agreed to adopt national water pricing principles, the Queensland Government would understand the NWI agreement’s impact on subordinate agencies and publicly-owned water monopoly companies.

Recent and ongoing announcements about downward adjustments to the bulk water pricing regime add to confusion over the true impact of State Government bulk water charges in the absence of an independent regulatory review and/or scrutiny. Despite this, the Queensland Government maintains it has been transparent – publishing a 10-year price path for bulk water.^{cvi} Infrastructure Australia, however, recognise the Queensland Water Commission (QWC) is not fully independent from government and cites a confusing pricing policy, which caps the State bulk water price at a four per cent pre-tax target rate of return on newly constructed “drought” assets, while targeting a commercial rate of return on the majority of bulk water, which is sourced from existing assets and otherwise new capital.^{cvi} Additionally, Cousins (2010) argues the QWC published data indicating the movement of bulk prices and the retail price flow-through for ten years was flawed because it didn’t include normal inflation, or other cost pressures for retail-distribution entities.

Given the cost of bulk water is now the major cost driver for household water and sewerage bills, it is a concern that Queensland Government Bulk Water Charges are not subject to the same ongoing independent regulatory oversight and scrutiny as price-setting for SEQ's distribution-retail sector. In Sydney, for example, the price of bulk water supplied to its distribution-retail entities (Sydney Water), together with the prices Sydney Water charges its retail customers, are set by the Independent Pricing and Regulatory Tribunal (IPART). In Queensland, however, the State Government appears to be using its independent regulatory authority, the Queensland Competition Authority (QCA), for political purposes. For example, Cousins points out the QCA was directed to monitor prices set by Council water businesses in 2009-10, but the State Government seemed more concerned about attribution of the causes of price rises than it did with efficient price setting.^{cviii}

Perhaps, as a first step, the Commission needs to “de-politicise” its reform approach by evaluating how access to water and sanitation is linked to a range of civil rights – community service obligations – and the appropriate balance of public and commercial values for national “drought proofing” investment. The rapidly evolving policy confusion about participant obligations under various COAG agreements seemingly highlights a need – for the integrity of the COAG, NWI and other national productivity and efficiency reforms – for the national urban water sector to identify specific “security of supply” assets and expenditure that could, more appropriately, be financed outside a business-as-usual paradigm. Sydney Water (2010) argue irrespective of whatever structure is adopted, the key issue is providing utilities with incentives to continue to pursue efficiency gains and make the right investment decisions.^{cix}

The Commonwealth has an important role to play in balancing national water security objectives with increasing cost of living pressures now associated with a more secure and sustainable urban water supply. This is also consistent with Infrastructure Australia's view that the availability of reliable and affordable water is fundamental to maintaining a high living standard for all Australians – it is a critical enabler of economic activity and a significant economic sector in its own right.^{cx} The Commonwealth could, for example, link capital subsidies and grants to national performance benchmarks on energy efficiency, environment and sustainability, productivity and population/economic growth (affordable housing). Pursuing reform under a national umbrella is likely to expedite outcomes, especially if linked to rewards and sanctions.^{cxii} This underlines the importance of inter-jurisdictional structures, such as the Council of Australian Government's (COAG) NWI, to reignite momentum to build on earlier urban water initiatives.^{cxii}

While not yet quantified, the costs of uncertainty and duplication in the Queensland Government's rapidly evolving urban water policy framework posed an ongoing risk to the long-term feasibility of SEQ water supply and distribution. For example, the *Courier-Mail* observed: “*The irony of it is impossible to ignore – the State*

Government spent nearly \$7billion drought-proofing the region just in time for the wettest summers on record...not only is the new water system exceedingly expensive but it is also extremely confusing. Perhaps that's just what the Government wanted, a way to spread the blame.^{cxiii} In this context, there is a preference for a considered policy development dialogue with all levels of government, industry stakeholders and consumers – and truly independent regulatory oversight for price-setting decisions.

Yarra Valley Water (2010) point out there is scope for the National Performance report published by the National Water Commission to become the prime vehicle for an Australia-wide comparative performance regime to drive efficiency and improvements in customer service across urban water utilities in Australia. And, there is scope for State economic regulators to prepare local comparative reports which take account of local factors where there are a sufficient number of urban water utilities.^{cxiv} Similarly, the National Competition Council (2010) argue the regulation of access under the National Access Regime may be appropriate in some situations in the water sector, but a coordinated national approach to access regulation, similar to the approach adopted for the gas industry, is likely to have significant merit for urban water infrastructure services.^{cxv}

In the absence of a cooperative approach, Cousins (2010) and Infrastructure Australia (2010) recommend consideration of a single national regulator for the water industry. Such a regulator would be more able to isolate itself from the tensions associated with State and Local Governments relations which are more evident in Queensland than in other jurisdictions.^{cxvi}

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APPENDIX A



MONASH University

Centre for Regulatory Studies

Review of Water Prices

**Final Report
December 2010**

**Prepared for the Council of Mayors (SEQ) by
Dr David Cousins AM Professorial Fellow**

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Executive summary

This report examines the setting of prices for the supply of water services to residential users in South East Queensland (SEQ). The independent review was commissioned by the Council of Mayors (SEQ) in October 2010 to examine the basis on which prices had been set for 2011-2012 by the newly established distributor-retailer entities covering SEQ. The local government owners of these entities had been subject to on-going criticism by the State Government over the setting of retail prices. At the same time the price of bulk water supplied to the distributor-retailers was increasing sharply as a result of new infrastructure spending aimed at drought proofing the region.

The terms of reference for the review included consideration of the methodology used by the three distributor-retailers, Queensland Urban Utilities (QUU), Allconnex Water and Unitywater, in determining their prices, and the cost and profitability considerations they took into account. The review was also required to consider regulatory requirements affecting pricing, best practice pricing principles, and prices in other metropolitan areas. The review examined a large number of background documents, submissions made by the distributor-retailers to the Queensland Competition Commission (QCC) and a report prepared by the AEC Group on the Assessment of Drivers of Water Price Increases in SEQ.

The setting of water prices takes place within the context of a number of intergovernmental agreements. In essence, these agreements seek to have efficient prices set for urban water, in particular through cost reflective price structures and levels. This requires that prices cover operating and capital costs, where the latter covers both a return of capital (depreciation) and a return on capital (interest and rate of return). The agreements include the 1994 Water Reform Framework, which was later incorporated into the 1995 National Competition Policy reforms; the 2004 National Water Initiative; the 2006 Competition and Infrastructure Reform Agreement relating to access terms and conditions; and the 2010 National Water Initiative Pricing Principles. Practice in implementing what governments have agreed to has been variable. However, the recent long running drought has highlighted the increased urgency of doing so.

The long drought induced significant infrastructure investment by the Queensland Government to ensure on-going adequate supplies of water for SEQ. It also led to significant structural and institutional change in the industry with the State Government acquiring bulk water assets from local governments and three independent distributor-retailer entities being established, but remaining in local government ownership. The State Government sought to reduce the short-term price impact of the new infrastructure costs by lowering its required rate of return on this investment and spreading its cost recovery over a ten year price path, with some under-recovery in the initial years and increased recovery in later years. It called on Councils to also ensure price restraint in the short-term. Subsequently, it has been strongly critical of the Councils in relation to retail prices and Councils have responded by pointing to the impact of the bulk water price increases on retail prices.

The State Government directed the Queensland Competition Authority to monitor prices set by Council water businesses in 2009-10, prior to commencement of operation of the independent distributor-retailers. The Government's main concern was with the attribution of reasons for price increases given by the Councils. The QCA found that the Councils had correctly reflected the bulk water price increases in their prices, but not all of them had referred to other factors also influencing prices. The bulk water price increase was the dominant influence on Council prices. Some Councils did increase prices by more than their cost increases, but in each case their total revenues were less than fully attributed costs. The QCA noted that Councils generally did not achieve a commercial return on their assets. Council generally were unable to identify accurately the costs of the services they provided to different customer groups, so that tariffs were not necessarily set on a cost reflective basis.

The new distributor-retailer entities announced their prices for 2010-2011 only a few months after formally commencing operations. Previous prices were escalated upwards to cover cost increases and achieve an acceptable rate of return. Given the limited time and availability of data no significant changes were made to the structure of prices to ensure these reflected efficient costs of supply. In setting the level of prices the

entities took into account the Maximum Allowable Revenue (MAR) concept adopted by the QCA as a basis for its monitoring of entity prices. All three entities increased their prices significantly.

Allconnex Water limited its price increases to 20%; QUU adopted a lower target rate of return than the other entities. Unitywater moved more aggressively to set its prices at MAR levels, although it claimed that further work had indicated it was below full MAR. Its price increases in Moreton Bay were the largest in the entire SEQ region and these led to significant customer backlash, especially in the Redcliffe area. In retrospect and given all the circumstances, the justification for such large increases seems dubious.

The major cost driver for price increases in 2010-2011 again was the increase in bulk water charges. Capital cost increases accounted for around 20% of total cost increases, reflecting, in part, a significant expansion in new investment. Establishment costs were significant, especially for the smaller Unitywater. These costs included the costs of the establishment of the single distributor entity in 2009-10, which was subsequently axed as a result of a change in State Government policy. The 2009 State Budget decision to remove the 40% capital subsidy on new infrastructure by 2011 will also have some impact on the costs of the entities. In the short term, the scope for achieving efficiency savings from the amalgamation of previous Council businesses is restricted by undertakings given to maintain employment and working conditions for labour.

The scope for Council owners to influence entity pricing decisions is also limited by restrictions placed on board membership and requirements for board members to act in a commercial manner in the best interests of the entities. State Government criticisms of the payment of dividends to Participating Councils take no account of the use of those dividends by the Councils, the business implications of not paying dividends, or impact on consumer demand. Suggestions that the payment of dividends amounts to profiteering have no factual basis. The entities are subject to formal monitoring by the QCA until June 2013. From then the QCA will have deterministic powers over prices, a move which seems premature and unduly heavy-handed.

Price comparisons across jurisdictions need to recognise the impacts of investment cycles, the incidence of drought and other jurisdiction specific factors. The latest available National Performance Benchmark data suggests SEQ prices are relatively high compared to other major cities in Australia. Australian Bureau of Statistics data indicate Brisbane prices have increased more rapidly than all other capital cities apart from Canberra over the last decade, but the increases for Sydney, Melbourne and Canberra have been greater over the past five years. Water and sewerage prices will continue to rise sharply in most capital cities given recent decisions of price oversight bodies.

State government criticism of Councils for the pricing of the distributor-retailers seems contrary to the basis on which the Government established these entities as independent bodies, having a commercial focus and subject to independent prices oversight. State Government, or Council, suggestions to ignore the costs of providing water services, or to restrict the degree of efficient cost recovery through pricing intervention, will result in inefficient and possibly inequitable prices being set. Recent legislation, requiring the QCA to consider the application of price paths when proposed price increases exceed the rate of inflation and giving the Minister power to make codes relating to price determinations, raises concerns that efficient pricing will be compromised.

With the passing of the drought there is increased pressure to limit price increases stemming from the major investments undertaken in recent years to drought proof the State. Some cost avoidance has come from not constructing the Traveston Dam, and lower operating costs can be achieved by placing higher cost desalination and water treatment plants on standby mode. Thus some reduction in foreshadowed price increases can be achieved. Greater pricing efficiency might be achieved by ensuring bulk water prices adjust more flexibly to the actual use of facilities like the desalination plant.

There is still a need, however, for governments to communicate more effectively the rationale for efficient pricing and to work better together to achieve this. Public disagreements between the different levels of government on water pricing has caused confusion and undermined support for structural and institutional reforms. The distributor-retailers also need to achieve more effective community engagement on pricing and their prices need to better reflect efficient costs of supply. The entities need to focus on achieving cost

efficiencies where they can, including in relation to capital expenditures. In the absence of a more cooperative approach between State and Local Governments on SEQ water pricing, it is suggested that consideration be given to supporting independent oversight by a national oversight body, in line with the recent suggestion to this effect by Infrastructure Australia.

1. Introduction

The Council of Mayors (South East Queensland) initiated this review in October 2010 following State Government criticism of prices set by Council owned distributor-retailer water entities. The on-going political and media commentary on water pricing in South East Queensland (SEQ) has resulted in public confusion as to why prices have been rising and where responsibility for this really lies.

The report has six sections. Section 1 provides the terms of reference and briefly discusses the methodology adopted for the review. Section 2 provides background on inter-governmental agreements and other matters affecting principles for water industry pricing. Section 3 looks at recent changes to institutional arrangements in South East Queensland affecting the costs and prices of water services. Section 4 reviews water pricing in South East Queensland in 2009-2010, which was subject to monitoring by the Queensland Competition Authority (QCA). Section 5 next examines water pricing in 2010-2011. The basis for price setting in this year by the Council owned distributor-retailers is considered together with the cost drivers affecting pricing. Finally, section 6 comments on future pricing reform.

1.1 Terms of reference

The review was to examine the basis on which water and wastewater charges set for 2010-2011 by South-East Queensland distributor-retailers - Queensland Urban Utilities, Allconnex Water and Unitywater - have been determined.

The Review was to have particular regard for:

1. The methodology underlying the determination of these prices; and
2. The detailed cost and profitability considerations taken into account by the businesses. Matters to be considered by the review included:
 - Formal legislative and regulatory requirements impacting on costs and prices;
 - Best practice pricing principles including whether prices are within Maximum Allowable Revenue and consistent with competition policy principles;
 - The impact of major cost components, including bulk water charges and capital investment and the establishment costs of the entities;
 - Rate of return and dividend policies; and
 - Comparisons with water prices in other metropolitan areas.

A report with findings and recommendations, as appropriate, was to be provided to the Council of Mayors by 30 November 2010.

1.2 Methodology

The primary source for the review was considered to be the public submissions made by the three water entities to the QCA in connection with that Authority's statutory role of monitoring water prices. A Local Government Association of Queensland (LGAQ) commissioned study from the AEC Group on the Assessment of Drivers of Water Price Increases in SEQ was also to be made available to the reviewer.

A significant amount of background material relating to the reform of the water industry in SEQ was obtained and considered by the reviewer. In addition, interviews were held with the Chief Executive Officers of the three SEQ distributor-retailer entities and relevant regulatory and other staff. Further information was obtained from these entities about relevant matters including dividend and other policies. A meeting was also held with the Chairman of the Council of Mayors, Campbell Newman, the Lord Mayor of the Brisbane City Council. (A list of people interviewed during the course of the review is contained in Appendix 1)

Although the submissions to the QCA by the water entities were informative, it was considered necessary to also seek from the entities copies of the board papers prepared to facilitate their decisions in relation to 2010-2011 prices. It was expected that these papers would give a better indication of the rationale for pricing decisions, including the methodologies which underpinned them, than would the QCA submissions which were influenced by the standard format information request made by the Authority. The QCA's role in relation to 2010-2011 prices was a monitoring one, so that there was no reason to assume that prices had to be set in any particular way. Whilst the Mayors requested the assistance of the chairs of the boards of the distributor-retailers to provide these papers, the responses did not facilitate a timely review of them.

1.3 The reviewer

This review was conducted by Dr. David Cousins AM, Professorial Fellow with the Monash University Centre for Regulatory Studies. Dr. Cousins has had an extensive background in pricing issues as a public official and private consultant. From 1989 to 1995 he was a Member of the Australian Prices Surveillance Authority and its Chairman from 1992 to 1995. He was a Commissioner with the Australian Competition and Consumer Commission from 1999 to 2002, where he had special responsibility for GST pricing.

1.4 Disclaimer

This report has been prepared for the Council of Mayors (South East Queensland). The author undertakes no responsibility in any way whatsoever to any person or body (other than the Council of Mayors (South East Queensland)) in respect of the information set out in this report, including any errors or omissions therein, arising through negligence or otherwise, however caused.

2. Background: Water pricing principles

2.1 Water Resources Policy and National Competition Policy

Reform of the water industry in Australia, including South East Queensland, has been a national priority since the early 1990s. In February 1994, the Council of Australian Governments (COAG) adopted a strategic water reform framework which included commitments to price water for full cost recovery, establish secure property rights separate from land titles, provide for water trading, allocate water for environmental needs, require water service providers to operate on commercial principles, and improved public consultation and education processes¹.

In 1995, COAG agreed to National Competition Policy (NCP) reforms, and water reform was incorporated into this process. In 1997-98 guidelines were developed by the Standing Committee on Agriculture and Resource Management (SCARM) to assist the jurisdictions with implementation of full cost recovery principles. These guidelines were endorsed for use in the assessment of performance for competition payments².

Prior to the reform process, urban water pricing practices provided little incentive for efficient water use. Prices were often based on property values rather than consumption and did not provide appropriate signals for consumers and suppliers to make efficient consumption and production/investment decisions. Quantitative restrictions rather than prices were relied upon to ration demand when supply problems emerged. Pricing was further distorted by cross subsidies which provided benefits to particular customers, often residential customers, in non-transparent, inefficient ways. Often suppliers did not recover the full costs associated with their supply of water, including an appropriate return on capital. They frequently combined regulatory and commercial roles, for example in relation to water quality, which raised inevitable conflicts of interest. Pricing decisions were heavily politicized; water bodies did not have to operate in a commercial manner; and publicly owned bodies generally benefited from cost and taxation savings not open to private sector firms. Incentives for efficiency were dulled by the separation of management from the owners of the businesses and the threat of punishment for lax management practices by the capital markets was minimal. There was little in the way of independent oversight of price setting by pricing experts.

In relation to pricing COAG agreed:

(a) *in general -*

(i) *to the adoption of pricing regimes based on the principles of consumption-based pricing, full-cost recovery and desirably the removal of cross-subsidies which are not consistent with efficient and effective service, use and provision. Where cross-subsidies continue to exist, they be made transparent,*

- *Queensland, South Australia and Tasmania endorsed these pricing principles but have concerns on the detail of the recommendations;*

(ii) *that where service deliverers are required to provide water services to classes of customer at less than full cost, the cost of this be fully disclosed and ideally be paid to the service deliverer as a community service obligation;*

(b) *urban water services*

(i) *to the adoption by no later than 1998 of charging arrangements for water services comprising an access or connection component together with an additional component or components to reflect usage where this is cost-effective;*

1 Council of Australian Governments meeting in Hobart 25 February 1994.

2 Endorsed for COAG by the Agriculture and Resource Management Council of Australia and New Zealand (ARMCANZ) at its Hobart meeting on 27 February 1998.

(ii) that in order to assist jurisdictions to adopt the aforementioned pricing arrangements, an expert group, on which all jurisdictions are to be represented, report to COAG at its first meeting in 1995 on asset valuation methods and cost-recovery definitions; and

(iii) that supplying organisations, where they are publicly owned, aiming to earn a real rate of return on the written down replacement cost of their assets, commensurate with the equity arrangements of their public ownership;

(c) metropolitan bulk-water suppliers

(i) to charging on a volumetric basis to recover all costs and earn a positive real rate of return on the written-down replacement cost of their assets;

The guidelines developed by SCARM recognised the different circumstances faced by suppliers and allowed for flexibility in price setting between upper and lower bounds. The Guidelines are shown in the box below.

COAG pricing guidelines

1. Prices will be set by the nominated jurisdictional regulators (or equivalent) who, in examining full cost recovery as an input to price determinations, should have regard to the principles set out below.
2. The deprival value methodology should be used for asset valuation unless a specific circumstance justifies another method.
3. An annuity approach should be used to determine the medium to long term cash requirements for asset replacement/refurbishment where it is desired that the service delivery capacity be maintained.
4. To avoid monopoly rents, a water business should not recover more than the operational, maintenance and administrative costs, externalities, taxes or TERs [tax equivalent regime], provision for the cost of asset consumption and cost of capital, the latter being calculated using a WACC [weighted average cost of capital].
5. To be viable, a water business should recover, at least, the operational, maintenance and administrative costs, externalities, taxes or TERs (not including income tax), the interest cost on debt, dividends (if any) and make provision for future asset refurbishment/replacement (as noted in (3) above). Dividends should be set at a level that reflects commercial realities and stimulates a competitive market outcome.
6. In applying (4) and (5) above, economic regulators (or equivalent) should determine the level of revenue for a water business based on efficient resource pricing and business costs. Specific circumstances may justify transition arrangements to that level.
7. In determining prices, transparency is required in the treatment of community service obligations, contributed assets, the opening value of assets, externalities including resource management costs, and tax equivalent regimes.

COAG originally envisaged that the strategic water reform framework would be implemented by 2001. Subsequently it extended the implementation timeframe to 2005.

2.2 National Water Initiative

In June 2004, COAG first ministers signed an Intergovernmental Agreement on a National Water Initiative, which developed and extended the original water reform strategic framework.³ They recognised a pressing need “to increase the productivity and efficiency of water use, sustain rural and urban communities, and to ensure the health of river and groundwater systems”.⁴ Under the National Water Initiative, a new body, the National Water Commission, was established to oversee implementation of the reform program.

Agreed outcomes and commitments to specific actions under the Initiative were set out under a number of key elements including:

- Water Access Entitlements and Planning Framework;
- Water Markets and Trading;
- Best Practice Water Pricing;
- Integrated Management of Water for Environmental and Other Public Benefit Outcomes;
- Water Resource Accounting;
- Urban Water Reform;
- Knowledge and Capacity Building; and
- Community Partnerships and Adjustment.

Best practice water pricing and institutional arrangements were outlined in clauses 64 - 77 of the Intergovernmental Agreement. Some of the more relevant clauses to this review are outlined below. The paragraph numbering accords with the paragraph numbers in the Agreement.

64. The Parties agree to implement water pricing and institutional arrangements which:

i) promote economically efficient and sustainable use of:

a) water resources;

b) water infrastructure assets; and

c) government resources devoted to the management of water;

ii) ensure sufficient revenue streams to allow efficient delivery of the required services;

iii) facilitate the efficient functioning of water markets, including inter-jurisdictional water markets, and in both rural and urban settings;

iv) give effect to the principles of user-pays and achieve pricing transparency in respect of water storage and delivery in irrigation systems and cost recovery for water planning and management;

v) avoid perverse or unintended pricing outcomes; and

vi) provide appropriate mechanisms for the release of unallocated water.

65. In accordance with NCP commitments, the States and Territories agree to bring into effect pricing policies for water storage and delivery in rural and urban systems that facilitate efficient water use and trade in water entitlements, including through the use of:

i) consumption based pricing;

3 Intergovernmental Agreement on a National Water Initiative, 25 June 2004.

4 Council of Australian Governments Communiqué 29 August 2003.

ii) full cost recovery for water services to ensure business viability and avoid monopoly rents, including recovery of environmental externalities, where feasible and practical; and

iii) consistency in pricing policies across sectors and jurisdictions where entitlements are able to be traded.

66. In particular, States and Territories agree to the following pricing actions:

Metropolitan

i) continued movement towards upper bound pricing by 2008;

ii) development of pricing policies for recycled water and stormwater that are congruent with pricing policies for potable water, and stimulate efficient water use no matter what the source, by 2006;

iii) review and development of pricing policies for trade wastes that encourage the most cost effective methods of treating industrial wastes, whether at the source or at downstream plants, by 2006; and

iv) development of national guidelines for customers' water accounts that provide information on their water use relative to equivalent households in the community by 2006;

74. The Parties agree that as far as possible, the roles of water resource management, standard setting and regulatory enforcement and service provision continue to be separated institutionally.

75. The States and Territories will be required to report independently, publicly, and on an annual basis, benchmarking of pricing and service quality for metropolitan, non-metropolitan and rural water delivery agencies. Such reports will be made on the basis of a nationally consistent framework to be developed by the Parties by 2005, taking account of existing information collection

76. Costs of operating the above performance and benchmarking systems are to be met by jurisdictions through recovery of water management costs.

77. The Parties agree to use independent bodies to:

i) set or review prices, or price setting processes, for water storage and delivery by government water service providers, on a case-by-case basis, consistent with the principles in paragraphs 65 to 68 above; and

ii) publicly review and report on pricing in government and private water service providers to ensure that the principles in paragraphs 65 to 68 above are met.

Also relevant to this review are clauses of the agreement relating to community partnerships and adjustment.

93. Parties agree that the outcome is to engage water users and other stakeholders in achieving the objectives of this Agreement by:

i) improving certainty and building confidence in reform processes;

ii) transparency in decision making; and

iii) ensuring sound information is available to all sectors at key decision points.

94. Parties also agree to address adjustment issues raised by the implementation of this Agreement.

The National Water Initiative was adopted prior to much of the severe drought which affected many parts of the country, including SEQ. In 2008 a Working Group on Climate Change and Water reported to COAG on the

state of play of water reform including a stock take of key challenges facing urban water supply. The report noted the significant infrastructure programs being implemented to secure metropolitan water supplies, including use of less climate dependent supplies such as desalination and recycling. However, it considered that “the substantial urban infrastructure programs need to be bolstered by appropriate pricing, planning and institutional arrangements to ensure appropriate investments occur into the future”.⁵

In line with this view, the Natural Resource Management Ministerial Council in April 2010 endorsed National Water Initiative Pricing Principles. “These principles have been agreed by Australian Governments as the basis for setting water prices/charges in their jurisdictions. Governments agree that if a decision was made not to apply these principles in a particular case, the reasons for this would be tabled in parliament.”⁶

The NWI pricing principles are comprised of four sets of principles, including:

1. Principles for recovering capital expenditure to provide guidance to water service providers on asset valuation and cost recovery for urban and rural capital expenditure.
2. Principles for urban water tariffs to provide guidance for price setting in situations where there are monopoly providers and the absence of competitive pressures.
3. Principles for water planning and management to provide guidance, for urban and rural water service providers, in identifying and allocating the costs of water planning and management activities between government and water users.
4. Principles for recycled water and stormwater reuse to provide broad policy guidance to stimulate efficient water use, in urban and rural settings, no matter what the water source.

Of particular relevance to this review are the principles relating to the recovery of capital expenditure and to urban water tariffs. These principles are reproduced in Appendix 2.

2.3 Competition and Infrastructure Reform Agreement

Following concerns about the impact of access regulation on investment, especially in areas such as ports and railways, the Commonwealth, State and Territory Governments agreed in 2006 to a set of reforms which aimed to achieve a simpler and more consistent regulatory approach in this area⁷. The Agreement would seem to apply to water supply distribution systems. In the first instance it was agreed that the terms and conditions for third party access to services provided by means of significant infrastructure facilities should be as agreed by the access seeker and infrastructure service provider. If regulation was considered to be required, or when regulation was being scaled back, it was agreed that price monitoring should be considered as a first step where this would improve the level of price transparency.

In so far as regulated prices were concerned, it was agreed that “prices should be set so as to:

- i. generate expected revenue for a regulated service or services that is at least sufficient to meet the efficient costs of providing access to the regulated service or services and include a return on investment commensurate with the regulatory and commercial risks involved;
- ii. allow multi-part pricing and price discrimination when it aids efficiency;
- iii. not allow a vertically integrated access provider to set terms and conditions that discriminate in favour of its downstream operations, except to the extent that the cost of providing access to other operators is higher; and

5 Working group on Climate Change and Water, Report to the Council of Australian Governments, March 2008, p.1.

6 National Water Initiative Pricing Principles, clause 10.

7 Competition and Infrastructure Reform Agreement, 10 February 2006.

- iv. provide incentives to reduce costs or otherwise improve productivity”⁸.

2.4 Queensland Competition Authority water pricing principles

In December 2000 the Queensland Competition Authority, which exercises price oversight over declared monopoly businesses in Queensland, including water businesses, issued a Statement of Regulatory Pricing Principles for the Water Sector. These Principles were “intended to reduce the possibility that some service providers may take advantage of their monopoly or near monopoly status by charging users of their services unfair prices, providing inappropriate services or quality of services or, restricting access to facilities which could be more effectively utilised for the community’s benefit”.

The principles “largely reflect outcomes associated with the operation of competitive markets but also seek to take account of a wide range of other public interest matters. Prices should be cost reflective, forward looking, ensure revenue adequacy, promote sustainable investment, ensure regulatory efficiency and take into account relevant public interest matters”.

“In most instances, a maximum revenue will need to be established for a regulated service provider, consisting of three “building blocks” - a return on capital, a return of capital and an appropriate estimate of efficient operating costs. Where specific prices will need to be set, the Authority considers that they should reflect the long run marginal cost of service provision. Where such prices do not achieve revenue adequacy, two-part tariffs will be appropriate for most water businesses. Under certain circumstances, a value for the water resource will need to be established. Usually incentive measures will also be required to promote efficiency over the regulatory period”.⁹

The QCA water pricing principles built on the COAG pricing principles and guidelines developed by SCARM. They provided an excellent detailed practical guide for businesses and a preliminary view as to the approach the QCA was likely to take when reviewing water prices. They appear to be quite consistent where they overlap with the later principles issued under the National Water Initiative. However, it would seem appropriate that the Authority review the December 2000 document in light of the principles more recently issued under the NWI.

2.5 Impact of inter-governmental agreements on water pricing

Despite the series of agreements between the Australian, State and Territory Governments to implement efficient water pricing and moves made in this direction, progress has been variable. Engineers Australia has recently commented as follows: “By now urban water prices should be set in line with commercial principles. This has not been generally achieved and water remains under priced leading to higher consumption, the viability of other supply and demand management options has been undermined and the revenue flows required for investment to ensure that all water infrastructure is fit for present and future purposes has been less than it should be.”¹⁰

And the Water Services Association of Australia has also expressed concerns, specifically in relation to SEQ. “Various forms of capital and operating subsidies continue to be applied in the water sector and impact on the realisation of efficient pricing outcomes. In southeast Queensland, for instance, the Queensland Government determined to apply a lower rate of return on certain ‘drought-response’ assets accompanied by a ten year phase in for full cost recovery at the bulk level. The incentive for newly formed distributor-retailer authorities to consider wastewater recycling and potable substitution options is reduced under such

8 Ibid., clause 2.4b.

9 Queensland Competition Authority, Statement of Regulatory Pricing principles for the Water Sector, December 2000, p.i.

10 Engineers Australia, Submission to Productivity Commission, Inquiry into Australia’s Urban Water Sector, October 2010, p.1

pricing arrangements: such projects are not financially attractive even though they might be economic from a broader, whole of grid perspective in the absence of such subsidies.”¹¹

2.6 Conclusions

Governments across Australia have agreed that water service prices should more closely reflect efficiency pricing principles. This has included endorsement of cost reflective pricing and the inclusion of the full opportunity cost of capital.

The relevant efficiency pricing principles have been articulated and confirmed on a number of occasions, but their application has been variable.

Independent prices oversight has been seen as a way to help facilitate efficient pricing of water services. There is a preference for more light-handed methods of oversight, including monitoring.

It is desirable that the Queensland Competition Authority (QCA) updates its water pricing principles to take full account of commitments made under the National Water Initiative.

¹¹ Water Services Association of Australia, Submission to Productivity Commission, Inquiry into Australia’s Urban Water Sector, November 2010, p.14.

3. Background: Institutional developments affecting water pricing in SEQ

Over the past decade there have been major changes to structural and institutional arrangements affecting water supply in SEQ. These changes have been largely driven by the need to ensure water security in the context of a long drought commencing in 2002 and reaching crisis point in 2006-07 when storage levels in the Wivenhoe, Somerset and North Pine Dams dropped below 17% and severe restrictions on water use were in operation. Rapid population growth and forecast growth were further driving factors for change.

As part of the SEQ Regional Plan, a review of institutional arrangements for water supply in SEQ commenced in 2005. In June 2006 the Queensland Water Commission (QWC) was established as an independent statutory authority responsible for water supply and demand management in SEQ and other designated regions. Around the same time the Government announced the planned construction of major new water infrastructure including dams, water grid interconnection pipelines, a desalination plant and recycling scheme.¹²

Soon after its establishment, references were given to the Commission to provide advice on cost recovery and pricing and institutional arrangements.

3.1 Cost recovery and pricing

The QWC released a draft report in February 2007 on cost recovery and pricing.¹³ This discussed arrangements to apply in relation to the purchase and sale of water by a Grid Manager and the role envisaged for economic regulation. The Grid Manager would enter into contracts with bulk suppliers and transport providers and recover these bulk water costs and its own costs from downstream customers. The QCA would be able to arbitrate on contractual disputes between the Grid Manager and Grid Asset owners and, after a transition period, it would have price monitoring and complaint investigation with deterministic powers in relation to Grid Sales Contracts. To reduce regulatory risk for Grid Customers it was recommended that the QCA be provided with clear guidance in relation to its monitoring and investigation roles.

The Commission recognized that “pricing decisions for water grid products will have a significant impact on the price of water at the retail level. It is expected that price increases at the wholesale level will, subject to each retailers own cost recovery and pricing arrangements, be passed through to end users.”¹⁴ Retail tariff design remained the responsibility of the retailers, but a key objective was to “provide price signals to end-use customers about the costs of future supplies, and to reward efficiency in use.”¹⁵

The Commission provided preliminary advice on the cost and pricing impacts of the new supply and demand arrangements. It assumed the total value of new assets to be \$9.2 billion (including the then proposed Traveston Crossing Dam), a 7% pre-tax real cost of capital, a medium savings demand scenario and full cost recovery over 50 years. The analysis suggested that the cost-reflective wholesale water price would rise by an approximate average of \$1400-\$1500/ML in levelised terms by 2013. This did not take into account the operation of any price path which could be used to moderate the short term impact of the price rises. In effect, a price path would alter the timing of recovery of costs, reducing it in the short term and increasing it in the longer term.

The Commission proposed that bulk water prices be subject to price paths set, initially by the Government for a three year period, from 1 July 2008. For each retailer the bulk price increase would be capped at the dollar equivalent of a 20% increase in the average retail price of Brisbane Water. A longer price path was

12 The Hon. Peter Beattie, Premier, “Dam Decisions essential for SEQ Future Water Needs; Report”, Media statement 5 July 2006.

13 Queensland Water Commission, Draft Report 2 Cost Recovery and Pricing for Urban Water Supply in South East Queensland, Draft Report for Consultation, February 2007.

14 Ibid, p. 12

15 Ibid.

seen as being appropriate for some Council retail suppliers whose bulk prices had been lower. Following the transition period it was proposed that the Water Grid Manager review prices with the Grid Asset owners and retailers and negotiate appropriate adjustments where necessary.

It was claimed by the Commission that the application of price paths to reduce initial price shocks for consumers was consistent with the National Water Initiative principles of full cost recovery. Full cost recovery would just be achieved over a longer time frame.

In responding to the QWC's report the Treasurer indicated a desire to moderate price increases for residents. Treasury was asked to examine ways the State Government might achieve this. At the same time the Government called on assistance from the Commonwealth Government and Local Councils. "If the Howard Government came to the party with the \$408 million grant for the Western Corridor Project we seek and local Councils reinvested their water profits in water infrastructure, we could drastically cut the impact of water prices on South-East Queensland residents."¹⁶

Shortly after this, the Deputy Premier announced that the State would be reducing the target rate of return it would be applying to the new infrastructure investment to 4% from the 7% used in the modeling done by the Commission and extending the price path from five years to ten years. The cost to the Government of the reduced rate of return was estimated to be \$1.5 billion. It was suggested that this "would mean that the average bill would increase from \$350 to \$525 in real terms (excluding normal inflation) over 5 years rather than to \$733 under the Commission's recommendations."¹⁷

Bulk water prices applying from 2008-09 were announced one year later following more extensive modeling and other work by the Commission. The Deputy Premier commented:

"We worked to ensure the increase in the price of bulk price of water (sic) was kept to roughly \$17 dollars a quarter in the average Brisbane household and we will be watching the behavior of Councils carefully to ensure prices are fair.

"Some Councils have said they intend to include the bulk water prices separately on the bills and that is something we would strongly support.

"The Queensland Competition Authority will act as a watchdog on water charges and we will publish water charges annually."¹⁸

The QWC provided data indicating the expected movement of bulk prices and the retail price flow-through for ten years, assuming the operation of price paths over the first five year. The retail data provided by the QWC, however, were presented as indicative only as the Councils controlled retail prices. The figures excluded "normal inflation and assume no other changes by Councils, other than passing through the increase in the bulk price each year. Cost components under Council control such as distribution charges and retail costs remain constant in this model. Council's current bulk water costs account for a different proportion of the customer's bill in each Council area. The average across the regions is 40% of the Council bill."¹⁹ The data provided by the QWC seems to have been used by some as a guide as to how retail prices would actually change. This was incorrect as other factors affecting retail prices were not considered in the QWC analysis.

16 The Honourable Peter Beattie, Premier and Minister for Trade, "All Levels of government Must Pay: Beattie", Media Statement 10 March 2007.

17 The Honourable Anna Bligh, Ministerial Statement: Water prices, Queensland Parliament Hansard 13 March 2007.

18 The Honourable Paul Lucas, Deputy Premier and Minister for Infrastructure and Planning, Media statement; Water security for \$1.30 a week, 12 May 2008.

19 Queensland Water Commission, Expected Retail Bill Increases due to Bulk Charges (for 250 KL/year), n.d.

3.2 Institutional arrangements

In May 2007 the QWC released its final report proposing major changes to institutional arrangements governing the supply of water in SEQ. In relation to bulk water supply it proposed that:

- bulk supply assets be grouped with water and wastewater treatment assets so as to provide incentives to optimise the efficiency of asset investment and encourage the development of specialist skills;
- dams and groundwater infrastructure, water treatment plants and wastewater treatment plants be amalgamated from 25 owners to two based on catchment boundaries;
- the Desalination Plant at the Gold Coast and the Western Corridor Recycled Scheme (including the Western Corridor Pipeline) be owned by a stand alone state-owned entity for the present;
- a Bulk Transport Business be established to own all the major pipelines other than the Western Corridor Pipeline; and
- a Water Grid Manager be established to manage water sharing across the region contracting with bulk supply, transport and the retailers.

In relation to retail water supply it proposed that:

- Council retail businesses be consolidated from 17 businesses to three;
- bulk transport and distribution assets be placed in separate entities from the remainder of the water supply system to provide a clearer focus on improved asset management and service delivery objectives while providing the framework necessary to support competition if introduced in the future;
- a single distribution business owning all the water reticulation, service pipes meters and sewerage reticulation in the region be established to allow the development of consistent service standards and asset maintenance;
- a retail structure be established which provides a platform for the potential introduction of retail competition across the SEQ Region - both between the aggregated licensed retailers and potential new retail entrants; and
- all stormwater assets remain with the Councils.

The report also proposed changes to the asset management and economic regulatory arrangements including:

- the establishment of an asset management regulatory regime where all asset owners are required to prepare asset management plans, including the service standards that those assets will deliver and undertake that those standards are maintained before returns from the businesses are paid; and
- that prices charged at various points of the supply chain be subject to more robust economic regulation than compared to current arrangements where decisions by the arbitrator on complaints are simply recommendatory rather than mandatory.²⁰

In presenting the Commission's report to the Parliament the Deputy Premier indicated that the Government saw the proposals as representing substantial reform and were "a fair way forward." Councils it stressed would be fairly compensated for giving up their bulk assets.²¹ Further negotiations with key stakeholders led to modifications to the Commission's proposals. Initially, there was agreement that there could be up to 10 retail businesses. This matched the number of Councils now in the South East Region as, following the Government's acceptance of the recommendations of the Local Government Reform Commission in May 2007 the number of Councils was being reduced from 17 to 10.²² Later on, however, agreement was reached

²⁰ Queensland Water Commission, *Our Water: Urban water Supply arrangements in South East Queensland*, final report May 2007.

²¹ The Honourable Anna Bligh, Deputy Premier, Treasurer and Minister for Infrastructure, Queensland Parliament Hansard, Ministerial Statement: Water Grid, 24 May 2007.

²² The Honourable Anna Bligh, Deputy Premier, Treasurer and Minister for Infrastructure, Queensland Parliament Hansard, Ministerial Statement: Water Reforms, 4 September 2007.

on maintaining three vertically integrated distribution and retail businesses to be owned by their constituent Councils²³. The new arrangements relating to the downstream industry were recognized in the *South East Queensland Water (Distribution and Retail Restructuring) and Natural Resources Provisions Act 2009*. The new retail-distributors became operational from 1 July 2010.²⁴

The structural and institutional changes made to the water industry in SEQ significantly reduced the number of separate entities involved in supply, from 21 to 7, increased the involvement of the State Government and reduced the involvement of local governments. Local governments have ownership of the three distributor-retailers, but no direct operational control over their activities.²⁵ The organizations involved in the industry are:

Seqwater - catches, stores and treats water by managing catchments, storages and water treatment plants. It supplies water to SEQ Water Grid Manager.

WaterSecure - supplies desalinated water to the Water Grid and supplies purified recycled water to power stations and other customers.

LinkWater - manages, operates and maintains SEQ's potable bulk water pipelines. It moves water from dams and other sources through bulk pipeline networks.

SEQ Water Grid Manager - operates the SEQ Water Grid and oversees the flow of water around the Grid. It purchases the services to store, treat and transport bulk water to sell water to the distributor-retail entities.

Councils have been critical of the new structure of the bulk water segment of the industry suggesting that having a number of specialist bodies was less efficient than combining their functions. On 5 December 2010, the State Government announced that it would be merging Seqwater and Watersecure²⁶. It was also announced that the desalination plant operated by Watersecure and Gibson Island water treatment plant operated by Seqwater would be placed in standby mode.

Three distributor-retailers sell and deliver water to customers, collect, transport and treat wastewater:

Queensland Urban Utilities services Brisbane, Ipswich, Scenic Rim, Somerset and Lockyer Valley Councils;

Unitywater services Sunshine Coast and Moreton Bay Councils; and

Allconnex Water services Gold Coast, Logan and Redland Councils.

23 The Honourable Stephen Robertson, Minister for Natural Resources, Mines and Energy and Minister for Trade, Media Statement: Bligh Government moves forward with SEQ water reforms, 8 July 2009.

24 The upstream arrangements were given effect to in the *South East Queensland Water (Restructuring) Act 2007* and commenced on 1 July 2008.

25 The relevant legislative provisions are discussed in section 5.4 of this report. Whilst the Minister clearly indicated in his Second Reading Speech on the *South-East Queensland (Distribution and Retail Restructuring) and Natural Resources Provisions Bill* (Hansard, Queensland Parliament, The Honourable S Robertson, 6 October 2000, pp. 2511-2512) that the new entities would be owned by the Councils and the assets involved would be owned by the Councils through the entities, the Act does not clearly specify this. The Act refers to Councils as Participants entitled to a share of future profits of the entities.

26 The Honourable Andrew Fraser, Treasurer and Minister for Employment and Economic Development, and The Honourable Stephen Robertson, Minister for Natural Resources, Mines and Energy and Minister for Trade, Joint Media Statement, "Water reforms save money for households", 5 December 2010.

3.3 Controversy over price rises

Significant political focus has been given to the increases in SEQ water prices following the new infrastructure development and this has affected the way the structural reforms have been perceived. This was highlighted by the Opposition in responding to the *South East Queensland (Distribution and Retail Restructuring) and Natural Resources Provisions Bill 2009* which established the distributor-retailer entities. “The big danger that I see for those retail entities, and for the Councils that own them, is that they will get the blame. They will be left with the responsibility for the increases in the price of water that South-East Queenslanders are facing as an inevitable consequence of the government’s mismanagement of the water business. As I indicated that mismanagement began with the refusal of the Goss government to construct the Wolffdene Dam.”²⁷

Separately the Leader of the Opposition, John-Paul Langbroek, has indicated that the Liberal National Party would cap retail water bills and bulk water charges to Consumer Price Index movements.

The State Government has indeed shown every indication of wanting to distance itself from responsibility for large price increases associated with the new drought proofing investments. It has sought to stand behind the QWC and, rather than point to the distributor-retailers, it has sought to ‘lay blame’ on local governments for not exercising restraint on retail prices. Local Government has responded to these criticisms by highlighting the pricing consequences of the State Government’s actions in undertaking major drought proofing investments and restructuring the industry. This confrontation has undermined community confidence and the ability to set efficient prices.

The State Government on 5 December 2010 announced changes to its bulk water price path. This was, at least in part, a response to community concerns about rising prices, but it was also a response to the changed water demand and supply outlook and failure to obtain Australian Government environmental approvals to construct the Traveston Dam. The Government indicated it would reduce the bulk charge in 2011-2012 by around \$5 from what had previously been announced and, with further reductions overtime, to more than \$30 by 2017-2018. These changes were made possible by not building the Traveston Dam, putting the Tugun desalination plant and Gibson Island water treatment plant in standby mode, and merging Seqwater and Watersecure.

3.4 Conclusions

Significant infrastructure spending has been undertaken by the State Government in order to drought-proof SEQ. This has had the inevitable effect of increasing bulk water prices significantly.

Structural changes have led to the separation of bulk water activities from distribution and retailing, with the latter now being undertaken by new bodies set up to operate independently of Councils.

The State Government has wanted to avoid short term price shocks arising from its new infrastructure investments by implementing price paths for bulk water. It has also agitated for local governments to restrain price rises in the short term.

There has been significant political controversy over water price increases, which has influenced the way people view the institutional and structural reforms to the SEQ industry.

On 5 December 2010, the State Government revised its 2008 bulk water price plan to reduce prices as a consequence of changed investment plans, water supply and demand and other efficiencies.

²⁷ Mr. Seeney, Member for Callide, Second Reading Debate, South-East Queensland (Distribution and Retail Restructuring) and Natural Resources Provisions Bill 2009, Queensland Parliament Hansard 29 October 2009, p.3082.

4. Queensland Competition Authority monitoring reports of 2009-2010 water prices

On 28 July 2008, the Premier and Treasurer referred the water supply activities of SEQ Local Governments to the QCA for a price monitoring investigation under Section 23A of *Queensland Competition Authority Act 1997*. This was to cover a one year period from 1 July 2009. The Ministerial Direction was amended on 1 July 2009 to require the Councils to provide a Statement of Reasons to explain their retail water prices.

The monitoring seemed to have more to do with concerns to ensure that retail price increases were not just blamed on State Government bulk water price increases than to ensure efficient prices were set by the Councils. The QCA was asked to report on the extent to which increases in retail water prices were attributed to and in line with increases in bulk water costs and other costs taking into account statements provided by the Councils, their budgets, media statements and other relevant data. As it commented: "The Authority's role is limited to reporting the pricing information that explains changes in retail water prices. The Authority is not required to verify that prices are appropriate in terms of regulatory pricing principles or to recommend changes in prices. This would typically require an assessment of demand forecasts and the efficient costs of supply over the medium to long term".²⁸

The major reason highlighted by the Councils for price increases was the increase in bulk water costs. The Councils were found to have correctly reflected actual bulk water cost increases in their prices. Not all Councils indicated that there were also some increases in other Council costs (generally as reflected in the movement of the Local Government Association of Queensland cost index), but these increases were generally a much smaller percentage of the total cost increases.

Some Councils increased charges to consumers by more than their verified cost increases, including bulk water costs. Clearly this was of concern to the State Government which was seeking to restrain increases in the short term as much as possible. The majority of Councils which increased charges by more than cost increases were, however, also found to have total revenues which were less than fully attributed costs. They therefore had a case to increase revenues by more than their cost increases, but the issue was whether this was an appropriate time to do this in view of the substantial increase in bulk costs also passing through into prices.

The key findings of the monitoring reports for each of the Councils are briefly outlined below.

4.1 Brisbane City Council ²⁹

Charges were increased in 2009-10 by 14.1%, less than the 17.3% required to recover forecast increases in costs. Bulk water accounted for 72% of cost increases in this year, rising from 35% of total costs in 2008-2009 to 39.5% in 2009-2010. Brisbane City Council reported that other costs rose by 4.8%. Overall, a 3 per cent revenue under-recovery was expected, but the cost increases taken into account were also understated as a result of not indexing asset values and not taking establishment costs of the new water body into account. The weighted average cost of capital used in determining costs had also been reduced from 9.7 per cent the previous year to 9.2 per cent, which the QCA found difficult to understand. Overall, the QCA concluded that revenues were less than necessary to achieve full cost reflectivity.

28 Queensland Competition Authority, Final Report Retail Price Monitoring in SEQ Urban Water Sector, Brisbane City Council, October 2009, p.3.

29 Queensland Competition Authority, Final Report, Retail Price Monitoring in SEQ Urban Water Sector Brisbane City Council, October 2009.

4.2 Ipswich City Council ³⁰

Total revenues from increased charges were expected to rise by 17.5%, which was in excess of the increase in costs of 14.7%. Bulk water costs as a percentage of total costs were expected to rise from 24.4% to 28.6% as they accounted for 61.9% of the expected increase in costs in 2009-2010. After taking account of a fall in dividends and of capital revenues and costs, the return on capital was 9.01%, which the QCA saw as being low relative to target rates of return for other utilities.

4.3 Lockyer Valley Regional Council³¹

The Council budgeted for an increase in revenue from water charges of 10.6%, above the 8.1% needed to account for verified increases in costs. Bulk water costs were expected to account for 38.6% of total costs in 2009-2010, up from 36.6% the previous year. The bulk water cost increase accounted for 71.4% of the verified total cost increases. The net increase in water related revenue was offset, however, by a reduction in capital related revenues. The estimated return on capital of 4.2% was below the previous year. A target rate of return of 2.5% applied. The QCA could not understand why it was so low.

4.4 Scenic Rim Regional Council³²

Revenues from water charges were budgeted to decrease by 1.0% in 2009-2010 compared to a decline of 3.1% in costs. Bulk water costs increased by 27.2% and accounted for 23.3% of total costs in 2009-2010, up from 18.1% the previous year. Other costs declined over the two years, notably the return on capital, and these outweighed the impact of the bulk water cost increase. The target rate of return on capital decreased to 8.3%, but even so, losses significantly outweighed this figure.

4.5 Somerset Regional Council³³

Revenues for this Council were expected to increase by 22.5% in 2009-2010 compared to the budget of the previous year. Cost increases of 23.9% were expected. Bulk water costs accounted for 88.1% of the increase in costs and were 61.7% of total costs in the year, up from 55.5% the previous year. A significant increase in water volumes contributed to these rises. The QCA estimated a rate of return on assets of 2.3% compared to the Council's low target of 2.4%.

4.6 Sunshine Coast Regional Council³⁴

The Council forecast a rise in revenues in 2009-2010 of 0.6% (including allowance for reduced capital revenues), compared to a rise of 7.5% in total costs. Bulk water costs accounted for 55.8% of the rise in total costs and represented 30.5% of total costs in 2009-2010, up from 28.6% the previous year. The target return on capital had been reduced from 9.8% to 8.4%, which appeared low to the QCA given recent changes related to the global financial crisis. The Council moved from experiencing a surplus to a deficit on its water activities.

30 Queensland Competition Authority, Final Report, Retail Price Monitoring in SEQ Urban Water Sector Ipswich City Council, October 2009.

31 Queensland Competition Authority, Final Report, Retail Price Monitoring in SEQ Urban Water Sector Lockyer Valley Regional Council, December 2009.

32 Queensland Competition Authority, Final Report, Retail Price Monitoring in SEQ Urban Water Sector Scenic Rim Regional Council, October 2009.

33 Queensland Competition Authority, Final Report, Retail Price Monitoring in SEQ Urban Water Sector Somerset Regional Council, October 2009.

34 Queensland Competition Authority, Final Report, Retail Price Monitoring in SEQ Urban Water Sector Sunshine Coast Regional Council, October 2009.

4.7 Moreton Bay Regional Council³⁵

The Council forecast increased revenues of 2.97% in 2009-2010, compared to the budget of the previous year. Increased operating revenues of 6.6%, likely to be significantly under-stated, were to a significant degree offset by reduced capital revenues of 15.9%. Costs were expected to rise by 4.8%. Bulk water cost increases were 293.1% higher than the total cost increases. This was because of a significant reduction in capital costs, including depreciation and particularly dividends and taxes paid. Bulk water costs were 46.3% of total costs in 2009-2010 up from 34.4% in the previous year. The QCA considered the target rate of return of 8.8% to be low and assessed the actual rate of return to be 5.47% on the opening written down value of assets. Even with the under-statement of revenues from increased charges, revenues were insufficient for full cost attribution.

4.8 Gold Coast City Council³⁶

Gold Coast Council budgeted for an increase in water related revenues of 17.1% in 2009-2010 made up of increased operating revenues of 38.2% and reduced capital related revenues of 49.7%. Total costs were forecast to rise by 28.7% resulting in a shortfall of revenue of 1.2% compared to a significant surplus the previous year. Bulk water costs accounted for 68.3% of the increase in total costs with bulk water costs being 38.9% of total costs in 2009-2010 compared to 30.5% in the previous year's budget. Cost increases included a significant increase in dividends. The increased return on capital of 4.3% on the written down value of assets was, however, lower than the target rate of return of 10.3%, also considered low by the QCA.

4.9 Logan City Council³⁷

Logan City Council budgeted for an increase in water related revenues of 17.9% in 2009-2010 comprising an increase of 26.6% in operating revenues and a reduction of 29.9% in capital related revenues. Total costs were budgeted to increase by 27.8%. Bulk water cost increases accounted for 58.9% of total cost increases and were 41.0% of total costs in 2009-2010 compared to 35.9% the previous year. There was a revenue shortfall of 7.2% in 2009-2010 compared to a surplus the previous year. A significant component of cost increases related to depreciation due to a change in approach to asset valuation. The QCA estimated the actual rate of return for the business to be 1.45% compared to its target rate of return of 5.04%, both rates being considered well below commercial levels.

4.10 Redland City Council³⁸

Redland City Council budgeted for an increase in total revenues in 2009-2010 of 9.7%, comprising an increase in operating revenues of 19.91% and a reduction of 39.4% in capital related revenues. Total costs were forecast to increase by 12.5%, however, resulting in a slightly reduced surplus. Bulk water cost increases accounted for 62.5% of the increase in total costs. Bulk water costs represented 24.6% of total budgeted costs in 2009-2010, compared to 19.8% the previous year. The return on capital factored into pricing was 4.8% in 2009-2010 on the written down value of the assets. When allowance was made for budgeted net profit, the rate of return increases to 5.98% in that year. Again these rates are low compared to those considered appropriate for other utilities.

35 Queensland Competition Authority, Final Report, Retail Price Monitoring in SEQ Urban Water Sector Moreton Bay Regional Council, October 2009.

36 Queensland Competition Authority, Final Report, Retail Price Monitoring in SEQ Urban Water Sector Gold Coast Council, October 2009.

37 Queensland Competition Authority, Final Report, Retail Price Monitoring in SEQ Urban Water Sector Logan City Council, October 2009.

38 Queensland Competition Authority, Final Report, Retail Price Monitoring in SEQ Urban Water Sector Redland City Council, October 2009.

Table 1 provides a summary of the findings of the QCA in relation to the contribution of bulk water costs and increases in bulk water costs to the total costs of the Council run businesses. It shows that for most Councils bulk water cost increases accounted for more than 60% of total cost increases and that bulk water generally comprises more than 25% of total distributor-retailer costs.

Table 1: Bulk water costs and cost increases of distributor-retailers in relation to total costs

Council	Bulk water costs % of total costs 2008-2009	Bulk water share of total cost increases % in 2009-2010	Bulk water costs % of total costs 2009-2010
Brisbane	35.0	72.0	39.5
Ipswich	24.4	61.9	28.6
Lockyer Valley	36.6	71.4	38.6
Scenic Rim	18.1	(Note 1)	23.3
Somerset	55.5	88.1	61.7
Sunshine Coast	28.6	55.8	30.5
Moreton Bay	34.4	293.1 (Note 2)	46.3
Gold Coast	30.5	68.3	38.9
Logan	35.9	58.9	41.0
Redland	19.8	62.5	24.6

Note 1 Total costs declined despite the increase in bulk water costs

Note 2 The increase in bulk water costs outweighed the total cost increase due to other cost reductions

Source: Queensland Competition Commission, Monitoring Reports SEQ Councils 2009-2010

4.11 QCA reflections

In its report on proposed monitoring arrangements to apply from 2010-2011 to 2012-2013, the QCA reflected on its monitoring of Council water business pricing in 2009-2010. It observed that:

“(a) retail water prices are not generally informed by the application of full cost pricing principles. Return on capital is often treated as a residual, rather than a cost input. As a result, Councils do not generally achieve a commercial return on their assets;

(b) Councils have addressed key issues of pricing differently. These issues include the treatment of capital gains in determining the return on capital, and asset revaluations. In particular, there is an apparent lack of a structured approach to managing the relationship between annual prices and capital revenues such as infrastructure charges and subsidies;

(c) budgetary and financial systems appear largely unsuited to the application of full cost pricing, vary significantly between Councils, are based on different accounting and expenditure policies and are only now being integrated (with substantial difficulty). Council information systems generally do not allow for costs to be allocated by service or customer group and they do not allow for an analysis of whether individual prices are cost-reflective. Budgets often do not align with other planning documents and assumptions; and

(d) tariff structures and tariff setting principles differ across Councils. In many cases, the setting of tariffs is based on adjusting historical charges and not on any underlying principle of short run or long run marginal cost for volumetric charges or the recovery of fixed costs through access charges”.³⁹

39 Queensland Competition Authority, Final Report SEQ Interim Price Monitoring Framework, April 2010, pp. 16-17.

4.12 Distributor-retailer annual reports 2009-2010.

The first annual reports of the three water bodies, covering the period 3 November 2009 to 30 June 2010 were tabled in the Parliament on 30 November 2010. Expenditures incurred during this time related to the establishment of the new bodies and the transition from Council owned water businesses. In total this amounted to around \$67 million (Queensland Urban Utilities \$37.5m; Allconnex Water \$16.4m; and Unitywater \$13.0m).⁴⁰ As the businesses did not commence operations until 1 July 2010, no income from the provision of services was recorded during the reporting period. The amount expended on establishment costs in the reporting period represents less than 5% of the income of the Council water businesses in 2009-2010. These costs are essentially of a one off nature and should have a very minor impact on prices over time.

4.13 Conclusions

The QCA was directed to monitor prices set by Council water businesses in 2009-2010. The State Government seemed more concerned about attribution of the causes of price rises than it did with efficient price setting.

Councils were found to have correctly reflected bulk water price increases in their retail prices.

Bulk water price increases were the major driver of higher retail water prices.

Some Councils increased their charges by more than their cost increases but they were also found not to be fully recovering efficient costs.

No consistent pattern of price and cost changes and rates of return were evident across the businesses.

All Council businesses were pricing below the full MAR level associated with full cost reflective, efficient pricing.

Councils generally did not have the necessary budgetary and financial systems in place to facilitate efficient price setting.

Establishment costs incurred by the new distributor-retailers in 2009-2010 amounted to less than 5% of the income of Council water businesses in that year and would have only a minor impact on prices over time.

⁴⁰ Some of these costs did not directly relate to the establishment of the three distributor-retailers, but related to the establishment in 2009-10 under State Government policy of a single distributor, which was the direction being taken before agreement was reached to establish the three vertically integrated distributor-retailers. Of the \$13.0m incurred by Unitywater, for example, \$5.8m was attributable to the Interim Distribution Entity.

5. Basis for the determination of distributor-retailer prices 2010-2011

The three distributor-retailers commenced operations on 1 July 2010. Whilst work on establishing the entities had commenced sometime before this, it is not surprising that there was little change made to the structure of prices for 2010-2011 compared to the previous year. The entities were still at an early stage in developing their own financial reporting systems and had to rely on data obtained from the frequently inadequate systems of their participant Councils. The focus was essentially limited to adjusting the level of prices to take account of operating and capital cost changes, including considerations of appropriate rates of return.

In setting the level of prices the entities appear to have been significantly influenced by the methodology which is to be used by the QCA in monitoring their prices. In this regard the concept of the Maximum Allowable Revenue (MAR) is significant as the Authority has indicated that it will be using MAR as a key basis for assessing whether an entities prices are excessive or, alternatively, too low in the sense of not fully reflecting efficient costs. MAR values are to be determined for both water and wastewater services.

The key documents available to the reviewer in considering 2010-2011 prices have been the submissions made by the three distributor-retailers to the QCA in relation to its monitoring role and a report prepared by AEC Group which also examined these submissions. A limited amount of further information was provided to the reviewer in response to requests made and after interviews with key staff. However, the key documents sought by the reviewer to help explain the basis for the determination of 2010-2011 prices, the papers considered by the respective boards of the entities when making their price determinations, were not made readily available.⁴¹ This is despite requests from the Mayors of the Participating Councils to the distributor-retailer entity chairs to do so. Whilst the submissions to the QCA are informative, they essentially cover the information the authority wanted to obtain to conduct its monitoring, not necessarily what was in the minds of those who made the pricing decisions at the time.

5.1 Prices set for 2010-2011

Table 2 provides a summary of the water prices set by the three entities for residential customers in 2010-2011. These prices are compared with those set by the respective Council businesses the previous year with the percentage differences between them shown.

⁴¹ Queensland Urban Utilities and Allconnex Water indicated that the documents could be made available, but this was on terms that were not acceptable to the reviewer.

Table 2: SEQ distributor-retailer residential water prices 2010-2011 compared to 2009-2010

Queensland Urban Utilities

LOCATION	CHARGE TYPE	2009/10	2010/11	% DIFF
Brisbane	Access	\$155.24	\$162.96	5.0
	Consumption	0-255kl = \$1.84/kl	0-255kl = \$2.17/kl	17.9
		256-310kl = \$1.88/kl	256-310kl = \$2.21/kl	17.6
>310kl = \$2.39/kl		>310kl = \$2.75/kl	15.1	
Ipswich	Access	\$309.00	\$324.48	5.0
	Consumption	0-320kl = \$1.91/kl	0-320kl = \$2.24/kl	17.3
		321-480kl = \$2.36/kl	321-480kl = \$2.71/kl	14.8
>480kl = \$2.68/kl		>480kl = \$3.05/kl	13.8	
Scenic Rim	Access	n.a.	\$342.12	n.a.
	Consumption	n.a.	\$2.63/kl	n.a.
Lockyer Valley	Access	n.a.	Gatton/Laidley \$382.68 Forest Hill \$340.20	n.a. n.a.
	Consumption	n.a.	0-300kl = \$1.93/kl	n.a.
		>300kl = \$2.77/kl	n.a.	
Somerset	Access	n.a.	\$287.40	n.a.
	Consumption	n.a.	0-300kl = \$2.32/kl >300kl = \$3.62/kl	n.a. n.a.

Allconnex Water

LOCATION	CHARGE TYPE	2009/10	2010/11	% DIFF
Gold Coast	Access	\$160.00	\$192.00	20.0
	Consumption	\$2.24/kl	2.68/kl	19.6
Logan	Access	Logan North \$200.00	Logan North \$240.00	20.0
		Logan East \$180.00	Logan east \$216.00	No discount
		Logan South \$340.00 (5% discount- all)	Logan South \$408.00	
	Consumption	\$2.25/kl	\$2.70/kl	20.0
Redland	Access	\$233.50	\$240.36	2.9
	Consumption	0-146kl = \$1.55/kl	0-146kl = \$1.59/kl	2.6
		147-292kl = \$1.95/kl	147-292kl = \$2.00/kl	2.6
>292kl = \$2.41/kl		>292kl = \$2.41/kl	2.6	

Unitywater

LOCATION	CHARGE TYPE	2009/10	2010/11	% DIFF
Moreton Bay	Access	Caboolture \$276.00	\$334.00	Caboolture 21.0
		Pine Rivers \$316.00		Pine Rivers 5.7
		Redcliffe \$180.00		Redcliffe 85.6
	Consumption	0-280kl \$1.50/kl	0-280kl = \$1.82/kl	21.3
281-360kl = \$2.04/kl		281-360kl = \$2.47/kl	21.1	
>360kl = \$2.40/kl		>360kl = \$2.91/kl	21.3	
Sunshine Coast	Access	\$211.00	\$224.00	6.2
	Consumption	0-219kl = \$1.35/kl >219kl = \$1.80/kl	0-219kl = \$1.59/kl >219kl = \$2.07/kl	17.8 15.0

Source: AEC Group, Assessment of Drivers of recent Water Price increases in SEQ, Final Report November 2010

The overall view is that prices in 2010-2011 were increased significantly by all three entities. In no case were prices reduced. Queensland Urban Utilities (QUU) applied lesser percentage increases to its access charges than it did to its consumption or volume related charges. Allconnex Water price rises were around 20 per cent, except for those relating to Redland which were below the general inflation rate. Unitywater very substantially increased the access charge for Redcliffe and the consumption charge increases for Moreton Bay exceeded 20 per cent. The increases for the Sunshine Coast were more in line with those set for Brisbane by QUU.

5.2 Pricing strategies

Each of the entities experienced real difficulties in setting prices in circumstances where the underlying data was far from ideal and there was insufficient time to undertake the necessary research and consultation to make significant changes to the structure of tariffs from the past. The entities also pointed to the uncertainty surrounding their regulatory environment. Should they wait to be told what to do by the regulator, or do they just get on and do it and convince the regulator later, if necessary, that what they have done is not inappropriate?

Allconnex Water has absorbed the water businesses of three local governments. Within these three local government supply areas prices for water and wastewater services were set uniformly on a 'postage stamp' basis, although there were differences according to customer type or service. It was suggested that each of the Councils had been moving their businesses towards full cost recovery, but were at different stages of this progression. Collectively the businesses did not generate a commercial rate of return on the assets involved.

Allconnex pointed to significant cost increases, including for bulk water and energy and for capital works, which needed to be covered just to hold its existing position. Consequently it claimed to have "adopted a transitional approach to pricing which for 2010-11 incorporates price increases which are significantly less than required to achieve MAR. Over the medium term, this strategy translates into a revenue glide path which is longer than the QCA's interim price monitoring period."⁴² A consistent percentage increase was applied to all charges within a particular district/product category. "The level of the percentage increase reflects the percentage required to achieve MAR up to a maximum of 20%. Practically, this results in a lower percentage increase for Redland customers, with higher increases for Logan and Gold Coast customers, since Redland's charges for 2009-10 were already near its (district-level) MAR".⁴³

Queensland Urban Utilities has maintained the tariff structures it has inherited from its participating Councils in setting prices for 2010-2011. This includes a variety of sub-district tariffs applying prior to the merger of Councils in March 2008. The entity has indicated that it is waiting for a direction to be given to the QCA from the Queensland Treasury and QWC to commence consulting on and developing long term pricing principles needed before assessing tariff structures.

The level of prices is likely to have been set below MAR levels. The entity determined that it would apply a return on capital charge (a nominal post-tax Weighted Average Cost of Capital) of 9.2% which is at a level that the QCA has previously considered on the low side⁴⁴. The entity said that it "considered not only the economic rate of return that might be used but also the impact of price increases on customers. The rate was selected having regard to this being the first time Queensland Urban Utilities set prices and to ensure a conservative approach to price setting for 2010/11, particularly in view of the number of uncertainties related to the application of the regulatory framework."⁴⁵

42 Allconnex Water, Price Monitoring Submission 2010-2011 to Queensland Competition Authority, 7 September 2010, p. 5.

43 Ibid.

44 Both Allconnex Water and Unitywater applied a WACC of 9.88%, which was the mid-point of an appropriate range identified by an external consultant.

45 Queensland Urban Utilities, Price Monitoring Information Return, 31 August 2010, p. 7.

Unitywater also indicated that it has adopted the existing Council tariff structures as the basis for setting its prices in 2010-2011. It suggested that it intended to limit changes here until the QCA publishes pricing principles, which have been foreshadowed.

Unitywater also noted that it “was required to set prices on the basis of limited historic information about its anticipated MAR, and amid uncertainty about key parameters such as the opening RAB (Regulatory Asset Base)”⁴⁶. The entity indicated that it had set the level of prices to the then anticipated MAR level. However, since then it claims that its knowledge has grown as it has refined its costing projections to the point where the estimated MAR is \$48m above its forecast revenue for 2010-2011. The intention is to smooth its prices over time so that MAR is achieved over a defined period on a net present value neutral basis.

In announcing its prices for 2010-2011, Unitywater indicated that the prices set “reflect the true economic cost of providing water supply and sewerage services”⁴⁷ in the Council areas within its customer base. By implication, this presumably meant that the areas with the highest increases were those where under-pricing had been greatest before. It was also suggested that “the entity was moving towards standardised pricing across the region for fairer and more equitable services for customers in the combined 5,138km² Unitywater service area.”⁴⁸

Unitywater’s price increases in Moreton Bay were the largest in the entire region and it is not surprising that it led to significant customer backlash, especially in the Redcliffe area. Its communications with customers about the need for substantial price rises was poor and indeed the rationale for those rises seemed suspect. Given its existing knowledge of its costs, such large increases seemed premature. Moreover, the suggestion seemed to be that it was moving to align prices across its region at the highest price level. This is without fully assessing the appropriateness of postage stamp pricing, as opposed to nodal pricing, and demonstrating that it had done all it could to reduce costs to more efficient levels. The Allconnex Water approach of placing a cap on the size of increases in any one year was a more sensible strategy in the short term and reflected the desires of the State Government for restraint, but it delayed the period of full cost recovery.

Three days after announcing its increases, Unitywater released revised retail prices which took into account a two year subsidy the Moreton Bay Regional Council was to provide. This subsidy is equal to one-half of the difference between the existing fixed charge and the fixed charge Unitywater had earlier announced for 2010-2011. This had the effect of cutting the increase in charges for an average householder in the Redcliffe area to around 37%, from 66%.

5.3 The drivers of increased prices in 2010-2011

Table 3 draws on data provided by the AEC Group and the submissions of the three distributor-retailers to the QCA to highlight the changes in major cost categories over the past year, which have to a significant degree underpinned the announced price increases. No separate category of retail/corporate cost was identified by QUU and hence is not included in the table. At a very high level the data do show some interesting variations between the three entities, no doubt reflecting a range of factors such as their size, the density and age of their networks. In due course, if sufficiently detailed and timely comparative data is published, it should provide a stimulus for the entities to look for efficiency improvements in their own organisations on the basis of what others have achieved.

The table highlights a number of key drivers of costs and prices. Firstly, the importance of **bulk water price increases** is readily apparent, particularly for QUU and Allconnex Water where it accounts for well over one-half of the total cost movement. For the smaller Unitywater, **retail/corporate costs** were the largest area of

46 Unitywater, Response to Interim Price Monitoring Information Requirement, August 2010, p. 9.

47 Unitywater, Media Releases 25 June 2010 re. charges.

48 Ibid.

cost increase, reflecting in part the early moves by this organisation to establish new systems separate from its Participating Councils and new headquarters.

Increases in **capital costs** have contributed around one-fifth of the movement in costs overall. This reflects in part significant capital works programs, especially in wastewater. The capital works programs of each of the three distributor-retailers are substantial and have increased from the previous year. For example, QUU announced that it had committed \$269.8m to water and sewerage infrastructure work in 2010-2011, which was \$104.8m more than the previous year spent by its Participating Councils⁴⁹. In total the three entities planned to spend more than \$1b on capital in 2010-2011. Growth in population is a key driver of this new investment. The acceleration in capital growth is not expected to be maintained beyond the next year in the case of Allconnex Water and this year in the case of Unitywater.

Infrastructure grants and subsidies

As part of its response to the effects of the Global Financial Crisis, the Queensland Government announced in its 2009-2010 Budget that it would stop payments under its Local Government Infrastructure and Subsidy Program 2006-2011. The State had by then approved projects with a total funding of \$880.5M under this program, as against an announced \$700m.⁵⁰ Under the Water and Sewerage component of the program a maximum subsidy of 40% of eligible capital costs (50% on some effluent works) was paid to SEQ Councils based on stringent criteria. From 1 July 2011 a much more limited scheme providing \$45m per annum targeted at Councils in Queensland with limited capacity to fund necessary community infrastructure is to apply. It has been suggested that removal of the subsidy program will involve a loss of revenue for Councils of \$85m a year.⁵¹ However, not all of this relates to water infrastructure spending. It includes subsidies for roads, for example, and does not just cover SEQ Councils.

Removal of the subsidy scheme will have an impact on the new distributor-retailer water entities, which cover the SEQ region where most of the State's population growth will occur. The cost of capital works will effectively increase without the subsidy. QUU has estimated this cost to be around \$200m over five years, while Unitywater estimated it to be \$100 million over three years.⁵²

These cost increases may not lead to commensurate increases in prices. The entities will need to assess what capital works are economic within unsubsidised price levels and determine whether it is appropriate to proceed, delay, or modify projects, for example by adjusting quality or service levels if possible. It is important that the entities do not just adopt an approach of costs driving prices. Rather, they should see prices as having a significant role in driving costs, as is the case in competitive markets.

49 Queensland Urban Utilities, "Record Investment in Water and Sewerage Infrastructure", Media release 28 June 2010.

50 See Queensland Government State Budget 2009-2010, Budget Strategy and Outlook, Budget Paper No. 2, p.8.

51 Local Government Association of Queensland, News Release: State breaks promises to Local Councils, 16 June 2009.

52 Recent moves by the State Government to cap infrastructure headworks charges, which constitute around 20%-30% of the distributor-retailer entities' income could also add pressure for price increases in coming years if capped charges are set below full cost recovery. See Queensland, Infrastructure Charges Taskforce, Interim Consultation Report, November 2010.

Table 3: SEQ Distributor-retailers: Major cost categories 2010-2011 compared to 2009-2010

	2009-2010 (\$'000)	2010-2011 (\$'000)	Change (\$'000)	% contribution
Qld. Urban Utilities				
Bulk water	\$150,613	\$188,732	\$ 38,119	83.8
Operating costs	\$ 78,138	\$ 74,957	\$ - 3,181	-7.0
Depreciation	\$ 56,632	\$ 63,150	\$ 6,518	14.3
Return on capital	\$ 34,280	\$ 38,297	\$ 4,017	8.8
Total	\$319,662	\$365,137	\$ 45,475	100.0
Allconnex Water				
Bulk water	\$120,197	\$154,663	\$ 34,466	61.7
Operating costs	\$ 60,632	\$ 60,843	\$ 211	0.4
Retail/corp costs	-	\$ 12,571	\$ 12,571	22.5
Depreciation	\$ 40,341	\$ 44,852	\$ 4,511	8.1
Return on capital	\$ 43,650	\$ 47,728	\$ 4,078	7.3
Total	\$264,820	\$320,658	\$ 55,838	100.0
Unitywater				
Bulk water	\$ 62,038	\$ 75,334	\$ 13,296	34.5
Operating costs	\$ 28,335	\$ 29,778	\$ 1,443	3.7
Retail/Corp costs	\$ 12,971	\$ 28,694	\$ 15,723	40.8
Depreciation	\$ 20,970	\$ 22,321	\$ 1,351	3.5
Return on capital	\$ 17,683	\$ 24,377	\$ 6,694	17.4
Total	\$141,997	\$180,504	\$ 38,507	100.0

Source: AEC Group, Assessment of Drivers of Recent Water Price Increases in SEQ, Final Report, November 2010.

5.4 Formal legislative and regulatory requirements affecting costs and prices

The three distributor-retailers were established under the *South-East Queensland Water (Distribution and Retail Restructuring) Act 2009*. Existing distribution and retail assets, functions and employees of local governments were transferred to the new entities and in return participating rights were allocated enabling the Councils to share in the profits of the entities. The State Minister had powers to approve the transfers involved.

The entities are not established as bodies corporate, do not represent the State and are not constituted by the Participants, meaning that the Councils are not treated as members of the entities. Section 11 of the Act sets out the primary functions of the entities and section 12 their powers. These provide formal authority for the entities to determine charges for services provided.

The distributor-retailers are required to enter a Participation Agreement with their Participating Councils. These agreements must deal with certain matters including the way distribution of profits is to be approved. These agreements must be approved by the Minister and be made public through tabling in the Parliament.

Each of the Agreements specify objectives for the distributor-retailers which, inter alia, highlight their intended commercial and customer service focus. Relevant extracts from the Agreements are shown in the box below.

Decisions in relation to pricing are made by the boards of the distributor-retailers who are responsible for determining strategies and operational, administrative and financial policies for their organizations and for ensuring the proper, effective and efficient performance of functions and use of powers. The boards

are appointed by the Participants, but the Act (section 33) contains significant restrictions on who can be appointed board members. No Councilor of a Participating Council and no more than two employees of a Participating Council can be appointed as board members. This means that the Participating Councils have limited capacity to influence directly board decisions. Board members are required to act in good faith in the distributor-retailers best interests and for a proper purpose. The interests of distributor-retailers will not necessarily be fully aligned with those of their Participating Councils.

Participating Councils do, however, have reserve powers for enabling them to give written directions to their distributor-retailer about the way its functions must be performed. A direction can only be given if all or the required majority of Participating Councils “are satisfied the direction is necessary and in the public interest of the distributor-retailers geographic area and the SEQ region”, and the view of the distributor-retailer board as to “whether, in the board’s opinion, complying with the direction is consistent with the performance of the distributor-retailers functions” is obtained beforehand.⁵³ It seems likely that these powers could only be invoked in unusual circumstances. It seems doubtful, for example, whether it would be in the public interest of the SEQ region as a whole, or consistent with the functions of a distributor-retailer for its prices to be restrained by a direction from its Participating Councils.

Extracts from Participation Agreements

Participation Agreement Central SEQ Distributor-Retailer Authority (Queensland Urban Utilities)

3.1 Objectives

3.1 (d) to operate on a sustainable basis and to provide commercial returns to Participants;

3.1 (e) to be an innovative and responsive organization that engages with the communities it serves;

3.1 (f) to ensure continuity of service and, maintenance and improvement of existing customer service standards.

Northern SEQ Distributor- Retailer Authority Participation Agreement (Unitywater)

3.1 Objective of the business

3.1 (b) to operate on a sustainable basis

3.1 (c) to provide commercial returns to Participants

3.1 (d) to be an efficient, innovative and responsive organization that engages with the communities it serves; and

3.1 (e) to ensure continuity of service, maintenance and improvement, of existing customer service standards and focus.

Southern SEQ Distributor-retailer Authority Participation Agreement (Allconnex Water)

3. Business Objectives

(b) to operate using the principles of excellence in governance, economy, environment, social responsibility and health

(d) to deliver optimal returns on investment to the Participants

(e) to provide excellence in customer service.

⁵³ Section 49 *South-East Queensland Water (Distribution and Retail Restructuring) Act 2009*.

The Act imposed a number of requirements on distributor-retailers which will inevitably raise their operating costs above what they might otherwise be and in turn impact on prices. For example, employees in existing Council water businesses who transferred to the new distributor-retailers were employed on the same terms and conditions and no forced retrenchments were permitted.⁵⁴

Similar protections had applied in relation to Council amalgamations which preceded the establishment of the distributor-retailers. It seems likely that these restrictions have significantly delayed the achievement of some potential efficiencies from scale and specialization expected to be obtained from the amalgamations. Customers will also be protected by a Customer Water and Wastewater Code including minimum and Guaranteed Service Standards. The Code will be made by the Minister. Increases in quality and service standards can be expected to have cost impacts on the businesses. Further the Act requires that the distributor-retailers pay tax equivalents to their participating local governments.

Prices set by the distributor-retailers are subject to oversight by the QCA. On 2 July 2010, the Premier and Treasurer referred the water and wastewater activities of the 3 distributor-retailers to the QCA for price monitoring investigation to apply for an interim regulatory period from 1 July 2010 to 30 June 2013. This followed an investigation and report by the Authority on an appropriate price monitoring framework.⁵⁵

A copy of the formal direction given to the QCA by the Ministers in relation to the monitoring of the distributor-retailer businesses over the next three years is provided in Appendix 3. The Ministers indicated the Government's strong preference for a light handed monitoring framework where the new businesses were clearly responsible for price setting and where there was clear recognition given to the early development stage the businesses were in. Once again the Ministers also emphasized their desire to avoid price shocks. They said in their covering letter to the QCA that:

"Throughout the institutional water reform process, the Government has been consistently sending a strong message to the water entities and their local government owners that they should seek to avoid price shocks. In this context, the attached Direction requires the QCA to take account of proposals by the new entities to smooth price increases over time".⁵⁶

From 1 July 2013, it has already been determined that the QCA will have formal deterministic powers in relation to the prices set by these organizations. This decision seems premature in the absence of a formal assessment against the declaration criteria and assessment of the effectiveness of the monitoring framework. It also seems inconsistent with the intent of the Competition and Infrastructure Reform Agreement discussed in 2.3. These oversight processes will involve extensive information collection, documentation preparation and consultation and will add to the costs of the businesses.⁵⁷

5.5 Rate of return and dividend policies

The Maximum Allowable Revenue (MAR) is the level of revenue which allows a regulated business to recover its efficient costs of operation, including both operating and capital costs including an appropriate allowance for risk. This incorporates both a return of capital used in the process of generating income (depreciation) and a return on capital as typically measured as a Weighted Average Cost of Capital (WACC). The WACC takes account of returns paid to creditors (interest) and to owners (dividends, retained earnings) for the capital invested in the business.

54 Sections 79-83 of the *South-East Queensland Water (Distribution and Retail Restructuring) Act 2009* provides the basis for these workforce restrictions.

55 Queensland Competition Authority, Final Report SEQ Interim Price Monitoring Framework, April 2010.

56 Letter Premier Anna Bligh and Treasurer Andrew Fraser to Chairman Queensland Competition Authority dated 2 July 2010.

57 The information collection and reporting requirements placed on the businesses during the interim price monitoring period are outlined in Queensland Competition Authority, SEQ Interim Price Monitoring Information Requirements for 2010/2011, July 2010.

The Participation Agreements each require that the distributor-retailers report at least annually on their participation return (dividend) policies to the Participating Councils and in their annual reports.⁵⁸ Participation policies and returns are determined by the boards in full awareness of the financial position of the businesses. Projected returns are required to be included in the five year strategic plans. Payments are only able to be made out of net profits after tax, excluding unrealized capital gains from asset revaluations.

QUU is the only one of the three bodies which has a specified dividend payout. Its Participation Agreement requires that the Participation Return Policy “shall state that there will be a minimum final annual Participation Return of 85% of estimated Net profit (Estimated Return) and a minimum Interim Participation Return of 85% of estimated Net Profit for the first six months of the financial year (Interim Estimated Return) unless the Participants agree otherwise ..”⁵⁹ Unitywater’s dividend policy makes it clear that the Board must have regard to the cash flow and capital needs of the business in determining dividend payments.⁶⁰ Allconnex Water indicated in its submission also that it had developed a profit distribution/dividend policy and that the actual amount paid may vary depending on a range of factors. In the submission it assumed this to be 75% of distributable profits defined as net profits after tax less capital contributions.⁶¹

The payment of dividends to the Participating Councils is clearly recognised as legitimate under the Participating Agreements approved by the Minister and is consistent the National Water Initiative Pricing Principles. Criticisms by State Government Ministers, however, often seem to cast doubt on the legitimacy of the payment of dividends by the distributor-retailers. This is not conducive to building public confidence in the new institutional arrangements. The State Government has also suggested that Councils should forgo dividends in order to allow a smoothing of prices over time. Again this suggestion seems at odds with the National Water Initiative Pricing Principles. The wisdom of such a policy is in any event questionable. The appropriate level of dividends, given independent oversight arrangements are in place, can really only be determined by the Councils concerned and by the businesses. If the Councils did not receive dividends or were forced to use them to subsidise water prices, it may mean foregoing spending on other important services for ratepayers. Expenditure in these other areas may be more targeted to people in need than would be the case with a general reduction in water prices. And the effect on prices of foregoing dividend payments and thus allowing for a reduced rate of return to be built into the price may only be relatively small overall, given that the owner’s return is only one component of the total retail price. The consequences for the businesses, however, in not being able to generate sufficient capital to fund new investment may be quite severe, with potential flow-on effects for sequencing of development across the region.

5.6 Comparisons with water prices in other metropolitan areas

Under the National Water Initiative governments agreed to independent and public reporting of pricing and service quality of water supply entities each year. The benchmark National Performance Reports are published by the National Water Commission and the Water Services Association of Australia. The latest publication covers the year 2008-09; the 2009-10 data will not be available until around April 2011. Price comparisons in any one year need to be treated with caution as they may not be fully representative of the longer term picture. For example, the timing of major infrastructure works may have significant short term effects on prices. Similarly, the timing of drought cycles and restrictions, which can impact on water volumes, can also affect prices. With these caveats in mind, it is nevertheless of interest to compare prices across jurisdictions to help point to possible opportunities to enhance the efficiency of service provision. Table 4 provides a list of comparative charges for residential water and sewerage services, both assuming a consumption of 200KL per annum, provided by major utilities (more than 100,000 customers) in Australia in 2008-09. Typically the water charges are made up of a fixed component and a volume component comprising a number of steps.

58 Queensland Urban Utilities Participation Agreement Clause 15.1 (c) (iii); Allconnex Water Participation Agreement 7.1 (d) (iii); Unitywater Participation Agreement 8.1 (2) (iii).

59 Queensland Urban Utilities Participation Agreement clause 14.1(c) (i) B. 1)

60 Unitywater, Participation Return (Dividend) Policy, approved 26 July 2010.

61 Allconnex Water, Submission to QCA, p.50.

The sewerage charges are generally just a fixed charge, but in a few instances volume charges also apply. The list includes Brisbane, Gold Coast and Logan Councils.

The data show that the Gold Coast and Logan were charging the highest prices of all the entities shown. The Brisbane prices were on a par with those in Perth (WA Water) and Sydney (Sydney Water) and below those in Canberra (ACTEW). They were significantly above those in Melbourne (City West, SE Water, Yarra Valley) and NSW (Hunter Water) and to a lesser extent Adelaide (SA Water).

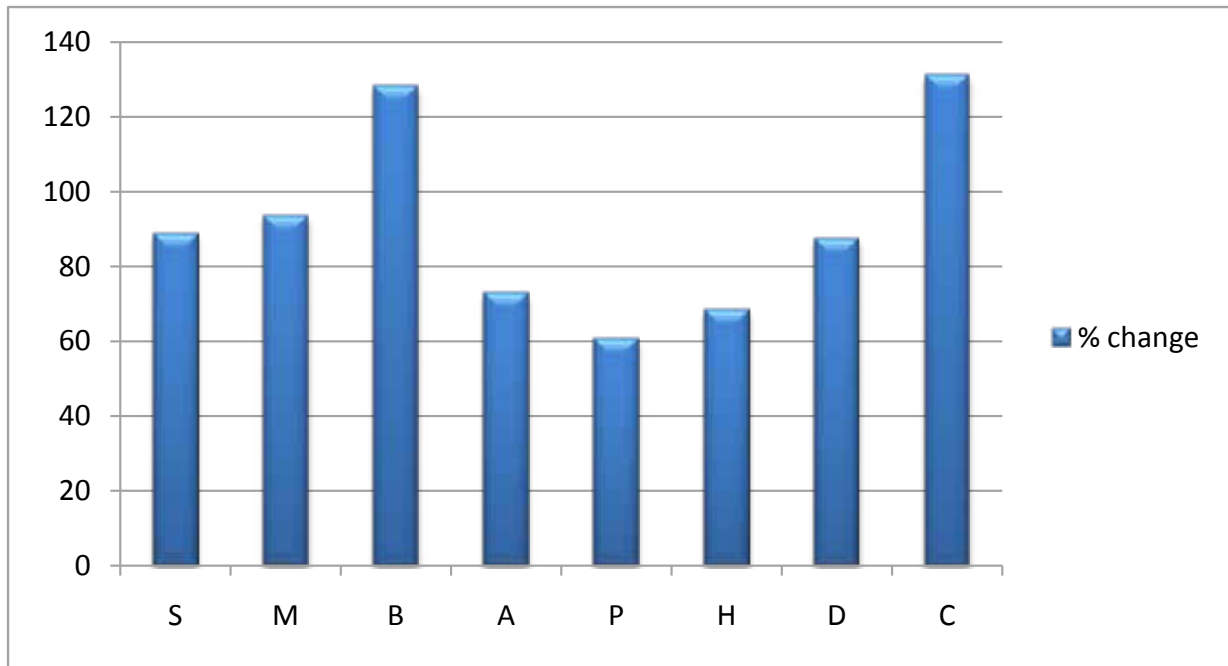
Table 4: Comparisons of charges by major water entities in Australia 2008-09 residential water and sewerage (200kl/a)

Entity	Water (\$)	Sewerage (\$)	Water and Sewerage (\$)
ACTEW	455	443.82	898.82
Sydney Water	397.7	480.31	878.01
Hunter Water	295.46	368.17	663.63
City West	338.59	300.07	638.66
South East	266.62	373.08	639.70
Yarra Valley	286.00	369.00	655.00
SA Water	353.00	434.25	787.25
WA Water	318.35	529.09	847.44
Brisbane	452.12	398.24	850.36
Gold Coast	526.00	520.00	1046.00
Logan	551.00	423.00	974.00

Source: Australian National Water Commission and Water Services Association of Australia, National Performance Report 2008-09, Urban Water Utilities Part C, April 2010

A longer comparative perspective on capital city water and sewerage price increases is shown in graph 1 below, which reports movements in the water and sewerage expenditure class of the Consumer Price index.

Graph 1: Percentage increases in water and sewerage prices June quarter 1998 - June quarter 2010 by capital city



Source: Australian Bureau of Statistics, Consumer Price Index Cat. 6401.0

The graph shows that Canberra (C) and Brisbane (B) had the largest increases in prices over this period (131.2% and 128.2% respectively). The increases in Sydney (S=88.8%), Melbourne (M=93.6%) and Darwin (D=87.5%) were significantly less than this. The smallest increases were in Perth (P=60.8%), Hobart (H=68.4%) and Adelaide (A=72.7%).

Most of the increase in prices in all capital cities has been experienced over the past five years. The increases since June 2005 are as follows:

- Sydney 60.3%
- Melbourne 59.6%
- Brisbane 51.6%
- Adelaide 32.7%
- Perth 32.0%
- Hobart 34.8%
- Darwin 34.4%
- Canberra 69.8%

5.7 Future price increases

Water and sewerage prices will continue to rise sharply in most capital cities in coming years given recent decisions of price oversight bodies, which generally set a price path for a number of years into the future.⁶² In NSW, IPART has approved real average annual bill increases of 7.7% for Sydney Water over the period 2008-2009 to 2011-2012. In Melbourne the Essential Services Commission has approved real average annual increases of between 10.9% and 13.2% for the three distributor-retail bodies over the period 2009-2010 to 2012-2013.

⁶² See National Water Commission and Water Services Association of Australia, National Performance Report 2008-2009 Urban Water Utilities, p. 25.

In Brisbane, the QWC indicated that retail water charges would increase by an annual real rate of 11.9% over the period 2008-2009 to 2012-2013 due to bulk water increases alone.⁶³ These estimates appear to have included costs associated with the then proposed Traveston Crossing Dam. However, the Government has since indicated that no planning or pre-construction costs associated with this dam will be passed on to consumers through water prices. Further it indicated that the cost of the South East Water Grid would be \$7b without the dam compared to the \$9b previous estimate with it. The Government still claimed that it was pricing water below cost, but that in five years it may be approaching a break-even point. "At that point, the absence of Traveston Crossing Dam costs may be taken into consideration, which may result in lower price increases for the second five years of the plan than previously anticipated. But all factors affecting the price of bulk water, including population growth interest rates and capital depreciation and operating costs of the water grid will also need to be considered."⁶⁴ Since this statement was made, the Government has announced some reduction in prices set under the price path in response to not building the Traveston Dam, placing desalination and water treatment plants in standby mode and merging Seqwater and WaterSecure.⁶⁵

In Adelaide (South Australia) water charges will increase 21.7% in 2010-2011. In Perth, the Economic Regulation Authority recommended a real annual increase of 10% for water and 2% for sewerage for each year from 2009-2010 to 2011-2012. In Hobart water and sewerage charges have been capped at 5% increases per year until June 2012, following intervention by the Government. In Darwin the increases are expected to be 20% in nominal terms for each year from 2009-2010 to 2011-2012. Finally, in Canberra the independent regulator has determined real average annual increases of 1% for water and 4.8% per cent for sewerage over the period 2009-2010 to 2012-2013.

5.8 Achieving greater price restraint

Shortly after their establishment the three distributor-retailers announced significant increases in water prices for 2010-2011 as highlighted in table 2. This prompted criticisms and comments from Ministers, which could have led the community to believe the entities were profiteering. Colourful terms such as 'price gouging', 'water price rip offs', 'dishonest and tricky' may attract reporting by the media and resonate with consumers, but they have been used without evidence and, again, are hardly likely to inspire community confidence with the new institutional arrangements.

The Treasurer raised a number of specific concerns about transparency and price setting. Relevant sections of the Treasurer's media statement are given below.

Treasurer Andrew Fraser has called on Brisbane City Council to come clean to the people of Brisbane about their plans to reap financial benefits from increases to ratepayer water charges.

Mr. Fraser said Council had been hiding the details of what they are doing with increasing water charges and it's time for them to tell residents exactly what they are being charged by Council, and the dividends and other payments they Council will be taking in return.

"The new Council owned water businesses yesterday announced a \$107 increase in the average water bill for Brisbane residents.

63 The Commission indicated an expected water bill for 250kl/annum of \$747 in 2012-2013 up from \$506 in 2008-2009. This data was released at the time it released the ten year price path for bulk water but has since been removed from its website.

64 The Honourable Stephen Robertson, Ministerial Statement: Water Grid, Hansard Queensland Parliament, 18 August 2010, pp. 2662-3.

65 The Honourable Andrew Fraser, Treasurer and Minister for Employment and Economic Development, and The Honourable Stephen Robertson, Minister for Natural Resources, Mines and Energy and Minister for Trade, Joint Media Statement, "Water reforms save money for households", 5 December 2010.

“Only \$44 of that amount is due to increases in State bulk water charges. The remaining \$63 goes to Council-owned water businesses who deliver their dividends and payments back to Council.

“Its time they came clean on what benefits they will receive, and owned up to the fact that the Councils set the water price and they are increasing their water price”.

“The final question for Brisbane City Council is will they provide a new subsidy for their residents to ease the pressure of the increases they have set, given the expected revenue they will receive in dividends and other payments?”⁶⁶

Transparency of reporting by the Councils is important, but any dividends received by Participating Councils from their distributor-retailers would not be reflected in Council financial statements until the end of 2010-2011, well after the comments made by the Treasurer.

The Treasurer also asserted that the Councils were setting water prices and that Brisbane City Council and, presumably other Councils also, should provide residents with a subsidy to keep down the prices of water.

The Treasurer’s comments seem to be at odds with the basis on which the Government has established the distributor-retailers. These entities have been established as independent bodies charged with operating on a commercial basis and subject to price oversight. Unlike normal commercial entities, however, unusual constraints have been placed on their Council owners in terms of who can sit on their boards. In these circumstances it seems strange to suggest Councils now can directly set water prices. These are set by the statutory independent distributor-retailers and Council members have no direct representation on their boards.⁶⁷ In fact, given that they are established under State law, the State Government is likely to have just as much ability to influence the operations of the distributor-retailers as do the Councils.

The use of dividends to subsidise water prices seems at odds with the intergovernmental agreements governing water and the move to full cost reflective pricing. However, some Councils may feel pressured into doing this by the State government’s criticisms of them.⁶⁸ A more targeted approach, which the SEQ Councils already adopt is to provide rebates on rates and water charges for pensioners, sporting and community groups.

Another suggestion by the State Government has been for the Councils to simply forgo dividends, thus presumably allowing the entities to adopt a lower Weighted Average Cost of Capital and set lower prices. The State Government has reduced the size of the bulk water price rises by applying a lower rate of return on the new assets required to drought-proof the region. However, on other existing bulk assets it is not apparently doing this and there seems to be no logical reason for Councils to apply a lower rate of return to their existing distribution-retail assets, even if they did have the ability to influence the statutory independent water bodies in this way. Once again, this approach seems to be at odds with the National Water Initiative Pricing Principles which seek full cost reflectivity. It also seems to be at odds with the general approach adopted by the Government to State-owned corporations, including electricity utilities.

Other suggestions have been made by State and Local Governments as to how price increases could be mitigated. For example suggestions have been made that price rises should be limited to inflation or that the value of new bulk water assets not be taken into account in pricing.⁶⁹ Both approaches may prevent the recovery of efficient costs and in this respect are not dissimilar to the proposal to lower or eliminate dividend

66 The Honourable Andrew Fraser, Treasurer and Minister for Employment and Economic Development, Media Statement: Treasurer calls on Brisbane City Council to come clean on their water windfall, 29 June 2010.

67 A recent legal opinion obtained by the LGAQ indicated that “participating local governments have no meaningful power to change or affect prices charged by the distributor-retailers.” King & Company Solicitors, 6 September, p. 5.

68 See the Honourable Stephen Robertson, Minister for Natural Resources, Mines and Energy and Minister for Trade, Media Statement: ‘Shame File’ Council fesses up to Water Rip-off, 24 September 2010.

69 Steven Wardill, “Pressure may ease on home water bills in Southeast Queensland” The Courier Mail 4 September 2010.

payments. However, interesting issues do arise with the treatment of bulk assets. Since the immediate necessity for some of the new water supply assets is no longer apparent, it might be argued that they should not be reflected in the asset bases used in the determination of bulk water prices. The investments could be regarded as neither efficient (cost effective) nor prudent (needed). However, the investments can also be seen as a form of insurance and they need to be paid for. Presumably if water users do not pay for them, taxpayers will through general taxation.

Another approach would be to seek to recover most of the costs of the desalination plant when it was utilized at times of normal supply shortages. This would be somewhat analogous to the situation in the electricity industry when at peak load times higher priced gas fired plants come into operation. In the water industry, however, it may be necessary to recover the costs associated with maintaining operational capability of the desalination plant in normal bulk water prices.

These alternative funding approaches raise efficiency and equity considerations. On efficiency grounds it seems clear that water prices should reflect efficient supply costs over time. This is what all governments in Australia have formally agreed to under the National Water Initiative. On equity grounds, there does not seem a strong basis for departing from a user pays approach. If income redistribution is an objective then funding infrastructure through taxation might be more effective given the existing approach of not discriminating in water pricing between different income groups.

It is important that the distributor-retailers recognize the need for price restraint and demonstrate this to their customers. The best way that they can go about achieving price restraint is by striving to achieve greater efficiencies in their operating and capital expenditures.

5.9 Water and Other Legislation Amendment Act 2010

This Act was passed by the Parliament on 25 November 2010. It introduces a number of significant measures affecting pricing, not all of which were highlighted in the Minister's Second Reading Speech. Some measures seem to have been directly prompted by the on-going dispute with Councils over responsibility for price increases.

Some of the main sections of the Minister's Second Reading Speech are provided below for convenience.

Following the commencement of the Council owned distributor-retailers on 1 July 2010, the government is now implementing a strengthened package of transparency and regulatory protections for customers. Under these amendments customers will be informed about their distributor-retailer's governance and accountability arrangements in respect of its participant Councils; be notified of proposed and final water and wastewater prices and charges; be better informed about the contents of their water and wastewater bill, including identifying when it has been based upon an estimated meter read; and have access to an independent dispute resolution process provided by the Energy and Water Ombudsman Queensland in accordance with a Customer Water and Wastewater Code.

A regulation-making power will also be introduced to allow the contents of a water and wastewater bill to be further defined. This is necessary in light of the somewhat dishonest and tricky campaigns that have been launched by some Councils in South-East Queensland over the last number of months. Through confusing water bills, some Councils have deliberately set out to blame the state for water charges levied by Council owned water and sewerage businesses. Some Councils have been deliberately hiding the simple facts that, on average, three-quarters of the average South-East Queensland water and sewerage bill is levied by Council owned water businesses. Only a quarter of the average bill is a result of state government bulk water charges. This regulation-making power is designed to enable the development of a clear template to ensure residents receive straightforward and honest information.

The Energy and Water Ombudsman is an expanded role for the current Energy Ombudsman. It will be industry funded and supported by an advisory Council comprising industry and customer representatives.

The introduction of the ombudsman is necessary in light of confusing messages from some Councils and the current high number of complaints about service.

The Customer Water and Wastewater Code will be released for public consultation shortly. Public feedback will be incorporated into the final code, which will commence on 1 January 2011 in line with the Energy and Water Ombudsman. While the Energy and Water Ombudsman will have jurisdiction in South-East Queensland only at this stage, its powers could be expanded later across the state. This expansion might be necessary to protect consumers should some local governments continue to engage in misleading and confusing campaigns about water and sewerage services and prices.

The bill also includes amendments to the Queensland Competition Authority Act 1997. These amendments will enable the Queensland Competition Authority to make binding and enforceable price determinations for the water and wastewater services provided by South-East Queensland's three distributor-retailer water authorities: Allconnex Water, Queensland Urban Utilities and Unitywater. Based on a transparent and independent scrutiny of the costs of providing water and wastewater services, enforceable price determinations will allow the Queensland Competition Authority to regulate the prices these water authorities may charge consumers. This will provide increased consumer protection and will ensure that the prices consumers are charged are fair and efficient. Price determinations for these water authorities will be in place from 1 July 2013.

The bill will also make amendments to the Queensland Competition Authority Act to update and enhance the existing process for the making of price determinations. Importantly, the bill will explicitly require the authority to consider implementing price paths in order to moderate the impact on consumers of increases in price over time.

The bill also provides for amendments to the South-East Queensland Water (Distribution and Retail Restructuring) Act 2009 to continue previously held exemptions from the payment of fixed access charges for water and wastewater services under the Local Government Act 2009 and associated regulations.⁷⁰

The extension of the Energy Ombudsman scheme to also cover water, and the funding basis for this scheme, is relatively uncontroversial and consistent with interstate precedents. However, the Government needs to make it clear that this scheme will not deal with complaints consumers have about the general level of prices.

The declaration of the three distributor-retailer bodies seems, as previously discussed premature. The QCA will have price determination powers from 1 July 2013. The requirement to explicitly consider the implementation of a price path when price increases exceed the rate of inflation is unusual. The requirement on the QCA to explain why it decided not to implement a price path in this situation suggests a clear presumption on the Government's part for price paths to be adopted. It is unclear how the QCA would consider what is in the legitimate interests of a supplier in this situation. If a supplier was merely recovering costs definitely incurred, it seems doubtful that the Authority could say this was not in the supplier's legitimate interest. This seems to push the QCA into a position where it will be forced to consider non-efficiency related considerations in its pricing oversight, which goes against COAG's key objective in wanting oversight arrangements set up in the first place. It seems contrary to recent views expressed by Infrastructure Australia on the need to strengthen the independence of pricing and regulatory agencies.⁷¹

The Bill also introduces a process for Ministers to make codes establishing rules for the making of water price determinations for monopoly water supply activities. Whilst Ministers must consult on any such code, the scope of what a code may cover is potentially very broad.⁷² The Authority must not make a decision that is

⁷⁰ The Honourable S Robertson, Minister for Natural Resources, Mines and Energy and Minister for Trade, Second Reading Speech Water and Other Legislation amendment Bill, Queensland Parliament Hansard, 26 October 2010, pp. 3798-3799.

⁷¹ Infrastructure Australia, (Pricewaterhouse Coopers) Review of Urban Water Security Strategies, May 2010.

⁷² Section 170ZX of the Bill relates to the purpose and contents of codes: '(1) The purpose of a code is to set out rules

inconsistent with a code. Once again these provisions would seem to raise the significant risk of the price determination process being politicised.

The Bill seeks to remove the negotiate/arbitrate provisions of the Act which apply to access seekers and potentially to disputes between the bulk suppliers and the Grid Manager. It is suggested that these provisions are redundant, that they have been seldom used and that Section 46 of the *Trade Practices Act 1974* (misuse of market power) could be used in their stead. In the absence of a detailed assessment of this issue and of the failure to declare the bulk water entities, this approach is questionable and seemingly at odds with COAG views on infrastructure regulation.

A range of other requirements are imposed on distributors-retailers which seem both unnecessary and unduly prescriptive. For example, there is a requirement to publish the Participation Agreements between Council owners and the businesses and to publish proposed and actual prices. The Participation Agreements are now readily available as they are required to be tabled in Parliament, but the requirements imposed will add to costs. No impact assessment was undertaken to show that these measures provided net public benefits. A clearly incorrect assertion was made that there were no other viable alternatives to achieve the policy objectives involved. One is left with the impression that the main concern of the State Government here is to further the political fight with local Councils over recent price rises.

that apply for all or particular types of monopoly water supply activities.’(2) For subsection (1), a code may provide for any issue about a monopoly water supply activity.’(3) Without limiting subsections (1) and (2), a code may provide for the following—(a) the process for making or amending a water pricing determination, whether the process has to be complied with by a water supplier or the authority;(b) water pricing principles and practices.’

5.10 Conclusions

Prices for 2010-2011 were generally determined by the new distributor-retailers by just escalating previous prices set by the Councils. There was inadequate time to ensure price structures reflected efficient costs of supply.

The distributor-retailers should take the initiative and act to review and reform price structures and not wait to be told what to do by the QCA. The businesses must have the key role in price setting, even when the regulator has deterministic powers.

The distributor-retailers were mindful of the MAR when setting the level of their prices. COAG and NWI pricing principles suggest they should be setting prices at the MAR (upper bound) level.

Price rises in 2010-2011 were generally well above 15% with some Council areas being significantly more than this and provoking community backlash. The pricing strategies applied by the distributor-retailers varied as to the timing of full cost recovery.

Distributor-retailers need to consult fully with the community on price changes and adopt effective ways of explaining the reasons underlying price determinations. Sensible strategies to minimise price shocks should be adopted, provided they do not compromise efficient price setting. The most effective way for the entities to exercise price restraint is for them to exploit fully opportunities to enhance cost efficiency.

Bulk water cost increases were the key cost driver for each of the distributor-retailers. Retail and corporate cost increases associated with setting up the new businesses also appear to be significant, especially for Unitywater. Increased capital costs contributed around one-fifth to the total cost increases.

Councils have limited direct ability to influence prices set by the new distributor-retailers despite their ownership of them.

The distributor-retailers have significant constraints in achieving efficiency savings in the short term arising from agreements surrounding the transfer of staff from the Councils to them. At the same time efforts to improve service and water quality standards are likely to add to cost pressures over time.

Prices oversight will have a significant influence on price setting in coming years and will be costly for the companies to comply with.

Dividend payments to Councils are subject to approval by independent boards of the distributor-retailers. Even if the Councils could influence the boards; it is questionable whether reducing target rates of return and dividends is a sensible policy to respond to upward price pressures. Reducing dividend payments to allow for lower water service prices to be set is contrary to agreements the Queensland Government has signed with other jurisdictions. It would distort pricing signals, encourage more consumption and discourage new supply options. Councils can make better use of the funds they obtain from dividends on water by providing other needed services for their communities.

The NWI benchmarking of water prices in 2008-09 suggest that South East Queensland water and sewerage prices are relatively high compared to other metropolitan areas in Australia. Over the past decade Brisbane water and sewerage prices have increased in percentage terms more than most other capital cities in Australia, but over the past five years the increases have been less than for Sydney, Melbourne and Canberra. Increases well in excess of the general inflation rate are expected to continue to be the pattern for the next few years in most, if not all jurisdictions, as indicated by recent decisions of regulatory bodies.

It is only on new drought proofing bulk water investments that the State Government in Queensland is accepting lower rates of return in the short term to smooth prices over time. State Government statements seem to imply that local governments should not be making profits on water or receiving dividends. This would cover all capital, new and existing. These statements seem contrary to the National Water Initiative

Pricing Principles as well as being inconsistent with the approach it has adopted in the bulk water sector and with respect to State owned corporations, such as the electricity utilities, more generally. Counter proposals to set prices without regard to efficient costs of supply, by limiting them to inflation or ignoring new assets entirely, also raise concerns. However, there would seem to be a case to ensure prices set to cover high cost bulk supply sources relate more closely to the use of those sources.

The *Water and Other Legislation Amendment Bill 2010* will require the QCA to consider implementing price paths and will enable the Government to establish codes for the making of water price determinations. There is a danger with these measures that politics rather than economics will drive price setting.

6. Sustaining the momentum for reform in the water industry

In the context of one of the worst droughts on record and extremely low reserves of water, major changes to the structure of the SEQ water supply industry were put into place by the Queensland Government with the cooperation of Local Government. The changes have meant a much bigger role for the State Government in the industry and a lesser role for local Councils. Local Governments were not entirely happy with the outcome in terms of having three vertically integrated distributor-retailers owned by the Councils, but independent of them in day to day operations.

New infrastructure investment to drought proof the region had a cost which had to be paid for and this has meant significantly higher bulk water prices. Water pricing reform, which has been on the agendas of all governments in Australia for many years, has also suddenly become more urgent. Consumption and investment decisions need to be guided by efficient price signals to ensure the overall welfare of the community is maximized.

With the urgency of the drought no longer present, there is increasing questioning of the wisdom of earlier reforms and increasing reluctance by governments to confront the realities of pricing reforms. There has been a community backlash against rising prices which is affecting attitudes to the institutional and structural reforms made in recent years.

A recent survey of SEQ residents, undertaken by Market Facts (Qld.) Pty. Ltd. For the LGAQ found that 85% of residents considered recent price increases for water were unreasonable or very unreasonable. This percentage was even higher at 92% for the Western Sector covering Ipswich, Scenic Rim, Somerset and Lockyer Valley Council areas.

Over two-thirds of residents blamed the State Government for this situation. Water was reported to be the greatest concern to households in terms of ongoing affordability by 37.8% of residents.

There were significant differences of view in relation to perceptions of quality and value for money for reticulated water supply with 69% of residents in the Unitywater area suggesting it was poor or very poor, but 64% of residents in the Allconnex Water area saying it was good and only 9% saying it was poor.

The survey found that nearly 40% of residents were unclear or very unclear about current organizational responsibilities for water supply in SEQ.

When the changes in responsibilities were explained to residents, nearly 70% saw them as quite unnecessary or undesirable. This perception was higher in the Unitywater area where dissatisfaction with recent price increases was greatest.

There has been a tendency for governments in SEQ to try to shift blame on to others rather than to work constructively together to ensure efficient pricing is implemented. Ultimately, whatever the perceived short term political gains from this blame game, it is likely that no party will benefit.⁷³ Most importantly, the effect of this disputation will be to undermine community confidence and support for reforms to be maintained.

Infrastructure Australia has recently reviewed water industry reforms in Australia. Its comments seem particularly apposite to South East Queensland:

“Most jurisdictions can point to ongoing pricing reform, and it is important to acknowledge that phased implementation is a justifiable policy. Major “overnight” changes to water prices would impose a considerable

⁷³ See Courier Mail editorial “Gushing with blame, dry on water solutions”, 9 November 2010.

shock on individuals and businesses, which have only limited short-term capacity to change water-using behaviours. Unfortunately, institutional inertia, and the lack of political acceptability and public understanding of reforms, is also acting as a block to progress.

Two fundamental steps are required to overcome this situation. First, policy makers need to communicate the true impact of below-cost pricing to users and the wider community. Second, strong leadership is required to get this message out and to support change in public institutions.”⁷⁴

The distributor-retailers have a key role to play in informing and educating consumers about prices, why they are changing and the rationale for this. They need to be strongly focused on community consultation and demonstrating the efficiency of their operations. The State Government and local governments need to show joint leadership in supporting community education and the need for reform.

In the absence of this cooperative approach, it is also suggested that consideration be given to supporting the idea recently floated by Infrastructure Australia of having a single national regulator for the water industry.⁷⁵ Such a regulator would be more likely to be able to isolate itself from the tensions associated with State and local government relations which are more evident in Queensland than in other jurisdictions, than could the QCA. This is not a criticism of the QCA, merely a reality.

The LGAQ has indicated it “would be concerned with how an independent price regulator would be effective across different jurisdictional, regional, climatic and scheme variability.”⁷⁶ However, this is not seen to be a problem in other areas of economic regulation such as corporate and competition law and a precedent already exists in the energy sector where a national regulator, the Australian Energy Regulator, has assumed many of the regulatory functions previously performed by State regulators. The advantages of having an independent national regulator may then outweigh the potential disadvantages identified by the LGAQ.

74 Infrastructure Australia, *Review of Urban Water Security Strategies*, May 2010, p.5.

75 *Ibid.*, p. 27.

76 Local Government Association of Queensland Ltd., *LGAQ Submission, Productivity Commission, Review of Australia’s Urban Water Sector*, November 2010, p. 24.

Appendix 1 List of organization/people interviewed

Allconnex Water

Kim Wood	Chief Executive Officer
Andrew Foley	General Manager Strategy & Development
Jane Nant	General Counsel

Council of Mayors (SEQ)

Campbell Newman	Chairman Council of Mayors (SEQ) and Lord Mayor Brisbane City Council
David McLachlan	Brisbane City Councillor, Chairman City Businesses & Local Assets
Cris Anstey CSC	Chief of Staff Office of the Lord Mayor
Steve Whitehouse	Brisbane City Council Policy Adviser

Council of Mayors (SEQ) Secretariat

John Cherry	Executive Director
Anthony Jones	Acting Executive Director
Francis Quinlivan	Senior Policy Officer

Local Government Association of Queensland

Greg Hallam	Executive Director
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Queensland Urban Utilities

Noel Faulkner	Chief Executive Officer
Louise Dudley	Chief Financial Officer

Unitywater

Jon Black	Chief Executive Officer
Damian Platts	Manager Regulatory Affairs
Ross Muir	Director Synergies Economic Consulting Pty. Ltd.
Roz Cooper	Manager Communications & Marketing

Appendix 2 Extract National Water Initiative Pricing Principles

Principles for the Recovery of Capital expenditure

Principle 1: Cost recovery for new capital expenditure

For new or replacement assets, charges will be set to achieve full cost recovery of capital expenditures (net of transparent deductions/offsets for contributed assets and developer charges – refer to principle 6 – and transparent community service obligations(i), (ii) through either:

- a) a return of capital (depreciation of the RAB) and return on capital (generally calculated as rate of return on the depreciated RAB); or
- b) a renewals annuity (iii) and a return on capital (calculated as a rate of return on an undepreciated asset base (ORC)).

Where jurisdictions have drawn a ‘line in the sand’, this principle would apply only to new investment decisions made after the date the line in the sand was drawn (the legacy date). For investment decisions made prior to the legacy date, see principles 3 and 4.

The rate of return should be consistent with the Weighted Average Cost of Capital (WACC iv) with the cost of equity derived from the Capital Asset Pricing Model (CAPM).

Notes:

(i). Charges may be set to achieve up to full cost recovery of capital expenditures in the rural and regional sector where it is demonstrated that it is not practicable to move towards upper bound pricing as per the terms identified in clause 66 (v) of the NWI.

(ii). See also Principles 4 and 5.

(iii). To ensure revenue outcomes generally consistent with option (a), the renewals annuity should be structured as a sinking fund to include a provision on a forward-looking basis for the cost of replacing the relevant asset and/or asset components. In calculating the undepreciated asset base, the ORC should not include the renewals reserve.

(iv). The WACC return sought should be tuned to the RAB valuation methodology adopted. The WACC used should be consistent with the form of asset valuation methodology used (e.g.. a nominal WACC applies to a historical cost valuation, and a real WACC applies to a current cost valuation). The use of replacement cost valuations can give rise to capital gains and losses measured against the Consumer Price Index (CPI). Where an asset value is used to determine revenue requirements, a systematic escalation in the value of assets above the increase in the CPI will give rise to a capital gain in real terms, all other things being equal. Where an asset on revaluation is subject to a systematic decrement in real terms, a capital loss will result. Where replacement cost valuations methods are used, the WACC will need to be adjusted to cater for systematic capital gains or losses.

Principle 2: Valuation of new assets

New and replacement assets (i) should be initially valued at efficient actual cost (ii).

Notes:

(i) A new asset refers to any investment (be it on a new asset or a replacement asset) that occurs after the legacy date.

(ii) To avoid circularity in price setting the amount included in the RAB should not be based on the net present value of cash flows.

Principle 3: Valuation of legacy assets

Legacy assets (i) that are to be retained should be valued at Depreciated Replacement Cost (DRC); Depreciated Optimised Replacement Cost (DORC); Optimised Replacement Cost (ORC), indexed actual cost, Optimised Deprival Value (ODV)ii or using another recognised valuation method.

Notes:

(i) Legacy assets are those which existed as at the legacy date (see iii for a definition of the legacy date).

(ii) This is consistent with the findings of the expert group on asset valuation methods which stated that the deprival value approach to asset valuation should be adopted. (The deprival value is the value of future economic benefits that would be foregone if the entity is deprived of an asset. If the asset to be lost is to be replaced, it can be valued at its market value, replacement cost or reproduction cost, depending on the circumstances. If the asset is not to be replaced, then it should be valued at its economic value, which is the greater of either the net present value of the income expected to be earned from the asset, or the fair market value. The optimised deprival value is the lesser of the DORC and the economic value of the asset.)

(iii) The legacy date equates to the date where a line in the sand has been drawn. Where jurisdictions have not drawn a line in the sand, the legacy date will be no later than 1 January 2007 and may be in accordance with earlier dates as determined by governments or economic regulators.

Principle 4: Recovery of legacy capital expenditure

In respect of legacy (i) investment decisions, and on the assumption that assets are to be retained, charges will achieve cost recovery by way of a depreciation charge or annuity charge and a positive return (ii) on an asset value used for price setting purposes as at the legacy date (iii). If assets are to be sold then they are to be valued at their net realisable value.

Notes:

(i) Legacy investment decisions are decisions made prior to the legacy date (refer to (iii) below for a definition of the legacy date).

(ii) The return earned should be no less than the return being achieved at the legacy date, and, if the return being earned before the legacy date is above the current WACC return, no more than the return being achieved at the legacy date.

(iii) The legacy date will be no later than 1 January 2007 and may be in accordance with earlier dates determined by governments or economic regulators. Once set, the legacy date should not change. Costs funded by governments after the legacy date should be reported through a transparent subsidy.

Principle 5: Rolling forward asset values after the legacy date

The RAB comprising prudent new investments and legacy investments should be rolled forward each year in accordance with the following formula, which can be expressed in nominal or real terms (i)

$$\text{RAB } t = (\text{RAB}_{t-1} + \text{Prudent Capital Expenditure } t - \text{Depreciation } t - \text{Disposal } t \text{ (discarded assets)}).$$

(Where t = the year under consideration).

Where assets are optimised (ii), they should not be subject to further optimisation unless there are relevant changes in market circumstances.

Where DRC or DORC is used as a basis for asset values, the RAB comprising new investments and legacy investments should be re-valued through an independent appraisal on a rolling basis in accordance with Accounting Policy Standards.

Where a renewals annuity is used, asset values should not be depreciated.

Notes:

(i) When applicable, CPI or other relevant indexation factor may be used.

(ii) The RAB should be adjusted for 'unplanned' excess capacity through optimisation (that is, delivery of an equivalent service that reflects least cost planning reflecting prudent engineering and technological advancements), where 'unplanned' excess capacity is capacity which is not the result of a planned level of utilisation.

Principle 6: Contributed assets

New contributed assets (i), (ii), (iii) (i.e. grants/gifts from governments and contributions from customers (e.g. developer charges)) should be excluded or deducted from the RAB or offset using other mechanisms so that a return on and of the contributed capital is not recovered from customers (iv). If a renewals annuity is used, it should include provision for replacement of contributed assets.

Notes:

(i) For contributed assets other than developer charges, funding should be recognised as an asset contribution only where there is clear contractual or policy evidence that this funding was meant to be used to lower long-term prices.

(ii). For the purposes of principle 6, contributed assets exclude gifts or grants where there is clear contractual or policy evidence that charges be set to achieve full cost recovery, inclusive of the value of the gift or grant.

(iii) Equity injections should be distinguished from grants /gifts /contributions.

(iv) It is acceptable for principle 6 to apply to legacy contributed assets if adequate information is available to identify them.

Principles for Urban Water Tariffs

Principle 1: Cost recovery

Water businesses should be moving to recover efficient costs consistent with the National Water Initiative (NWI) definition of the upper revenue bound: ‘to avoid monopoly rents, a water business should not recover more than the operational, maintenance and administrative costs, externalities, taxes or tax equivalent regimes, provision for the cost of asset consumption and cost of capital, the latter being calculated using a Weighted Average Cost of Capital (WACC)’(i).

Notes:

(i) Application of this principle would be in the context of commitments to full cost recovery in accordance with paragraph 66 of the NWI.

Principle 2: Tariff structures

Two-part tariffs (comprising a service availability charge and a water usage charge) should be used to recover the revenue requirement from retail residential and non-residential and bulk customers (i), (ii)

Notes:

(i) Unless this is demonstrated to not be cost effective.

(ii) This does not preclude charging for peak capacity.

Principle 3: Cost reflective tariffs

The water usage charge should have regard to the long run marginal cost of the supply of additional water (i).

Notes:

(i) On economic efficiency grounds the water usage charge should comprise only a single usage charge. However, governments may decide on more than one tier for the water usage charge for policy reasons, e.g. sending a strong pricing signal to encourage efficient water use; and having regard to equity objectives.

Principle 4: Setting the service availability charge

The revenue recovered through the service availability charge should be calculated as the difference between the total revenue requirement as determined in accordance with Principle 1 and the revenue recovered through water usage charges and developer charges.

The service availability charge could vary between customers or customer classes, depending on service demands and equity considerations. Unattributable joint costs should be allocated such that total charges to a customer must not exceed stand-alone cost or be less than avoidable cost where it is practicable to do so.

Principle 5: Pricing transparency

Urban water tariffs should be set using a transparent methodology, through a process which seeks and takes into account public comment, or which is subject to public scrutiny.

Principle 6: Over recovery of revenue

Where water usage charges lead to revenue recovery in excess of upper bound revenue requirements in respect of new investments, jurisdictions are to address the over recovery. In addressing the over recovery, revenues should be redistributed to customers as soon as practicable.

Notes:

(i) This principle recognises that in some cases, long run marginal cost may exceed average cost.

Principle 7: Differential water charges

Water charges should be differentiated by the cost of servicing different customers (for example, on the basis of location and service standards) where there are benefits in doing so and where it can be shown that these benefits outweigh the costs of identifying differences and the equity advantages of alternatives (i).

Notes:

(i) Differential pricing may be achieved by upfront contributions, including developer charges.

Principle 8: Setting developer charges

Developer charges should reflect the investment in both new and existing assets required to serve a new development (i) and have regard to the manner in which ongoing water usage and service availability charges are set.

Notes:

(i) Where there are benefits beyond the boundary of the development, the developer charge should have regard to the share of capacity required to serve the development.

Principle 9: Capping developer charges

Developer charges should not exceed the costs of serving new developments which includes investment in both new and existing assets required to serve a new development.

Principle 10: Revenue from developer charges

To avoid over-recovery, revenue from developer charges should be offset against the total revenue requirement either by excluding or deducting the contributed assets from the RAB or by offsetting the revenue recovered using other mechanism.

Appendix 3 Ministers Direction Notice for Price Monitoring

As the Premier and the Treasurer of Queensland, pursuant to section 23A of the Queensland Competition Authority Act 1997 (the QCA Act), we refer the monopoly distribution and retail water and wastewater activities (the activities) of the following Distributor-Retailer Authorities (the entities):

Southern SEQ Distributor-Retailer Authority (Allconnex Water);

Central SEQ Distributor-Retailer Authority (Queensland Urban Utilities); and

Northern SEQ Distributor-Retailer (Unitywater);

to the Queensland Competition Authority (the QCA) for a price monitoring investigation covering the period from 1 July 2010 to 30 June 2013 (the interim regulatory period).

Conduct of the QCA pursuant to this Direction

In referring this investigation, the Ministers direct the QCA under section 24 of the Act as follows. For each entity, the QCA shall:

(a) provide timely and transparent information to customers about the costs and other factors underlying the annual increase in water and wastewater prices, including distinguishing the bulk and distribution/retail components to the extent that it is possible given the availability and reliability of relevant information;

(b) provide guidance to entities on the application of the information requirements referred to in (j) below;

(c) recognise the Government's policy that the prices charged by the SEQ Water Grid Manager for bulk water storage, treatment and delivery are to be passed through to customers in full;

(d) consider the availability of information from the entity, their emerging capability to provide information and the transitional work required to integrate and establish the entities;

(e) accept the operational constraints imposed by the SEQ Urban Water Arrangements Reform Workforce Framework 2010;

(f) monitor the revenues of each activity having regard to the maximum allowable revenue over the interim regulatory period, based on the total costs of carrying on the activity including each of the following:

(i) the operational costs incurred in carrying on the activity;

(ii) depreciation; and

(iii) return on capital employed.

(g) consider a weighted average cost of capital (WACC) within a reasonable range of values for 2010-11. The QCA is to advise the entity by 1 March 2011 and 1 March 2012 of the WACC benchmark that it will consider in 2011-12 and 2012-13 respectively;

(h) roll forward the regulated asset base (RAB) using the following principles:

(i) Council distribution/retail asset valuations, establishing the initial regulated asset base as at 1 July 2008, are as advised by the Minister for Natural Resources, Mines and Energy and Minister for Trade;

(ii) the opening RAB for each subsequent year to be rolled forward annually in accordance with the following formula: $RAB_t = (RAB_{t-1} + \text{Capital Expenditure}_t - \text{Regulatory Depreciation}_t - \text{Disposal}_t + \text{Indexation}_t)$ where t = the year under consideration;

(iii) to assess Capital Expenditure in (ii) above, the QCA is to assess capital expenditure (including information technology systems) for prudence and efficiency. The QCA must accept as prudent and efficient, and include in the RAB: actual capital expenditure, excluding establishment costs, for water and waste water as included in Council financial accounts for the period 1 July 2008 to 30 June 2010; allowable establishment costs as advised by the Minister for Natural Resources, Mines and Energy and Minister for Trade; and contributed, donated and gifted assets and capital expenditure funded through cash contributions and subsidies (capital contributions), for water and waste water for the period 1 July 2008 to 30 June 2010.

(iv) the QCA is to accept that, in setting prices from 1 July 2008, the Councils applied a revenue offset approach to account for capital contributions received. This approach is to remain in effect until such time that the entity nominates, through their price monitoring information returns, to adopt the asset offset method. Where a change in methodology is adopted, the RAB is not to be adjusted retrospectively;

(v) to assess Regulatory Depreciation in (ii) above, the QCA must take into account for the period 1 July 2008 to 30 June 2010 the apportionment of Council distribution/retail valuations in (i) above to individual assets and evidence that regulatory depreciation on the physical assets has been calculated using existing useful lives attaching to the individual assets;

(vi) to assess the Indexation in (ii) above, the QCA must take into account the latest available Australian Bureau of Statistics Consumer Price Index (all groups, Brisbane), however, for the period 1 July 2009 to 30 June 2010, the 2009-10 Queensland State Budget inflation forecast may be used;

(i) take into account any revenue glide path submitted by the entity for the purpose of avoiding price shocks over the interim period; and

(j) monitor according to the QCA Final Report on the SEQ Interim Price Monitoring Framework (April 2010) and Information Requirements for 2010-11 (December 2009), except as amended by this referral, and excluding the process for triggering consideration of price setting regulation.

Consultation

The QCA must undertake an open consultation process with all relevant parties and consider submissions within the timetable for the review and reports. Consistent with section 34 of the QCA Act, all reports and submissions must be published on the QCA website.

Timing

For 2010-11, the entities must provide their price monitoring information returns to the QCA by 31 August 2010. For each subsequent year, the entities must provide their price monitoring information returns to the QCA by 1 July.

The QCA must provide a Final Report to the Ministers and the Minister for Natural Resources, Mines and Energy and Minister for Trade as follows:

- a) for 2010-11, by 31 March 2011; and
- b) for 2011-12 and 2012-13, by 31 December respectively.

ANNA BLIGH
Premier
Minister for the Arts

ANDREW FRASER
Treasurer
Minister for Employment and Economic Development

COUNCIL OF MAYORS (SEQ)

- structural separation of water distribution and retail functions -

“You will recall that one of the Council of Mayors (SEQ) arguments for an improvement to the Queensland Water Commission’s (QWC) model for water distribution and retailing was centred around the intrinsic link between councils responsibilities for land use planning and the customer and critical water and wastewater services”

Letter to Deputy Premier, Treasurer and Minister for Infrastructure (the Hon Anna Bligh MP) – 8 August 2007

“We are concerned that at a time when record growth is occurring in South East Queensland, the new institutional arrangements for distribution and retail will stifle rather than facilitate this growth...We are committed to ensuring the implementation of a model which best provides the services to the community, reduces water demand, minimises cost and achieves whole of water cycle outcomes. We are not convinced the proposed model at the distribution and retail level will deliver on these outcomes...”

Letter to Deputy Premier and Minister for Infrastructure and Planning (the Hon Paul Lucas MP) – 30 November 2007

“Whilst Mayors support the proposed reform at the bulk level, they are more and more concerned about the risks associated with the separation of the water distribution and sewerage systems. They are particularly concerned how the separation would impact on the delivery coordination of infrastructure services across Council boundaries and whole of water outcomes, including the environment.”

Letter to the Queensland Premier (the Hon Anna Bligh MP) – 7 December 2007

“Councils have committed to implementation of the State Water reform model. However, they harbour a number of concerns, particularly in relation to the retail sector. The model seems unnecessarily complex and costly, assumes a level of maturity in the water businesses that for smaller councils simply does not exist, and contemplates timeframes that are highly ambitious and risky.”

Letter to the Queensland Premier (the Hon Anna Bligh MP) – 30 May 2008

“Establishing four separate legal entities will impose additional costs on users for little or no apparent benefit, while adding significant complexity to the transaction.”

Letter to Deputy Premier and Minister for Infrastructure and Planning (the Hon Paul Lucas MP) – 16 September 2008

“The Council of Mayors (SEQ) is concerned by the complexity and likely cost of reforms proposed by the QWC and considers that the long term community and customer benefits are questionable. We are also concerned that recent decisions on future water supply sources may adversely impact on meeting future water needs.”

Letter to the Queensland Premier (the Hon Anna Bligh MP) – 16 January 2009

“While the Government has, to date remained committed to the water institutional reforms proposed by the Queensland Water Commission (QWC) in May 2007, the Council of Mayors (SEQ) believe that it is appropriate time to reflect on whether the model remains the best way forward. Since May 2007, there have been four major reviews of water entities interstate, in New South Wales, Victoria, Western Australia, and Tasmania. No other state has followed the QWC’s approach, identifying little benefit in shifting from a water structure with typically one or two entities to the seven-level structure proposed by the QWC.”

Letter to the Queensland Premier (the Hon Anna Bligh MP) – 8 April 2009

“I appreciated the opportunity to present our case, but am disappointed that the fundamental flaws in the Government’s policy approach will remain unaddressed. Given the issues that have emerged with the electricity model in recent months, the merits of imposing such a flawed and expensive model on water users deserves more careful consideration.”

Letter to the Minister for Natural Resources, Mines and Energy (the Hon Stephen Robertson MP) – 19 May 2009