

# SUBMISSION TO TASMANIAN ECONOMIC REGULATOR

## Southern Water Pricing Proposal 2012-2015

### 1. Introduction

This submission addresses the Pricing & Services Proposal submitted to the regulator by Southern Water. The recommendations of the “regulator” are largely ignored since they are a 250 page rubber stamping of the proposed price increases, with scant attention paid to costs and equity. The regulator accepts without question the fact that Southern Water’s assets are valued some 41% higher than their own benchmark regions and that operating and maintenance costs are 14.2% higher. Southern Water’s proposal is nevertheless approved (almost to the cent), by the non-independent uneconomic non-regulator.

It is difficult to imagine a more comprehensive botch job than the establishment of the three Sewerage & Water Corporations from the political, economic, social and pretty much every other viewpoint. I shall endeavour to concentrate on issues directly related to pricing however.

### 2. Governance and its Costs

In a spectacular display of inaccuracy and non-independence, the Tasmanian Economic Regulator Chairman, Mr Glenn Appleyard recently (The Mercury 16 March 2012) stated that three Water & Sewerage Corporations were not financial sustainable in the long term based on their existing assets without increases in revenue – all this before the pricing proposals have been approved – perhaps that is why the Regulator no longer prefaces its name with the word “Independent”.

He is partly correct in that the return on assets can be improved by revaluing the existing assets downwards - this would appear to be necessary in view of the mainland benchmarking data and frequent claims that assets have been run down by councils. One could also increase revenues, but could instead increase third party (customer and state government) capital contributions, decrease costs, or a mix of all four of the above measures. A group of public servants just jacking up prices by 10% every year is not sustainable.

The regulator is part of the same Treasury Department which conceived the ‘reforms’ and cannot therefore be considered independent in any sense of the word. The Government Prices Oversight Commission, which was supposed to protect our interests with respect to such matters, has been amalgamated with the Office of the Economic Regulator, so where is the required transparency?

At the very least we need to see a genuinely independent review of pricing, full justification for future increases and sensible/ sustainable operating and capital budgets.

The Board representation of the three regional corporations and the “Common Services” corporation are breathtakingly unrepresentative. Southern Water and Onstream have **no** direct Council (i.e. Owner) representation on their Boards. Indeed, the three major southern councils (Hobart, Clarence and Glenorchy) had no say in the make-up of the Boards and there

appears to be no significant ongoing role for the nine owner representatives from around the state who did have a part in selecting Directors.

This bears directly on financial viability, with the Southern Board costing around \$1million, compared with zero for the previous Board of Hobart Water.

Recent discussions regarding the amalgamation of the three corporations would most probably result in one even more ridiculously highly paid Board, a further one or two layers of bureaucracy, and still more unnecessary costs to restructure the organisation, re-furbish offices, attend constant inter-state meetings etc. So called “restructuring” is almost always disruptive and costly. It cannot replace a detailed functional analysis of the responsibilities of the organisation. The sewerage and water corporations have suffered more than anything else from the unrealistic expectations of the Government.

All current board members should be required to resign, to be replaced by nominated elected members of the member Councils. These personnel do not have much background in electricity generation, forestry or cheese-making, but they do know how to live within the rates and borrowing restrictions placed upon them by the state government and the community.

### **3. What is Full Cost Recovery?**

Earlier claims that household water bills may need to double to achieve full cost recovery did not reconcile with the facts. Hobart Water reported a net **profit** (profit = **more** than full cost recovery) of more than \$4.7M in 2007/ 08 and \$3.2M in 2008/ 09 (not counting the \$9.0M “Special Dividend”). Other claims have been made that Councils have been **profiteering** from water and sewerage in the past – you can’t have it both ways, either you want full cost recovery or you don’t. The facts suggest that we already had **better** than full cost recovery, so perhaps we should have left things as they were, or maybe we should **reduce** the charges?

Southern Water has solved this dilemma by re-defining full cost recovery. It is now seen as including all maintenance and operating costs, plus depreciation and a return on capital. In a stable operating environment, if you recover the (non-cash) depreciation allowance from your customers, this is your return on capital, at least for ongoing asset replacement. i.e. there appears to be some double counting going on. Certainly, where there are third party contributions for new infrastructure, a return on capital should not be expected – you are asking the same people who provided you with the capital, to also give you a return on their own investment! It is arguable that any return on assets should exclude **all** past third-party contributions.

### **4. Capital Expenditure and Cross-subsidisation**

Price increases significantly greater than CPI are simply unsustainable, hence the profligate capital and operational expenditure that has already occurred (starting with the various advertising propaganda campaigns), must be wound back as a matter of urgency.

Capital expenditure should be justified at the time of commitment, by a discounted cash flow analysis as used in the private sector to evaluate and prioritise projects. Projects are either

justified by their future cash flows, or by the necessity to replace ageing plant and equipment. The future cash flows for new capital projects should include the capital contributions and increased future revenues derived only from the customers who benefit from the project. If the state government deems a non-viable project to be necessary for health reasons, then the additional contribution required to make the project viable should come from the state government as a social contribution – i.e. from all taxpayers, not just urban ratepayers who have already contributed to their own infrastructure.

There is no justification for people who have paid for completely adequate water and sewerage systems in their areas now to be expected to subsidise those in other areas who have paid little or nothing. This cross-subsidisation cannot possibly be consistent with a move towards User Pays and is supposedly not permitted under the legislation and regulatory requirements.

People should not expect to move to rural areas, where rates and charges are less, then demand that urban ratepayers (who rightly benefit from economies of scale in return for a more congested and stressful lifestyle) should pay for their infrastructure. New tourism and other commercial ventures that are established in remote areas (e.g. Freycinet Peninsula) should expect to pay for their own infrastructure – as is the case in other states and countries.

From its inception, the move to regional water and sewerage corporations was a blatant attempt to shift costs from the state government and the big end of town to urban ratepayers.

## **5. Obligation to consider consumers**

The Water & Sewerage Act 2008, Part 4 15(d) **requires** pricing considerations to have due regard of the rate of change of prices for customers. Instead, there appears to have been no regard paid.

Southern Water's target annual tariff of \$957 for residential services in 2012-13 amounts to an 18% increase over the present charges in Clarence, whose council had minimal cross-subsidisation between these charges and the general rate. A proposed 10% price cap fools nobody and only delays the eventual increase of almost 30% over three years. The widely publicised 3.6% and 5.4% increases apply to future years, not to year 1. Much is made of the proportion of customers who will pay the target tariff in the future, when the problem is the target tariff itself. If you reduce it to an acceptable increase by exercising cost constraint, a greater proportion of customers will pay it sooner.

Over the past three years average weekly earnings increased by 5% p.a., CPI increased by 2.85% and balanced super returns averaged 1.5%. Around 34% of Tasmanians receive social security payments (linked to CPI) and many are self-funded retirees and ordinary wage-earners. The solution to affordability does not just lie in increasing subsidies to the less well off; we must pursue permanent cost efficiencies.

Claims that areas like Clarence are “under-contributing” whilst areas like Glenorchy are “over-contributing” ignores the fact that Clarence was not cross-subsidising its general rate, and that Glenorchy receives a special dividend as a quite ridiculous reward for practising cross-subsidisation. In reality the objective evidence suggests that Clarence’s present charge

is a fair benchmark, and that other areas should be adjusted downwards (except unless otherwise compensated by special dividends) as soon as possible to match this benchmark.

Playing up the disparity between Local Government Areas is a transparent attempt to shift attention from Southern Waters' unsustainable spending record.

## **6. Fixed and Variable Costs**

The target tariff includes an estimated 38% variable charge (assuming that Southern Water's consumption estimate is correct) compared with actual variable costs around 15% - thereby contravening the "user-pays" principle. The regulator publishes short run marginal costs (i.e. variable costs) of \$0.30/kL for Southern Water (around 13% of total costs), but rubber stamps their proposal to charge \$0.90/kL, acknowledging that this constitutes cross-subsidisation, which is not permitted under the pricing principles. The excuse that a higher variable charge will permit customers to reduce their bills by reducing consumption is ludicrous. Reducing the variable charge to its proper value will achieve this much more readily and equitably.

The establishment of an equitable future pricing structure requires an understanding of fixed costs, variable costs and what is meant by "User Pays"

85% of water costs are related to the provision of infrastructure, rather than the volume of water used. The infrastructure required by a large business will obviously be greater than that required for a household, and urban areas should also benefit from the economies of scale that accompany increased population density. These are however, fixed costs, albeit fixed at different levels.

The variable costs as determined by meters in a true User Pays system, would be only some 15% of total charges (and hence would be too small to encourage any meaningful conservation). It is well known that Hobart Water investigated the costs associated with water meters several times in the past, and found them to be unjustifiable – let's do away with the future costs of installing, maintaining and reading meters immediately.

Higher variable charges have also been justified as a conservation measure; however conservation is not the business of a supply organisation, certainly not the conservation of a plentiful resource. With 3% of Australia's population, Tasmania receives 14% of its rainfall – not a reason to waste water, but certainly no justification to misplace our efforts.

Much of the push for User Pays has distorted the term to argue for full variable costing. Such arguments have come publicly from organisations such as the Property Council in their attempt to shift the costs of businesses onto domestic properties. They argue that many businesses have a large investment in infrastructure (e.g. for fire fighting systems), but in practice they use very little water. This deliberately ignores the fact that 85% of the costs of supporting their systems relate to infrastructure, not to usage.

## **7. Cost Control**

Cost control by Southern Water is currently a sad joke, with total capital expenditure more than doubling in 2011 from \$30.3M to an unsustainable \$63.3M, whilst third party

contributions have actually declined from 9.7% (\$3.0M) to 9.4% (\$6.0M) of Capex. i.e. almost all of the increased Capex will be serviced by cross-subsidisation from existing urban ratepayers.

Operating and maintenance costs increasing by a massive 14.3% (\$8.6M) and debt-servicing costs are projected to increase by 35% over two years. Whilst debt financing is not necessarily a problem, the rate of increase must be controlled. The present scenario bears all of the hallmarks of a corporation out of control.

Capex should be reduced and financed as described in Section (4) above. **Overall** future price increases should aim at no more than 5% for two years, then CPI. Variable charges should directly reflect variable costs. Water meter installation, maintenance and use should be immediately discontinued. Individual municipal **decreases** should be permitted to equalise charges between municipalities after allowing for special dividends.

An analysis should be made of organisational structures, consultancy costs, and staff numbers, functions and costs since the “more efficient” regional Corporations came into effect and stricter budgetary controls exerted to reduce operating and maintenance costs by 10% over the next two years.

I have already mentioned the million-dollar unrepresentative Board.

## **8. Debt Financing**

One of the earlier ‘justifications’ claimed for the forecast future exorbitant price increases is that the new corporation must clear its \$100Million in debt before it can pay dividends to member Councils. In an organisation having \$1.1Billion in Total Assets and \$0.9B in Net Assets, this is a miniscule debt: equity ratio of less than 8%. There is no rational argument for the new corporation to achieve debt-free status within **any** particular time frame. The use of debt financing is perfectly justifiable for long term infrastructure projects and the existence of debt does not preclude the payment of dividends to Councils.

To insist that the present generation pays fully for infrastructure which will be used by future generations also violates the principle of inter-generational equity.

## **9. The Big Picture**

Excepting the relatively short term effects of the GFC, unemployment has fallen from the long term 12% range as the boomers generation retires, and skills shortages are becoming common. At the same time, the demand for Government services in the areas of social security, health and aged care continue to increase. By the mid 1990’s, total Australian Government expenditure was some 35% of GDP, of which almost 40% was spent on health, education and defence. This has accelerated further, with the total budget for health and human services in Tasmania almost doubling over the last ten years to 36% of all state government expenditure.

Industries such as Tourism were a welcome luxury when unemployment was high, but no more. By any measure, despite a few worth-while wealth-generating pockets, most of Tourism is now a dumb industry, requiring seemingly endless taxpayer support.

The demographic changes already in progress suggest that we need to devote our diminishing labour resources to wealth generation. We need wealth generation to pay for health, education, aged care etc. The value of commodity exports from our wealthy industries also keeps the value of the A\$ high, making imports cheaper and hence protecting our standard of living.

It should be obvious that the largely wealth-absorbing public sector must be brought under control.

## **10. A Failure of Policy and Implementation**

The public information and consultation which has accompanied the introduction of the Sewerage and Water Corporations has been almost non-existent and completely ineffective.

My own submission to Treasury of 14 May 2009 was met by a response on the Treasury website which answered **none** of the issues raised by me. Objections raised directly with Southern Water on 9 November 2009, resulted in a fob-off to the Treasurer or the Ombudsman and erroneously claimed that meters are a user-pays mechanism. A subsequent submission to the Ombudsman dated 30 November 2009 met with a similarly confused response, attempting to fob me off to the ACCC and stating that the Ombudsman can do nothing about pricing matters.

These responses reinforced the previous impression that the entire process was unduly rushed, ill thought out, and involved a large amount of philosophical confusion over just what full cost recovery, user-pays and cross-subsidisation actually mean.

To add insult to injury you must now sign a compulsory Customer Contract (isn't a contract an **agreement** between two parties?) and you may be charged for any negligent damage to the meter you did not want, regardless of who caused it - then you wonder why the public will not support this nonsense.

It's time to establish a prices tribunal with private sector and community representation - people who are in touch with reality and who understand contributions to and the prioritisation of capital expenditure, not to mention cost control and the necessity of restraining the public sector. It is accepted that many of the above problems are not the fault of just government, the regulator or the water corporation. They cannot be fixed merely by fiddling with the pricing proposal; we need all three organisations to get their act together.

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