National Competition Council

WATER REFORM IN QUEENSLAND: WATER PRICING BY TOWNSVILLE CITY COUNCIL

National Competition Policy Supplementary Assessment

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The National Competition Council

The National Competition Council was established on 6 November 1995 by the *Competition Policy Reform Act 1995* following agreement by the Commonwealth, State and Territory governments.

It is a federal statutory authority which functions as an independent advisory body for all governments on the implementation of the National Competition Policy reforms. The Council's aim is to 'improve the well being of all Australians through growth, innovation and rising productivity, and by promoting competition that is in the public interest'.

Information on the National Competition Council, its publications and its current work program can be found on the internet at www.ncc.gov.au or by contacting National Competition Council Communications on (03) 9285 7474.

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Abbreviations

CoAG	Council of Australian Governments
NCP	National Competition Policy
QCA	Queensland Competition Authority

Introduction

Under Australia's National Competition Policy, governments must implement reform obligations set out in the strategic framework for the reform of the Australian water industry agreed by the Council of Australian Governments (CoAG) in 1994. The National Competition Council (the Council) assesses the progress achieved by governments against the reform obligations in the CoAG framework.

The Council's first three assessments of governments' progress with implementing the NCP agenda took place in 1997, 1999 and 2001. Following a decision of CoAG in 2000, all assessments following the 2001 assessment have been conducted annually (CoAG 2000). From time to time the Council also conducts supplementary assessments. These address matters that the Council has identified in annual assessments as requiring additional work by a jurisdiction in advance of the next annual assessment.

The matter of the nonapplication of consumption-based pricing by the Townsville City Council (Townsville) has a long history. The Council first noted that Townsville was not applying consumption-based pricing for water in the 1999 assessment. At that time Townsville had chosen not to adopt the recommendation of an independent consultant, Australian Economic Consultants Pty Ltd, to implement a two part tariff. Subsequently the Council considered Townsville's pricing arrangements in supplementary assessments in December 1999 and June 2000 and again in the annual assessments in 2001 and 2002. In both the annual assessments, the Council identified the failure by Townsville to apply consumption-based pricing to water services, or to provide a robust case that application would not be cost effective, as a failure of compliance with the CoAG water reform framework. At the Council's recommendation, the Federal Treasurer reduced annual competition payments to Queensland in each of 2001-02 and 2002-03 by $270 000 in relation to water pricing by Townsville. The Council's assessments are available on the Council's website at www.ncc.gov.au.[1]

In the 2002 assessment, the Queensland Government undertook to ask its independent economic regulator, the Queensland Competition Authority (QCA), to assess evidence provided by Townsville that application of consumption-based pricing would not be cost effective. The Council undertook to recommend that the competition payment penalty for Queensland be lifted if the QCA assessment showed that there was a robust case to support nonapplication. Queensland has now provided the report of the QCA to the

[1] The Council considered water reform progress in the 2002 assessment (NCC 2002), the 2001 assessment (NCC 2001) and the second tranche assessment (NCC 1999). The Council has also conducted supplementary assessments on water reform in December 1999, June 2000, September 2000, and February 2001.

Council, arguing that this provides a convincing case to support the Townsville approach. Queensland is seeking reimbursement of all competition payments withheld to date. This supplementary assessment examines the QCA findings as a basis for determining Townsville's compliance with CoAG water pricing obligations.

Outstanding issue, 2002 assessment

Outstanding issue: Queensland is to demonstrate that water pricing by Townsville addresses CoAG obligations on consumption-based pricing.

Reference: Water reform agreement, clause 3(b).

The CoAG water reform strategic framework requires governments to have adopted, by no later than 1998, a charging arrangement for water services comprising an access or connection charge with an additional charge to reflect usage. The purpose of the usage based component is to ensure that water users face appropriate incentives to better manage water consumption. There are potentially additional benefits to the extent that reductions in the consumption of water mean that new investment in water infrastructure can be deferred and additional water made available for other uses, including for the environment. The pricing obligation is qualified in that it need not be adopted if it can be shown that adoption would be not cost effective.

In a supplementary assessment in June 2000, the Council recommended the suspension of 5 per cent of Queensland's competition payments for 2000-01 because Townsville and two smaller local government water service providers had made insufficient progress towards pricing water on a consumption basis. The Council was particularly concerned about the approach being taken by Townsville. Townsville is one of the big 18 Queensland local governments: the benefits from more economical water use and deferred investments are likely to be greater for the larger water providers. The competition payments suspension was lifted in January 2001 when Townsville agreed to bring forward formal resolution of this matter to June 2001.

In the 2001 assessment, the Council found that Townsville had not introduced two part tariffs for its residential consumers or undertaken to do so. Townsville was however implementing a user pays approach for nonresidential customers. Townsville provided a brief report on the reasons for its approach and resolved to form a committee to review the impacts of pricing changes. The Council was not satisfied that the statement of reasons by Townsville provided a sufficiently objective analysis of the case for nonimplementation, or that Townsville's proposal to review pricing impacts constituted progress towards implementing the CoAG pricing obligation. The Council recommended a permanent reduction in Queensland's competition payments of $270 000 per year from 2001-02 until consumption-based pricing is introduced or until Queensland provides satisfactory evidence to Council that demonstrates that consumption-based pricing would not be cost effective. The figure of $270 000 represents the amount of money that would have been received by Townsville for implementing CoAG water reforms available through the Queensland Government's Financial Incentives Scheme.

Townsville commissioned a further report on the cost effectiveness of introducing consumption-based pricing, providing the report of this study to the Council in January 2002. This second study, conducted by the consultant Montgomery Watson, concluded that introducing two part tariffs for residential customers would not provide a net benefit (MWA 2001). It found that the phased introduction of a two part tariff over five years would cost between $1.45 million and $3.5 million depending on the treatment of meter upgrade costs. While there would be some increase in income to Townsville as a result of upgrading the meter fleet, it was argued that there was little opportunity to reduce the costs of supplying water because up to 95 per cent of costs were fixed nonvolume-related.

The second Townsville study also argued that there are several public interest reasons why the city council should not introduce a two part tariff for residents. Reasons included the impact on the corporate vision of 'Greening Townsville', that reducing water use would increase prices due to the high level of fixed costs, that further investigation would be required on ways of mitigating expected impacts on customer groups, and that revenue stability would be affected due to the unknown level of the initial impact on demand of the price increases.

In the 2002 assessment, the Council raised several questions about the analysis supporting the findings of the second Townsville cost effectiveness study. In particular, the Council questioned whether the:

- estimated price increases were overestimates of the effects of introducing consumption-based prices in that they included both the move to two part tariffs and the move to full cost recovery;

- estimated meter replacement costs and revenue gains took into account that meters will need to be replaced regardless of any decision to introduce consumption-based prices;

- 'Greening Townsville' objective implied that any reduction in water consumption would mean that two part tariffs should not be adopted; and

- inability to identify cost savings from consumption-based pricing is the result of the premise that NQ Water does not price on a volumetric basis.

In the 2002 NCP assessment, Queensland advised that it would ask its independent regulator, the QCA, for advice on whether the approach in Townsville's second report meets Queensland Government guidelines on the introduction of two part tariffs and is supported by rigorous analysis. Queensland undertook to request the QCA to also report on the concerns raised by the Council in the 2002 assessment. The Council acknowledged that this showed the Queensland Government's commitment to resolving the

Townsville water pricing matter. The Council noted, however, that it had been three years since it had first raised the matter and that Townsville had not implemented consumption-based pricing nor provided a robust case to show that implementation would provide no net benefit. The Council recommended that the permanent reduction in Queensland's 2001-02 competition payments of $270 000 continue in 2002-03, but that this penalty be immediately lifted if the QCA finds that the second Townsville cost effectiveness study is robust (NCC 2002).

Activity since the 2002 assessment

The Queensland Government provided the report of the QCA to the Council on 19 March 2003 (QCA 2003). The QCA report assesses the rigour of the arguments in the second Townsville study supporting nonimplementation of consumption-based pricing, the July 2002 addendum to the Townsville report dealing with further analysis of the demand impacts of a two part tariff, and additional information provided to the QCA in January 2003 by the consultant, Montgomery Watson. The QCA's report also refers to the Australian Economic Consultants Pty Ltd cost effectiveness report, which recommended that Townsville introduce two part pricing (AEC 1999).

The Queensland Competition Authority report findings

In meetings between the Council and Queensland Government officials at the time of the 2002 assessment, it was agreed that the QCA would be asked to report on:

- whether Townsville's second review report meets the requirements set down in the Queensland Government's 'Guidelines for Evaluation of Introducing and Improving Two-Part Tariffs' (DRNM 1997); and
- whether the recommendation of the second report to reject the implementation of a two part tariff arrangement for the residential sector is supported by rigorous analysis; and
- the concerns raised by the Council.

The QCA assessed Townsville's second report against the relevant legislative requirements, including the Queensland Government's two part tariff guidelines. The QCA also sought to establish the validity of information and analysis in the Townsville report, and to determine whether CoAG objectives have been met.

Compliance with the Queensland Government's 'Guidelines for Evaluation of Introducing and Improving Two-Part Tariffs'

The QCA found that Townsville's second report was not undertaken in accordance with Queensland's 'Guidelines for Evaluation of Introducing and Improving Two-Part Tariffs'.

The QCA found, however, that the addendum to the second report provided a separate and better developed analysis of the impact of a two part tariff on the demand for water and an assessment of breakeven demand reductions. The additional information provided in January 2003 also appropriately specified the analysis of cost effectiveness and so largely addressed the main shortcomings of the second report.

Rigour of the case for nonimplementation for the residential sector

The QCA considered that the material it received subsequent to Townsville's second report and the decision not to implement a two part tariff provides a satisfactory treatment of many components of a cost effectiveness study, including the demand projections, augmentation costs, operating costs savings and estimated implementation costs. This information is contained in the addendum to the report and the additional information.

The QCA considered, however, that the consultant's cost effectiveness analysis underestimated the potential cost savings that could be achieved by Townsville under current cost sharing arrangements because it underestimated reductions in costs attributable to reduced purchases of bulk water by Townsville (QCA 2003, p. 21).

Townsville purchases bulk water from NQ Water. NQ Water's operating and fixed costs are shared between Townsville and another city council it supplies (Thuringowa) according to each council's share of usage. In any given year, each council is charged an expected share of NQ Water's costs. This charge is then adjusted in the following year when actual consumption is known.

The QCA noted that because the costs to each council for bulk water depend on NQ Water's costs and each council's share of those costs, any reduction in demand for bulk water by Townsville as a result of the introduction of two part tariffs should reduce NQ Water's variable cost, and also reduce Townsville's share of NQ Water's fixed costs. The QCA also noted that the *Local Government Act 1993* requires that the cost effectiveness analysis be undertaken from the perspective of the water business concerned: hence, costs and benefits external to Townsville should not be taken into account (The Townsville evidence, however, took account of the costs and benefits external to Townsville's water service operations as a reason for not including a share of NQ Water's fixed costs in the cost effectiveness analysis).

The second Townsville report and addendum did not find that Townsville could achieve any savings if it were to reduce its water consumption and therefore its share of NQ Water's fixed costs. The report argued that the benefits (cost savings) to Townsville would be offset if Thuringowa also reduced its consumption, and that if this occurred similar savings could be achieved by both councils. From Townsville's perspective the savings in its share of NQ Water's fixed costs would be significant if Thuringowa does not further progress implementation of two part tariffs. If Thuringowa advances implementation, there would be significant losses incurred by Townsville under current pricing arrangements with NQ Water if it did not put in place a two part tariff.

The QCA undertook its own analysis to incorporate likely savings from reductions in bulk water demand. For the residential sector, the inclusion of bulk water fixed cost savings meant that the introduction of a two part tariff would 'break even' if there is a reduction in the demand for bulk water of 6.3 per cent. The QCA estimated the break even figure omitting fixed costs savings to be 17 per cent.

The QCA considered that on the basis of comparative analysis of water service providers, and given Townsville's extreme climatic conditions, the achievable demand reduction for the detached houses sector is likely to be about 5 per cent. Therefore, despite its questions about the analysis in the Townsville report, the QCA agreed there would not be a net financial benefit to Townsville from introducing a two part tariff.

The QCA noted, however, that future growth of the city of Townsville (and depending on the nature of any future pricing arrangements with NQ Water) meant that it would be prudent for the Townsville City Council to keep the appropriateness of a two part tariff under review.

The Council's questions about the Townsville cost effectiveness evidence

The QCA report has considered the four concerns raised by the Council in previous assessments. A summary of the QCA's findings is provided below.

Are meter replacement costs attributed correctly to the 'with' and 'without' two part tariffs cases?

The addendum to the second Townsville report notes that in both the 'with' and 'without' two part tariff cases, the entire fleet of 20mm meters would require replacement for residential consumers.

- For the 'without' case 25 600 meters will need to be replaced over eight years.
- For the 'with' case replacement would need to be implemented over four years.

The QCA considered that the meter replacement programs and associated estimates of costs are reasonable, and are consistent with Queensland's 'Guidelines for Evaluation of Introducing and Improving Two-Part Tariffs'.

The addendum to the Townsville report estimated that the different meter replacement programs would result in an additional cost of $140 000 per year if two part tariffs were implemented. The report also estimated that the cost of implementing a two part tariff would be $100 000 in the first year and $50 000 per year for three years thereafter.

Does the Townsville report calculate (incorrectly) the cost of moving to consumption-based pricing as the impact of both moving to two part tariffs and moving to full cost recover?

As noted above, the QCA considered that Townsville's second report is not consistent with the objectives of the CoAG strategic water reform framework because it was not developed in accordance with Queensland's 'Guidelines for Evaluation of Introducing and Improving Two-Part Tariffs'. Further, the QCA found that the second report incorrectly combined the effect of implementing both two part tariffs and full cost pricing, and did not make the relative impacts of each clear. The QCA found however that the addendum to the second report addressed these shortcomings, and that the additional information supplied by Townsville in January 2003 contained a robust analysis of the cost effectiveness of introducing consumption-based pricing. As noted above, the analysis by the QCA confirmed that introduction would not provide a net benefit.

Why are there only minimal cost savings from reduced bulk water consumption?

The Council's question relating to bulk water consumption is addressed in the section above on 'Rigour of the case for nonimplementation for the residential sector'.

What is the relevance of the Greening Townsville policy, and are there alternative means of achieving the objective?

Townsville provided the QCA with substantial evidence which it claimed showed that the Greening Townsville policy is well structured, covers a wide range of initiatives involving all sectors of the community, and is transparently budgeted and costed.

The QCA considered there are likely to be significant net benefits in terms of tourism, liveability, and quality of life from the 'without' two part tariff case. The QCA considered that although the benefits of Greening Townsville are nonquantifiable, it is legitimate to compare them to the potential financial benefits of implementing a two part tariff.

The QCA also noted that practices other than pricing can influence water use. It considered that Townsville has in place a comprehensive package of water use efficiency measures, and that the city is well advanced in these practices.

Overall, the QCA accepted that the net benefits of the Greening Townsville policy would be likely to exceed the net benefits of introducing a two part tariff.

Overall view of the QCA

The overall view of the QCA is that there is now robust evidence to show that there would be no net benefit from Townsville introducing consumption based pricing for residential customers. The QCA stated that:

> *Townsville City Council's decision not to implement a two part tariff is therefore consistent with CoAG water reform objectives.* (QCA 2003, p. 27)

Discussion and assessment

The Council is satisfied that the QCA's analysis and findings provide sufficiently robust evidence to now support the Townsville case that there is not a net benefit from introducing consumption-based pricing for residential customers. The Council notes, however, that the QCA found the case for nonimplementation could be sustained only after Townsville provided evidence in addition to its second cost effectiveness report, and after undertaking its own analysis. The QCA considered that Townsville's second report alone did not provide sufficient evidence that the introduction of consumption-based pricing is not cost effective.

The Council considers that Queensland has therefore now met its NCP obligations in relation to the application of consumption-based pricing for urban water supplies in Townsville. The Council recommends that the competition payments penalty imposed on Queensland for 2002-03 be lifted and that the Federal Treasurer reimburse all 2002-03 payments.

This recommendation does not affect the Council's 2001 assessment recommendation that Queensland's 2001-02 competition payments be permanently reduced by $270 000. The Council's rationale for recommending that the 2001-02 reduction be permanent was explained at the time of the 2001 assessment, and is summarised below.

- The timetable set in the CoAG strategic water reform framework is for the adoption of a consumption-based charging arrangement where cost effective by no later than 1998. Townsville had exceeded this timetable by three years at the time of the 2001 assessment.

- There had been many opportunities to implement the required pricing reforms or to provide a rigorous case for not doing so through the NCP assessment process. The Council first raised this matter with Queensland in the June 1999 assessment following a consultancy report that recommended Townsville introduce a two part tariff. The Council recommended a suspension of Queensland's competition payments in June 2000 only when Townsville had not progressed this matter. This suspension was lifted in January 2001 when Townsville agreed to bring forward formal resolution to June 2001. Townsville did not meet this undertaking.

- The recommendation for a permanent penalty of $270 000 in 2001-02 reflected Townsville's failure to objectively analyse the cost effectiveness of a two part tariff. The quantum of the penalty approximates the amount that Townsville would receive for successful completion of water pricing reform through the Queensland Government's financial incentives package.

Finally, the Council brings to the attention of both the Queensland Government and the Townsville City Council comments by the QCA relating to the desirability of keeping the case for the introduction of consumption-based pricing under review.

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