AUSTRALIAN INDUSTRY

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Mr David Heeps
Chief Executive Officer
c/o Water Division
Essential Services Commission
Level 37 / 2 Lonsdale Street
MELBOURNE 3000

By email: water@esc.vic.gov.au

Dear David

Feedback – Water Price Review 2013-2018

Introduction

The Australian Industry Group (Ai Group) is grateful for the opportunity to provide feedback to the Essential Services Commission (ESC) on its 'Summary of metropolitan businesses water plans Water Price Review 2013-2018'.

Our document provides member feedback from the principal viewpoint of manufacturing sites in the metropolitan area which typically are significant water customers and trade-exposed operations including sectors such as:

- Food Confectionery and Beverages
- Printing and Paper, Containers, Packaging and paper recycling
- Pharmaceuticals, Bio-technology
- Chemicals, Rubber and Plastics, Paint
- Fuel refining
- Industrial laundries
- Power stations and energy production
- Construction/Infrastructure, Heavy Engineering,
- Building materials and Glass
- Transport, Automotive, Aviation, Rail, General Engineering
- Waste treatment
- Timber, Furniture and Furnishings
- Textiles and dyeing

For these companies, water is usually a critical input and connection to the trade waste system is an essential service – water can be a material input or needed for cleaning and hygiene, or in production, for process cooling or building systems etc.

Background information

Ai Group has provided the following feedback and information to the ESC for use in its analysis of price plans provided by the respective metropolitan water businesses. We recognise that three retail water businesses (City West Water, South East Water and Yarra Valley Water) have proposed a steep increase in water and sewerage prices in the first year of the regulatory period, followed by zero real increases over the remainder of the regulatory period – Western Water has proposed a smooth price path with annual increases of around 6% over the period.

ESC's review of water pricing in Victoria for regulatory period 2013-2018 comes at a challenging time for industry in Victoria and for the community in general.

Having emerged from long term drought conditions we now facing the economic impact of the major infrastructure investments needed to provide secure water supplies. The timeframe for the initial payments is the critical issue.

Industrial and business customers have implemented responses and made significant investments in water efficiency initiatives and compliance requirements such as waterMAPs, EPA Environment and Resource Efficiency Plans (EREPs) and naming of large water users, in order to deliver long-term water savings and increased utilisation of recycled water. Significant additional costs to customers are now proposed.

Current economic conditions are significantly different to those at the time of the previous two ESC water price reviews. Major structural adjustments are underway in the Victorian economy, with many trade exposed businesses losing competitiveness and scaling back local production due to the high Australian dollar and escalating input costs for wages, power, gas, raw materials and waste disposal. Faced with strong international competition and customer resistance, businesses have had to absorb many of these additional costs in order to remain competitive, though this reduces profitability and raises the bar for reinvestment.

Recent Ai Group research on the initial impacts of the introduction of the carbon price illustrates the difficulties businesses face in passing on increased costs. In a survey of a broad cohort of manufacturing, services and construction businesses we found that while most manufacturing and construction businesses saw immediate input cost increases from 1 July 2012 due to the carbon price, only about 40 per cent were able to increase selling prices on any of their products in the same timeframe. Food processors were the most squeezed of any subsector we studied, with 90% seeing immediate input cost rises and only 11% able to increase selling prices. A dramatic increase in water prices could be expected to flow through in a similar way, with much of the impact being felt in reduced business profitability and viability rather than being passed on to customers.

This indicates the importance of keeping price rises to the minimum compatible with recovery of the efficient costs of water provision – and of introducing any price rises as gradually as possible. In the current climate of intense pressure on Victorian business,

ESC needs to consider carefully the implications of the potential 65.7% increase in wholesale water and sewerage prices in real terms over the regulatory period (pg 3) and increases in retail prices ranging from 31.7% to 35.9% (pg 4).

Business feedback

Discussion with member companies about the proposed major price increase for water and sewerage services in metropolitan Melbourne has elicited a range of responses. Some companies have understood and agree with the case for a major price increase applied in the first year of the regulatory period, followed by zero real increases in subsequent years. Other companies have expressly pointed out their preference instead for a smooth price path with around 6% increases in subsequent years. There appears to be an understanding by companies regarding the government's timeframe for payment for the Victorian Desalination Plant, however a significant proportion of member companies would prefer the implementation of a payment over the five-year regulatory period. Notably the implications and impacts associated with a payment over the years of the regulatory period are not understood, and these need to be articulated during the ESC review. The prevailing economic conditions of various industry sectors which Ai Group believes the ESC should consider in its analysis of options in its the price review are provided and follow below.

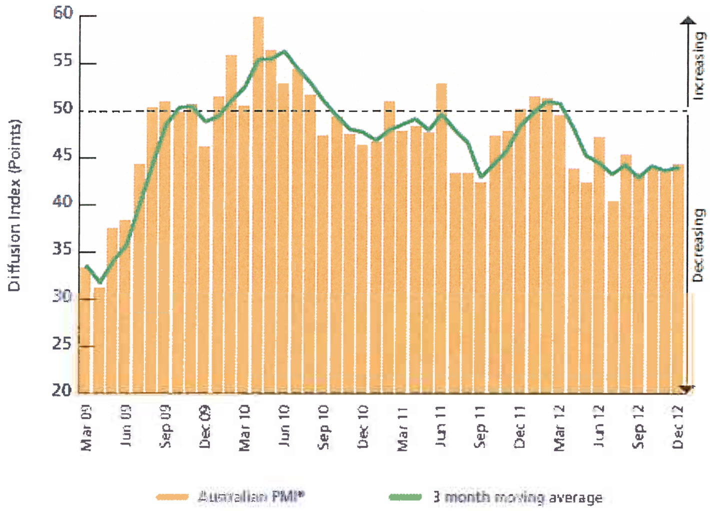
Discussion of prevailing economic conditions for industry and business

1. Manufacturing sector

Ai Group's latest Performance of Manufacturing Index (PMI) released in December 2012 confirmed that manufacturing activity had contracted for the 10th consecutive month.

Survey respondents remained cautious about the outlook and cited a range of inhibitors including: soft demand; higher energy charges; stronger import competition; and the strong Australian dollar.

The survey respondents also confirmed that wages and input costs continued to rise in December, while the persistent decline in selling prices eased only slightly, indicating that the profits for manufacturers remain under pressure.

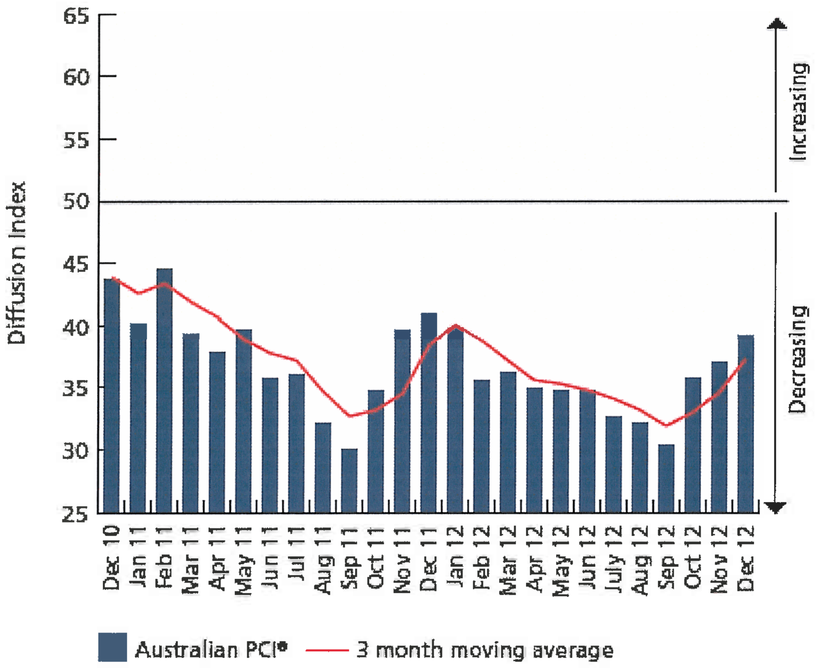


Australian Performance of Manufacturing Index (Dec 2012) showing period March 2009 to December 2012

2. *Construction sector*

Ai Group's Performance of Construction Index (PCI) released in December 2012 confirmed substantial weakness in areas of commercial construction, engineering construction, apartment building and house building.

Survey respondents confirm there has been slowing in decline in activity and new orders which are mainly attributed to tight credit conditions, strong competition for existing work and uncertainty about the economic outlook.

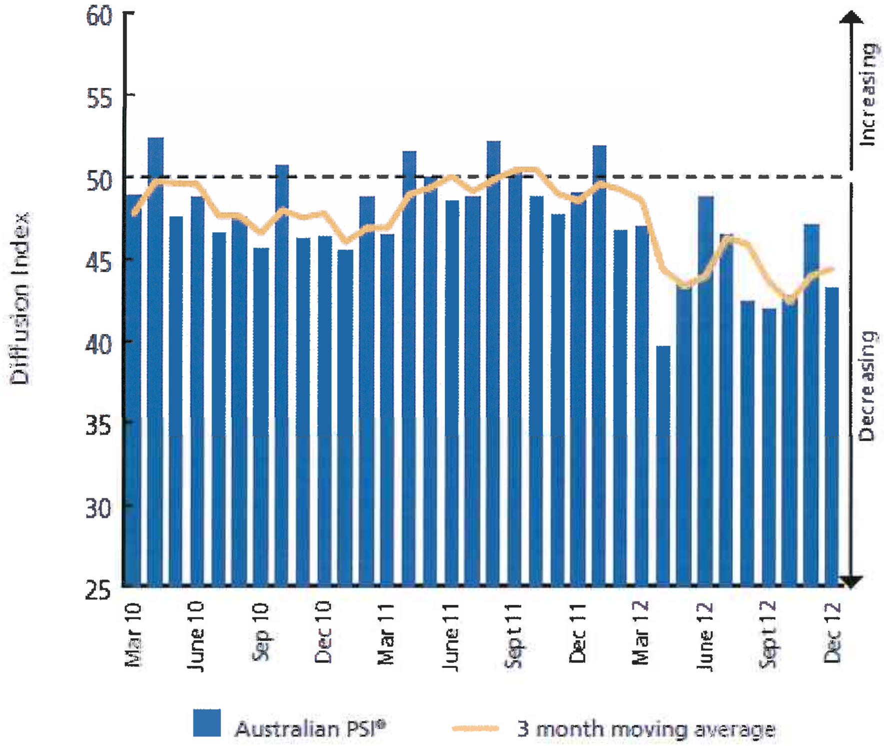


Australian Performance of Construction Index (2012) showing period December 2010 to December 2012

3. Services sector

The Ai Group/Commonwealth Bank Australian Performance of Services Index (Australian PSI) for December 2012 confirmed low levels of household confidence and ongoing economic uncertainty. Sub-sectors directly exposed to household spending (including retail trade, accommodation, cafes and restaurants) all reported that activity levels declined in December.

Declining activity levels were also reported from the rest of the services industry including wholesale trade, transport & storage, communications, personal & recreational services, etc.



Ai Group/Commonwealth Bank Australian Performance of Services Index (Dec 2012) showing period March 2010 to December 2012

4. *Australia's Carbon-tax pricing responses*

Ai Group's survey of initial business responses to Australia's carbon tax, released on 29 January 2013, suggests that the carbon tax was estimated to have increased energy prices by around 14% broadly across manufacturing, construction and services. Beyond the importance of the carbon price in adding to competitive pressures on many businesses, it also illustrates the difficulty trade-exposed businesses face in passing on cost increases – including water costs – to their customers.

Table 1 below, sourced from our report, presents data from the manufacturing sector – including many Victorian businesses – showing that more than 60% saw immediate input price rises, but less than 40% intended to raise selling prices as a result on any of their products. Of those businesses that did intend to increase selling prices, three quarters did no on less than half of their products and only 7% raised prices on all products. Food and beverage manufacturers stand out as suffering the biggest gap between input price pressures and selling price increases of the subsectors considered. Additional in-depth research with a smaller sample of Victorian manufacturing businesses confirmed that food manufacturers in particular face intense pricing pressure from large retailers, greatly limiting their ability to recover increased costs.

Table 1: Input prices and selling price intentions, manufacturing

	Increase in total energy costs due to carbon tax (as reported in Nov) (% of respondents)	Input price rises experienced from 1 July (as reported in July) (% of respondents)	Selling price rises planned from 1 July (as reported in June) (% of respondents)
Yes price increases	**66.0%**	**61.3**	**39.5**
No price increases	**4.0%**	**32.5**	**51.5**
No response / not applicable	**30.0%**	**6.2**	**9.0**
'Yes' responses by sector:	(average % increase p.a.)	(% of respondents)	(% of respondents)
Food & beverage	15.7	90.9	11.1
Basic metals	14.2	71.4	52.9
Chemicals, petroleum & coal	12.0	70.6	38.8
Machinery & equipment	12.6	66.7	38.8
Miscellaneous manufactures	12.8	64.3	58.3
Fabricated metals	14.8	60.3	38.8
Textiles, clothing & footwear	9.5	57.1	33.3
Wood products & furniture	17.0	44.4	50.0
Transport equipment	14.0	37.5	25.0
Paper, printing & publishing	16.3	37.5	14.3
Construction materials	20.7	16.7	60.0
ALL MANUFACTURERS	**14.5% p.a. average**	**61.3% of respondents**	**39.5% of respondents**
If yes to a price increase, then:		(% of respondents)	(% of respondents)
Price increase on less than half of all items/services		76.0	27.0
Price increases on more than half of all items / services		18.0	22.0
Price increases on all items/services		7.0	51.0

Conclusion

Ai Group has provided a range of economic performance information and trends pertaining to industrial water users for consideration by ESC in its analysis of proposals for water price increases in the metropolitan area of Melbourne. The information provides a backdrop that shows the challenging times that industry and the community are currently facing and the outlook during the coming regulatory period for water pricing. Clearly there is a subdued business climate with weak demand and continuing escalation of input costs. A segment of businesses have expressed a preference for a once-off price increase while others would prefer the increases to be distributed over the regulatory period to reduce the impact of a 'price shock' for water – however these companies seek further information about the alternative options for price increases over the five-year period. It is clear that industry has little capacity to pass on additional price increases to customers, but also that the scope to absorb further costs is limited given broader pressures. This difficult situation makes large single-step price increases hard to bear, but increases spread over the regulatory pricing period would not be easy to bear either.

There is little to be done about the significant costs associated with the desalination investment; we recognise that this facility is a long-term insurance policy and that insurance carries a cost. But given the extreme pressures on industry outlined above, the ESC should examine additional investment plans closely and set a very high bar in determining the extent of necessary investment.

We look forward to further consultation from the Commission as it considers the options.

If you require more information, please contact Robert Lorenzon on 03 9867 0240 or robert.lorenzon@aigroup.asn.au

Yours sincerely

Timothy Piper
Director - Victoria