

APPENDIX

**BULK WASTEWATER COLLECTION TREATMENT AND DISPOSAL CONTRACT;
SUMMARY OF KEY ISSUES**

Background

The bulk wastewater agreement negotiations between Watercare and the LNOs were finalised in June 2003.

The Commercial Review of the contract has been completed.

The tariff details are still to be agreed amongst the LNOs.

The total 2 year financial commitment for Metrowater will be approximately \$94.2 million.

It is recommended that the 5 June draft of the Agreement and the proposed process to finalise the tariff be endorsed.

The Bulk Water Agreement was signed in July 2002 after 30 months of negotiations.

Negotiations for the provision of Bulk Wastewater Services commenced in August 2002.

The parties negotiating this agreement are:

- Watercare Services Limited
- Metro Water Limited
- Manukau City Council
- Waitakere City Council
- United Water International Pty Limited

Although each contract will be unilateral between each LNO and Watercare, all the contracts have identical provisions.

The contract is for domestic wastewater only and excludes trade waste. Watercare's responsibility for the administration and management of trade wastes is defined under the provisions of the Auckland Metropolitan Drainage Act 1960 and the Auckland Regional Council Trade Wastes Bylaw 1991.

CONTRACT APPROACH

Key Issues	Approach taken by LNOs
<p>Auckland Metropolitan Drainage Act (AMD Act): Contract must not enshrine any monopoly or other powers of Watercare under the AMD Act.</p>	<p>The approach has been to not include in the contract anything already covered in the AMD Act. Effectively, the overall relationship between the parties can only be discerned by reading the AMD Act alongside the contract. The focus over the next year is to review the AMD Act.</p>

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<p>Flow/Load:</p> <ul style="list-style-type: none"> Flow/load data is required to support the tariff structure Exceeding flow/load must trigger joint planning to resolve capacity issues 	<ul style="list-style-type: none"> Flows/loads are determined from Hydraulic Models The contract relies on the production of accurate information at Hydraulic Information Points to be finalised during the term of the contract. These points and their associated flows can only be changed by agreement.
<p>Trade Wastes:</p> <p>There are some aspects of trade wastes which are <i>not</i> dealt with in the Auckland Metropolitan Drainage Act 1960 and the Auckland Regional Council Trade Wastes Bylaw 1991.</p>	<p>The contract is for domestic wastewater only. Both Watercare and the LNOs have identified the activities and responsibilities that relate to tradewaste and gaps in the legislation that should be plugged to manage tradewaste effectively.</p> <p>There will be an exchange of letters between Watercare and the LNOs detailing each party's commitment to managing tradewaste and addressing the gaps in the legislation.</p>
<p>Pricing:</p> <p>The price is set in the contract for both years of its term (subject only to CPI adjustment). Watercare's total revenue requirement is set by Watercare external to the wastewater contract.</p>	<p>The contract:</p> <ul style="list-style-type: none"> prevents Watercare from doing anything which will effectively determine the price for the 2005/2004 year or beyond. specifies a process, for setting prices generally (to create an expectation that this process will form part of the contract for the 2005/2006 years and beyond).
<p>Investment Signals:</p> <p>Contract should not send any unnecessary investment signals to Watercare.</p>	<ul style="list-style-type: none"> The service levels in the Contract are to not establish Watercare obligations that are more than is needed. Contract prevents "gold plating" by Watercare (ie providing a service above contracted service levels, and beyond that which is needed to satisfy its other obligations under the contract and the law). Contract establishes a clear delineation of responsibilities between the LNO and Watercare. Contract creates and encourages an optimal level of planning efficiency, by the LNOs and Watercare (particularly for system extensions and upgrades, but also for major refurbishments and other items of Capex). Contract requires Watercare to size its system to meet agreed flow and load forecasts.

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<p>Tariff: There must be no room for manipulation of this by Watercare.</p>	<p>The tariff structure and transition will be clearly defined in the Contract.</p>
<p>Contingency Planning</p>	<p>Contract requires the parties to consult on each others plans and to jointly test these plans.</p>
<p>Avoiding Deadlocks</p>	<p>Contract has a generic dispute resolution mechanism of:</p> <ul style="list-style-type: none"> • Compulsory escalation • Mediation/arbitration or other non litigation processes • Options open if above steps fail to resolve dispute <p>The joint planning process has a dispute process of:</p> <ul style="list-style-type: none"> • Compulsory escalation • Joint report produced setting out the differences
<p>Watercare's Obligation to Receive Wastewater</p>	<p>Watercare have an absolute obligation to receive into its system, all wastewater discharged by the LNO (within agreed peak flows), without causing "back ups" or other engineering problems within the LNO system.</p>
<p>Risk in Domestic Wastewater</p>	<p>Contract establishes when risk in wastewater passes (to assist in determining liability for illegal discharges of Domestic Wastewater)</p>

PRICE AND TARIFF

Price

The objective of the LNOs was to achieve:

- Price certainty for each of the two years during the term of the contract.
- Minimise the ability for Watercare to adjust its prices within the contract period.

In their 2002/03 Funding Plan, Watercare committed to a CPI - 2% price path for the next three years. This covers the term of this contract.

The draft contract:

- Will set Watercare's revenue requirement for each of the two years based on Watercare's 2003/04 Funding Plan.
- Each year the revenue requirement is adjusted for CPI - 2%.
- Watercare is limited to increasing its revenue requirement if only all of the following occur:
 - An increase in revenue is required because of an event that is beyond the reasonable control of Watercare (acting as a prudent operator)

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- Watercare could not have reasonably foreseen the event.
- The event has a greater than \$10 million (cash) impact on Watercare during the year.

Current Tariff Structure:

The current tariff structure has no variable component. The allocation is based on:

- 50% population of each LNO based on 1991 census
- 50% rateable land value in each LNO area based on 1991 values

Although simple, this tariff structure is arbitrary and sends no economic signals.

Marsden Jacob Associates

The LNOs engaged Marsden Jacob Associates (MJA) to advise an appropriate tariff structure. This was reported to the Board at its meeting on 17 March. The Board approved the tariff structure in principle, subject to finalising the tariff quantum.

Tariff Structure

The total amount of costs to be recovered from the four LNOs is fixed externally to the wastewater contract. The total revenue requirement is set through the Funding Plans and is based on cash flow adequacy.

The proposed tariff seeks to allocate that fixed cost in a way that will promote greater focus on reducing future costs of the system and thereby reduce future wastewater charges.

MJA have applied the economic principle that prices should reflect incremental costs. The recognised method for deriving an estimate of the incremental costs is to estimate the:

- **Short Run Marginal Cost (SRMC).** For a wastewater business this is limited to chemicals and pumping costs including electricity; and
- **Long Run Capacity Cost (LRCC).** The cost of Capex required for growth in infrastructure capacity due to increased population, as estimated from Watercare's Asset Management Plan (AMP).

The balance between the required revenue level and the revenues derived to cover the SRMC and the LRCC is recovered via a charge unrelated to capacity. In this case the "balance item" is apportioned accordingly to shares of total serviced population.

Proposed Tariff:

MJA propose a 3 - part tariff:

$$\text{Revenue} = \text{Long Run Capacity Cost (LRCC)} + \text{Short Run Marginal Cost (SRMC)} + \text{Balance}$$

LRCC:

MJA estimate two thirds of Watercare's forward Capex is to provide capacity for growth, reducing overflows and targeting health and environmental issues. The high cost of upgrading the existing Watercare system has a direct linkage with the performance of the LNO system (e.g. high stormwater infiltration in the LNO system impacts on capacity).

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The LRCC identifies the current and future costs of augmenting the system, thereby

enabling the LNOs and Watercare to modify behaviour and reduce future costs.

Actual costs that will be incurred for planned expenditures will not be known until some time after the expenditures have occurred. However, the estimates shown in the AMP must be interpreted as "best" estimates.

For these several reasons, scrutiny and sign-off of the AMP is a critical task and responsibility for shareholders and the LNO customers.

Thus, using the LRCC as an element in the bulk wastewater tariff is not only good economics, but increases the incentive for parties other than Watercare to scrutinise the strategy assumptions and estimates contained in the AMP.

MJA propose that the Long Run Capacity Cost be allocated across the LNOs by quantifying the required peak capacity to accommodate each LNO flow, determined from the Watercare hydraulic model and verified by each LNO.

SRMC:

The Short Run Marginal Cost is approximately 5% of Watercare's annual costs (e.g. electricity, chemicals etc.,).

MJA propose that SRMC be distributed amongst the LNOs by proportioning the annual wastewater volume that each LNO discharges into the Watercare system.

Balance:

The balance item is shared amongst the LNOs using current serviced population.

**\$200m Regional
Containment
Project**

As the LRCC is based on the Watercare AMP, the \$200m project proposed by Watercare in 2010 has a significant impact on the tariff calculation. This environmental/capacity project is proposed by Watercare to address the overflows from the Auckland City area, however there has been little consultation with Metrowater.

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Tariff Values

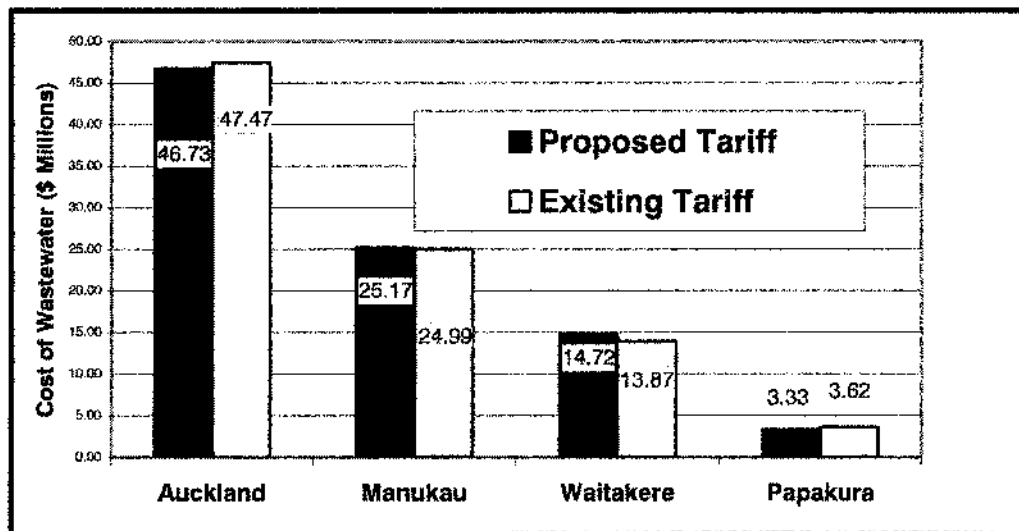
The proposed tariff values, (including the \$200m Regional Containment Project in the Watercare AMP) are:

Tariff	Auckland	Manukau	Waitakere	Papakura	TOTALS
Balance	44.11%	33.08%	18.64%	4.18%	100.00%
LRCC	78.93%	10.58%	8.87%	1.62%	100.00%
SRMC	49.14%	29.35%	15.84%	5.68%	100.00%
Balance \$	29,034,596	21,774,088	12,267,872	2,753,412	65,829,968
LRCC \$	15,488,295	2,076,140	1,740,473	317,666	19,622,573
SRMC \$	2,211,075	1,320,769	712,630	255,525	4,500,000

% Share	52.0%	28.0%	16.4%	3.7%	100.0%
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New Tariff (\$M)	46.73	25.17	14.72	3.33	89.95
Existing (\$M)	47.47	24.99	13.87	3.62	89.95
\$ Change (\$M)	-0.74	0.18	0.86	-0.30	0.00
% Change	-1.6%	0.7%	6.2%	-8.2%	0.0%

The impact on each LNO area is:



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Other tariff scenarios:

For the purposes of comparison, two other tariff scenarios have been calculated:

- 3 part tariff, excluding \$200m regional containment project
- 1 part tariff, solely based on population

3 part tariff, excluding \$200m regional containment project:

Tariff	Auckland	Manukau	Waitakere	Papakura	TOTALS
New Tariff (\$M)	43.18	27.47	15.72	3.59	89.95
Existing (\$M)	47.47	24.99	13.87	3.62	89.95
\$ Change (\$M)	-4.29	2.47	1.85	-0.03	0.00
% Change	-9.0%	9.9%	13.4%	-0.9%	0.0%

1 part tariff, based on population:

	Auckland	Manukau	Waitakere	Papakura	TOTALS
New Tariff (\$M)	39.67	29.75	16.76	3.76	89.95
Existing (\$M)	47.47	24.99	13.87	3.62	89.95
\$ Change (\$M)	-7.80	4.76	2.90	0.14	0.00
% Change	-16.4%	19.0%	20.9%	3.9%	0.0%

Transition

To encourage acceptance from the other LNOs, a transition strategy is considered essential.

The principles of this strategy should be:

- there must be no price shocks for each LNO
- there must be no change next year as councils and LNOs are currently setting their rates and prices
- transition must commence in this contract term (2 years)
- transition does not push results away from ultimate direction

On this basis, it is considered that a 2 year or 3 year transition is appropriate:

2 year transition		3 year transition	
Year 1	No change	Year 1	No change
Year 2	New tariff	Year 2	Step 1 of change (50% of Δ)
		Year 3	New tariff

The impact of the proposed new tariff for each customer of each LNO is:

	Auckland	Manukau	Waitakere	Papakura
Annual impact / Customer	-\$6	\$2	\$15	-\$2
	-1.0%	0.5%	3.8%	-0.6%

Although the transition period is still to be approved by the LNOs, a two-year transition is considered appropriate.

PEER REVIEW

Peer Reviews Culley Knipe & Associates have carried out a peer review of the contract commercial risks.
Mike Brooker of Phillips Fox will carry out a peer review of the legal risks when the tariff is finalised.

Commercial Peer Review Culley Knipe identified some areas where the LNO's are likely to carry undue risk and areas of exposure.

All of the identified high risk issues have been addressed in recent negotiations. The remaining moderate or low risk issues identified were known to the negotiating team during the negotiations.

Culley Knipe & Associates state that the majority of the issues relating to the commercial interface between the parties to the Agreement are well covered although the detail of the contract tends to favour Watercare.

Specifically, Culley Knipe state that the draft adequately covers key areas such as price setting, escalation, force majeure, limitation of liability, consultation, joint planning, payment of accounts, breach resolution, termination, dissemination of information and access to property.

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