



INQUIRY INTO THE 2009/10 METROPOLITAN AND REGIONAL WATER AND WASTEWATER PRICING PROCESS ISSUES PAPER

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REQUEST FOR SUBMISSIONS

The Essential Services Commission of SA (the Commission) invites written submissions from interested parties in relation to the issues raised in this paper. Written comments should be provided by **1 May 2009**. It is highly desirable for an electronic copy of the submission to accompany any written submission.

It is Commission policy to make all submissions publicly available via its website (www.escosa.sa.gov.au), except where a submission either wholly or partly contains confidential or commercially sensitive information provided on a confidential basis and appropriate prior notice has been given.

The Commission may also exercise its discretion not to exhibit any submission based on their length or content (for example containing material that is defamatory, offensive or in breach of any law).

Responses to this paper should be directed to:

Inquiry into the 2009/10 Water & Wastewater Pricing Process

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Public Information about ESCOSA's activities

Information about the role and activities of the Commission, including copies of latest reports and submissions, can be found on the ESCOSA website at www.escosa.sa.gov.au.

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GLOSSARY OF TERMS

ADP	Adelaide Desalination Plant
ARMCANZ	Agriculture and Resource Management Council of Australia & New Zealand
CoAG	Council of Australian Governments
COMMISSION	Essential Services Commission of SA
CSO	Community Service Obligation
LRMC	Long-Run Marginal Cost
NCP	National Competition Policy
NWC	National Water Commission
NWI	National Water Initiative
NWIC	National Water Initiative Committee
SA WATER	South Australian Water Corporation
SCARM	Standing Committee on Agriculture & Resource Management
WACC	Weighted Average Cost of Capital

1 INTRODUCTION

Pursuant to section 35(1) of the *Essential Services Commission Act 2002*, the Treasurer has referred to the Commission an inquiry into the water and wastewater pricing processes followed by the Government in late 2008 in setting prices for metropolitan and regional South Australia for 2009/10 and an in-principle revenue direction to June 2013.

The Commission received the Notice of Referral on 1 April 2009. It is required to submit a draft report to the Treasurer and the Minister for Water Security by 1 July 2009, with a final report to be delivered by 12 August 2009.

The following are the terms of reference for this inquiry:

- (a) *The Commission is to inquire into price setting processes undertaken in the preparation of advice to Cabinet, resulting in Cabinet making its decision on the level and structure of SA Water's water and wastewater prices in metropolitan and regional South Australia in 2009-10 and an in principle revenue direction to June 2013 having regard to:*
 - a. *the adequacy of the application of 1994 CoAG pricing principles;*
 - b. *the National Water Initiative, specifically, Clause 65 with respect to the continued application of pricing principles to urban areas, Clause 66(i) with respect to water and wastewater pricing in the metropolitan area and Clause 66(v) with respect to water and wastewater pricing in regional (urban) areas; and*
 - c. *the NWIC draft urban water pricing principles, to be considered by COAG.*
- (b) *In undertaking this inquiry, the Commission is to take into account:*
 - a. *the accredited South Australian National Water Initiative Implementation Plan with respect to Clauses 65, 66(i) and 66(v)*
 - b. *the National Water Commission First Biennial Assessment of the National Water Initiative, August 2007, Attachment 1 'Summary progress on implementing NWI actions' with respect to Clauses 65, 66(i) and 66(v);*
 - c. *the National Water Commission Update of progress in water reform, February 2008, Attachment A with respect to Clauses 65, 66(i) and 66(v);*
 - d. *the attached Transparency Statement Metropolitan and Regional Water and Wastewater Prices in South Australia 2009-10 (Part A) dated January 2009;*
- (c) *In considering the processes undertaken for the preparation of advice to Cabinet, the Commission is to advise on the extent to which information relevant to the 1994 CoAG pricing principles, the National Water Initiative and the NWIC draft urban pricing principles was made available to Cabinet.*
- (d) *These terms of reference specifically do not extend to additional information on alternative approaches to setting prices.*



The Transparency Statement provided by the Treasurer (which outlines the factors considered by the Government in setting the prices) provides the basis for this inquiry.

Term of Reference (a) makes clear that the Commission is to review the processes undertaken by (and the provision of information to) Cabinet in coming to its 2009/10 water and wastewater pricing decisions, with regard to the application of the 1994 CoAG pricing principles, certain clauses of the NWI and the National Water Initiative Committee (NWIC) draft urban water pricing principles. This instruction is quite specific and defines the scope of this inquiry. Most importantly, it means that the Commission is to examine the process that led to a pricing outcome. The Commission is not calculating a pricing outcome itself, nor is it examining or evaluating the actual pricing outcomes.

The Commission interprets its task as being one of assessing the extent to which the price setting processes facilitate pricing decisions that are consistent with the pricing principles. Where the Commission considers that consistency has not been achieved, it will suggest modifications to the price setting processes in order to achieve such consistency.

The Commission has conducted annual inquiries into the Government's urban water and wastewater pricing processes since the 2004/05 pricing decisions. All previous inquiry reports are available on the Water section of the Commission's website (www.escosa.sa.gov.au).

The water and wastewater pricing processes here are again combined; hence the Transparency Statement – Part A covers both water and wastewater prices. Accordingly, the issues that the Commission will examine in this inquiry are somewhat similar to those examined previously.

The Commission notes that a key issue that has influenced the price setting process for 2008/09 and 2009/10 has been the need to provide a sustainable and secure water supply in the face of the existing drought conditions. The Government has proposed a number of major projects and initiatives to ensure that South Australia has access to sufficient water supply in the longer term, including the construction of the Adelaide Desalination Plant (ADP) at Pt. Stanvac, and a north-south water pipeline interconnector. The Government has explained that these investments are a major driver in the decision to increase water charges in 2009/10 on average by 17.9% in real terms. This follows an average water charge increase in 2008/09 of 12.7% in real terms. The Government's in-principle revenue direction to 2012/13, while not binding, suggests annual price increases of similar magnitude to the 2009/10 increase.

As part of the current Inquiry, the Commission intends to examine the steps that the Government has taken to deal with the issues raised in the previous reports, and in meeting the relevant requirements of the NWI. The following section of this Issues Paper describes both the relevant 1994 CoAG pricing principles and the NWI. It also discusses the impact of the NWIC draft urban water pricing principles on the Government's price setting process.

Interested parties are encouraged to focus on such matters in their submissions.

In accordance with the instructions in the Treasurer's Notice of Referral, written submissions are due by 1 May 2009 (28 days after the publication of the Notice of Inquiry).

2 THE COAG PRICING PRINCIPLES

In conducting this Inquiry, the Commission is required to have regard to the 1994 CoAG pricing principles for water (including wastewater). These principles were developed by Australia's State, Territory and Commonwealth governments as part of the National Competition Policy.

As is explained in the Transparency Statement, the pricing principles for water are contained in the strategic framework for water, as set out in the Compendium of National Competition Policy Agreements (NCC 1998, 2nd Edition).¹

Section 3 of the strategic framework is specifically dedicated to pricing issues. However, it is a very broad pricing statement and provides limited detail (see below).

Relevant clauses of the CoAG Strategic Framework 1994 (pages 103-104).

In relation to water resource policy, CoAG agreed:

2 *to implement a strategic framework to achieve an efficient and sustainable water industry comprising the elements set out in (3) ... below.*

3 *In relation to pricing:*

(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, ...;*
- 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 —*

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

¹ See <http://www.ncc.gov.au/activity.asp?activityID=39>.

To complement these clauses, the Standing Committee on Agriculture and Resource Management (SCARM), through the Agriculture and Resource Management Council of Australia and New Zealand (ARMCANZ), provided a detailed set of guidelines. This detailed set of guidelines is generally referred to as “the CoAG pricing principles”.

Guidelines for applying Section 3 of the Strategic Framework and Related Recommendations in Section 12 of the Expert Group Report:

- 1 *Prices will be set by the nominated jurisdictional regulators (or equivalent) who, in examining full cost recovery as an input to price determination, 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.*
- 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.*
- 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.*

Terms requiring further comment in the context of these guidelines (these comments form part of the CoAG Strategic Framework) (Pages 112-113):

- *The reference to “or equivalent” in principles 1 and 6 is included to take account of those jurisdictions where there is no nominated jurisdictional regulator for water pricing.*
- *The phrase “not including income tax” in principle 5 only applies to those organisations which do not pay income tax.*
- *“Externalities” in principles 5 and 7 means environmental and natural resource management costs attributable to and incurred by the water business.*
- *“Efficient resource pricing” in principle 6 includes the need to use pricing to send the correct economic signals to consumers on the high cost of augmenting water supply systems. Water is often charged for through a two-part tariff arrangement in which there are separate components for access to the infrastructure and for usage. As an augmentation approaches, the usage component will ideally be based on the long-run marginal costs so that the correct pricing signals are sent.*



- *“Efficient business costs” in principle 6 are the minimum costs that would be incurred by an organisation in providing a specific service to a specific customer or group of customers. Efficient business costs will be less than actual costs if the organisation is not operating as efficiently as possible.*

3 THE NATIONAL WATER INITIATIVE

The NWI, which the Government signed in 2004, builds on and expands the 1994 CoAG Strategic Framework and pricing principles. The NWI includes clauses that establish commitments in relation to urban water and wastewater pricing (particularly clauses 64 to 77 inclusive). It should be noted that the NWI also deals with many other aspects of water management. The full text is available from the website of the National Water Commission (NWC) (www.nwc.gov.au). The NWC has the responsibility to oversight implementation of the NWI by each jurisdiction.

The Terms of Reference for this Inquiry identify several specific clauses for assessment by the Commission:

Clause 65

In accordance with National Competition Policy (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*
- ii) full cost recovery for water services to ensure business viability and avoid monopoly rents, including recovery of environmental externalities, where feasible and practical*
- iii) consistency in pricing policies across sectors and jurisdictions where entitlements are able to be traded.*

Clause 66

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

Metropolitan

- (i): continued movement towards upper bound pricing by 2008.*

Rural and Regional

...

(v): full cost recovery for all rural surface and groundwater based systems, recognising that there will be some small community services that will never be economically viable but will need to be maintained to meet social and public health obligations:

- a) achievement of lower bound pricing for all rural systems in line with existing NCP commitments*
- b) continued movement towards upper bound pricing for all rural systems, where practical*
- c) where full cost recovery is unlikely to be achieved in the long term and a CSO is deemed necessary, the size of the subsidy is to be reported publicly and, where practicable, jurisdictions to consider alternative management arrangements aimed at removing the need for an ongoing CSO.*



The reason for the Commission's task is set out in clause 77 of the NWI:

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; and

(ii) the Parties agree to use independent bodies to publicly review and report on pricing in government and private water service providers to ensure that the principles in paragraphs 65 to 68 are met.

The Commission has previously observed that the NWI pricing principles have a greater focus on outcomes than the 1994 CoAG pricing principles.² It noted that discussions between the Commission and the NWC confirmed that the NWI is intended to build on the 1994 pricing principles, rather than simply restating them. The Commission's view is that the NWI, particularly clauses 65, 66(i) and 66(v), increase the scope of water pricing reform beyond that of the 1994 CoAG pricing principles, with the stated intent of achieving best practice water pricing.

The Terms of Reference for the current Inquiry again refer the Commission to the *South Australian National Water Initiative Implementation Plan* and the NWC's 2007 *National Water Initiative First Biennial Assessment of Progress in Implementation*. For the first time, the Terms of Reference require the Commission to have regard to the NWC's *Update of progress in water reform*, dated February 2008. These documents provide further guidance for the Commission's assessment and can be found on the NWC website.

Further detail regarding the NWI is contained within the Transparency Statement.

² For example, refer to the Commission's *Final Report on the Inquiry into the 2008/09 Metropolitan and Regional Water and Wastewater Pricing Process*, p 12.

4 NWIC DRAFT URBAN WATER PRICING PRINCIPLES

The Terms of Reference refer to the NWIC draft urban water pricing principles. Transparency Statement – Part A indicates that these draft pricing principles “build on the 1994 COAG Strategic Framework and the NWI”. The draft pricing principles, which are not publicly available, cover:

- ▲ The recovery of capital expenditure;
- ▲ Urban water tariffs;
- ▲ Recovering the costs of water planning and management activities; and
- ▲ Recycled water and stormwater reuse.

Transparency Statement – Part A states that:

In November 2008, COAG agreed to improve the security of urban water by adopting an enhanced national urban water reform framework, including the finalisation of draft national pricing principles.³

The Commission understands that the draft pricing principles will be referred to the relevant Ministerial Council for consideration sometime this year. It also understands that, once approved, the pricing principles will not replace the COAG and NWI pricing principles, but rather will expand upon them and provide practical guidance for implementing the principles.

4.1 Recovery of capital expenditure

Section A of the NWIC Draft Pricing Principles relates to the treatment of new and existing assets. In summary, the principles require:

- ▲ full cost recovery for new and replacement capital expenditure following a “legacy date” (in the case of South Australia, the legacy date referred to in Transparency Statement – Part A is 30 June 2006);
- ▲ new and replacement assets should initially be valued at efficient actual cost;
- ▲ existing assets (assets that existed as at the legacy date) should be valued based on a recognized valuation method, such as Depreciated Replacement Cost (DRC), Depreciated Optimised Replacement Cost (DORC), Optimised Replacement Cost (ORC), indexed actual cost or Optimised Deprival Value (ODV);
- ▲ cost recovery for legacy assets should be achieved by way of a depreciation charge or annuity charge and a positive return on an asset value used for price setting purposes as at the legacy date. If assets are to be sold then they are to be valued at their net realisable value.
- ▲ The regulatory asset base should be rolled forward (in either nominal or real terms) by including prudent capital expenditure and deducting depreciation and asset

³ 2009/10 Transparency Statement - Part A, p11.

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

- ▲ New contributed assets (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. If a renewals annuity is used, it should include provision for replacement of contributed assets.

One of the key aspects of the NWIC Draft Pricing Principles is that it allows the return on assets achieved historically (prior to the defined legacy date) to be locked in, and full cost recovery only sought in relation to new and replacement capital investments incurred following the legacy date (30 June 2006), which implies that prices should be set to at least achieve a full WACC of 6% (pre-tax, real) for capital expenditure beyond 30 June 2006, with no attempt to adjust prices to reflect any over-recovery or under-recovery relative to the full WACC for capital expenditure prior to this date.

Transparency Statement – Part A calls this approach “Go-Forward-Full-Cost- Recovery” (GFFCR). It notes that in the long-run, as existing assets are replaced, GFFCR will gradually tend towards the upper revenue bound until eventually the full WACC is earned on all assets. The application of the GFFCR approach to SA Water’s water and wastewater revenues is discussed in Transparency Statement – Part A. It observes that the historical returns on water assets have been 3.1% (ie. below the upper bound) and that the historical returns on wastewater assets have been 7.2% (ie. above the upper bound). Under the GFFCR approach, these historical returns would effectively be locked-in until the assets are replaced.

4.2 Urban Water Tariffs

Section B of the NWIC Draft Pricing Principles sets out the following relevant principles for the design of urban water tariffs:

- ▲ Water tariffs should recover forecast target revenue, which should not exceed the Upper Revenue Bound (to “avoid monopoly rents”);
- ▲ Two-part tariffs, comprising of a service availability charge and a usage charge, should be used to recover the revenue requirement from retail residential, non-residential and bulk customers;
- ▲ The water usage charge should have regard to the long run marginal cost of supply of additional water;
- ▲ The revenue from the service availability charge for water should be calculated as the difference between the target revenue and the revenue recovered through water usage charges and developer charges;
- ▲ 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;

- ▲ Where water usage charges lead to revenue recovery in excess of the upper bound in respect of new investments, the overrecovery is to be addressed, ensuring that revenues are not permanently withheld from customers;
- ▲ Water charges should differentiate between the cost of servicing different customers where the benefits of doing so outweigh the costs of identifying the differences and the equity advantages of alternatives.
- ▲ Revenue from developer charges should be offset against the total revenue requirement either by deducting the contributions from the RAB, or through some other offset mechanism.

In general, the Commission considers the draft principles for the design of urban water tariffs to be consistent with the COAG and NWI pricing principles, where the primary objective is to promote consumption based pricing. The Commission notes that the draft pricing principles discuss the need for a transparent and consultative process for setting urban water tariffs.

5 KEY ISSUES

In its previous inquiries the Commission identified a number of areas where improvements to the pricing process could be made, having regard to the CoAG pricing principles and, more recently, the NWI. The relevant sections of the Transparency Statement include reference to these earlier views and the Government response thus far.

Interested parties are invited to examine the Transparency Statement and to comment in their submissions on whether they believe the pricing processes are in accordance with both the CoAG pricing principles, the NWI, and the NWIC Draft Pricing Principles. Interested parties are, of course, welcome to address any other matter they consider relevant to the Terms of Reference set for the Commission.

The key areas to be examined by the Commission (in part based on its previous inquiries) are summarised below. In respect of each issue, or any other matters, the Commission asks the following:

Do the water and wastewater price setting processes enable Cabinet to make a decision that is consistent with the relevant CoAG and NWI Pricing Principles (incorporating the NWIC Draft Pricing Principles)?

Have Government responses to the earlier recommendations and suggestions of the Commission been addressed in the Transparency Statement – Part A?

In reviewing the Government's process for determining 2009/10 water and wastewater prices, an important question that the Commission must consider is whether or not Cabinet had access to sufficient information in order for it to reach a decision that is consistent with the requirements of the CoAG and NWI pricing principles, and the NWIC draft pricing principles. For example, the Commission must review whether the material provided to Cabinet demonstrated that forecast costs are efficient, that an appropriate rate of return has been determined and that forecasts of demand are reasonable. The information should also enable Cabinet to be satisfied that the proposed prices are reflective of efficient costs, including any indirect costs/benefits associated with water usage (externalities). Where other factors have been taken into account in setting prices (eg. equity, affordability and regional issues), the impact of these factors on prices should be made transparent in the information.

The Commission also notes that Section B of the NWIC Draft Pricing Principles states that 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.

The following sections of this Issues Paper discuss some of these key issues relating to the price-setting process adopted by Government, focusing on areas that the Commission has previously expressed some concern with and providing some preliminary comments on how these matters have been addressed in the 2009/10 Transparency Statement – Part A.

5.1 Forecast Capital Expenditure

To accord with the relevant pricing principles, it is critical that the information presented to Cabinet addresses proposed capital expenditure, and does so sufficiently to enable Cabinet to conclude that the forecast capital expenditure is efficient.

The Commission has expressed concern in previous reviews about the lack of information presented in Transparency Statement – Part A, to demonstrate that proposed capital expenditure is considered least cost. This concern was accentuated in the 2008/09 review, where the Commission expressed particular concern over the absence of sufficiently detailed information to demonstrate the efficiency of the proposed capital expenditure on the ADP and north-south interconnector. Both of these projects were major influences on the Government's decision to increase prices in real terms by 12.7% in 2008/09 and 17.9% in 2009/10.

The Government's response to the Commission's Final Report for the 2008/09 Inquiry argued that the extent of public Parliamentary scrutiny means there will be an extremely high level of public transparency around the efficiency of future costs related to all major water security investments. It also suggested that Cabinet was privy to a range of other information focussed specifically on the decision about water security, including a comprehensive report from the Desalination Working Group, which included information on a large number of options to secure long term water requirements and a report from KPMG in which it examined the comprehensiveness and reasonableness of cost information and the assumptions and methodology for the new water security projects. The Commission notes that this information was not reflected in Transparency Statement – Part A, and that the KPMG report was not provided to the Commission as part of the previous Inquiry.

The Commission would welcome comment from stakeholders on the level of the information presented in Transparency Statement – Part A, concerning the efficiency of the proposed capital expenditure on the Government's water security projects, particularly the information on the proposed Adelaide Desalination Plant and the north-south interconnector.

In its previous review, the Commission acknowledged that the proposed water security projects were still at a preliminary stage, and that the uncertainty over the costs of the projects should be clarified over time as a due diligence program is undertaken and firmer cost estimates are produced. This was confirmed in the Government's response to the Commission's Final Report, in which the Government stated that adjustments to water charges would be made in future years to reflect latest estimates of the project costs, and that it considered it appropriate that water charges be adjusted to recover fully the incurred costs of projects such as the desalination plant – no more and no less.

The Commission observes that the water pricing decision for 2009/10 will see an average increase in water charges of 17.9% in real terms. While it was anticipated that annual increases of 12.7% in real terms would achieve full cost recovery, Transparency Statement – Part A explains that the Government’s decision to accelerate the ADP and purchase additional water allocations have caused prices to increase by more than was expected when the 2008/09 pricing decision was made. Downward adjustments to SA Water’s revenue forecasts (eg. as a result of revised demand elasticity estimates) have also had an impact on the decision.

Comments are sought on whether or not the information presented to Cabinet, as summarised in Transparency Statement – Part A, is sufficient to demonstrate that the increased costs associated with the proposed acceleration of the Adelaide Desalination Plant are prudent and efficient.

5.2 Operating, Maintenance and Administration (OMA) costs

In past Inquiries, the Commission has suggested that more effective compliance with the CoAG pricing principles and the NWI would result if the Government were to undertake more comprehensive analysis of SA Water’s costs to enable more reliable conclusions on cost efficiency to be reached. In the 2008/09 Inquiry, the Commission noted that there had been some improvement in the analysis of drivers of OMA costs and in the level of cost benchmarking information, although it concluded that there was insufficient information to explain how historical performance and emerging trends are linked to forward-looking OMA requirements.

The Government’s response to the Commission’s 2008/09 Inquiry Final Report states that the Government’s pricing model provides forward looking cost information based on SA Water’s approved Budget and is provided in the Transparency Statement in respect of Indicative Revenue Direction to 2012-2013. It argues that Cabinet was provided with information that would reasonably enable it to consider that SA Water is operating efficiently.

The 2009/10 Transparency Statement – Part A states that:

There are two key factors in place to ensure that OMA costs are efficient, namely significant outsourcing and transparent public disclosure of costs and the basis for decisions such as that to build the desalination plant. Given these factors, the government considers SA Water’s OMA costs to be efficient.⁴

Further information regarding SA Water’s 15 year system management contract with United Water International, and the existence of other outsourcing arrangements, is discussed in Transparency Statement – Part A. It also seeks to substantiate the proposition that OMA costs are efficient by providing benchmarking data comparing SA

⁴ 2009/10 Transparency Statement – Part A, p 18.

Water to other comparable interstate utilities, taken from the NWC National Performance Report 2006/07. Here, Transparency Statement – Part A suggests that:

While there are some indicators where SA Water's performance has room for improvement, the general position is that SA Water performs well by comparison, featuring in the top half against most indicators.

The Commission would welcome any comments from stakeholders on whether or not the information presented in the 2009/10 Transparency Statement – Part A would be sufficient to conclude that SA Water's forward-looking OMA costs are efficient.

5.3 Externalities

In its past two Inquiries, the Commission has expressed concern that the Transparency Statement – Part A does not address the broader view of externalities that the NWI introduces, focussing instead on just those externality costs that are attributable to and incurred by SA Water (licence fees and levies paid to Natural Resources Management (NRM) Boards).

While the Commission acknowledged that the incorporation of externalities into pricing decisions was a difficult matter, and that the requirements of the NWI in relation to externalities are somewhat uncertain, it recommended that the Government at least seek to identify relevant externalities. It noted that a number of other states have made significant progress in this area, in advance of any guidance being produced by the NWI Steering Group. For example, the Commission is aware that the ACT Government has a water abstraction charge of 55 c/kL of water, part of which recovers costs associated with the ACT Government's catchment management, the scarcity value of water and environmental costs.

The 2009/10 Transparency Statement – Part A states that there has been a delay in consideration by jurisdictions of nationally consistent pricing principles for environmental externalities and until such principles are developed, the Government has continued to adopt the more narrow definition of externalities. The Commission notes that this national review has been flagged in the 2007/08 and 2008/09 Transparency Statement, but that little progress appears to have been made in this area.

Comments are sought on the approach taken to the treatment of environmental externalities, and its consistency with the NWI requirements.

5.4 Efficient resource pricing

The COAG pricing principles and NWI require consumption based pricing, which sends the correct economic signals to consumers on the high cost of augmenting water supply systems. As an augmentation approaches, the usage component will ideally be based on the long-run marginal costs (LRMC).

The Commission was encouraged by the information presented in the 2008/09 Transparency Statement, which supported a change in pricing structures to reflect an updated estimate of the LRMC, thereby promoting movement towards consumption based pricing.

Notwithstanding this progress, the Commission recommended that further information be provided to explain the benefits of retaining the current multi-tiered usage charge rather than moving towards a single usage charge based on LRMC. It also suggested that there was little information to support the Government's estimated LRMC of \$1.90 per kL.

The 2009/10 Transparency Statement – Part A explains that the current estimate of LRMC is based on the cost of expanding the ADP from 50GL to 100GL. These updated costs are summarised in the Transparency Statement, which leads to a revised LRMC estimate of \$2.30 per kL in 2008/09 dollars, or \$2.35 per kL in 2009/10 dollars.

Is the information presented in Transparency Statement –Part A sufficient to demonstrate the robustness of the estimated LRMC?

The increase in 2009/10 water usage charges bring them closer towards the estimated LRMC value, particularly the third-tier usage charge that applies to single residential dwellings, which is \$2.26 per kL. This third tier applies only to very few large residential users – the majority of residential users will face usage charges at the first and second tier, which are set well below the estimated LRMC. The Commission also notes that non-residential users do not face the third tier usage charge, and that there does not appear to be any discussion in the Transparency Statement about the merits of not applying a third tier to these customers.

Comments are requested on the extent to which the information in Transparency Statement – Part A demonstrates consistency of the water tariff structures with the consumption based pricing principles.

5.5 Revenue direction

The 2009/10 Transparency Statement contains a revised projection of revenue needs to 2013. It states that, based on current costs, annual increases in water charges of 17.9% in real terms until 2013 will see revenue increase to marginally above its targeted “Go Forward Full Cost Recovery” in 2012/13. Under this in-principle revenue direction, water

prices would almost double over the next four years in order to fully recover costs associated with the Government's major water security projects, and other costs.



6 NEXT STEPS

In accordance with the Treasurer's instructions, submissions are due by 1 May 2009 (28 days after the Commission publishes its Notice of Inquiry).

The Commission will consider all submissions received and prepare a draft report by 1 July 2009. In accordance with the requirements for the inquiry, the draft report will be submitted to the Treasurer and the Minister for Water Security.

A final report will be presented to the two Ministers by 12 August 2009. The final report will be made public in accordance with section 38 of the *Essential Services Commission Act 2002*.