

PROPOSED PRICE REGULATION FOR WATER AND SEWERAGE SERVICE PROVIDERS OTHER THAN SA WATER

DISCUSSION PAPER

July 2012



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 **24 August 2012**. 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).

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Proposed Price Regulation for Service Providers other than SA Water

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TABLE OF CONTENTS

Glossary of Terms	iv
1 Introduction	1
1.1 Final Advice	2
1.2 Pricing Order	3
1.3 Review Process	4
2 Price Regulation of Water Services	7
2.1 Nature of Services	7
2.1.1 Drinking Water	8
2.1.2 Sewerage	9
2.1.3 Recycled Water and Stormwater	10
2.1.4 Other Non-Drinking Water	17
2.1.5 Other Related Water and Sewerage Services	17
3 Pricing Principles	18
3.1 Existing Pricing Practices	18
3.1.1 Drinking Water	18
3.1.2 Sewerage	18
3.1.3 Recycled Water and Stormwater	19
3.1.4 Other Non-Drinking Water	19
3.1.5 Other Related Water and Sewerage Services	20
3.2 Proposed Pricing Principles	20
3.2.1 The National Water Initiative Pricing Principles	20
3.2.2 Interpreting the Principles	22
3.2.3 Drinking Water	24
3.2.4 Sewerage	28
3.2.5 Recycled Water and Stormwater Use	30

3.2.6	Other Non-Drinking Water	36
3.2.7	Other Related Water and Sewerage Services	38
3.2.8	Abuse of Market Power	39
3.3	Duration of First Price Determination Period and Reviewing the Effectiveness of the Pricing Principles Framework	39
4	Price Monitoring Frameworks	41
4.1	Options for Monitoring Prices	41
4.2	Price Monitoring Regimes in Other Regulated Industries	42
4.2.1	South Australian Ports	42
4.2.2	Victorian Ports	43
4.2.3	Aeronautical Services	43
4.2.4	Bulk Water Services	44
4.3	Price Monitoring Framework	44
4.3.1	Regulatory Objective	44
4.3.2	Implementation Principles	44
4.4	Proposed Price Monitoring Frameworks	46
4.4.1	Reporting Obligations	46
4.4.2	Monitoring of Pricing Outcomes	52
4.4.3	Public Reporting and Regulatory Intervention	54
5	Next Steps	59

GLOSSARY OF TERMS

ACCC	Australian Competition and Consumer Commission
ASR	Aquifer Storage and Recovery
COMMISSION	Essential Services Commission of South Australia
COAG	Council of Australian Governments
CPI	Consumer Price Index
CSO	Community Service Obligation
CWMS	Community Waste Management Systems
DAFF	Dissolved Air Flootation Filtration
DRAFT ADVICE	Commission’s Draft Advice on the Economic Regulation of the South Australian Water Industry
EPA	Environment Protection Agency
ESC ACT	<i>Essential Services Commission Act 2002 (SA)</i>
ESCV	Essential Services Commission of Victoria
FINAL ADVICE	Commission’s Final Advice on the Economic Regulation of the South Australian Water Industry
GL	Gigalitre (one thousand megalitres)
IPART	Independent Pricing and Regulatory Tribunal
IWRP	Integrated Resource Water Planning
LG ACT	<i>Local Government Act 1999</i>
LGA	Local Government Association
LRAC	Long-run Average Cost
LRMC	Long-run Marginal Cost
ML	Megalitre (one million litres)
NWC	National Water Commission
NERA	NERA Economic Consulting
NWI	National Water Initiative
PRICING ORDER	To be made by the Treasurer setting the terms under which the Commission can make a determination.
QCA	Queensland Competition Authority

REVIEW	The Essential Service Commission of South Australia’s review of the precise forms of the pricing frameworks to apply to service providers other than SA Water.
ROI	Return on Investment
SRMC	Short-run Marginal Cost
TER	Taxation Equivalent Regime
WATER ACT	<i>Water Act 2007 (Cth)</i>
WFG	Water for Good: a plan to ensure our water future to 2050
WIA ACT	<i>Water Industry Act 2012</i>
WATER INDUSTRY BILL	<i>Water Industry Bill 2010</i>
WBU	Water Business Unit
WTP	Willingness to pay

EXECUTIVE SUMMARY

The *Water Industry Act 2012* (**WI Act**) gives the Essential Services Commission of South Australia (**the Commission**) responsibility for regulating a range of matters relating to the quality, reliability and price of retail services offered in the water industry. These services include water (including recycled water and stormwater) and sewerage services offered by SA Water, Local Government, and a number of private businesses across the State.

The Commission has already consulted on the broad framework for licensing and compliance it intends to apply, and the regulation of services standards and prices, through the public consultation process for the advice provided to the Treasurer on the appropriate form of price and non-price regulatory regime to apply to the South Australian water industry.

The Commission has always acknowledged it will need to apply different approaches to the regulation of water and sewerage services provided by SA Water, the State's dominant water and sewerage service provider, and the water and sewerage services provided by others such as Local Government and private businesses.

This is because these other providers, and the services they offer, are markedly different to SA Water which is a Government-owned, vertically integrated, monopoly provider supplying services across the whole State. The Commission's approach to the regulation of SA Water's prices is therefore being dealt with through a separate process.

The Commission has previously proposed a more 'light-handed' approach to price regulation of other providers compared with SA Water, and has proposed that pricing principles and price monitoring frameworks should apply to them.

This Discussion Paper commences the Commission's review (**Review**) of the precise forms of the pricing frameworks proposed to apply to Local Government and private water and sewerage service providers. The Commission hopes that this paper will provide greater clarity to stakeholders on the overall price regulatory proposals, and will assist in the identification of key issues that should be considered by the Commission during its review.

The Commission recognises that the objectives of the WI Act, and the proposed price regulatory frameworks may, in some instances, represent a significant change of approach to current practices. As such, the Commission is committed to ensuring that appropriate transitioning arrangements occur. The Commission will also keep in mind the need to tailor its regulatory approach to the specific circumstances of each operation, to ensure that the benefits of regulation outweigh any associated costs. The Commission will be liaising closely with each service provider to ensure that its approach best addresses the long-term interests of consumers, consistent with the Commission's primary objective under the Essential Services Commission Act (**ESC Act**).

Discussion Paper

Proposed Price Regulation for Service Providers other than SA Water

The views in this paper are not final, and the Commission welcomes feedback from stakeholders on the proposals herein, or any other matter that they see as relevant to this process.

1 INTRODUCTION

The Essential Services Commission of South Australia, established under the *Essential Services Commission Act 2002 (ESC Act)*, is the independent economic regulator of essential services in South Australia. In undertaking its regulatory functions, the Commission has the primary objective of protecting the long-term interests of South Australian consumers with respect to price, quality and reliability of essential services.

In 2009, the South Australian Government announced a framework of reforms and commitments to address water security issues for South Australia's environmental, economic and social benefit. That framework was embodied in the comprehensive plan entitled "*Water for Good: a plan to ensure our water future to 2050*" (**Water for Good**).¹

The Commission's role, as laid out in *Water for Good*, encompasses licensing, consumer protection, performance monitoring, compliance and pricing matters.

On 27 September 2010, the Treasurer wrote to the Commission seeking its advice on what it would consider to be an appropriate form of price and non-price regulatory regime to apply to the South Australian water industry were the proposed *Water Industry Bill 2010 (Water Industry Bill)* to be enacted². This request for advice was sought under section 5(f) of the ESC Act and required the Commission to consult publicly on the matters in accordance with its Charter of Consultation and Regulatory Practice. The Commission's Final Advice on the Economic Regulation of the South Australian Water Industry³ (**Final Advice**) was provided to the Treasurer on 11 June 2012.

The Commission's Final Advice, among other things, sets out the various price regulatory regimes that would be applied to certain water retail services provided by water and sewerage service providers other than SA Water. The Commission's Final Advice proposed a 'light handed' approach to price regulation for these service providers, as summarised in Table 1-1.

¹ The Water for Good plan is available at <http://www.waterforgood.sa.gov.au/>.

² The *Water Industry Act 2012* received Royal Assent on 17 April 2012.

³ <http://www.escosa.sa.gov.au/library/120607-EconomicRegulationWaterIndustry-FinalAdvice.pdf>.

Table 1-1: Summary of the Commission's Final Advice on price regulation of Licensees other than SA Water

WATER RETAIL SERVICES	FORM OF PRICE REGULATION
Drinking water and sewerage services	Pricing principles/price monitoring
Mandated water recycling schemes	Pricing principles/price monitoring
Voluntary water recycling schemes	Pricing principles
Miscellaneous services	Pricing principles

To determine the precise forms of the abovementioned price regulatory frameworks, including the duration of the first regulatory period, the Commission's Final Advice proposed a separate public consultation process to provide stakeholders with the opportunity for input. The release of this Discussion Paper commences that public consultation process.

This Discussion Paper sets out further details of the Commission's proposed price regulatory frameworks. The Commission hopes this paper will provide greater clarity on the proposed regulatory frameworks and assist stakeholders in making submissions during this process.

1.1 Final Advice

In its Final Advice, the Commission stated that a pricing principles/price monitoring approach would apply to the provision of drinking water and sewerage services by providers other than SA Water for the first regulatory period. The duration of this first regulatory period was to be determined through consultation with stakeholders.

The Commission stated it would develop a set of pricing principles to which service providers will be required to have regard to when developing their prices, including:

- Principles relating to the identification and 'ring-fencing' of water and sewerage financial information;
- Principles for the recovery of capital expenditure (for example, the methodology used to value the regulatory asset base and the recovery of its efficient capital costs); and
- Principles for water and sewerage tariffs, including matters relating to:
 - Cost reflectivity;
 - Tariff structures; and
 - Willingness to pay.

In developing the pricing principles framework, the Commission stated it would also consider the following:

- Consistency with relevant national pricing principle frameworks, including the National Water Initiative (**NWI**) Pricing Principles; and
- The price regulation practices adopted in other regulated essential services in South Australia, and consistency with regulatory practices in other jurisdictions.

The Commission also stated that it would apply a pricing principles/price monitoring framework to non-recycled, non-drinking water services for non-SA Water service providers if they constitute a retail service under the WI Act.

1.2 Pricing Order

The Commission's general price regulation powers are contained in section 25 of the ESC Act, which allow the Commission to make determinations regulating prices, conditions relating to prices, and price fixing factors for goods and services in a regulated industry.

Through the declaration of the water industry as a regulated industry under section 17 of the WI Act, the Commission is able to regulate prices in that industry, subject to the Treasurer issuing a 'Pricing Order' under section 35 (4) of WI Act that:

- a) Sets out any policies or other matters that the Commission must have regard to when making a determination contemplated by this section;
- b) Specifies various parameters, principles or factors that the Commission must adopt or apply in making a determination contemplated by this section;
- c) Relates to any other matter that the Treasurer considers to be appropriate in the circumstances.

On 23 May 2012 the Treasurer wrote to the Commission confirming that he would be issuing to the Commission one or more Pricing Orders under section 35 of the WI Act. On 22 June 2012 the Commission received a Final Draft Pricing Order that specified to the Commission a range of matters that it must comply with in respect to the price regulation of SA Water and other water and sewerage service providers (Appendix A).

The content of the draft Pricing Order has implications for the way the Commission must treat SA Water and other licensed water retailers. The impact of the Pricing Order on the Commission's approach to regulating SA Water is covered in the Economic Regulation of SA Water's Revenues – Statement of Approach⁴. For other service providers, the Pricing Order will impact on price regulation by:

requiring the Commission to adopt or apply the National Water Initiative (NWI) Pricing Principles (other than the Principles for Recovering the Costs of Water Planning and Management Activities) when making a determination, to the extent that those, or any of those, principles are relevant to the determination in question (refer 3.1 of the Pricing Order).

Whilst it was the Commission's intention to have regard to the NWI pricing principles, as indicated in its Final Advice, the Commission had expected to have greater flexibility in the adoption of these principles for service providers other than SA Water. The effects of this draft Pricing Order, therefore, represents a deviation from the Commission's intended approach, as stated in its Final Advice.

1.3 Review Process

The release of this Discussion Paper marks the first step in the Commission's process of public consultation on the proposed form of pricing principles and price monitoring for licensees other than SA Water. The purpose of this paper is to engage stakeholders in the identification of key issues that should be considered by the Commission as part of the Review. The Commission stresses that the purpose of this paper is not intended to limit the scope of the consultation; stakeholders are free to comment on any matter they see as relevant to the Review.

The Commission invites written submissions from all stakeholders on the proposed frameworks, and strongly encourages suggestions of changes that would enhance their effectiveness. As comments received in response to this Discussion Paper form an important input into the development of the regulatory frameworks, the Commission seeks the involvement of all stakeholders in this Review to ensure a wide range of views and experiences can be considered.

The Commission will consider all comments received and will prepare a Draft Report and Draft Price Determination for further public consultation in October 2012 before a Final Report and Final Price Determination is released in December 2012. The Final Price Determination will set out the Commission's final decisions on the precise forms of pricing principles/price monitoring regulatory frameworks.

⁴ Refer to <http://www.escosa.sa.gov.au/library/120713-EconomicRegulationOfSAWatersRevenue-StatementOfApproach.pdf>.

Discussion Paper

Proposed Price Regulation for Service Providers other than SA Water

The Commission will also be consulting with stakeholders during the submission process, and will be commencing dialogue with potential licensees within coming months, in preparation for the new regulatory regime.

The requirement to hold a licence for the provision of retail water services commences on 1 January 2013. The Commission's price determination, implementing the pricing principles/price monitoring framework, will apply from 1 July 2013.

The Commission recognises that the objectives of the WI Act, and the proposed price regulatory frameworks may, in some instances, represent a significant change of approach to current practices. Furthermore, it is recognised that the current pricing practice of some service providers may require the implementation of new processes and/or systems, and therefore, as a part of this Review, the Commission is considering appropriate transitional arrangements for price regulation.

An indicative timetable for this Review is set out below in Table 1-2 and Figure 1-1.

The views in this paper are not final, and the Commission welcomes feedback from stakeholders on the proposals herein, or any other matter that they see as relevant to this process. Details on how to make written submissions are provided at the beginning of this Discussion Paper.

Table 1-2: Proposed Timetable for the Review

ACTION	DATE
Release of Discussion Paper	13 July 2012
Public Consultation (6 weeks)	13 July - 24 August 2012
Draft Report and Draft Price Determination	12 October 2012
Public Consultation (4 weeks)	12 October - 9 November 2012
Final Report and Final Price Determination	21 December 2012
Licensing under the Water Industry Act commences	1 January 2013
Initial Price Regulation period (3 years) commences	1 July 2013

Discussion Paper

Proposed Price Regulation for Service Providers other than SA Water

Figure 1-1: Proposed Timetable for the Review and SA Water Price Regulation Process



2 PRICE REGULATION OF WATER SERVICES

2.1 *Nature of Services*

The WI Act defines retail services, water services and sewerage services as follows:

retail service means a service constituted by—

- a) the sale and supply of water to a person for use (and not for resale other than in prescribed circumstances (if any)) where the water is to be conveyed by a reticulated system; or
- b) the sale and supply of sewerage services for the removal of sewage,

sewerage service means—

- a) a service constituted by the collection, storage, treatment or conveyance of sewage through the use of a reticulated system; or
- b) any other service, or any service of a class, brought within the ambit of this definition by the regulations;

water service means—

- a) a service constituted by the collection, storage, production, treatment, conveyance, reticulation or supply of water; or
- b) any other service, or any service of a class, brought within the ambit of this definition by the regulations

Water and sewage are further defined in the WI Act as:

water includes rainwater, stormwater, desalinated water, recycled water and water that may include any material or impurities, but does not include sewage.

sewage includes any form of waste that may be appropriately removed or dealt with through the use of a sewerage service.

The WI Act also contains Ministerial designation power, which allows the Minister for Water to designate particular customers, services or classes of customers, as falling within the scope of the economic regulation framework.

At the time of preparing this paper, these designations had not been made. In the absence of formal designation, for the purposes of preparing the Final Advice, the Commission made assumptions as to which customers and which services are to be designated. These assumptions are reflected in Table 2-1. The Commission will proceed on these assumptions until formal designation has occurred.

Table 2-1: Commission’s Assumptions about Ministerial Designations of Retail Services, Customers and Classes of Customers

RETAIL SERVICE						
Water				Sewerage		
Drinking Water		Non-drinking Water (including Recycled Water and Stormwater)		Trade Waste	Other	
Residential	Non-residential	Residential	Non-residential	Non-residential	Residential	Non-residential

The water industry in South Australia is characterised by one large public provider, SA Water, and many smaller service providers, primarily based in regional or remote areas of the State. These small service providers provide a range of water and sewerage services as described in sections 2.1.1 to 2.1.4 below.

There are also a number of ancillary services that are offered by retail service providers which may be associated with any of the above classes of services or customers. These services are discussed further in section 2.1.5 of this paper.

2.1.1 Drinking Water

Approximately 96%⁵ of the State’s population receives drinking water from SA Water. The remaining population, mainly in regional or remote areas of the State, receives drinking water from Local Government, water carters, or directly from rainwater tanks.

SA Health estimates that there are approximately 600 service providers of drinking water services in the State (refer to Table 2-2). However, under the WI Act, the

⁵ National Water Commission (2012), National Performance Report 2010-11 Urban Water Utilities, <http://www.nwc.gov.au/publications/topic/urban/nprs-2010-11>, Accessed 10 May 2012.

majority of these services may not be considered retail services, as they are either not reticulated, or there is no consideration provided to the service provider by the customer for the provision of the water service. Where this is the case, these services will not be subject to price regulation by the Commission.⁶

Table 2-2: Drinking Water Service Provider Estimates– South Australia

SERVICE PROVIDERS	ESTIMATED NUMBERS
Large – SA Water	1
Independent town supplies	10
– Remote community/Aboriginal supplies	25
– SA Water and Outback Communities Authority	
Small supplies	
• B&B/Farmstay	200
• Other accommodation	300
• Schools	10
• Hospitals/care facilities	25
• Water carters	20
Total	600

Source: SA Health Department (2012), unpublished data.

2.1.2 Sewerage

Around 60% of the State’s population is supplied with sewerage services by SA Water. The rest of the population is served by a range of smaller service providers.

There does not appear to be a central register of sewerage service providers in South Australia, so the total number of service providers is not known. However, Local Government serves a significant portion of the State’s population (approximately 10%) through various forms of Community Waste Management Systems (CWMS)⁷.

⁶ Drinking water is subject to health regulation, by SA Health under the *Safe Drinking Water Act 2011*. That Act requires that drinking water is fit for purpose, and provides guidance on how this requirement can be achieved and how it can be measured.

⁷ Calculated from Local Government Association (LGA) CWMS data (2012) <http://www.lga.sa.gov.au/site/page.cfm?u=1117>, Accessed 2 April 2012.

A CWMS is a system designed to collect, treat, re-use and/or dispose of primary treated effluent from septic tanks on individual properties. The collection system typically comprises of a network of pipes and pumping stations which transport effluent from the septic tanks to the treatment site⁸.

Local Government currently operates 172 CWMSs in 45 Councils and authorities throughout the state (refer to Appendix B).

As submitted to the Commission through consultation on its Draft Advice on the Economic Regulation of the South Australian Water Industry (**Draft Advice**), local government representatives have noted that the provision of these retail services has often been a matter of necessity rather than a true commercial undertaking. However, for the purpose of price regulation under the WI Act, these services are retail services, and therefore may be subject to some form of price regulation.

Some properties, particularly in regional and remote parts of the State, have septic tanks that are periodically emptied by mobile tankers. As this type of an arrangement cannot be described as 'reticulated', it is not considered a retail service under the WI Act and is not in scope of the Commission's price regulation framework.

2.1.3 *Recycled Water and Stormwater*

As defined in the WI Act, and listed in Table 2-1, both recycled water and stormwater services are considered water services under the WI Act, not sewerage services. However, the WI Act does not provide a definition for these types of water.

Water for Good defines recycled water as water derived from sewerage systems, or stormwater drainage systems, which has been treated to a standard that is appropriate for its intended use.⁹ Based on this definition, stormwater is a type of recycled water.

In recent years in Australia, water recycling has increased as an alternative form of water supply due to a convergence of inter-related factors, such as concerns about climate change and below-average rainfall.

In South Australia, recycled water services are supplied by a number of different service providers (e.g. local councils and private operators) for both residential and non-residential uses. These services can be classified as either mandated or voluntary schemes (refer Box 2-1).

⁸ Refer to <http://www.lga.sa.gov.au/site/page.cfm?u=1113>

⁹ Water for Good (2009) p.186.

Box 2-1: Mandated and Voluntary Water Recycling Schemes

Mandated Schemes

Mandated schemes predominantly service new residential developments where recycled water is supplied through third-pipe developments. As the connection to these schemes is mandated, providers of these services have considerable market power, with the potential for misuse of that power in the absence of effective economic regulation.

An example of a mandated scheme in South Australia would be the Mawson Lakes development.

Voluntary Schemes

Voluntary schemes service customers who are connected to the recycled water at their discretion. As these customers are able to choose whether or not to connect to the recycled water network, it could be argued that the extent of market power is not as great as that observed for customers connected to mandated recycled water schemes.

The Commission understands that the prices charged for the provision of such services to non-residential customers are sometimes determined through commercial negotiation on an individual basis and, in some cases, are not set at a cost-reflective level.

An example of a voluntary scheme in South Australia would be the Seaford Meadows development.

According to data released by the National Water Commission (NWC), Metropolitan Adelaide has one of the highest rates of water recycling compared with other metropolitan centres.¹⁰

The Commission understands that most water recycling in the State is carried out by SA Water. In 2010/11, approximately 12% of the volume of water supplied by SA Water was recycled water.¹¹

The use of stormwater as a recycled water source has been increasing in recent years, and is a notable substitute to mains water, particularly in South Australia (refer to Figure 2-1).

¹⁰ National Water Commission (2012) *National Performance Report 2010-11 urban water utilities*, <http://www.nwc.gov.au/publications/topic/urban/npr-2010-11>, accessed 4 April 2012.

¹¹ National Water Commission (2012) *National Performance Report 2010-11 urban water utilities*, <http://www.nwc.gov.au/publications/topic/urban/npr-2010-11>, accessed 4 April 2012.

Figure 2-1: Volume of Captured Stormwater (ML) Used – Australian States and Territories



Source: Marsden Jacobs (2012)¹²

Stormwater can be considered as rainwater that enters the drainage system either by being collected off roofs in gutters and pipes, or by falling on paved areas such as driveways, roads and footpaths. In the past, stormwater has been considered wastewater because of potential contamination issues. It has mainly been managed by Local Government as runoff into the sea.¹³

There are a number of stormwater capture and reuse schemes currently in operation in South Australia. Some of these utilise the ‘aquifer storage and recovery’ technology (refer to Figure 2-2). A recent study estimated that existing and committed projects total approximately 18 GL per annum capacity, and that there is the potential for a further 48 GL per annum.¹⁴

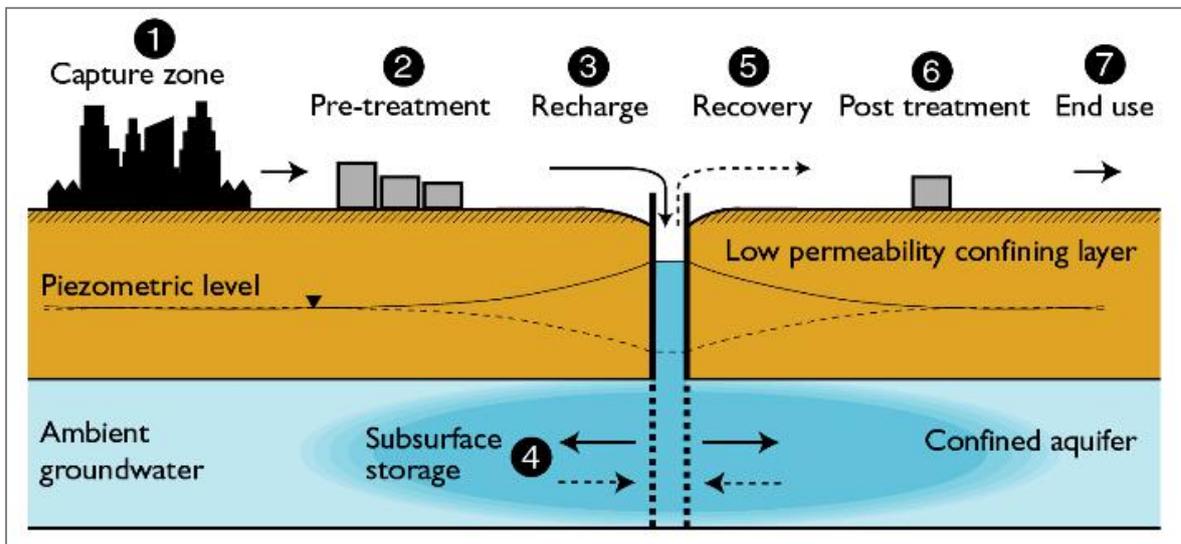
The Commission understands that most water recycling projects, other than those undertaken by SA Water, are carried out by Local Government. The Commission has prepared a list of recycled water schemes, based on information provided by SA Health and the Local Government Association (LGA)(refer to Appendix C).

¹² Marsden Jacobs (2012) *Progress against the national target of 30% of Australia’s wastewater being recycled by 2015*, <http://www.environment.gov.au/water/publications/urban/pubs/recycled-water-target-final-report.pdf>, Accessed 10 May 2012

¹³ Refer to <http://www.sa.gov.au/subject/Water,+energy+and+environment/Water/Water+resources+in+SA/Stormwater>.

¹⁴ Wallbridge and Gilbert (2009) *Urban Stormwater Harvesting Options Study*, <http://www.waterforgood.sa.gov.au/wp-content/uploads/2009/07/081266rep001.pdf>, Accessed 16 May 2012.

Figure 2-2: Aquifer Storage and Recovery Process



Source: *Water for Good* (2012)¹⁵

Onkaparinga, Salisbury, and Mt Barker councils are all significant suppliers of recycled and stormwater services. Box 2-2 provides a summary of Salisbury Council’s Water Business Unit which provides stormwater services to the community of the City of Salisbury.

Box 2-2: Salisbury Council Water Business Unit – Overview

Salisbury Council’s Water Business Unit (WBU) provides approximately 1,800 ML of water to customers through a range of projects that have been funded, in part, by a combination of State and Federal Government grants.

There are currently 3 methods by which the WBU provides water to the community:

1. Community Bores

Salisbury Council has 22 community bores. A combination of permanent licence allocations (e.g. purchased from Market Gardeners when their land is sold for development) and ‘traded credits’ are used to facilitate the sustainable licensed extraction from these bores. The bores are generally used to irrigate school grounds and sporting facilities in close proximity, with 600ML per annum supplied to users.

¹⁵ Water for Good (2012), *Stages of a Managed Aquifer Recharge (MAR) Scheme*, <http://www.waterforgood.sa.gov.au/stormwater-wastewater/managed-aquifer-recharge/stages-of-a-mar-scheme/>, Accessed 11 May 2012.

Water is currently distributed from community bores and provided to a school, 3 council reserves and over 150 homes in the Boulevard sub-development. At completion, it will supply over 800 homes in Parafield Gardens. The water is provided for garden watering and is connected only to toilets within the homes. This groundwater supply scheme, based on trade credits, is the only Salisbury project that currently supplies into homes.

2. Reclaimed Waste Water scheme at Mawson Lakes

This scheme supplies garden and toilet water to over 3,000 homes at Mawson Lakes. It is owned and operated by SA Water. The WBU role is to provide a bulk supply of wetland treated stormwater to the SA Water mixing tank at Mawson Lakes.

The stormwater is supplied from the Parafield Airport Aquifer Storage and Recovery (**ASR**) scheme. The low salinity stormwater is blended with the high salinity reclaimed effluent from the Dissolved Air Flotation Filtration (**DAFF**) plant at the Bolivar Waste Water Treatment Plant. SA Water chlorinate the reclaimed effluent at Bolivar, and again at Mawson Lakes, after the stormwater blending process.

3. Operational ASR schemes

Salisbury Council has 12 ASR schemes in operation or under construction.

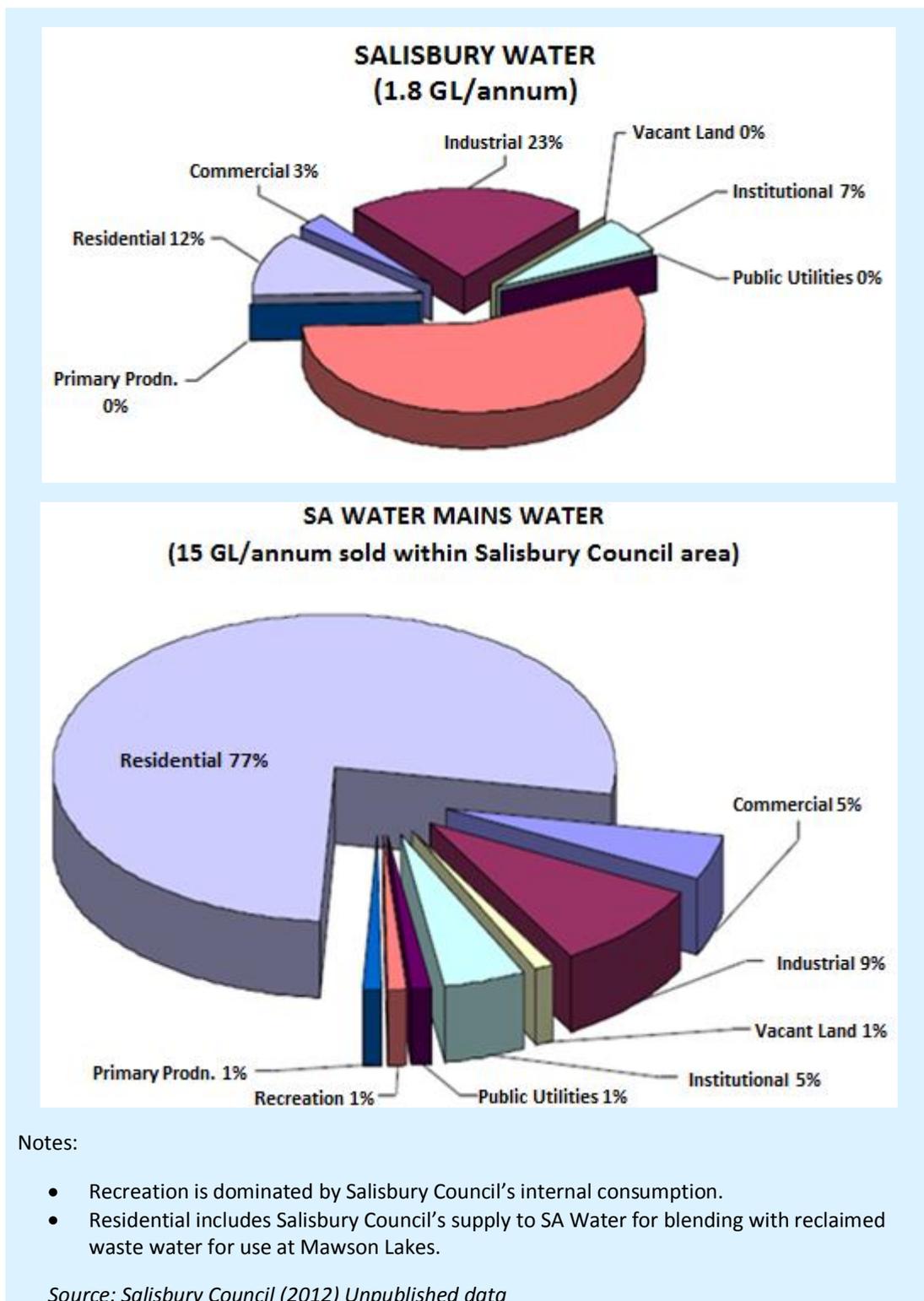
In the wet season, stormwater run-off from the catchment is slowed and detained by weirs and in-stream basins. Gross pollutants, litter and silt are removed in purpose designed traps and sedimentation basins. The raw water is percolated slowly through constructed wetland beds, where physical and biological processes cleanse the water. When the water is tested and meets EPA Licence quality criteria, it is pumped (injected) into wells drilled into the aquifer.

In the dry season, submersible down-well pumps are operated at steady flow rates to raise the water into above ground buffer storage tanks. Multi-pump distribution pumping stations feed into a 'purple-pipe' reticulation network to meet customer demand.

Source: Salisbury Council (2012) Unpublished

Customers:

The diagram below provides a break-down of Salisbury Council's typical water sales into different customer categories, and compares this with mains water use in Salisbury Council.



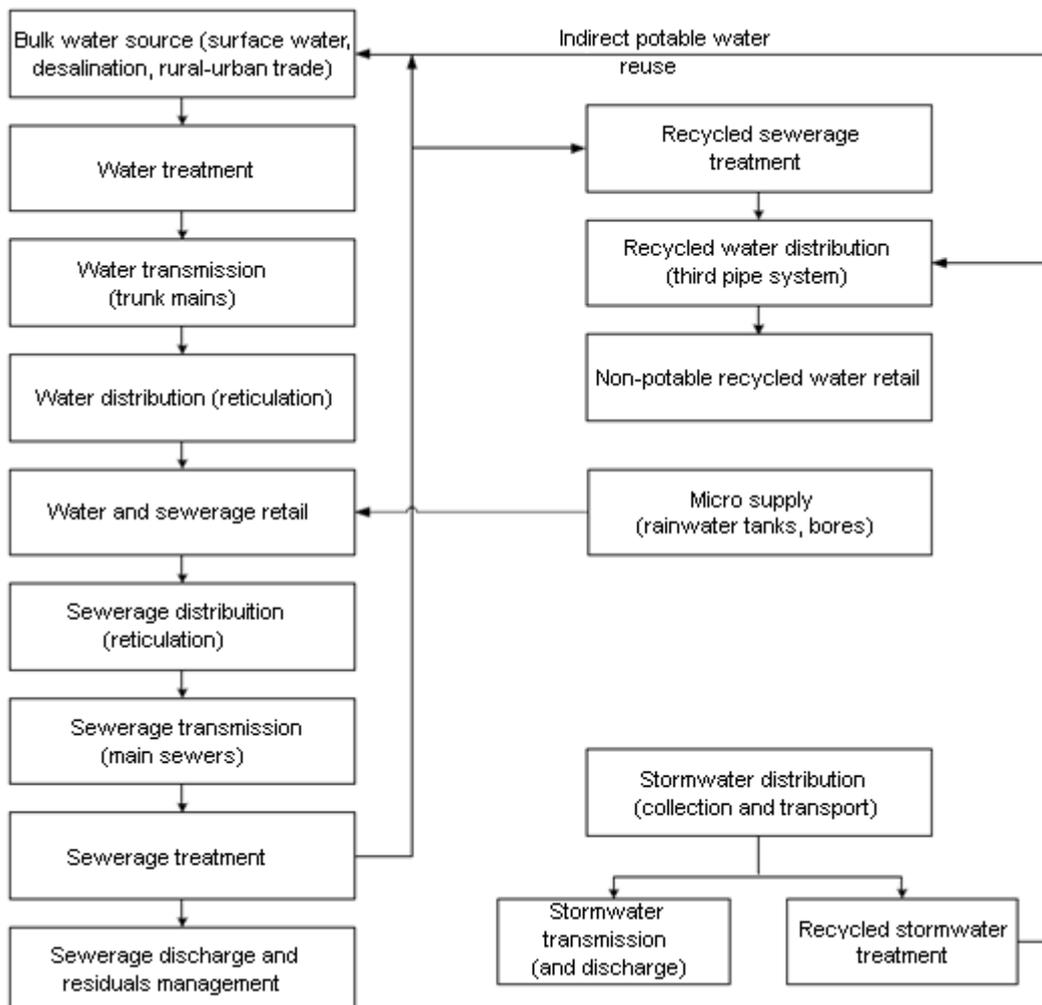
Although the technology and treatment methods may be different between stormwater and recycled water, the Commission proposes to treat these services in a consistent manner for the purpose of price regulation.

However, for the purpose of price regulation under the WI Act, the Commission has excluded stormwater services provided solely for the provision of flood mitigation, as these services do not constitute a retail service as described under the WI Act.

Where a relevant operation includes both a retail and flood mitigation component, the point at which infrastructure stops serving the purpose of flood mitigation and starts providing the retail service will ultimately be a matter to be determined by the Commission through its licensing process. Only the retail component would be subject to the requirements of Part 4 of the legislation.

In reality, the supply chain of a water service provider may be a complex matter (refer to Figure 2-3).

Figure 2-3: Supply chain for Water and Sewerage Services



Source: Productivity Commission (2011) *Australia’s Urban Water Sector – Inquiry Report, No. 55, 31 August 2011.*

2.1.4 *Other Non-Drinking Water*

In addition to recycled stormwater and recycled wastewater, there are various other non-drinking water operations in South Australia, provided by different operators. The quality of such water services is of non-drinking standard, but can be used for other purposes (e.g. washing).

The Commission is aware that non-recycled, non-drinking water is being provided to residents at Skye in the Adelaide hills, and to various outback and regional communities. The Commission understands that a relatively very small number of customers (estimated at less than 1,500 in total) receive these services across the State.

These operations are provided under various legislative, contractual, and ownership arrangements.

Where these water services can be described as being sold or supplied to customers for use through a reticulated system, these services may be considered a water retail service under the WI Act.

2.1.5 *Other Related Water and Sewerage Services*

There is also a number of ancillary services that are offered by retail service providers that may be associated with any of the above classes of services, or their associated customers. For example, some retail service providers offer meter readings and inspections for a fee.

The Commission understands that certain legislative and regulatory frameworks outside of the Water Industry Act may impact the setting of these fees.

For example, there may be specific regulatory changes that will impact Local Government from the Technical Regulation reforms to be implemented as a part of the WI Act, and the forthcoming *Public Health Wastewater Regulations 2012*. These may impact the fee setting arrangements (e.g. for administrative, regulatory and enforcement functions) for Local Government water industry service providers.

Price regulation for these services will need to take these regulatory and legislative developments into account.

3 PRICING PRINCIPLES

3.1 Existing Pricing Practices

3.1.1 Drinking Water

Section 155 (1)(a) of the *Local Government Act 1999 (LG Act)* provides the relevant powers for Local Government to price for water services (drinking and non-drinking). It does not preclude, however, Local Government from entering into commercial agreements with customers for the provision of such services.

The Commission understands there is a range of pricing practices currently employed by other service providers other than SA Water. The Commission seeks to better understand the advantages and limitations of these pricing practices, and invites comments from relevant parties, including providers of these services and their customers.

Issue 3.1

- ▲ **What are the advantages and limitations of current pricing practices for providers of drinking water services (excluding SA Water)?**

3.1.2 Sewerage

Section 155 (1)(b) of the LG Act also allows Local Government to apply a service charge or a service rate (or a combination of both) to establish, operate, maintain, improve and replace a CWMS over the full duration of its life.

A service charge encompasses the principle of 'user pays' or 'fee for service' and is applied equally to all properties that receive the service. A service rate, on the other hand is calculated based on the value of the land. This is a similar methodology to that used by Local Government for general rates or by SA Water for its sewerage rates. Appendix D provides further detail of the pricing practices for Local Government CWMS.

In addition to sewerage services offered by Local Government, there are sewerage services provided by other service providers to outback communities in the State. The Commission understands that the pricing arrangements vary substantially amongst these service providers, with a broad range of sophistication in pricing practices employed, largely as a result of varying agreements, ownership models, legislation, funding arrangements, and customer capacity to pay.

Issue 3.2

- ▲ **What are the advantages and limitations of current pricing practices for providers of sewerage services (excluding SA Water)?**

3.1.3 *Recycled Water and Stormwater*

Section 155 (1)(a) of the LG Act also provides the power for Local Government to charge for recycled water and stormwater services. Appendices E-G summarise the pricing practices of three of the largest non-SA Water providers of these services in the State, beyond SA Water (Salisbury, Mt Barker and Onkaparinga councils).

As can be seen, there is a range of practices between these service providers. For example, Salisbury has some unmetered customers, Onkaparinga links the price of recycled water to SA Water's potable water price, and Mt Barker provide rebates for certain customers.

Recognising the different pricing practices employed by recycled water and stormwater service providers, the Commission seeks to better understand the details of these practices, including the advantages and limitations of the different approaches. The Commission therefore invites comments from relevant parties, including providers of these services and their customers.

Issue 3.3

- ▲ **What are the advantages and limitations of current pricing practices for providers of recycled water and stormwater services (excluding SA Water)?**

3.1.4 *Other Non-Drinking Water*

In addition to non-drinking water services offered by Local Government, there is a number of non-drinking water services provided by other service providers to outback communities in the State.

The Commission understands that the pricing arrangements vary substantially amongst these service providers, with a broad range of sophistication in pricing practices employed, largely as a result of varying agreements, ownership models, legislation, funding arrangements and customer capacity to pay.

For example, the Commission is aware of certain arrangements that exist for the provision of non-drinking water to residents at Skye, east of Adelaide. There are five companies that are involved in the reticulation and sale of water to residents, with many of the residents being shareholders in the companies. This arrangement has been described to the Commission as "self-supply", with the costs of the scheme being shared amongst the shareholding residents. The Commission will be

liaising with the relevant service providers at Skye to better understand the arrangements currently in place, and to discuss the application of the Commission's price regulation role under the WI Act to the operations at Skye.

Noting the various existing pricing practices for non-drinking water services, the Commission seeks comments from relevant parties, including providers of these services and their customers.

Issue 3.4

- ▲ **What are the advantages and limitations of current pricing practices for providers of other non-drinking water services (excluding SA Water)?**

3.1.5 *Other Related Water and Sewerage Services*

The Commission understands that certain legislative frameworks outside of the WI Act may impact the setting of prices for a number of ancillary services that are offered by retail service providers (e.g. the *Public Health Regulations 2012*).

Having regard to these legislative frameworks, the Commission seeks further feedback on how existing, or emerging legislative and regulatory arrangements may affect the price regulation of these 'other related water and sewerage services' as proposed in this Discussion Paper.

Issue 3.5

- ▲ **What are the advantages and limitations of current pricing practices for the other related water and sewerage services?**
- ▲ **What relevant legislative and regulatory matters should the Commission have regard to in the price regulation of these services?**

3.2 *Proposed Pricing Principles*

3.2.1 *The National Water Initiative Pricing Principles*

The South Australian Government is a signatory to the NWI, which was agreed to in 2004 by the Council of Australian Governments (**COAG**). The NWI includes a number of reforms which aim to increase the efficiency of Australia's water use, and lead to greater certainty for investment and productivity. Under paragraph 64 of the NWI agreement, governments have made commitments to best practice water pricing including to:

- promote economically efficient and sustainable use of:
 - water resources;
 - water infrastructure assets; and
 - government resources devoted to the management of water.
- ensure sufficient revenue streams to allow efficient delivery of the required services;
- facilitate the efficient functioning of water markets, including inter-jurisdictional water markets, and in both rural and urban settings;
- give effect to the principle of user-pays and achieve pricing transparency in respect of water storage and delivery in irrigation systems and cost recovery for water planning and management; and
- avoid perverse or unintended pricing outcomes.

In 2010 a set of pricing principles to assist the States and Territories meet their obligations under the NWI was developed by a Steering Group on Water Charges and agreed to by Australian governments. Governments agree that if a decision was made not to apply these principles in a particular case, the reasons for this would be tabled in parliament.

These four sets of principles include principles for:

- recovering capital expenditure;
- setting urban water tariffs;
- recovering the costs of water planning and management; and
- the pricing of recycled water and stormwater reuse

A list of these principles is included in Box 3.1. The full set of pricing principles is included in Appendix H.

As stated in section 1.2, the draft Pricing Order issued to the Commission on 22 June 2012 requires the Commission to comply with these NWI Pricing Principles, other than the principles for recovering the costs of water planning and management activities. The Commission has therefore applied these directly to its proposed price regulation framework for service providers other than SA Water.

3.2.2 *Interpreting the Principles*

The NWI Pricing Principles are not structured exactly according to the type of services in the Commission's Final Advice, or as described in chapter 2 of this paper. The remainder of this section includes the Commission's proposals for how it will apply these principles to these services.

The Commission recognises that there may be instances where the application of these principles provides insufficient coverage for the services discussed in chapter 2, or instances where the application of these principles should not occur. These are discussed in the following sections of this chapter.

Box 3-1: NWI Pricing Principles

1. RECOVERY OF CAPITAL EXPENDITURE

- Principle 1: Cost recovery for new capital expenditure
- Principle 2: Valuation of new assets
- Principle 3: Valuation of legacy assets
- Principle 4: Recovery of legacy capital expenditure
- Principle 5: Rolling forward asset values after the legacy date
- Principle 6: Contributed assets

2. SETTING URBAN WATER TARIFFS

- Principle 1: Cost recovery
- Principle 2: Tariff structures
- Principle 3: Cost reflective tariffs
- Principle 4: Setting the service availability charge
- Principle 5: Pricing transparency
- Principle 6: Over recovery of revenue
- Principle 7: Differential water charges
- Principle 8: Setting developer charges
- Principle 9: Capping developer charges
- Principle 10: Revenue from developer charges

3. RECOVERING COSTS OF WATER PLANNING AND MANAGEMENT ACTIVITIES

- Principle 1: Water planning and management activities
- Principle 2: Government activities
- Principle 3: Cost-effectiveness test
- Principle 4: Cost allocation

- Principle 5: Differentiation of costs
- Principle 6: Community Service Obligations

4. RECYCLED WATER AND STORMWATER USE

- Principle 1: Flexible regulation
- Principle 2: Cost allocation
- Principle 3: Water usage charge
- Principle 4: Substitutes
- Principle 5: Differential pricing
- Principle 6: Integrated water resource planning
- Principle 7: Cost recovery
- Principle 8: Transparency
- Principle 9: Gradual approach

Furthermore, the Commission recognises that the consistent application of all the NWI principles may result in trade-offs, as some of the principles appear to 'compete' or 'over-ride' each other. For example, applying a commercial rate of return for recycled water assets may discourage the use of recycled water, which has been identified by governments as an attractive, non-climate dependent, source of water.

In the application of these principles, the Commission will therefore be guided by the following:

- Achievement of the various factors specified in section 6 of the ESC Act, in particular the need to ensure that the long-term interests of consumers with respect to price, reliability and quality of supply are served;
- The intent of the NWI, in particular, paragraph 64 of the agreement that deals with pricing reform commitments; and
- Consistency with other regulatory regimes, in South Australia and other jurisdictions.

Finally, it is the Commission's view these principles should not overshadow the ability for a recycled water service provider to enter into commercial negotiations with a customer, providing certain conditions are met that ensure the long term interest of consumers (e.g. the efficient costs of providing the service are recovered).

3.2.3 *Drinking Water*

The Commission considers the NWI Principles in Box 3-2 to be relevant in the consideration of drinking water services.

The Commission does, however, feel that care needs to be taken in interpreting and applying these principles. Some of the pricing principles appear to be focused on large, monopoly service providers, and their application to smaller service providers requires careful thought.

The following explains some of the key points of these principles in more detail.

Box 3-2: NWI Pricing Principles for Drinking Water

1. RECOVERY OF CAPITAL EXPENDITURE

- Principle 1: Cost recovery for new capital expenditure
- Principle 2: Valuation of new assets
- Principle 3: Valuation of legacy assets
- Principle 4: Recovery of legacy capital expenditure
- Principle 5: Rolling forward asset values after the legacy date
- Principle 6: Contributed assets

2. SETTING URBAN WATER TARIFFS

- Principle 1: Cost recovery
- Principle 2: Tariff structures
- Principle 3: Cost reflective tariffs
- Principle 4: Setting the service availability charge
- Principle 5: Pricing transparency
- Principle 6: Over recovery of revenue
- Principle 7: Differential water charges
- Principle 8: Setting developer charges
- Principle 9: Capping developer charges
- Principle 10: Revenue from developer charges

3.2.3.1. *Recovery of Capital Expenditure*

Capital expenditure constitutes the major proportion of costs recovered through water charges. Capital expenditure includes expenditure for replacement of existing assets, and expenditure to expand the stock of assets to meet increases in demand, meet required service standards, and any to meet changes in regulatory obligations.

The NWI pricing principles for the recovery of capital expenditure are based on COAG pricing principles, and provide for the use of a renewals annuity to fund future asset refurbishment/replacement (lower bound pricing), and a return of, and on, capital to reflect the cost of asset consumption and cost of capital (upper bound pricing).¹⁶

It is important for all water retailers, regardless of size and scale, to ensure that prices are sufficient to ensure that the costs of future capital expenditure can be recovered. A failure to do so may result in:

- A requirement to subsidise these costs from elsewhere in the business (e.g. in the case of Local Government, from general rates) and/or;
- Insufficient investment, threatening the future viability of the service.

One way to ensure this principle is met is through the ‘annuity approach’. The annuity approach forecasts asset replacement and growth costs over a fixed period and converts these to a future annualised charge. The annuity approach is commonly applied to provide the cash requirements needed to renew non-financial assets over a medium to long-term time period.

The Commission understands that a number of water and sewerage assets in the State are ‘contributed assets’ (i.e. grants/gifts from governments and contributions from customers (e.g. developer charges)). The NWI Pricing Principles for the recovery of capital expenditure provide specific guidance on how these assets should be treated to ensure only appropriate costs are recovered from customers (refer to Principle 6).

¹⁶ It is common in utility regulation to establish explicit pricing principles to set upper and lower bounds of prices. The purpose of this principle is to ensure that all prices are subsidy free (i.e. there are no cross subsidies between customer classes or between different tariffs offered within a customer class) and to avoid incentives for the inefficient bypass of regulated infrastructure. This principle is also relevant to the costs allocated and the revenue expected to be collected from various services (e.g. recycled water versus potable water services). Refer to <http://www.esc.vic.gov.au/getattachment/bc3cc70b-692a-4287-814c-b7c4c26adf9d/Issues-Paper-tariff-issues-for-water-price-review.pdf>.

3.2.3.2. *Setting Urban Water Tariffs*

These NWI principles are developed for situations where there are *large monopoly* water service providers and an absence of water trading and associated competitive pressures to bring about efficient levels of cost recovery and associated tariff structures. The NWI pricing principles only apply to ‘urban’ water service providers, although a definition of urban is not provided.

Although various methodologies exist, charging structures adopted by water businesses (urban or regional) should generally comprise a service availability charge and a water usage charge¹⁷, with the service availability charge determined as the residual component to be recovered to meet the revenue requirement after the revenue from water usage charges has been estimated. The NWI principles state that, generally, the practice of large water service providers (i.e. the metropolitan water providers) is to set the usage component of the charge with reference to the ‘long run marginal cost’ (LRMC) of supply.¹⁸ Principle 3 of the Setting Urban Water Tariffs principles states that the water usage charge should have regard to the LRMC.

Water charges should be differentiated by the cost of servicing different customers (e.g. on the basis of location and service standards) where there are benefits in doing so and where it can be shown that these benefits outweigh the costs of identifying differences, and the equity advantages of alternatives.

Water charges may also include up-front developer charges to signal the infrastructure cost of servicing new developments or additions/changes to existing developments.

3.2.3.3. *Cost Recovery*

Water businesses should be moving to recover efficient costs consistent with the NWI definition of the upper revenue bound (for urban water businesses) or the lower revenue bound (for rural and regional water businesses), consistent with paragraph 66 of the NWI.

The terms upper and lower bound pricing are defined in Schedule B(i) of the NWI respectively as:

“the level at which, to avoid monopoly rents, a water business should not recover more than the operational, maintenance and administrative costs, externalities, taxes or tax equivalent regimes, provision for the cost of asset consumption and cost of capital, the latter being calculated using a weighted average cost of capital.”

¹⁷ On economic efficiency grounds the water usage charge should comprise only a single usage charge.

¹⁸ The LRMC can be defined as the cost attributable to an extra permanent unit of consumption in bringing forward the future capital program.

and

“the level at which, 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. Dividends should be set at a level that reflects commercial realities and stimulates [sic] a competitive market outcome.”

3.2.3.4. Setting the Service Availability Charge

These NWI Pricing Principles also provide guidance on setting the service availability charge. In accordance with the principles, the revenue recovered through the service availability charge should be calculated as the difference between the total revenue requirement, as determined in accordance with Principle 1 and the revenue recovered through water usage charges and developer charges (refer to principles 8-10).

The service availability charge could vary between customers or customer classes, depending on service demands and equity considerations. Unattributable joint costs should be allocated such that total charges to a customer must not exceed stand-alone cost, or be less than avoidable cost, where it is practicable to do so.

3.2.3.5. Pricing Transparency

These NWI principles also state that 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.

Chapter 4 of this paper discusses the Commission’s proposed price monitoring framework, which is intended to introduce greater transparency to water pricing.

3.2.3.6. Setting Developer Charges

In the Commission’s Draft Advice, the Commission noted the difference between services that should be shared between all users and funded through water and sewerage prices, and other services which may be provided for the benefit of only a few customers. Developer charges fit within this latter category.

The NWI Pricing Principles state that developer charges should reflect the investment in both new and existing assets required to serve a new development, and have regard to the manner in which ongoing water usage and service availability charges are set. Principles 8-10 of this set of principles deal with the treatment of developer charges.

Issue 3.6

- ▲ **How do the NWI Pricing Principles for Setting Urban Water Tariffs align with current pricing practices for providers of retail drinking water services (excluding SA Water)?**
- ▲ **Are there any impediments to applying these NWI Pricing Principles from 1 July 2013?**
- ▲ **Are there any other relevant factors the Commission should take into account in considering *these pricing principles*?**

3.2.4 Sewerage

The NWI principles only apply to capital expenditure incurred in the provision of water services. They do not cover sewerage services. The Commission is unaware of the reason for excluding sewerage services from these principles.

A number of the NWI pricing principles appear to be relevant to sewerage services, and the Commission considers it appropriate that consistency in price regulation between the regulated services should be promoted where practical.

Therefore, the question for the Commission is: what NWI pricing principles should be adopted for sewerage services? The Commission has considered this, and proposes that the pricing principles in Box 3-3, which are similar to those for drinking water services, should be adopted.

The following explains some of the key points of these principles in more detail.

Box 3-3: NWI Pricing Principles for Sewerage Services

1. RECOVERY OF CAPITAL EXPENDITURE

- Principle 1: Cost recovery for new capital expenditure
- Principle 2: Valuation of new assets
- Principle 3: Valuation of legacy assets
- Principle 4: Recovery of legacy capital expenditure
- Principle 5: Rolling forward asset values after the legacy date
- Principle 6: Contributed assets

2. URBAN WATER TARIFFS

- Principle 1: Cost recovery
- Principle 4: Setting the service availability charge
- Principle 5: Pricing transparency
- Principle 6: Over recovery of revenue
- Principle 7: Differential water charges
- Principle 8: Setting developer charges
- Principle 9: Capping developer charges
- Principle 10: Revenue from developer charges

The arguments for applying the above principles to sewerage services are, essentially, the same as they are for water, although the transition to cost reflective sewerage tariffs is probably more complex than it is for drinking water tariffs, given existing practices.

With respect to capital expenditure, it is equally important that appropriate capital costs are recovered from customers of sewerage services, as it is that these costs are recovered for water services. The Commission, therefore, proposes that all the principles relating to recovery of capital expenditure for water services should also apply to sewerage services.

With respect to sewerage tariffs, the Commission notes that the current practice amongst sewerage service providers is often to price these services according to property values. The Commission will be examining the appropriateness of property based sewerage charges as a part of an inquiry to be conducted in 2013, and, therefore, this practice will not be subject to consideration for this pricing period. As such, only the pricing principles that are congruent with property-based charging have been proposed by the Commission.

Issue 3.7

- ▲ **How do the proposed NWI Pricing Principles for sewerage services align with current pricing practices for providers of these services (excluding SA Water)?**
- ▲ **Are there any impediments to applying these NWI pricing principles from 1 July 2013?**
- ▲ **Are there any other relevant factors the Commission should take into account in considering these pricing principles?**

3.2.5 *Recycled Water and Stormwater Use*

Pricing for recycled water and stormwater needs to take into account a number of complex, and at times competing, factors. For example:

- recycled and stormwater projects often receive significant government funding. This is often for the initial capital only, with the operating costs to be borne by the schemes 'beneficiaries', which are often not directly apparent¹⁹;
- water recycling and stormwater harvesting have been heavily promoted by Governments as a favourable water supply option, to avoid system augmentation and for environmental reasons (e.g. to reduce demand on other water sources); and
- recycled water and stormwater can be direct substitutes for non-potable mains water, which can at times be less expensive to produce²⁰.

Similar to the Commission's Final Advice, the NWI states that light handed and flexible regulation (including use of pricing principles) is preferable, as it is generally more cost-efficient than formal regulation. However, formal regulation (e.g. establishing maximum prices and revenue caps to address problems arising from market power) should be employed where it will improve economic efficiency.

In its Final Advice, the Commission proposed to treat mandated and voluntary water recycling schemes differently, given the differences in the potential for abuse of market power between the two types of schemes.

Whilst a distinction is not made in the NWI Pricing Principles between the two types of schemes, the Commission still proposes to treat mandated schemes differently with respect to the price monitoring regime (refer to chapter 4 for details).

Within the intent of NWI Pricing Principle 1 of this set of principles, the Commission will still consider the degree to which market power is being used, and may still propose to apply a price monitoring approach to mandated schemes.

¹⁹ For example, the Commission understands that, of the current CWMS recycling projects underway or approved, 25% of the capital costs have been funded from either State or Federal Government.

²⁰ There has been some concern raised by other water retailers that the costs that are directly attributable to providing recycled water outweigh the revenue received by the retailers for those services. Refer to Victoria ESC (2009) *Metropolitan Melbourne Water Price Review 2009*, p.102-103., <http://www.esc.vic.gov.au/getattachment/f3f8deaa-d639-45e3-a5ec-af64c9654434/Final-Decision-Metropolitan-Water-Price-Review-200.pdf>.

The Commission considers the NWI Pricing Principles in Box 3-4 relevant in the consideration of these services. These principles are intended to assist States and Territories in meeting their commitments under paragraph 66 (ii) of the NWI. This paragraph states that recycling and stormwater pricing policies should be congruent with pricing policies for potable water, and stimulate efficient water use no matter what the source. It also states, that it is not expected that these principles should be applied to prices retrospectively.

The following explains some of the key points of these principles in more detail.

Box 3-4: NWI Pricing Principles for Recycled Water and Stormwater

4. RECYCLED WATER AND STORMWATER USE

- Principle 1: Flexible regulation
- Principle 2: Cost allocation
- Principle 3: Water usage charge
- Principle 4: Substitutes
- Principle 5: Differential pricing
- Principle 6: Integrated water resource planning
- Principle 7: Cost recovery
- Principle 8: Transparency
- Principle 9: Gradual approach

3.2.5.1. Cost Allocation

When allocating costs, a beneficiary pays approach — typically including direct user pay contributions — should be the starting point, with specific cost share across beneficiaries based on the scheme’s drivers (and other characteristics of the recycled water/stormwater reuse scheme).

To further assist recycled water and stormwater service providers, on the principle of allocating costs, the Commission proposes the following:

- Where the recycled water service is the lowest cost method of disposal, costs should be paid by sewerage customers;
- Where the users are industrial, agricultural or municipal customers, costs should be paid by the beneficiaries of the service; and

- Where the recycled water service is discretionary, the costs should be paid by the water provider's customer base, provided they have demonstrated willingness to pay (**WTP**).²¹

As per the definition of recycled water used by the Commission in section 2.1.3 of this paper, in considering cost allocation for recycled water services, it is important to consider any relevant sewerage infrastructure that relates to that service.

3.2.5.2. Cost Recovery

With respect to cost recovery, the NWI Pricing Principles state that prices should recover efficient, full direct²² costs — with system-wide incremental costs (adjusted for avoided costs and externalities) as the lower limit, and the lesser of stand-alone costs and customer's WTP as the upper limit. Any full cost recovery gap should be recovered with reference to all beneficiaries of the avoided costs and externalities. Subsidies and Community Service Obligation (**CSO**) payments should be reviewed periodically and, where appropriate, reduced over time.

3.2.5.3. Water Usage Charge

This NWI Pricing Principles state that prices should contain a water usage (i.e. volumetric) charge.

The Commission notes that Salisbury Council charges a fixed charge price for small (less than 300m²) residential properties where it is considered uneconomical to supply and read meters.

Whilst the Commission has not yet formed a view whether Salisbury Council's approach is appropriate in this instance, it would seem that the approach is inconsistent with Principle 3 of the Recycled Water and Stormwater Reuse set of principles.

The Commission notes that a requirement for a usage charge in Principle 3 of the Recycled Water and Stormwater Reuse set of principles is broadly consistent with Principle 2 of the Setting Urban Water Tariffs principles (Tariff Structures). However, adherence to Principle 2 does not need to occur if it is demonstrated to not be cost effective (refer to Appendix H).

²¹ The NWI Pricing Principles state that the willingness of water users to pay for water is determined either by the profitability of the output derived from its use, whether agricultural or industrial, or from the value derived from household use, or by the value derived from its environmental use.

²² Direct costs include any joint/common costs that a scheme imposes, as well as separable capital, operating and administrative costs. This definition of direct costs does not include externalities and avoided costs.

The Commission proposes that, for reasons of consistency, this proviso be applied to Principle 3 of the Recycled Water and Stormwater Reuse for consistency. This does not change the intent of the principle, as the default position will be a requirement for a water usage charge to be applied. If a recycled water/stormwater provider chooses not to apply a usage charge, they must demonstrate, to the satisfaction of the Commission, why such a charge would not be cost effective.

3.2.5.4. Substitutes

These NWI Pricing Principles also state that consideration of the price of substitutes (potable water and raw water) may be necessary when setting the upper bound of a price band. The Commission notes that this practice is adopted by the City of Onkaparinga, as highlighted in its pricing principles (Appendix G).²³

This is a complex matter, and one that has caused tensions between stakeholders and retailers. For example, retailers and users of recycled water have argued that recycled water should be priced lower than potable water, on the basis that recycled water is an inferior product, due to its lower quality. However, there are potentially other benefits in using recycled water that relate to its substitutes that may need to be taken into account, such as security of supply. Box 3-5 below highlights the Victorian Essential Services Commission's (ESCV) recent view on this particular relationship.

Box 3-5: Victorian Essential Services Commission Treatment of Recycled Water in Relation to Potable Water

While there are restrictions, the incentives to use recycled water may be different (if supported by the appropriate policy setting) which may justify some linkage to the price for recycled water prices.

For example, while water restrictions are in place, third pipe customers receive a clear benefit from being able to use recycled water for outdoor uses that are restricted for customers without access to recycled water. In the absence of water restrictions, households (without access to recycled water) that use water for outdoor uses such as garden watering, would generally use sufficient water to fall into the second tier of the usage charges for potable water in that state. Additionally, for customers who have plumbed recycled water indoors (for toilet flushing), it serves to reduce the customer's use of potable water.

²³ The Commission has been advised that, at the time the City of Onkaparinga prepared its Pricing Policy, that the NWC had stated that the price for recycled water/stormwater should be based on 70% and 80% of mains water respectively. This position is not currently held by the NWC.

Taking these factors into account, the Victorian ESC has stated proposed prices for recycled water should represent a benefit to customers while restrictions are in place.

Water restrictions are expected to be eased during the coming regulatory period (although they are not forecast to be removed until after 2012). As restrictions are eased, the benefits of using recycled water will diminish because households will be able to use potable water in a less restricted manner. To ensure that customers will continue to have sufficient incentive to continue using recycled water, the Victorian ESC will require the businesses to revise their recycled water tariffs as restrictions are eased during the coming regulatory period. The Commission will also require the businesses to develop a full pricing strategy.²⁴

3.2.5.5. Differential Pricing

Pricing structures should be able to reflect differentiation in the quality or reliability of water supply. Customers may assign a lower value to sources of water which possess a lower level of reliability or quality. Furthermore, differential pricing could be considered where the cost of providing consumers in various locations is substantially different to other users. Where these services are provided by operators at an increased (or decreased) cost, consistent with the principle of cost reflectivity, prices should reflect this.

3.2.5.6. Integrated Water Resource Planning

The NWC pricing principles also refer to integrated resource water planning (IWRP)(Principle 6). IWRP relates to the idea that alternative water supply options can be utilised to balance demand and supply and consequently, minimise system-wide costs. This, for example, includes demand-side options such as water efficiency measures or supply-side options such as providing recycled water as an alternative to potable water.

Essentially IWRP attempts to identify the optimal portfolio of options available to a supplier to satisfy the demand of its customers at the lowest possible social and environmental cost. In practice this will entail considering all direct and indirect costs and benefits of the available, or potentially available, options and ranking them in order of economic cost.

Recycled water can be an important part of an IWRP approach. Where appropriate, prices should reflect its role in balancing supply and demand. For example, the utilisation of a recycled water system may lead to a decrease in demand on the water and sewerage infrastructure systems. In turn, this

²⁴ Refer to <http://www.esc.vic.gov.au/getattachment/f3f8deaa-d639-45e3-a5ec-af64c9654434/Final-Decision-Metropolitan-Water-Price-Review-200.pdf>.

mitigates or delays the need for augmentation of current systems and, therefore, the capital expenditure associated with that augmentation. It is also clear that the costs associated with providing recycled water are costs that would be incurred when providing other water or sewerage services. It is important that prices reflect these and other identifiable benefits.

3.2.5.7. Transparency

The NWI principles also state that prices should be transparent, understandable to users, and published, to assist efficient choices. This is consistent with the Commission's Final Advice, which proposed a price monitoring regime for mandated recycled water services.

However, a distinction between mandated water recycling schemes and voluntary water recycling schemes is not made in the NWI. This principle therefore applies to all recycled water/stormwater schemes.

3.2.5.8. Transitional Considerations

It is the Commission's intention to develop a standard set of Pricing Principles that should apply to all recycled water and stormwater service providers in the first instance.

However, the Commission recognises that the application of these recycled water and stormwater principles may represent a significant deviation from the current practice of certain service providers, and that time may be needed for consumers of those services to adjust to new prices and price structures that may arise as a result of applying these principles.

Principle 9 of the Recycled Water and Stormwater Pricing Principles recognises this, and states that prices should reflect a strategy of 'gradualism', to allow consumer education and time for the community to adapt.

The Commission expects water service providers to demonstrate how they have considered this strategy in developing their prices, to ensure compliance against this pricing principle.

Issue 3.8

- ▲ How do the proposed NWI Pricing Principles for recycled water and stormwater services align with current pricing practices for providers of those services?**
- ▲ Are there any impediments to applying these NWI Pricing Principles from 1 July 2013?**

- ▲ **Over what period should a ‘gradualism’ approach to moving prices to comply with NWI Pricing Principles, be implemented?**
- ▲ **Are there any other relevant factors the Commission should take into account in considering the NWI Pricing Principles?**

3.2.6 *Other Non-Drinking Water*

In its Final Advice, the Commission indicated that it would adopt a pricing principle approach to other non-drinking services. The NWI Pricing Principles do not explicitly apply to these services.

In the consideration of pricing principles to adopt for other non-drinking water services, the Commission has been guided by the matters referred to in section 3.2.2.

To promote consistency in the regulatory framework the Commission has considered adopting relevant NWI pricing principles, and has referred to the intent of paragraph 64 of the NWI. The Commission therefore proposes pricing principles for other non-drinking services that:

- promote economically efficient and sustainable use of water infrastructure assets;
- ensure sufficient revenue streams to allow efficient delivery of the required services;
- avoid perverse or unintended pricing outcomes.

To this end, the Commission proposes that the following NWI Pricing Principles should apply to other non-drinking water services:

1. RECOVERY OF CAPITAL EXPENDITURE

- Principle 1: Cost recovery for new capital expenditure
- Principle 2: Valuation of new assets
- Principle 3: Valuation of legacy assets
- Principle 4: Recovery of legacy capital expenditure
- Principle 5: Rolling forward asset values after the legacy date
- Principle 6: Contributed assets

2. URBAN WATER TARIFFS

- Principle 1: Cost recovery
- Principle 4: Setting the service availability charge
- Principle 5: Pricing transparency
- Principle 6: Over recovery of revenue
- Principle 7: Differential water charges
- Principle 8: Setting developer charges
- Principle 9: Capping developer charges
- Principle 10: Revenue from developer charges

3.2.6.1. Gradual Approach

The adoption of these principles will need to occur within the various legislative, contractual, and ownership arrangements, as mentioned in section 3.1.5. For this reason, and to promote consistency between regulated services, the Commission proposes to adopt the 'gradual approach' pricing principle (Principle 9) under the recycled water and stormwater set of principles.

Issue 3.9

- ▲ **How do the proposed NWI Pricing Principles for other non-drinking water services align with current pricing practices for providers of those services?**
- ▲ **Are there any impediments to applying these NWI Pricing Principles from 1 July 2013?**
- ▲ **Over what period should a 'gradualism' approach to moving prices to comply with NWI Pricing Principles, be implemented?**
- ▲ **Are there any other relevant factors the Commission should take into account in considering the NWI Pricing Principles?**

3.2.7 *Other Related Water and Sewerage Services*

As the majority of these miscellaneous services are provided for the sole benefit of the recipient, the Commission believes the principle of user pays should apply. That is, the beneficiary should pay the full cost of the service and other consumers (who do not benefit from the service) should not be required to contribute to the cost of the service through water tariffs.

As these services are provided under differing circumstances (e.g. geographical location and the extent and design of infrastructure required), the associated costs should differ between consumers. The form of price regulation that should be applied to such services must be sufficiently flexible to reflect the different circumstances in which these services are being provided. The Commission believes a pricing principles approach will provide such flexibility, as it will allow regulated operators to develop prices for individual consumers, in a manner that reflects their specific circumstances and risks.

In light of the above, the following principles are proposed:

- Principle 1: Where a service is provided for the sole benefit of the recipient, the beneficiary should pay the full cost of the service and other consumers should not be required to contribute to the cost of the service through water tariffs.
- Principle 2: Where services are provided under differing circumstances, the associated costs can differ between consumers.

Issue 3.10

- ▲ **How do the proposed pricing principles for other related water and sewerage services align with current pricing practices for providers of those services?**
- ▲ **Are there any impediments to applying these NWI Pricing Principles from 1 July 2013?**
- ▲ **Are there any other relevant factors the Commission should take into account in considering these pricing principles?**

3.2.8 Abuse of Market Power

It should be noted, that if any evidence of material misuse of market power comes to light, the Commission will reserve the right to consider a “heavier-handed” form of price regulation.

3.3 Duration of First Price Determination Period and Reviewing the Effectiveness of the Pricing Principles Framework

Other matters for consideration, as raised in the Final Advice, include the length of the initial price determination period, and how the Commission will review the effectiveness of the pricing principles framework.

The length of the regulatory period can be defined as the fixed period over which certain parameters of a price determination are fixed. The Commission believes it is prudent to establish a framework for a limited period, to ensure an opportunity exists to review the effectiveness of the regulatory regime and make improvements if necessary.

Whilst the WI Act does not specify a minimum duration for a price determination in respect to services provided by service providers other than SA Water, the Commission’s practice across other regulated industries is to make a price determination of at least 3 years duration.

Furthermore, the Final Draft Pricing Order binds the Commission to adopting a three year period for SA Water’s initial price determination.

It is important to undertake reviews of the form of price regulation from time to time, to ensure that regulation remains appropriate to the context, and is in line with best regulatory practice. The Commission’s proposed initial approach for price regulation of water retailers other than SA Water is focused particularly on promoting increased transparency. Once that transparency is achieved, it may be appropriate to consider alternative forms of regulation, depending on the issues that have been identified during the first period.

A shorter initial regulatory period (e.g. 2-3 years) will provide greater flexibility to modify the regulatory approach should circumstances warrant it. However, it imposes greater costs through more frequent reviews and reduces certainty. A longer period (e.g. 5-10 years) promotes longer-term certainty, but is less flexible should there be a need to vary the approach.

The Commission is seeking stakeholders’ comment on the appropriate length of the initial regulatory period.

Issue 3.11

- ▲ **What is an appropriate duration for the initial price determination period for water service providers other than SA Water?**
- ▲ **What matters should the Commission consider when reviewing the effectiveness of the pricing principles framework? (Stakeholders may wish to consider the issues raised in chapter 4 of this Paper when addressing this question).**

4 PRICE MONITORING FRAMEWORKS

Price monitoring is a light-handed form of price regulation whereby the regulator observes certain aspects of the regulated business, such as prices and/or costs. Most price monitoring regimes place a strong emphasis on commercial outcomes or information transparency, with recourse to a dispute resolution process. Most price regulatory regimes are also complemented by the monitoring of operational performances by regulators to ensure that prices are not kept low at the expense of service standards.

Under a price monitoring regime, the regulator is not directly involved in the price-setting process. Rather, the regulated business is allowed to set its prices, with the threat of re-regulation to act as an ongoing deterrent against the misuse of market power. Generally, any regulatory intervention will involve the imposing of a more intrusive form of regulation, such as direct price setting by the regulator either during or at the end of the regulatory period.

The Productivity Commission concluded that monitoring could be used either as an instrument of regulation and compliance by a regulator or as a means of observing and understanding the performance of a firm, industry or market. The key difference between the two forms of monitoring lies in the willingness of a regulator to respond to market failure and the strength of the regulatory response.²⁵

4.1 Options for Monitoring Prices

There are several regulatory options by which a regulator could monitor prices. These options are not mutually exclusive and could be implemented in hybrid forms.

The options include the following:

- **Ad hoc price monitoring** – where the regulator reviews the pricing outcomes and may choose to intervene at its own discretion during the regulatory period, possibly in response to customer complaints or evidence of market power being misused;
- **Set period price monitoring** – where the regulator commits to reviewing the behaviour of service providers, market developments and effectiveness of the regime at the end of the regulatory period, to examine whether or not an alternative form of regulation is warranted; or

²⁵ Productivity Commission, *Review of the Prices Surveillance Act 1983 – Inquiry Report No. 14*, 14 December 2001, p. 48.

- **Trigger price monitoring** – where the regulator may intervene if certain trigger points are breached (e.g. above-CPI price increases), and the information provided by the regulated business does not adequately justify the real price increase.

4.2 Price Monitoring Regimes in Other Regulated Industries

Although price monitoring is commonly not used to provide oversight of water retail services in Australia, it has been implemented with considerable success in other regulated industries.

4.2.1 South Australian Ports

The South Australian ports price monitoring regime works on a five-yearly cycle, and requires the Commission to review the regime a year prior to its expiry, to examine whether or not there is an ongoing need for price regulation. If ongoing price regulation is required, the Commission must also determine the form of price regulation for the next regulatory period.

There are currently two sets of ports maritime services covered by the price monitoring regulatory regime established by the Commission; Essential Maritime Services and Pilotage Service. The regime allows a port operator to adjust prices for maritime services subject to price regulation as it sees fit, subject to the requirement that it publish a pricing schedule and inform the Commission of changes to that schedule. The regime also places a strong emphasis on commercial outcomes, with ports users encouraged to engage in commercial negotiations with ports operators over prices and service standards. If they are unable to reach a commercial agreement, ports operators must accept the prices in its pricing schedule.

Under the present regime, the Commission publishes annual ports price monitoring reports, to provide information on prices, and commentary on factors underpinning price movements. The key focus for the Commission in the monitoring of ports charges is determining whether or not any above-CPI price increase is adequately justified, and is not as a consequence of market power being misused by ports operators.

The regime also allows the Commission to intervene and introduce a more intrusive form of price regulation during the regulatory period should it believe that information provided by ports operators does not adequately justify the real price increases, or if there is any other reason to conclude that a heavier-handed form of regulation is warranted (e.g. evidence of market power being misused).

4.2.2 *Victorian Ports*

The Victorian ports price monitoring regime works on a five-yearly cycle, and applies to a set of Regulated Prescribed Services.²⁶ A provider of those services is required to set prices in accordance with the set of pricing principles established by the ESCV, maintain a Published Reference Tariff Schedule²⁷ and Pricing Policy Statement²⁸, and provide certain information to the ESC to assist in its monitoring role.

The regime similarly places a strong emphasis on commercial outcomes by allowing ports users and ports operators to negotiate terms and conditions (e.g. price and service standards) for Regulated Prescribed Services that differ from the published *Reference Tariff Schedule*. Ports operators must accept the prices in its pricing schedule, should parties fail to reach a commercial agreement.

In addition to collecting information on service quality and productivity from providers of Regulated Prescribed Services, ESCV may also publish annual monitoring reports to support its objective to facilitate commercial negotiation and competition, by making certain information publicly available.

Under the regime, ESCV does not have the ability to intervene to act on concerns over prices and the conduct of ports operators. A more intrusive form of price regulation can only be introduced with the approval of the responsible Minister.

4.2.3 *Aeronautical Services*

Price cap regulation of aeronautical services was replaced with a price monitoring approach by the Australian Government on 1 July 2007. The move to a lighter-handed form of regulation was intended to facilitate investment and innovation, while providing an ongoing deterrent against the misuse of market power by certain airports.

Under the regime, the Australian Competition and Consumer Commission (**ACCC**) requires airports to report certain financial and operational data to enable it to monitor prices and service quality at each airport. It publishes annual airport monitoring reports, to compare the performance over time of each airport with that of other airports against the following indicators:

- **Prices** – average aeronautical revenue per passenger;

²⁶ At present, Regulated Prescribed Services are only provided at the Port of Melbourne.

²⁷ The *Reference Tariff Schedule* provides a standing offer of terms and conditions upon which Regulated Prescribed Services will be available.

²⁸ The Pricing Policy Statement sets out how Port of Melbourne's reference tariffs have been calculated in accordance with its obligations under the Price Monitoring Determination for Victorian Ports.

- **Costs and profits** – operating margins (aeronautical revenue per passenger less aeronautical operating expenses per passenger) and rates of return (equity and assets); and
- **Quality of service** – airline and passenger surveys.

Those reports also comment on the degree of market power held by each airport, and the incentive and ability for that market power to be misused.

4.2.4 *Bulk Water Services*

Under *the Water Act 2007 (Cth) (Water Act)*, the ACCC is responsible for the monitoring of regulated water charges, transformation arrangements and compliance with the water market and water charge rules. The ACCC is required to release an annual water monitoring report to inform the relevant minister and stakeholders on the results of its monitoring activities.

The ACCC reports on bulk water charges by constructing hypothetical bulk water bills to represent how individual customers are affected by bulk water charges. To do so, it makes certain assumptions on customer characteristics (e.g. type of customer and type of water access entitlement) in each geographic charging area.

The use of hypothetical bulk water bills as opposed to focusing solely on price movements, was intended to reflect the differential charging approaches used by bulk water service providers (e.g. tariff structures of bulk water charges).

4.3 *Price Monitoring Framework*

The Commission considers that the design of an effective price monitoring framework should be guided by the following.

4.3.1 *Regulatory Objective*

The price monitoring framework must enable the Commission to meet its statutory objective of protecting the long-term interests of South Australian consumers.

4.3.2 *Implementation Principles*

The Commission believes that the operation of price monitoring regimes must be underpinned by a set of “best practice” regulatory principles.

The Commission notes that NERA Economic Consulting (**NERA**) and the Northern Territory Utilities Commission have identified several implementation principles that they believe should underpin the operation of a price monitoring regime. These principles are presented in Table 4-1.

Table 4-1: Implementation Principles of Price Monitoring

NERA ECONOMIC CONSULTING²⁹	
Transparency	The method for monitoring prices should be known, conclusions (where made) or further action should be based on observations and results of monitoring activities (where not confidential) should be published.
Flexibility	The regime should be sufficiently flexible to allow the monitoring body to report on areas of concern (e.g. barriers to entry may not be considered to be substantial at the beginning of a monitoring regime and therefore not reported but this may change over time).
Timeframe	Price monitoring should not be indefinite. NERA refers to PC's recommendation that price monitoring should, preferably, be for a three year period or less, or five years in exceptional cases.
Non-intrusive	Price monitoring should not be intended as a form of price control or entail unwarranted intrusion into the operation of businesses.
Not costly to administer or comply with	Reporting requirements should not be overly onerous on the businesses being monitored.
NORTHERN TERRITORY UTILITIES COMMISSION³⁰	
Consistency	Information must be disclosed on a consistent basis to allow meaningful comparison over time and against benchmarks.
Relevance	Published information must be relevant to meet stakeholders' need.

²⁹ NERA Economic Consulting, *Assessment of Price Monitoring in Australia, A Briefing Note to the AEMC*, 14 December 2007, p. 9.

³⁰ Utilities Commission, *Review of Options for the Development of a Retail Price Monitoring Regime for Contestable Electricity Customers – Issues Paper*, February 2010, p. 23.

The Commission concurs with both NERA and the Northern Territory Utilities Commission that the abovementioned principles are critical to the effectiveness of a price monitoring regime, noting that pricing principles accompanied by poorly designed procedures are likely to lead to sub-optimal outcomes. More importantly, the Commission considers that they are relevant in the context of the South Australian water industry.

Whilst the Commission considers that these principles are relevant in the context of the South Australian water industry, it also recognises that there is the potential for them to be in conflict with each other (e.g. compliance cost incurred in providing the relevant information to support the operation of the price monitoring regime). In those instances, the Commission would have to exercise judgement and make discretionary “trade-offs” between these principles (depending on their overall relevance and importance to the Commission’s monitoring efforts).

4.4 Proposed Price Monitoring Frameworks

The key design features of the Commission’s proposed price monitoring frameworks are discussed below.

4.4.1 Reporting Obligations

The Commission believes that a proper information disclosure arrangement is essential to informing consumers about the terms and conditions of supply, facilitating competition in the relevant markets, and enabling the Commission to perform its regulatory functions effectively. There are two main elements to the proposed information disclosure arrangements.

4.4.1.1. Public Information Disclosure

Regulated service providers are required to maintain a pricing schedule and an accompanying pricing policy statement, to demonstrate how the Commission’s pricing principles have been applied in determining those prices. Further, regulated service providers must provide, at the request of a consumer, a copy of those documents.

The requirement for regulated service providers to make such information available serves two purposes. First, it enhances the level of price transparency by allowing consumers to better understand how prices have been developed, helps in making informed consumption decisions and, where possible, provides a reference point to compare prices against other service providers or alternatives (e.g. rainwater harvesting for non-potable purposes). Second, it also has the effect of facilitating competition by allowing potential new entrants to assess the viability of entering the relevant market.

Issue 4.1

- ▲ **Is the public disclosure of a pricing schedule and pricing policy statement sufficient? If not, what other information should be published and why?**

4.4.1.2. Regulatory Reporting Requirements

There are two common regulatory reporting requirements under the Commission's proposed price monitoring frameworks.

First, regulated service providers are required to provide the Commission with an up-to-date copy of the pricing schedule and accompanying pricing policy statement, and provide information on factors underpinning price movements. The provision of such information on a timely basis enables the Commission to monitor prices, and to gain insights into the relative price movements between different regulated service providers.

Second, regulated service providers are required to provide regulatory accounts that cover all of their business activities (encompassing both regulated and unregulated services) in a manner prescribed by the Commission. These regulatory accounting statements will need to be prepared in accordance with the Australian Accounting Standards, and audited under the Australian Auditing Standards.

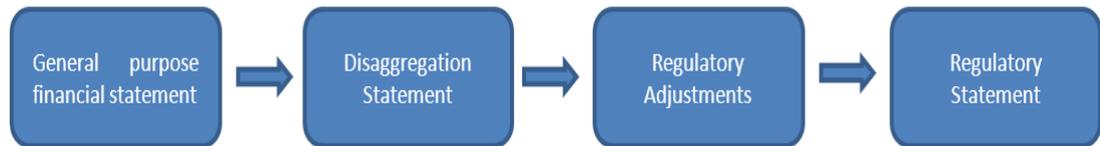
The provision of regulatory accounts serves several purposes, some of which are identified by the Commission below in Table 4-2.

Table 4-2: Main Purposes of Regulatory Accounts

PURPOSE	DESCRIPTION
<p>Detecting anti-competitive behaviour</p>	<p>Regulatory accounts allow the Commission to detect anti-competitive behaviour (e.g. misuse of market power and/or unfair cross-subsidisation). For example, where the Commission’s monitoring reveals that prices are being increased far in excess of the actual cost increase incurred by the regulated provider.</p> <p>They are therefore important regulatory instruments to assist the Commission in forming an opinion of the level of competition, and in identifying anti-competitive behaviour.</p>
<p>Monitoring the financial viability of regulated service providers</p>	<p>The Commission considers that the long-term interests of consumers are consistent with efficient and financially viable industries that have incentives for long-term investment.</p> <p>In that context, monitoring of financial information assists the Commission in ensuring that prices of water retail services are being set at a level that would allow for the full recovery of efficient costs.</p>
<p>Identifying key drivers of price increases</p>	<p>Regulatory accounts allow the Commission to identify the key drivers of any price increases. For example, whether those price increases are as a result of capital expenditure on new water infrastructure, or as a result of market power being exercised to earn monopoly rents.</p>
<p>Informing future regulatory decisions</p>	<p>In the absence of regulatory accounts, the Commission would not have the necessary financial information to inform future regulatory reviews. This could potentially lead to the Commission placing an undue emphasis on information gathering and analysing at the time of a regulatory review.</p> <p>The reporting of such information to the Commission also enables it to monitor financial performance between regulatory reviews.</p>

The Commission has based its information requirements on the basis of an assumption that a regulated operator's regulated business segment or segments are encompassed by a single set of general purpose financial statements that would be prepared regardless of the Commission's regulatory purposes.

The following diagram illustrates the general process for preparing regulatory accounts from a set of general purpose financial statement.



The disaggregation statements in combination with any regulatory accounting adjustments should provide an audit trail between the regulatory statement and the accounting records that underlie the audited general purpose financial statement. In general, the Commission requires:

- the regulatory statement to fairly state, on a disaggregated basis those revenue and costs of the regulated business segment, or segments, that the Commission requires to be disclosed; and
- an understanding of the basis on which the general purpose financial statement has been disaggregated.

Table 4-3 below summarises the type of financial information that is collected by the Commission to perform its regulatory functions across other regulated industries.

Table 4-3: Information for Financial Performance Reporting

INFORMATION REQUIREMENTS	DESCRIPTION
Disaggregation of income	<u>Regulated business segment disaggregation</u>
	<ul style="list-style-type: none"> • items of income in the general purpose financial statement shall be fairly attributed to each regulated business segment. • the regulatory accounting statement shall provide for the regulated business segments, an analysis of income by principal component, together with a description of each component.
	<u>Inter-segmental transactions</u>
	<ul style="list-style-type: none"> • inter-segmental income shall be recorded in the profit and loss accounts of the regulated business segments in which they arise and separately disclosed by way of note.
Disaggregation of costs³¹	<u>Regulated business segment disaggregation</u>
	<ul style="list-style-type: none"> • where a cost is attributed to a regulated business segment, it should reflect the consumption, or utilisation, of a resource or service; and where a regulated business segment consumes or utilises a resource or service, a corresponding cost attribution should take place. • the regulatory accounting statement shall include a note that discloses, for each accounting heading used to attribute costs: <ul style="list-style-type: none"> – amount of costs that can be directly attributed to a regulated business segment; – indirect costs attributed by allocation; – description of the basis of allocation; – a quantification of the allocators applied to each regulated business segment; and – the corresponding amount of costs allocated to each regulated business segment.

³¹ A cost can either be a direct cost that can be directly attributed to a regulated business segment or an indirect cost that needs to be attributed by allocation to a regulated business segment.

Depreciation	A depreciation charge should be attributed to the regulated business segment of that asset that gives rise to the charge.
Income tax attributed to operating profit	This item shall be recorded as “not allocated” in the disaggregation statement.
Interest payable, interest receivable, dividends payable and dividends receivable	This item shall be recorded as “not allocated” in the disaggregation statement.
Amortisation of goodwill arising on acquisition	This item shall be recorded as “not allocated” in the disaggregation statement.
Disaggregation of movements in provisions	The regulatory account statement shall disclose disaggregation information sufficient to provide a reconciliation of the provisions disclosed by the general purpose financial statement to those disclosed for the regulated business segments.
Related Party Transactions	The regulatory account statement shall disclose disaggregation information sufficient to reflect cross subsidisations between a regulated operator and related parties.
Third Party Benefits	The regulatory account statement shall ensure that the substance of underlying transactions and events is reported.

The Commission is mindful that there are numerous service providers other than SA Water, of different scales, currently providing water retail services in South Australia. Therefore, the Commission recognises that some of these service providers may not currently have the capacity to prepare regulatory accounting statements in the manner that would normally be required by the Commission.

In light of this, the Commission believes there is merit to having a transitional period, to allow these service providers to develop the necessary capacities to meet their regulatory obligations in respect to financial performance reporting under the new regulatory regime. The Commission considers that the transitional period would allow it to work collaboratively with these service providers, to ensure that the exact nature of information would both enable the Commission to perform its regulatory function, and minimise compliance costs for regulated service providers.

Issue 4.2

- ▲ **Stakeholders are invited to comment on the information for financial performance reporting set out in Table 4-3. For example, what other information should the Commission collect to enable it to monitor prices effectively and why?**
- ▲ **Stakeholders are invited to comment on their current operational practices in respect to financial information reporting (if any).**
- ▲ **Stakeholders are invited to comment on the duration of the proposed transitional period.**

4.4.2 Monitoring of Pricing Outcomes

The Commission believes that articulating how prices, cost and market outcomes are monitored is important to the transparency and accountability of a price monitoring regime.

In developing the different price monitoring approaches for stakeholders' comment, the Commission has taken into account issues specific to the relevant market. An important consideration for the Commission is ensuring that the outcomes of its price monitoring are relevant to the needs of stakeholders.

The Commission's proposed approaches to monitoring prices for the following water retail services are set out below.

4.4.2.1 Mandated Water Recycling Schemes

Mandated water recycling schemes predominantly service new residential developments where recycled water is supplied through third-pipe developments.

Due to the diverse nature of such schemes, the Commission recognises that prices may be structured differently to reflect differences in cost drivers (e.g. how fixed and variable costs are being allocated and how tariffs are structured) and scale of operations. The Commission is therefore of the view that the approach it utilises to monitor prices must be sufficiently flexible to accommodate such differences.

In light of these complexities, the Commission proposes to adopt a hypothetical annual bill approach to monitoring prices of mandated water recycling schemes. This approach is based on examining how the different charges would translate into individual bills, examining the sensitivity of the results to different assumptions about usage, and allowing for a meaningful comparison of recycled water charges across different regulated service providers.

The Commission proposes the following consumption profiles for calculating the hypothetical annual bills:

- Vacant property or properties with no recycled water meters (no recycled water usage)
- Low user (20 kL/annum)
- Medium user (80 kL/annum)
- High user (150 kL/annum)

Under the proposed hypothetical annual bill approach, the Commission's analysis would differentiate the proportion of the bills that is being attributed to fixed and variable charges.

4.4.2.2. *Drinking Water*

Similarly, the Commission proposes to adopt a similar hypothetical bill approach, albeit with different consumption profiles, to allow for a meaningful comparison of drinking water charges across different regulated service providers.

The Commission proposes the following consumption profiles for calculating the hypothetical annual bills:

- Vacant property (no water usage)
- Very low user (50 kL/annum)
- Average residential property (190 kL/annum)
- High user (350 kL/annum)

Under the proposed hypothetical annual bill approach, the Commission's analysis would differentiate the proportions of the bills that are being attributed to fixed and variable charges.

4.4.2.3. Sewerage

The recovery of costs associated with the provision of sewerage services involves levying a fixed charge on a per property basis.³² The price that a consumer pays for such services is independent of the level of usage.

Due to the way in which such services are being priced, the Commission proposes to monitor pricing outcomes by focusing on trends in sewerage costs, and examining whether or not those costs are moving in line with changes in property-based sewerage charges. If the Commission's price monitoring reveals that sewerage costs have increased by more than the change in property-based sewerage charges, the regulated operator would be required to provide the Commission with justification for such a price change.

Issue 4.3

▲ **Stakeholders are invited to comment on the appropriateness of the following proposed price monitoring approaches:**

- **a hypothetical bill approach for services provided by mandated water recycling schemes;**
- **a hypothetical bill approach for drinking water services provided by service providers other than SA Water; and**
- **monitoring sewerage costs against changes in property-based sewerage charges.**

4.4.3 Public Reporting and Regulatory Intervention

Providing stakeholders with relevant information in a timely manner, and preventing the misuse of market power, are both key means by which the Commission meets its statutory objective of protecting the long-term interests of South Australian consumers.

4.4.3.1. Public Reporting

Providing consumers, in particular, with information in respect to pricing outcomes is a crucial element underpinning the long-term success of the South Australian water industry.

³² This fixed charge is dependent on general movement in property values.

For this reason, the Commission intends to report on pricing outcomes across each of the markets as part of its South Australian Water Industry Annual Performance Report. These reports would provide stakeholders with information regarding operational performances (e.g. customer service and complaints handling) and commentary on factors underpinning price movements.

4.4.3.2. Regulatory Intervention

The South Australian water industry has many concentrated markets, due to factors such as geographical locations, and infrastructure constraints. Most of these markets are therefore either serviced by a limited number of service providers or by one dominant provider.

Whilst there is the potential for market power to be misused in these situations to increase prices higher than would otherwise be the case, submissions to the Commission's public consultation process for its advice to the Treasurer confirmed the Commission's own assessment that market power is not being misused.

Nevertheless, given that the Commission proposes to implement a light-handed form of price regulation (i.e. pricing principles) to regulate these markets, and that this would be the first regulatory period, the Commission is of the view that the regime should be sufficiently flexible to not only allow it to report on areas of concern but also to intervene in response to evidence of market power being misused during the regulatory period.

The Commission therefore proposes to adopt an ad hoc price monitoring approach to the regulating of these services for the initial regulatory period on the basis that it would not only provide an effective ongoing deterrent to the misuse of market power but would also promote consumers' confidence in these markets through the provision of a safety net (i.e. regulatory intervention in response to market failures).

Table 4-4 summarises the matters described above, into a proposed framework.

Issue 4.4

- ▲ Stakeholders are invited to comment on the Commission's proposed approach to public reporting.**
- ▲ Stakeholders are invited to comment on the appropriateness of an ad-hoc price monitoring approach being adopted for the initial regulatory period.**

Table 4-4: Proposed Monitoring and Performance Framework

	Mandated Water Recycling Schemes	Drinking Water	Sewerage
A Regulated Operator’s reporting obligations	<u>Public information disclosure</u>		
	<ol style="list-style-type: none"> 1. A Regulated Operator must maintain a pricing schedule and an accompanying pricing policy statement to demonstrate how the Commission’s pricing principles have been applied in determining those prices. 2. A Regulated Operator must provide, at the request of a consumer, a copy of the pricing schedule and/or accompanying pricing policy statement. 		
<u>Regulatory reporting requirements</u>			
<ol style="list-style-type: none"> 1. The Regulated Operator must provide the Commission with an up-to-date copy of the pricing schedule and accompanying pricing policy statement. 2. Prior to making any changes to prices, a Regulated Operator must give the Commission a copy of the proposed new pricing schedule and a description of the changes and the reasons for them. 3. A Regulated Operator must keep accounts and records relating to the provision of regulated water services separately from accounts and records related to other aspects of the business or businesses carried on by the operator. 4. The accounts and records must be prepared and maintained in accordance with guidelines issued by the Commission. The Commission will undertake consultation with relevant regulated service providers and other stakeholders as appropriate before making any significant amendments to the Guidelines. 5. A Regulated Operator must, at the request of the Commission, make the accounts and records available for inspection by the Commission. 6. The Commission’s obligations regarding confidentiality and the disclosure of information provided to it by a Regulated Operator are governed by Part 5 of the ESC Act. 			

Table 4-4: Proposed Monitoring and Performance Framework

	Mandated Water Recycling Schemes	Drinking Water	Sewerage
How would the Commission monitor pricing outcomes	1. The Commission’s monitoring approach is to focus on the published prices of water services. It does not collect nor report on actual prices negotiated between consumers and regulated service providers, which may be different to published prices.		
	2. The Commission will utilise a hypothetical bill approach to examine the impact of recycled water prices on consumers with the following consumption profiles: <ul style="list-style-type: none"> • Vacant property (no recycled water usage) or properties with no recycled water meters • Low user (20 kL/annum) • Medium user (80 kL/annum) • High user (150 kL/annum) 	2. The Commission will utilise a hypothetical bill approach to examine the impact of drinking water prices on consumers with the following consumption profiles: <ul style="list-style-type: none"> • Vacant property (no water usage) • Very low user (50 kL/annum) • Average residential property (190 kL/annum) • High user (350 kL/annum) 	2. The Commission will monitor sewerage prices by comparing sewerage costs with changes in property-based sewerage charges. 3. Where the Commission’s price monitoring reveals that sewerage costs have increased by more than the change in property-based sewerage charges, it will request the Regulated Operator to provide detailed information to justify such a change. 4. The Commission’s considerations of any real price increase, and the justifications, will be discussed as part of its annual performance report.

Table 4-4: Proposed Monitoring and Performance Framework

	Mandated Water Recycling Schemes	Drinking Water	Sewerage
How would the Commission act upon pricing outcomes	<ol style="list-style-type: none"> 1. The Commission would report on pricing outcomes as part of its annual performance report on the South Australian water industry. These reports would provide stakeholders with information regarding water prices, and commentary on factors underpinning price movements. 2. The Commission will adopt an ad hoc price monitoring approach whereby it would review pricing outcomes and may choose to intervene and introduce a more intrusive form of price regulation at any point in time during the regulatory period, possibly in response to customer complaints or evidence of market power being misused. 		
Length of regulatory period	<ol style="list-style-type: none"> 1. The length of the regulatory period is XX years, ending XX and each successive period of XX years thereafter. 2. The Commission will, within the last year of each regulatory period, conduct a review of the services which are subject to price regulation to determine if continued price regulation is required, and if so, what form of price regulation should be adopted. 		

5 NEXT STEPS

The Commission welcomes any comments on the issues raised in this Discussion Paper or on any other matters in relation to the proposed regulatory frameworks that stakeholders believe the Commission should consider in this Inquiry.

The Commission has set out an indicative timetable for the Inquiry in Chapter 1 of this paper. Comments in response to the Discussion Paper are to be provided to the Commission by 24 August 2012.

The Commission will consider all comments received and will prepare a Draft Report and Draft Price Determination for further public consultation in October 2012 before a Final Report and Final Price Determination is released in December 2012.



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