



Draft Inquiry Report: Inquiry into Reform Options for SA Water's Drinking Water and Sewerage Prices - July 2014

The Essential Services Commission (**Commission**) is conducting an Inquiry into reform options for SA Water's drinking water and sewerage price structures and associated charging arrangements. The Inquiry is being conducted pursuant to Terms of Reference issued by the Treasurer.

Following extensive research and public consultation, a draft Inquiry report has now been released, setting out draft findings and recommendations to inform a broader public debate on those issues. Comment from all members of the community on those matters is welcomed.

The Inquiry stems from the South Australian Government's Water for Good plan, which identified pricing reform as a key element in ensuring long-term water security and efficiency for South Australia, and recommended that the Commission should be asked to:

- examine price structures that may benefit economic efficiency and water security, and
- monitor and report on the effect of statewide pricing.

The Terms of Reference require the Commission to inquire into reform options based on considerations of economic efficiency and water security. The Inquiry is also to provide information on customer impacts that would arise if various reform options were to be implemented by the Government.

In doing so, the Inquiry is to assume that the overall revenue collected by SA Water is to remain constant. Further, while issues of social and environmental policy are fundamentally important in this area, economic efficiency and water security are the basis on which the Inquiry must make its findings and recommendation.

The Inquiry nevertheless recognises that social and environmental issues will have a strong bearing on future policy directions in relation to any structural reforms for drinking water and sewerage prices and associated charging arrangements. The findings and recommendations coming out of the Inquiry will be considered by the Government alongside those issues to deliver improved efficiencies for this State.

HIGHLIGHTS

A key message arising from this stage of the Inquiry is that, assuming revenue neutrality for SA Water, improvements in the economic efficiency of current arrangements could lead to economic benefits to the State in the order of \$30 to \$40 million per annum over the long-term.

In relation to water security, the Inquiry's draft finding is that recent investment in assets such as the Adelaide Desalination Plant has largely addressed such issues for much of the State for the foreseeable future.

The largest potential benefits would arise from reform of drinking water usage charges. The Inquiry's draft finding is that charges have, over time, moved away from cost-reflective levels. Water *usage* charges are set much higher than the costs of delivering water of usage and water *supply* (or infrastructure) charges do not reflect the costs of maintaining the infrastructure.

In short, there is significant cross subsidisation between usage and supply charges – consumers are paying infrastructure costs through usage charges and that is not economically efficient.

Changes in this area, with significantly lower usage charges, would provide better pricing signals for the use of, and investment in, SA Water's services, leading to productivity improvements.

However, the Inquiry has also found that seeking to achieve those efficiencies in drinking water usage charges in the short term would have dramatic bill impacts for most customers, particularly residential customers.

For example, the result of unwinding cross-subsidies would be that around 75 per cent of customers would receive annual bill increases of \$50 or more, with the remaining 25 per cent seeing no material change or a reduction in bills.

For that reason, the draft Inquiry report has laid out options for the transition to, and managing the impacts of, the reforms, should they be adopted.

KEY DRAFT FINDINGS AND RECOMMENDATIONS

Drinking Water

There are currently two drinking water charges: a variable (usage) charge and a fixed (supply) charge.

For residential customers, the variable charge has three tiers, with prices increasing with consumption (\$2.32 per kilolitre (kL), \$3.32 per kL and \$3.59 per kL, and there is a single supply charge of \$282.80 per annum.

For non-residential customers, there is a single variable charge of \$3.32 per kL and a single supply charge, set at either \$282.80 per annum or an amount the greater of \$282.80 and a charge based on the capital value of the property to which the service is provided.

In restructuring usage and supply charges, the greatest economic efficiency improvement can be achieved through cost-reflective usage charges, which impact on how water is used across different sectors of the economy. The focus has, therefore, been on reviewing options for setting usage charges that best promote economic efficiency. However, to be revenue-neutral for SA Water, any reduction in usage charges would need to be offset by an increase in fixed charges.

Reform of the current price structures and associated charging arrangements could, in the longer term, unlock overall economic benefits of between \$30 million to \$40 million per annum.

The largest element of that overall benefit, around \$25 million per annum, would come through setting drinking water usage charges at more cost-reflective levels, resulting in those charges being much lower than is the case now.

A draft recommendation of this Inquiry is the adoption of a single usage charge for all customers, based on the cost of supplying drinking water. That charge should be updated and set at a lower value to reflect recent investment in major water security infrastructure, such as the Adelaide Desalination Plant, which has led to water now being less scarce for most SA Water customers.

The Commission's estimate indicates that an appropriate usage charge for customers in greater Adelaide may be as low as \$0.62 per kL (compared with the current average usage price of \$2.96 per kL).

The water supply industry is capital-intensive and, therefore, most of SA Water's costs are fixed. Supply charges are used to recover most of those fixed costs. The Inquiry's draft finding is that the most cost-reflective way to set supply charges would be to base them on capacity requirements (by meter size), rather than the current flat charge for most customers. This is because capacity is the primary driver of network costs.

As this Inquiry assumes SA Water has a fixed revenue requirement, were usage charges to decrease to reflect current best estimates of \$0.62c per kL, supply charges would

need to increase above current levels – to a material degree. That impact needs to be carefully considered in any move to more cost-reflective price structures.

The draft Inquiry report also finds that the costs of supplying water vary across the State, depending on the local supply source and transportation costs. Economic benefits of approximately \$2 million to \$3 million per annum (in the longer term) may be available if locational pricing arrangements were adopted over time, rather than the current statewide pricing scheme.

Sewerage

Currently, SA Water charges for general sewerage services based on the value of the property to which the service is provided.

The cost to SA Water of providing sewerage services is largely fixed and is independent of the volume of sewage produced.

There is no significant benefit in charging volumetric sewerage prices and the cost of installing sewerage meters to facilitate accurate volumetric charging is likely to be much greater than any associated benefit. Therefore the Inquiry's draft recommendation is that fixed sewerage charges should continue and that volumetric charging should not be introduced.

However, it is recommended that the method for calculating those charges be changed from a *property value* basis to one based on the *capacity requirements* of each sewerage customer (with reference to the number and size of a customer's sewerage connections).

For large industrial sewerage (or "trade waste") customers, there are additional charges which relate to the type of pollutant and the volume of trade waste discharged into the sewerage network. The current regime is broadly based on cost-reflective principles and should continue.

Other charging arrangements

SA Water currently bills landowners for water and sewerage services. Economic benefits of around \$5 million per annum, over time, could be achieved through tenants having a direct customer-retailer relationship with SA Water.

Under this draft recommendation, there will be a greater likelihood that leaks within a property will be repaired more quickly (and therefore reduced), as leaks are often identified from high bills.

Tenants would also gain access to the full suite of consumer protection measures under the Commission's *Water Retail Code*. They would have, for example, access to flexible payment plans and SA Water's financial hardship program.

The Inquiry has made a further draft recommendation that current metering arrangements should continue. This is based on draft findings that the costs of requiring *all* properties to be metered, and the costs of installing smart meters to all properties, are likely to outweigh the benefits.

SA Water currently recovers through its drinking water charges amounts relating to water planning and management, which is a positive step in factoring environmental costs into prices. There would be value in an independent and public review of the prudent and efficient level of these charges.

CUSTOMER IMPACTS AND THE NEED FOR TRANSITION

While there are overall economic benefits arising from the draft recommendations, moving to economically efficient water and sewerage prices would lead to the unwinding of significant cross-subsidies that have benefitted most households at the expense of other customers, mainly large water users (e.g. industrial users).

This highlights that, while reforms of the type reviewed in this Inquiry would advance customers' welfare in the long run, there is a need for careful consideration of possible transition pathways to implementation of these reforms.

The Commission has therefore explored a number of options for transition that would ameliorate financial impacts and allow an orderly transition over time, avoiding or minimising price shocks. These include gradual transition to cost-reflective usage prices, implementation of some reforms ahead of others, and implementation of price reform within customer groups, rather than between customer groups.

Should the unwinding of cross-subsidies be implemented, another matter which should be considered as a part of that process is support to vulnerable customers – both in a transitional (e.g., through the provision of subsidies) and an ongoing (e.g. concessions regime) sense.

NEXT STEPS

The Commission welcomes comment from all stakeholders on the draft Inquiry report and will consider all submissions in preparing its Final Report.

Written submissions are sought by 10 September 2014.

To further assist members of the community to understand the draft Inquiry report, public forums and meetings with interested parties will be held during the consultation period. The proposed dates and locations for these are on the Commission's website.

The Commission will provide the final report to the Treasurer and the Minister for Water and the River Murray by 31 December 2014, as required under the Terms of Reference.

FURTHER INFORMATION

If you have any questions or would like to discuss any matter relating to the draft Inquiry report, please contact:

- Stuart Peavor, Manager, Pricing & Access
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