INQUIRY INTO THE 2010/11 METROPOLITAN AND REGIONAL POTABLE WATER AND SEWERAGE PRICING PROCESS

ISSUES PAPER

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REQUEST FOR SUBMISSIONS

The Essential Services Commission of SA (the Commission) invites written submissions from interested parties in relation to the issues raised in this paper. Written comments should be provided by **28 July 2010**. It is highly desirable for an electronic copy of the submission to accompany any written submission.

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

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

Responses to this paper should be directed to:

Inquiry into the 2010/11 Potable Water & Sewerage Pricing Process

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

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GLOSSARY OF TERMS

ADP	Adelaide Desalination Plant
CoAG	Council of Australian Governments
COMMISSION	Essential Services Commission of SA
CSO	Community Service Obligation
LRMC	Long-Run Marginal Cost
NCP	National Competition Policy
NWC	National Water Commission
NWI	National Water Initiative
SA WATER	South Australian Water Corporation
WACC	Weighted Average Cost of Capital

1 INTRODUCTION

Pursuant to section 35(1) of the *Essential Services Commission Act 2002*, the Treasurer has referred to the Commission an inquiry into the potable water and sewerage pricing processes followed by the Government in late 2009 in setting prices for metropolitan and regional South Australia for 2010/11.

The Commission received the Notice of Referral on 16 June 2010. It is required to submit a draft report to the Treasurer and the Minister for Water Security by 16 September 2010, with a final report to be delivered by 20 October 2010.

The following are the terms of reference for this inquiry:

(a) *The Commission is to inquire into price setting processes undertaken in the preparation of advice to Cabinet, resulting in Cabinet making its decision on the level and structure of SA Water's2010-11 potable water and sewerage prices having regard to the adequacy of the application of::*

  a. *the 1994 CoAG pricing principles;*

  b. *the National Water Initiative, specifically, Clause 65 on pricing principles for urban areas, Clause 66(i) on pricing in the metropolitan area and Clause 66(v) on pricing in regional areas; and*

  c. *the National Water Initiative Pricing Principles for the recovery of capital expenditure and urban water tariffs.*

(b) *In undertaking this inquiry, the Commission is to take into account:*

  a. *the National Water Commission Second Biennial Assessment of Progress in Implementation with respect to Clauses 65, 66(i) and 66(v); and*

  b. *the attached Transparency Statement – Part A – 2010-11 Potable Water and Sewerage Prices South Australia dated May 2010. ;*

(c) *In considering the processes undertaken for the preparation of advice to Cabinet, the Commission is to advise on the extent to which information relevant to the 1994 CoAG pricing principles, the National Water Initiative and the National Water Initiative Pricing Principles was made available to Cabinet.*

(d) *These terms of reference specifically do not extend to additional information on alternative approaches to setting prices.*

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

Term of Reference (a) makes clear that the Commission is to review the processes undertaken by (and the provision of information to) Cabinet in coming to its 2010/11 potable water and sewerage pricing decisions, with regard to the application of the 1994 CoAG pricing principles, certain clauses of the National Water Initiative, and the National Water Initiative Pricing Principles. This instruction is quite specific and defines the scope of this inquiry.

Most importantly, it means that the Commission is to examine the process that led to a pricing outcome. The Commission is not calculating a pricing outcome itself, nor is it examining or evaluating the actual pricing outcomes.

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

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

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

The Commission notes that a key issue that has influenced the price setting process from 2008 has been the need to provide a sustainable and secure water supply for the South Australian customers. The Government has proposed a number of major projects and initiatives to ensure that South Australia has access to sufficient water supply in the longer term, including;

- the construction of the Adelaide Desalination Plant (ADP) at Pt. Stanvac,
- the implementation of the Network Water Security Program, designed to improve the connectivity between the northern and south water supply systems,
- purchases of River Murray water, ensuring a sufficient quantity of water is available for critical human needs, and
- the provision of rebates, designed to encourage the public to implement water conservation products.

The Government has explained that these investments are a major driver in the decision to increase potable water prices in 2010/11 on average by 21.7% in real terms. This follows an average water price increase in 2009/10 of 17.9% in real terms. The Government's in-principle revenue direction to 2013/14, while not binding, suggests annual price increases of similar magnitude to the 2010/11 increase.

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

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

In accordance with the instructions in the Treasurer's Notice of Referral, written submissions are due by 28 July 2010 (28 days after the publication of the Notice of Inquiry).

2 THE COAG PRICING PRINCIPLES

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

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

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

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

In relation to water resource policy, CoAG agreed:

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

3 *In relation to pricing:*

(a) *in general —*

i. *to the adoption of pricing regimes based on the principles of consumption-based pricing, full-cost recovery and desirably the removal of cross-subsidies which are not consistent with efficient and effective service, use and provision. Where cross-subsidies continue to exist, they be made transparent, …;*

ii. *that where service deliverers are required to provide water services to classes of customer at less than full cost, the cost of this be fully disclosed and ideally be paid to the service deliverer as a community service obligation;*

(b) *urban water services —*

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

iv. *that in order to assist jurisdictions to adopt the aforementioned pricing arrangements, an expert group, on which all jurisdictions are to be represented, report to CoAG at its first meeting in 1995 on asset valuation methods and cost-recovery definitions, and*

v. *that supplying organisations, where they are publicly owned, aiming to earn a real rate of return on the written down replacement cost of their assets, commensurate with the equity arrangements of their public ownership;*

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1 See http://ncp.ncc.gov.au/docs/PIAg-002.pdf

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

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

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

2 *The deprival value methodology should be used for asset valuation unless a specific circumstance justifies another method.*

3 *An annuity approach should be used to determine the medium to long-term cash requirements for asset replacement/refurbishment where it is desired that the service delivery capacity be maintained.*

4 *To avoid monopoly rents, a water business should not recover more than the operational, maintenance and administrative costs, externalities, taxes or TERs (tax equivalent regime), provision for the cost of asset consumption and cost of capital, the latter being calculated using a WACC.*

5 *To be viable, a water business should recover, at least, the operational, maintenance and administrative costs, externalities, taxes or TERs (not including income tax), the interest cost on debt, dividends (if any) and make provision for future asset refurbishment/replacement (as noted in (3) above). Dividends should be set at a level that reflects commercial realities and stimulates a competitive market outcome.*

6 *In applying (4) and (5) above, economic regulators (or equivalent) should determine the level of revenue for a water business based on efficient resource pricing and business costs.*

7 *In determining prices, transparency is required in the treatment of community service obligations, contributed assets, the opening value of assets, externalities including resource management costs, and tax equivalent regimes.*

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

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

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

3 THE NATIONAL WATER INITIATIVE

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

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

Clause 65

In accordance with National Competition Policy (NCP) commitments, the States and Territories agree to bring into effect pricing policies for water storage and delivery in rural and urban systems that facilitate efficient water use and trade in water entitlements, including through the use of:

i) consumption based pricing

ii) full cost recovery for water services to ensure business viability and avoid monopoly rents, including recovery of environmental externalities, where feasible and practical

iii) consistency in pricing policies across sectors and jurisdictions where entitlements are able to be traded.

Clause 66

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

Metropolitan

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

Rural and Regional

…

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

a) achievement of lower bound pricing for all rural systems in line with existing NCP commitments

b) continued movement towards upper bound pricing for all rural systems, where practical

c) where full cost recovery is unlikely to be achieved in the long term and a CSO is deemed necessary, the size of the subsidy is to be reported publicly and, where practicable, jurisdictions to consider alternative management arrangements aimed at removing the need for an ongoing CSO.

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

> *The Parties agree to use independent bodies to:*
>
> *(i) set or review prices or price setting processes, for water storage and delivery by government water service providers, on a case-by-case basis, consistent with the principles in paragraphs 65 to 68; and*
>
> *(ii) the Parties agree to use independent bodies to publicly review and report on pricing in government and private water service providers to ensure that the principles in paragraphs 65 to 68 are met.*

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

The Terms of Reference for the current Inquiry require the Commission to have regard to the *National Water Initiative Pricing Principles for the recovery of capital expenditure and urban water tariffs.* The Commission is no longer required to have regard to the *South Australian National Water Initiative Implementation Plan* or the *National Water Commission Update of Progress in Water Reform.* Instead the Commission is to have regard to the *National Water Commission Second Biennial Assessment of Progress in Implementation* (released in October 2009). These documents provide further guidance for the Commission's assessment and can be found on the NWC website.

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

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

4 NWI WATER PRICING PRINCIPLES

The Terms of Reference refer to the NWI Pricing Principles. These Princing Principles were endorsed by the Resource Management Ministerial Council on 23 April 2010, incorporating the following principles:

- Recovery of capital expenditure,
- Setting urban water tariffs,
- Recovering the costs of water planning and management activities, and
- Recycled water and stormwater reuse.

The South Australian Government adopted these Pricing Principles (in their draft form) for its 2008/09 and 2009/10 pricing decision, and has continued this stance in its 2010/11 Transparency Statement – Part A which states:

> *The South Australian Government's water pricing methodology for 2010/11 continued to adopt these NWI Pricing Principles.*[3]

4.1 Recovery of capital expenditure

Section 1 of the NWI Pricing Principles relates to the treatment of new and existing assets. The principles apply only to capital expenditure incurred to provide water services, not to capital expenditure relating to sewerage services or stormwater services. In summary, the principles require:

- full cost recovery for new and replacement capital expenditure following a "legacy date" (in the case of South Australia, the legacy date referred to in Transparency Statement – Part A is 30 June 2006[4]),
- new and replacement assets should be initially valued at efficient actual cost,
- existing assets (assets that existed as at the legacy date) should be valued based on a recognized valuation method, such as Depreciated Replacement Cost (DRC), Depreciated Optimised Replacement Cost (DORC), Optimised Replacement Cost (ORC), indexed actual cost or Optimised Deprival Value (ODV),
- cost recovery for legacy assets should be achieved by way of a depreciation charge or annuity charge and a positive return on an asset value used for price setting purposes as at the legacy date. If assets are to be sold then they are to be valued at their net realisable value,

[3] 2010/11 Transparency Statement - Part A, p9.

[4] 2010/11 Transparency Statement – Part A, p38

- The regulatory asset base (RAB) should be rolled forward (in either nominal or real terms) by including prudent capital expenditure and deducting depreciation and asset disposals. Where a renewals annuity is used, asset values should not be depreciated, and
- New contributed assets (i.e. grants/gifts from governments and contributions from customers (e.g. developer charges)) should be excluded or deducted from the RAB or offset using other mechanisms so that a return on and of the contributed capital is not recovered from customers. If a renewals annuity is used, it should include provision for replacement of contributed assets.

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

Transparency Statement – Part A[5] calls this approach "Go-Forward-Full-Cost- Recovery" (GFFCR). It notes that in the long-run, as existing assets are replaced, GFFCR will gradually tend towards the upper revenue bound until eventually the full WACC is earned on all assets. The application of the GFFCR approach to SA Water's potable water and sewerage revenues is discussed in Transparency Statement – Part A. It observes that the historical returns on metropolitan water assets have been 3.1% (ie. below the upper bound) and that the historical returns on metropolitan sewerage assets have been 7.2% (ie. above the upper bound). Under the GFFCR approach, as applied to both potable water and sewerage assets, these historical returns would effectively be locked-in until the assets are replaced. The Commission is seeking to review the GFFCR approach to SA Water's potable water and sewerage revenue, to ensure consistency with relevant NWI Pricing Principles.

The Commission would welcome comments from stakeholders on the consistency of the GFFCR approach, with the NWI Pricing Principles, particularly in the context of its application to sewerage revenue.

4.2 Urban Water Tariffs

Section 2 of the NWI Pricing Principles sets out the following relevant principles for the design of urban water tariffs:

- Water tariffs should recover efficient costs consistent with the NWI definition of Upper Revenue Bound (to "avoid monopoly rents"),

[5] 2010/11 Transparency Statement – Part A, p. 40

- Two-part tariffs, comprising a service availability charge and a water usage charge, should be used to recover the revenue requirement from retail residential, non-residential and bulk customers,
- The water usage charge should have regard to the long run marginal cost of supply of additional water,
- The revenue from the service availability charge for water should be calculated as the difference between the total revenue required and the revenue recovered through water usage charges and developer charges,
- Urban water tariffs should be set using a transparent methodology, through a process which seeks and takes into account public comment, or which is subject to public scrutiny,
- Where water usage charges lead to revenue recovery in excess of the upper bound revenue requirements in respect of new investments, the over recovery is to be addressed via redistribution to customers as soon as practicable,
- Water charges should differentiate between the cost of servicing different customers where the benefits of doing so outweigh the costs of identifying the differences and the equity advantages of alternatives,
- 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,
- Developer charges should not exceed the costs of serving new developments which includes investment in both new and existing assets required to serve a new development, and
- Revenue from developer charges should be offset against the total revenue requirement either by deducting the contributions from the RAB, or through some other offset mechanism.

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

5 KEY ISSUES

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

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

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

> *Do the potable water and sewerage price setting processes enable Cabinet to make a decision that is consistent with the relevant CoAG Pricing Principles, the NWI and NWI Pricing Principles?*
>
> *Have Government responses to the earlier recommendations and suggestions of the Commission been addressed in the Transparency Statement – Part A?*

In reviewing the Government's process for determining 2010/11 potable water and sewerage prices, an important question that the Commission must consider is whether or not Cabinet had access to sufficient information in order for it to reach a decision that is consistent with the requirements of the CoAG, NWI, and the NWI Pricing Principles. For example, the Commission must review whether overall the material provided to Cabinet demonstrated that forecast costs are efficient, that an appropriate rate of return has been determined and that forecasts of demand are reasonable. The information should also enable Cabinet to be satisfied that the proposed prices are reflective of efficient costs, including any indirect costs/benefits associated with water usage (externalities). Where other factors have been taken into account in setting prices (eg. equity, affordability and regional issues), the impact of these factors on prices should be made transparent in the information.

The Commission also notes that Section 2 of the NWI Pricing Principles states that urban water tariffs should be set using a transparent methodology, through a process which seeks and takes into account public comment, or which is subject to public scrutiny.

The following sections of this Issues Paper discuss some of these key issues relating to the price-setting process adopted by Government, focusing on areas that the Commission has previously expressed some concern with and providing some preliminary comments on how these matters have been addressed in the 2010/11 Transparency Statement – Part A.

5.1 Forecast Capital Expenditure

A key driver of the 60% real increase in water prices since 2008-09 has been the significant increase in capital expenditure relating to the Government's water security investments, particularly the Adelaide Desalination Plant (ADP).

Table 5.1 reproduces information from Appendix 1 of Transparency Statement – Part A, and highlights the increase in capital expenditure since 2008-09, along with the projected capital expenditure forecasts to 2013-14. The Government's decision to expand the capacity of the ADP from 50GL to 100GL has had a major impact on the 2010-11 pricing decision. The estimated cost of the ADP, which is expected to be completed in December 2012, is approximately $1.8bn, which represents over half of the total forecast capital expenditure between 2008-09 and 2013-14.

Table 5.1. SA Water capital expenditure ($m nominal)

	2008-09	2009-10	2010-11	2011-12	2012-13	2013-14
Water	537	932	564	187	163	228
Wastewater	113	181	238	176	61	64
Total	650	1,113	802	363	224	293

In assessing whether or not the process for setting 2010-11 prices accords with the relevant pricing principles, the Commission must be satisfied that Cabinet was provided with sufficient information on capital expenditure forecasts, to enable it to conclude that capital expenditure is efficient.

In previous Inquiries, the Commission has commented on the lack of information provided to Cabinet to demonstrate the efficiency of proposed capital expenditure, particularly capital expenditure relating to the ADP and the north-south interconnector (now termed the Network Water Security Program). The Commission has, for a number of years, raised concerns over the general lack of information regarding whether or not:

- well developed asset management planning and processes are in place and being followed,
- projects are efficient and least cost solutions,
- unit rates are consistent with efficient external benchmark,
- the capital program is consistent with customer requirements or regulatory obligations, and
- the proposed expenditure program is deliverable in the timeframes proposed.

The Commission notes that this year's Transparency Statement – Part A provides greater commentary on the processes that are adopted by Government in relation to capital planning, approval and procurement, in order to demonstrate that the processes support decision making that leads to efficient cost outcomes. It includes discussion on SA Water's asset management processes, the processes for scrutinising SA Water's capital expenditure proposals, including through the SA Parliament's Public Works Committee, and the application of SA Water's Procurement Policy. This information has not been provided in previous Transparency Statements.

The Commission would welcome comment from stakeholders on the level of the information presented in Transparency Statement – Part A, which seeks to demonstrate the efficiency of proposed capital expenditure, particularly on the Government's water security projects including the expanded Adelaide Desalination Plant.

The Commission also raised concerns in its 2009 Inquiry Report, that the 6% cost escalation factor being adopted for new capital expenditure appeared high, given the evidence of a reduction in capital costs since 2008. Transparency Statement – Part A notes that the Government has revised the escalation rate for new capital expenditure from 6% to 3.5 % as part of the 2010-11 pricing decision, but only for those projects that do not have full financial approval (firmer estimates are provided for those projects that do have such approval). While Transparency Statement – Part A notes that a 3.5% escalation rate is consistent with the assumed expected inflation adopted in the WACC calculation, it is less clear how the change in the rate impacts on the future capital projects discussed in Appendix 1 of Transparency Statement – Part A.

Stakeholders are invited to comment on the information provided in Transparency Statement – Part A regarding the decision to change the escalation rate for new capital expenditure from 6% to 3.5%, and whether or not this information would assist Cabinet in forming a view that forecast capital expenditure is efficient .

5.2 Operating, Maintenance and Administration (OMA) costs

In past Inquiries, the Commission has suggested that more effective compliance with the CoAG pricing principles and the NWI would result if the Government were to undertake more comprehensive analysis of SA Water's costs to enable more reliable conclusions on cost efficiency to be reached.

In the 2008/09 Inquiry, the Commission noted that there had been some improvement in the analysis of drivers of OMA costs and in the level of cost benchmarking information, although it concluded that there was insufficient information to explain how historical performance and emerging trends are linked to forward-looking OMA requirements. In the 2009/10 Inquiry Final Report, the Commission noted a further improvement in the level of disclosed information had been provided, particularly in reference to the information included in the National Performance Report. However the Commission concluded that there was still insufficient forward looking cost information that could be used to ultimately determine appropriate prices.

The Government's response to the Commission's 2008/09 and 2009/10 Inquiry Final Reports states that the Government's pricing model provides forward looking cost information based on SA Water's approved budget, and is provided in the Transparency Statement in respect of indicative revenue direction to 2012-2013. It argues that Cabinet was provided with information that would enable it to satisfy itself that forward looking costs of SA Water were deemed efficient.

The 2010/11 Transparency Statement outlines the key legislative and financial management arrangements that are viewed to promote efficient OMA costs including; SA Water's budget being prepared in accordance with State Budget process, which is subject to Cabinet approval and review processes, and administered by the Department of Treasury and Finance.

Further, the 2010/11 Transparency Statement – Part A states that:

> *The Government is provided with sufficient information to enable it to consider the prudence and efficiency of SA Water's OMA costs through the Government's financial management and procurement arrangements. SA Water's OMA costs for the period 2008-09 to 2013-14, as presented and scrutinised by Cabinet in the various processes.*

The 2010/11Transparency Statement – Part A also seeks to substantiate the proposition that OMA costs are efficient by providing benchmarking data comparing SA Water to other comparable interstate utilities, taken from the NWC National Performance Report 2008/09. Here, Transparency Statement – Part A suggests that:

> *SA Water's operating cost per property for its Adelaide operations are amongst the lowest compared to other metropolitan utilities in Australia*
>
> *SA Water has experienced increases in operating cost per property in 2008-09 due to temporary water purchases, water security measures (e.g. rebates and introduction of quarterly billing), and the costs associated with moving SA Water's head office to Victoria Square*

The Commission would welcome any comments from stakeholders on whether or not the information presented in the 2010/11 Transparency Statement – Part A would be sufficient to conclude that SA Water's forward-looking OMA costs are efficient.

5.3 Externalities

In its past Inquiries, the Commission has expressed concern that the Transparency Statement – Part A does not address the broader view of externalities that the NWI introduces, focussing instead on just those externality costs that are attributable to and incurred by SA Water (licence fees paid to the Environmental Protection Authority (EPA) and the environmental improvement program agreed with the EPA, and levies paid to the

Natural Resources Management Boards, now classified within water planning and management costs).

The 2010/11 Transparency Statement – Part A states that a nationally consistent treatment of externalities was not developed at the same time as the NWI Pricing Principles and there has been a lack of clarity nationally about the differences between externalities and charging for water planning and management activities.

In its 2009/10 Final Report, the Commission concluded that the material provided to Cabinet was insufficient to make a pricing decision on relevant externalities costs that was consistent with NWI Pricing Principles. While the Commission acknowledged that the incorporation of externalities into pricing decisions was a difficult matter, and that the requirements of the NWI in relation to externalities were somewhat uncertain, it recommended that the Government at least seek to identify relevant externalities.

As outlined in the *2009 NWC Second Biennial Assessment of Progress in Implementation,* while some states had investigated or implemented the use of pricing and market-based instruments to address environmental externalities, the NWC report acknowledged that all states had further work to do to explore the feasibility of such actions.

The NWC report concluded that:

> *The Commission recommends that NWI parties renew collective and individual efforts to respond to NWI clause 73 (use of pricing and markets to deal with environmental externalities), given that well-designed externality pricing can be a powerful and enduring way of dealing with the environmental impacts of water provision and use.*

The 2010/11 Transparency Statement – Part A states that the Government manages its externalities via a range of non-market mechanisms (eg Coastal Water Study, water planning) and through its identification and management activities (eg Environmental Impact Assessment, SA Water's Climate Change Sector Agreement).

In the absence of a nationally consistent pricing approach to address the impact of environmental externalities, the Government has continued to adopt the COAG definition of externalities (i.e. only externalities that are both attributable to and incurred by' SA Water are included in the revenue requirement).

The Commission notes that this national review has been flagged in previous years' Transparency Statements, but that little progress has been made in this area.

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

5.4 Efficient resource pricing

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

As adopted in 2008/09 and 2009/10, the 2010/11 Transparency Statement – Part A continues to outline a pricing structure that is reflective of an updated estimate of the LRMC, thereby promoting movement towards consumption based pricing.

Notwithstanding this progress, as outlined in its 2008/09 and 2009/10 Final Report, while the Commission broadly supported the upward movement in usage charges towards LRMC, it expressed some concerns regarding the lack of information provided in the Transparency Statement – Part A to explain the advantages of introducing a third tier, as distinct from, for example, increasing tariffs across the first two tiers. It also suggested that there was little information provided to support the Government's calculation of the estimated LRMC.

The 2010/11 Transparency Statement – Part A states that the current estimate of LRMC is based on the same methodology that was adopted by the Government for its 2009/10 pricing decision, ie is based on the cost of expanding the ADP from 50GL to 100GL. These costs were summarised in the 2009/10 Transparency Statement, which leads to a LRMC estimate of $2.40 per kL in 2010/11 dollars.

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

The increase in 2010/11 water usage charges results in a situation where both the second and third-tier usage charges that apply to single residential dwellings are above the estimated LRMC, albeit only marginally for the second tier, being set at $2.48 per kL.

The third-tier usage charge only applies to very few large residential users. The 2010/11 Transparency Statement – Part A discusses the policy objective of discouraging excessive water use in residential property as the reasoning for the third-tier usage charge being above the estimated LRMC, set at $2.98 per kL.

As outlined in previous Inquiries, the Commission also notes that non-residential users do not face the third tier usage charge, and that there does not appear to be any discussion in the Transparency Statement about the merits of not applying a third tier to these customers.

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

5.5 Revenue direction

The 2010/11 Transparency Statement contains a revised projection of revenue needs to 2014/15. It states that, based on current costs, annual increases in potable water prices of 21.7% in real terms until 2013 will see revenue increase to marginally above its targeted "Go Forward Full Cost Recovery" (GFFCR) in 2013/14. Under this in-principle revenue direction, water prices would almost double over the next four years in order to fully recover costs associated with the Government's major water security projects, and other costs.

However as outlined in the Transparency Statement, as a means to smooth annual price increases over the period 2010/11 to 2013/14, (where it is expected that the large expenditure on water security project will result in fluctuations in the revenue requirements), the Government has adopted a revenue path that incorporates price increases of the same magnitude. The Transparency Statement states,

> *This indicative revenue path aims to match GFFCR on a cumulative basis, rather than each year, over the same period. For example, although SA Water's indicative revenue estimate in 2013-14 exceeds URB, it does not exceed GFFCR over the entire period 2011-12 to 2013-14*

6 NEXT STEPS

In accordance with the Treasurer's instructions, submissions are due by 28 July 2010 (28 days after the Commission publishes its Notice of Inquiry).

The Commission will consider all submissions received and prepare a draft report by 16 September 2010. In accordance with the requirements for the inquiry, the draft report will be submitted to the Treasurer and the Minister for Water Security.

A final report will be presented to the two Ministers by 20 October 2010. The final report will be made public in accordance with section 38 of the *Essential Services Commission Act 2002*.