INQUIRY INTO THE 2009-10 METROPOLITAN AND REGIONAL WATER AND WASTEWATER PRICING PROCESS

FINAL REPORT

August 2009

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GLOSSARY OF TERMS

ARMCANZ	Agriculture and Resource Management Council of Australia and New Zealand
CoAG	Council of Australian Governments
Commission	Essential Services Commission of SA
CPA	Competition Principles Agreement
CSO	Community Service Obligation
EPA	Environment Protection Authority
ESC	Essential Services Commission, Victoria
GFFCR	Go Forward Full Cost Recovery
IPART	Independent Pricing and Regulatory Tribunal (New South Wales)
LRMC	Long Run Marginal Cost
NCC	National Competition Council
NCP	National Competition Policy
NWC	National Water Commission
NWI	National Water Initiative
OMA	Operating, Maintenance and Administration
RAB	Regulated Asset Base
SA Water	South Australian Water Corporation
SCARM	Standing Committee on Agriculture and Resource Management
TER	Tax Equivalent Regime
URB	Upper Revenue Bound
WACC	Weighted Average Cost of Capital
WPA	Waterproofing Adelaide Program
WSAA	Water Services Association of Australia

NOTICE OF REFERRAL FOR AN INQUIRY INTO WATER AND WASTEWATER PRICING IN METROPOLITAN AND REGIONAL SOUTH AUSTRALIA
PURSUANT TO PART 7 OF THE ESSENTIAL SERVICES COMMISSION ACT 2002

FROM: **Kevin Foley, Treasurer**

TO: **The Essential Services Commission of South Australia**

RE: **Water and Wastewater Prices in Metropolitan and Regional South Australia July 2009 to June 2010 and in principle revenue direction to June 2013.**

BACKGROUND:

1. Pursuant to section 35(1) of the *Essential Services Commission Act, 2002* (**the Act**), the Commission must conduct an inquiry into any matter that the Minister, by written notice, refers to the Commission.
2. The Act is committed to the Treasurer by way of *Gazettal* notice dated 12 September 2002 (p. 3384).
3. The South Australian Government proposes to publish the attached Transparency Statement on SA Water's water and wastewater prices.
4. The Transparency Statement links Cabinet's decision on water and wastewater prices to the 1994 CoAG pricing principles, certain National Water Initiative obligations and four sets of draft pricing principles which have been developed under the auspices of the National Water Initiative Committee (the NWIC draft urban water pricing principles). It provides information on SA Water's financial performance in the context of pricing decisions and past and future expenditures, and addresses details of estimates of revenues, community service obligations, capital expenditure program, profit and its distribution.

REFERRAL:

I, Kevin Foley, Treasurer, refer to the Commission the matter described in paragraph (a) of the Terms of Reference for inquiry, in accordance with those matters in paragraphs (b), (c) and (d) of the Terms of Reference and subject to the Directions set out in this Notice.

TERMS OF REFERENCE:

The following are the Terms of Reference for the inquiry referred pursuant to section 35(1) of the Act:

a) The Commission is to inquire into price setting processes undertaken in the preparation of advice to Cabinet, resulting in Cabinet making its decision on the level and structure of SA Water's water and wastewater prices in metropolitan and regional South Australia in 2009-10 and an in principle revenue direction to June 2013 having regard to:

   a. the adequacy of the application of 1994 CoAG pricing principles;

   b. the National Water Initiative, specifically, Clause 65 with respect to the continued application of pricing principles to urban areas, Clause 66(i) with respect to water and wastewater pricing in the metropolitan area and Clause 66(v) with respect to water and wastewater pricing in regional (urban) areas; and

   c. the NWIC draft urban water pricing principles, to be considered by COAG.

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

   a. the accredited *South Australian National Water Initiative Implementation Plan* with respect to Clauses 65, 66(i) and 66(v)

   b. the National Water Commission *First Biennial Assessment of the National Water Initiative*, August 2007, Attachment 1 'Summary progress on implementing NWI actions' with respect to Clauses 65, 66(i) and 66(v);

   c. the National Water Commission *Update of progress in water reform*, February 2008, Attachment A with respect to Clauses 65, 66(i) and 66(v);

   d. the attached *Transparency Statement Metropolitan and Regional Water and Wastewater Prices in South Australia 2009-10* (Part A) dated January 2009;

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

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

REQUIREMENTS FOR INQUIRY:

The following requirements are made pursuant to section 35(5) of the Act:

a) I require that the Commission undertake its inquiry and submit a Draft Report to the Treasurer and the Minister for Water Security by no later than three months after receipt of these Terms of Reference;

b) I require that the Commission submit a Final Report on the inquiry to the Treasurer and the Minister for Water Security by no later than six weeks after submitting the Draft Report;

c) In conducting the inquiry, the Commission is not required to hold public hearings, public seminars or workshops but may receive and consider any written submissions as it thinks appropriate and it must advertise to call for written submissions to be lodged no later than 28 days from the date of publication of the Notice of Inquiry;

d) SA Water is to meet the reasonable costs of the Commission in undertaking the inquiry.

If the Commission requires further information in relation to this inquiry, it may contact the Director, Economic Regulation, Revenue and Economics Branch, Department of Treasury and Finance.

DIRECTIONS:

The following directions are made pursuant to section 35(5)(f) of the Act:

I direct that in undertaking its inquiry the Commission must preserve the confidentiality of any information, material or documentation provided by the Government to enable the Commission to undertake its inquiry, and to that end must enter into a Deed of Non-Disclosure with the Crown in right of the State of South Australia. I hereby authorise the Under Treasurer to act as agent for and on behalf of the Crown for that purpose. Further, the Commission must require any consultant firm or person providing consultancy services to the Commission in relation to the inquiry to be made a party to that Deed. A copy of the Deed will be made available to the Commission for comment.

OVERVIEW

In April 2009, the Treasurer directed that the Essential Services Commission of South Australia (the Commission) undertake an inquiry into the processes leading to the Cabinet decision on the level and structure of SA Water's water and wastewater prices in metropolitan and regional South Australia for 2009-10.

In undertaking its Inquiry, the Commission is to consider the extent to which information relevant to certain nationally agreed urban water pricing principles was made available to Cabinet. The key question for this Inquiry is whether or not this information was sufficient to enable Cabinet to reach a pricing decision that is consistent with the relevant principles. In considering this matter, the Commission has reviewed all information presented to Cabinet as part of the 2009-10 water and wastewater pricing process, which is summarised in the February 2009 report prepared by the Department of Treasury and Finance: *Transparency Statement Metropolitan and Regional Water and Wastewater Prices in South Australia 2009-10* (Part A).

This is the Commission's seventh inquiry into the South Australian Government process for setting SA Water's water and/or wastewater prices, and the third inquiry that has been conducted in the context of the National Water Initiative (NWI).[1]

Cabinet has approved an increase in water charges in 2009-10 on average by 17.9% in real terms. Metropolitan wastewater charges are to remain constant in real terms, with regional wastewater charges to increase by 0.5% in real terms.

The significant increase in 2009-10 water charges follows a 12.7% increase in water charges (in real terms) in 2008-09. A major driver of the announced increases is the proposal to construct a desalination plant at Port Stanvac, along with an interconnection pipeline between the Happy Valley Reservoir, the Hope Valley Reservoir and the Barossa trunk main. Both capital projects are aimed at providing greater security of water supply to metropolitan Adelaide. The movement from a 12.7% to 17.9% real terms increase in water charges reflects the Government's decision to accelerate the construction of the Adelaide desalination plant in order for it to commence operating by December 2010. The purchase of an additional 30GL of River Murray water entitlements and a downward adjustment to SA Water's revenue forecasts (eg. as a result of revised demand elasticity estimates) have also had an impact on the further price increase.

The magnitude of the proposed capital expenditure, and the resulting increases in water charges, provide an important context to the current Inquiry and accentuate the need to

1 For information on previous Inquiries conducted by the Commission refer http://www.escosa.sa.gov.au/site/page.cfm?u=72.

ensure that the pricing process is robust and can deliver on the NWI best practice pricing principles.

Consistent with the approach taken in previous inquiries, the Commission has identified the types of improvements that should be made to the pricing process in order to achieve greater consistency with the relevant pricing principles. The Commission notes that there have been a number of improvements in the 2009-10 price setting process (for example, in expanding the benchmarking information and through the consideration of tariff reform). However, many of the suggested areas for improvement are similar to those raised by the Commission in previous inquiries. In particular, the Commission has raised concerns with the lack of information presented to Cabinet to demonstrate that forward-looking prices are based on prudent and efficient forecast costs. This deficiency is particularly significant, given the impact of the proposed major capital projects on future water prices.

1 INTRODUCTION

Pursuant to section 35(1) of the *Essential Services Commission Act 2002*, the Treasurer of South Australia has referred to the Commission an inquiry into the processes followed by the Government in late 2008 in setting water and wastewater prices for metropolitan and regional South Australia for 2009-10. The Commission is required to assess whether or not the pricing processes complied with the relevant principles established through the Council of Australian Governments (CoAG) and under the National Water Initiative (NWI), as agreed to by all governments as the basis for water and wastewater pricing. For the first time, the Commission has also been directed to consider certain draft urban water pricing principles established by the National Water Initiative Committee (NWIC), which are to be considered by CoAG.

Since 2004/05, the Commission has, at the direction of the Treasurer, conducted inquiries into the annual processes for setting water and wastewater prices. These previous inquiry reports and associated documents are available on the water section of the Commission's website.[2]

As with the past several inquiries, the Commission's consideration of the water and wastewater pricing processes are again combined. Accordingly, the issues that the Commission will examine in this inquiry are similar to those examined previously.

The Commission's Inquiry into the process for setting 2009-10 water and wastewater prices, and the associated in-principle revenue direction, must take into account the significance of the Government's future water security investments (including the construction of the desalination plant at Pt. Stanvac) and the substantial price increases that have been announced. The manner in which the CoAG pricing principles, relevant NWI objectives and NWIC draft pricing principles were taken into account by the Government in reaching its decision to substantially increase water prices, is therefore a major focus of this current Inquiry.

1.1 The Price Setting Process

The South Australian Water Corporation (SA Water) is established under the *South Australian Water Corporation Act 1994* and is subject to the provisions of the *Public Corporations Act 1993*. SA Water provides water services to approximately 1.5 million domestic, commercial and industrial customers throughout South Australia, and wastewater services to around 1.2 million customers.

The South Australian Government owns SA Water. The Minister for Water Security is responsible for setting the prices that SA Water charges for services provided. In doing so, the Government has committed to set prices such that they comply with agreed pricing principles. These principles include the 1994 CoAG pricing principles and the principles

2 Refer http://www.escosa.sa.gov.au/site/page.cfm?u=74.

contained in the NWI, an agreement entered into by all jurisdictions in June 2004. These principles are discussed further in Chapter 2 of this report.

1.1.1 Cabinet decision

The decision on urban water and wastewater prices to apply in 2009-10 was taken by Cabinet in December 2008. The water prices that will apply to most customers in 2009-10 were gazetted on 5 December 2008, with commercial rates to be gazetted in June 2009, in accordance with the *Waterworks Act 1932*. Wastewater rates will also be gazetted in June 2009, in accordance with the *Sewerage Act 1929*. The June 2009 dates arise because those charges utilise property values, which are not available until that time.

The in principle revenue direction to 2012-13 is not a binding decision in the manner of the 2009-10 pricing decisions. Separate and subsequent pricing decisions will be required for each of those years. However, the direction provides some guidance in respect of those later decisions.

The business and decision making of Cabinet is completely confidential, as are all Cabinet documents and submissions. However, in order for the Commission to undertake this inquiry, it has been provided with copies of Cabinet submissions and agency Cabinet comments relating to the setting of SA Water's water and wastewater prices for 2009-10. These documents are classified "Strictly Confidential" and the Commission is required to preserve the confidentiality of such documents.

1.1.2 Preparation of the Transparency Statement

Subsequent to making its decision on 2009-10 water and wastewater prices, the South Australian Government has prepared a report: Transparency Statement – Part A, Water and Wastewater Prices in Metropolitan and Regional South Australia 2009-10, dated February 2009. This document sets out the process and the matters that have been considered by the Government in setting 2009-10 water and wastewater prices (including an in-principle revenue direction to June 2013). One of the purposes of Transparency Statement – Part A is to document the extent to which the Government's pricing decision applies the relevant pricing principles.

The Transparency Statement – Part A remains a largely incremental document. That is, it refers to practices reported in the earlier Transparency Statements and earlier Commission reports rather than repeating all relevant detail. As a result, it focuses on areas of change or new information.

This approach recognises the considerable repetition that would arise in respect of some elements of Transparency Statement – Part A, given that some methods and practices have not changed from year to year. As a result of this, the Commission sometimes refers in later chapters to earlier reports to more fully explain the issue at hand – particularly where a quote from the latest Transparency Statement – Part A would be insufficient to explain the issue.

This report considers Transparency Statement – Part A as the Government's explanation of its process and its justification that the 2009-10 water and wastewater prices apply the pricing principles. This report also comments, where possible, on the information that was made available to Cabinet in making its decision on 2009-10 water and wastewater prices (but is restricted given the confidential nature of Cabinet's consideration). Where relevant, the report also refers to comments made by the Government in responding to the Commission's 2008-09 inquiry final report.

Ultimately, this report is to serve as Part B of the overall Transparency Statement, and has been prepared accordingly. This means that it often refers to Part A – rather than repeating the content of Part A.

1.2 Conduct of the inquiry

The Commission received the Notice of Referral of an Inquiry from the Treasurer on 1 April 2009 setting out the Terms of Reference for the Inquiry.

The Notice of Referral required the Commission to:

- advertise the Inquiry;
- provide 28 days for the lodgement of written submissions;
- provide a draft report by 1 July 2009; and
- provide a Final Report by 12 August 2009.

Pursuant to Section 36 of the *Essential Services Commission Act 2002*, a Public Notice of Inquiry was placed in *The Advertiser* on 6 April 2009, asking for written submissions by 1 May 2009. An Issues Paper was released at the same time.

The Commission did not receive any submissions in response to the Public Notice and Issues Paper.

The low level of stakeholder engagement in this Inquiry is consistent with the Commission's experience in earlier water inquiries. The Commission continues to hold the view that the current form of inquiry, being a retrospective inquiry into processes for establishing prices, is not conducive to meaningful public consultation.

In conducting this Inquiry the Commission is principally informed by Transparency Statement – Part A and associated information provided.

2 THE PRICING PRINCIPLES

2.1 1994 CoAG pricing principles

The 1994 CoAG pricing principles provided the framework for water and wastewater pricing reform for all jurisdictions, including South Australia, and were incorporated into the National Competition Policy (NCP) Agreement.[3]

As is explained in Transparency Statement – Part A, the pricing principles are contained in the strategic framework for water, as set out in the Compendium of NCP Agreements (NCC 1998, 2nd Edition).

Section 3 of the strategic framework is dedicated specifically to pricing issues. However, it is a very broad pricing statement and does not provide much detail (see below).

Relevant clauses of the CoAG Strategic Framework 1994 (pp. 103-104) are as follows:

> *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;*

To complement these clauses, the Standing Committee on Agriculture and Resource Management (SCARM), through the Agriculture and Resource Management Council of Australia and New Zealand (ARMCANZ), provided a detailed set of guidelines. This detailed set of guidelines is generally referred to as "the 1994 CoAG Pricing Principles".

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3 See http://ncp.ncc.gov.au/

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

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) are as follows:

- *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.*

2.2 The National Water Initiative

The Commission is also required to have regard to the NWI in this Inquiry. The NWI builds on the 1994 CoAG framework and, in matters relevant to this inquiry, impacts upon the 1994 CoAG pricing principles. The Commission's Inquiry into the 2007-08 water and wastewater price setting process was the first to consider the 1994 CoAG pricing principles, as impacted by the NWI. In its Final Report on this Inquiry, the Commission observed that the NWI objectives, which include the pursuit of "best practice" pricing, required the Commission to become more demanding in its assessment of the Government's water and wastewater pricing process.

Also arising from the NWI was the National Water Commission (NWC). The NWC is a Commonwealth statutory body with a role of driving the national water reform agenda – as encapsulated in the NWI. Amongst other things, the NWC took over the role of the National Competition Council (NCC) in assessing each jurisdiction's progress with implementing, originally, the 1994 CoAG pricing principles and now, the NWI. The NWC's first biennial assessment of progress made by jurisdictions against the NWI occurred in 2007.[4] The NWC subsequently released an update of progress in water reform in February 2008.[5] The terms of reference for this Inquiry require the Commission to take into account both of these NWC assessments.

The NWI includes clauses that establish commitments concerning urban water and wastewater pricing (particularly clauses 64 to 77 inclusive). It should be noted that the NWI also deals with many other aspects of water management. The full text is available from the NWC website (www.nwc.gov.au).

The overarching policy objective of the NWI is set out in clause 5:

> *The Parties agree to implement this National Water Initiative (NWI) in recognition of the continuing national imperative to increase the productivity and efficiency of Australia's water use, the need to service rural and urban communities, and to ensure the health of river and groundwater systems by establishing clear pathways to return all systems to environmentally sustainable levels of extraction. The objective of the Parties in implementing this Agreement is to provide greater certainty for investment and the environment, and underpin the capacity of Australia's water management regimes to deal with change responsively and fairly (refer paragraph 23).*

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:*

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4 This report is available from the NWC website at http://www.nwc.gov.au/nwi/biennial_assessment/index.cfm.

5 This report can be accessed from the NWC website at http://www.nwc.gov.au/www/html/692-coag-update-report-on-water-reform.asp?intSiteID=1.

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 Commission's task in conducting this and earlier inquiries derives from NWI obligations and earlier NCP obligations. For example, clause 77 of the NWI states that:

> *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) 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 observes that its task, as set out in the Terms of Reference, is to review price-setting processes only. Further, the Terms of Reference require the Commission to have regard specifically to clauses 65, 66(i) and 66(v)– a narrower range than that set out in clause 77.

Nevertheless, the Commission notes that the NWC, in its submission to the Commission's Issues Paper for the Inquiry into the 2008-09 pricing process, made reference to the clause 77 obligations and stated that the Commission's inquiry process accords with the NWI commitments.

The South Australian Government's strategy for implementing its obligations under the NWI is set out in the *South Australian National Water Initiative Implementation Plan 2005* (the Implementation Plan). This plan has been accredited by the NWC, pursuant to the requirements of the NWI. The Terms of Reference for this Inquiry require the Commission to have regard to the Implementation Plan with respect to Clauses 65, 66(i) and 66(v) of the NWI.[6]

2.3 NWIC Draft Pricing Principles

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

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

Transparency Statement – Part A states that:

> *In November 2008, COAG agreed to improve the security of urban water by adopting an enhanced national urban water reform framework, including the finalisation of draft national pricing principles.*[7]

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

For the purposes of the current Inquiry, the NWIC draft principles relating to the recovery of capital expenditure and the design of urban water tariffs are of most relevance.

2.3.1 Recovery of capital expenditure

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

- full cost recovery for new and replacement capital expenditure following a "legacy date" (in the case of South Australia, the legacy date referred to in Transparency Statement – Part A is 30 June 2006);
- new and replacement assets should initially be valued at efficient actual cost;
- existing assets (assets that existed as at the legacy date) should be valued based on a recognized valuation method, such as Depreciated Replacement Cost (DRC), Depreciated Optimised Replacement Cost (DORC), Optimised

[6] The South Australian Implementation Plan is available on the NWC website at http://www.nwc.gov.au/nwi/nwi_implementation.cfm.

[7] 2009/10 Transparency Statement - Part A, p11.

Replacement Cost (ORC), indexed actual cost or Optimised Deprival Value (ODV);

- cost recovery for legacy assets should be achieved by way of a depreciation charge or annuity charge and a positive return on an asset value used for price setting purposes as at the legacy date. If assets are to be sold then they are to be valued at their net realisable value.
- The regulatory asset base should be rolled forward (in either nominal or real terms) by including prudent capital expenditure and deducting depreciation and asset disposals. Where a renewals annuity is used, asset values should not also be depreciated.
- New contributed assets (i.e. grants/gifts from governments and contributions from customers (e.g. developer charges)) should be excluded or deducted from the RAB or offset using other mechanisms so that a return on and of the contributed capital is not recovered from customers. If a renewals annuity is used, it should include provision for replacement of contributed assets.

One of the key aspects of the NWIC Draft Pricing Principles is that it allows the return on assets achieved historically (prior to the defined legacy date) to be locked in, and full cost recovery only sought in relation to new and replacement capital investments incurred following the legacy date (30 June 2006). This implies that prices should be set to at least achieve the Government's calculated 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 the value of assets in place prior to this date.

Transparency Statement – Part A calls this approach "Go-Forward-Full-Cost-Recovery" (GFFCR). It notes that in the long-run, as existing assets are replaced, GFFCR will gradually tend towards the upper revenue bound until eventually the full WACC is earned on all assets. The application of the GFFCR approach to SA Water's water and wastewater revenues is discussed in Transparency Statement – Part A. It observes that the historical returns on water assets have been 3.1% (ie. below the upper bound) and that the historical returns on wastewater assets have been 7.2% (ie. above the upper bound). Under the GFFCR approach, these historical returns on assets that existed as at 30 June 2006 would effectively be locked-in until the assets are replaced.

2.3.2 Urban Water Tariffs

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

- Water tariffs should recover forecast target revenue, which should not exceed the Upper Revenue Bound (to "avoid monopoly rents");

- Two-part tariffs, comprising of a service availability charge and a usage charge, should be used to recover the revenue requirement from retail residential, non-residential and bulk customers;
- The water usage charge should have regard to the long run marginal cost of supply of additional water;
- The revenue from the service availability charge for water should be calculated as the difference between the target revenue and the revenue recovered through water usage charges and developer charges;
- Urban water tariffs should be set using a transparent methodology, through a process which seeks and takes into account public comment, or which is subject to public scrutiny;
- Where water usage charges lead to revenue recovery in excess of the upper bound in respect of new investments, the overrecovery is to be addressed, ensuring that revenues are not permanently withheld from customers;
- Water charges should differentiate between the cost of servicing different customers where the benefits of doing so outweigh the costs of identifying the differences and the equity advantages of alternatives.
- Revenue from developer charges should be offset against the total revenue requirement either by deducting the contributions from the RAB, or through some other offset mechanism.

2.3.3 The Combined Pricing Principles

The 1994 CoAG pricing principles are expressed as a set of high level outcomes (e.g. full cost recovery, consumption-based pricing, transparency of cross-subsidies) and specific requirements or agreed actions (e.g. efficient costs, appropriate rate of return) that underpin the outcomes.

The NWI is a commitment by each jurisdiction to various reforms, based upon "*a continuing national imperative of increasing the productivity and efficiency of Australia's water use*". It includes a series of actions to be adopted by jurisdictions focussed on greater compatibility and best practice approaches to water management. The NWI pricing principles are specified at clauses 64 – 77 of the NWI (headed Best Practice Water Pricing and Institutional Arrangements).

The NWI pricing principles build on and incorporate the 1994 CoAG principles. Clause 65 begins with the words "*In accordance with NCP commitments…*". Clauses 65 and 66 are grouped together under the heading "Water Storage and Delivery Pricing". Clause 65 specifies a general commitment to outcomes to achieve the NWI objectives, including through consumption based pricing and full cost recovery. Clause 66 outlines specific agreed actions to achieve those outcomes.

There are at least two areas in which the NWI explicitly modifies the 1994 CoAG principles. These are the requirements of:

- clause 66(i), for continued movement towards upper bound pricing by 2008; and
- clause 66(v), for jurisdictions to consider alternative management arrangements aimed at removing the need for ongoing CSOs.

The Commission observes that the NWI pricing principles have a more explicit outcomes focus than the 1994 CoAG pricing principles, as evidenced by the statements of clause 65.

This is also confirmed by inspection of, in accordance with the Terms of Reference, the Government's NWI Implementation Plan. In addressing clauses 65 and 66 (and many other NWI clauses), the Implementation Plan includes, in each instance, a discussion about the "Link to outcomes in the NWI" and points to NWI clause 64 as being relevant to the understanding of clauses 65 and 66. Clause 64 is focussed entirely on outcomes.[8]

The NWIC draft pricing principles, if adopted by CoAG, would provide further clarification of the way in which the outcomes discussed in clauses 65 and 66 of the NWI could be achieved. For example, while there is a general NWI requirement to move towards upper bound pricing, the draft pricing principles recognise the practical limitations in doing so, given the varying historical returns that have been earned by water and wastewater utilities. The draft pricing principles also provide clarification on how consumption based pricing can be achieved through tariff design.

2.4 NWC Assessment of NWI Progress

The Terms of Reference require the Commission to take into account the NWC's August 2007 report *National Water Initiative First Biennial Assessment of Progress in Implementation*, and in particular Attachment 1 'Summary progress on implementing NWI actions' relevant to Clauses 65, 66(i) and 66(v). The Commission is also required to take into account the updated assessment by the NWC of these same NWI actions, as reported in its February 2008 *Update of Progress in Water Reform* (Attachment A).

The Commission notes that the NWC assessments provides a high level summary of progress by each jurisdiction in addressing NWI commitments. The nature of the assessments are fundamentally different to that undertaken by the Commission in the current inquiry, which is concerned with processes that can enable the achievement of relevant NWI objectives, rather than the achievement of the objectives themselves.

8 The Commission observes that it is not making an assessment in this Inquiry of performance against clause 64.

In its previous Inquiry report, the Commission noted that the 2007 Biennial Assessment provided general support for the progress being made in South Australia on many of the pricing related elements under the NWI. The February 2008 update likewise supports South Australia's progress, with the NWC concluding that across a number of pricing related areas, South Australia has made further progress relative to the 2007 assessment (for example, in relation to the development of policies for pricing of recycled water and stormwater, and in benchmarking efficient performance).

2.5 The Commission's assessment method

The Terms-of-Reference require the Commission to inquire into the processes used in the setting of water and wastewater prices for 2009-10, having regard to the application of certain pricing principles. The Commission is required to advise on the extent to which information relevant to those principles was made available to Cabinet. In undertaking the Inquiry and preparing the advice, the Commission is to take into account relevant matters outlined in certain documents.

> *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.*

Consistent with the approach used in previous Inquiry reports, the Commission's assessment will take into account both the high level outcomes and the specific requirements of the combined pricing principles, as outlined in Chapter 2 of the current report.

The assessment of the application of each pricing principle should consider whether or not the specific requirements are being dealt with and presented to Cabinet:

(a) in a transparent manner (i.e. was the matter addressed, was it shown to have been addressed); and

(b) in such a way as to have reasonably <u>enabled</u> Cabinet to make pricing decisions consistent with the principle (i.e. was it addressed in an appropriate manner).

The Commission's assessment of whether or not the pricing process is likely to achieve the NWI "best practice" pricing principles is a key factor in this current Inquiry. This will require the Commission to review the analysis and information that supported Cabinet's pricing decision to assess if it is sufficient to enable a decision to be reached that is consistent with the relevant principles. Given the decision by Cabinet to approve an increase in water prices in 2009-10 on average by 17.9% in real terms, which has followed a 12.3% real terms increase in average water prices in 2008-09, having a robust decision making process which can achieve the best practice pricing principles takes on even greater importance.

In this Inquiry, the Commission reaches conclusions (in Chapter 4) on whether the information presented to Cabinet as part of the price-setting process allows for adequate application of the pricing principles. In this context the terms “adequate” or “inadequate”, with associated explanation in each section, are sometimes used to provide the Commission’s conclusion as to whether or not a particular matter is dealt with:

(a) in a transparent manner; and

(b) in such a way as to have reasonably enabled Cabinet to make pricing decisions consistent with the high level outcomes.

Finally, the Commission notes that this Inquiry is still focussed on the pricing process, not prices themselves. Therefore, conclusions as to whether or not the chosen prices achieve any particular outcomes remain beyond the scope of the Commission’s inquiry.

3 APPLICATION OF THE PRICING PRINCIPLES

This chapter considers the adequacy of the pricing processes undertaken in the preparation of advice to Cabinet with respect to the pricing principles, as set out in earlier chapters.

In line with earlier inquiries the Commission has assessed the adequacy of Transparency Statement – Part A with the pricing principles, generally comfortable that it is a credible reflection of the information actually provided to Cabinet.

3.1 Comment on upper and lower bound pricing

The pricing principles are underpinned by the concepts of upper and lower bound pricing. These concepts, which are defined in Schedule B(i) of the NWI and are discussed more fully in previous inquiry reports, relate to the achievement of the ongoing viability of the water business (achievement of the lower revenue bound) while also ensuring that the business does not earn monopoly rents (revenue is below the upper bound).

The Commission notes that, unlike previous Transparency Statements, the 2009-10 Transparency Statement – Part A does not specifically discuss the achievement of the lower revenue bound. In recent years, achievement of the lower bound has not been of concern for SA Water as revenue has comfortably exceeded this minimum requirement. The description of the pricing process, as reflected in Transparency Statement – Part A, has therefore placed greater emphasis on upper bound issues than lower bound issues. The Commission accepts this approach, noting that its previous inquiry reports have mainly focussed on issues associated with the upper revenue bound rather than having any concerns over the achievement of the lower bound.

The definition of the upper bound is introduced with the term “to avoid monopoly rents”. Consistent with the application of this concept in other regulated industries, and the terms used in clause 65 as discussed in earlier chapters, the Commission interprets this outcome as requiring that:

- prices must reflect reasonable forecasts of efficient operational, maintenance and administrative (OMA) costs;
- prices must reflect forecasts of reasonable and efficient capital expenditure;
- costs must be tied to an identifiable and preferably supportable level of service provision;
- forecast revenue must be based on best available estimates of demand for services, including customer numbers and water sales;
- capital costs must not be double-recovered through the asset base – for example, capital contributions must be treated appropriately (not just transparently);
- asset sales and redundant assets must be removed from the asset base; and

- prices should allow for the recovery of a reasonable return on assets.

The extent to which the current pricing process is able to provide for a decision that avoids monopoly rents is considered in subsequent sections of this chapter.

3.2 Efficient business costs

The efficiency of business costs (including both operating and capital expenditure) can be assessed in terms of:

- levels of expenditure;
- the creation and consumption of assets (discussed in later sections); and
- impacts on service levels.

One of the key reasons for considering the efficiency of business costs is to provide a foundation for explaining and justifying future actions and requirements. Particularly in the case of pricing proposals, it is necessary to establish a logical link between past performances, the factors influencing those performances and where the expected combination of movements in cost pressures/opportunities and management action will place the utility in the future. It is this future scenario that should be considered when assessing the level of revenue required from the pricing decisions.

The long-lived nature of the infrastructure employed in delivering water and wastewater services means that improvements in capital performance can take a long time to achieve and are seldom considerations in short-term management decisions. However, particularly as infrastructure assets age, it may be reasonable to expect to observe longer term relationships emerging between the level of operational expenditure and capital-based costs (reductions in service capacity).

Performance comparison of the achievements by peer water service providers in recent years (both in terms of absolute cost levels as well as changes in costs) can provide useful insights into what constitutes efficient business costs. Performance comparison and benchmarking can also assist in identifying possible future cost pressures.

3.2.1 Pricing Principles

In relation to efficient costs, the 1994 CoAG pricing principles state that:

> Expert Group Report Recommendation 4
>
> *To avoid monopoly rents, a water business should recover no more than … the operational, maintenance and administrative costs…*
>
> Expert Group Report Recommendation 5
>
> *To be viable, a water business should recover, at least, the operational, maintenance and administrative costs …*

Expert Group Report Recommendation 6

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

In respect of these earlier requirements the NWC stated in its 2005 NCP Assessment that:

> *South Australia has demonstrated that it has implemented the recommendations of the Essential Services Commission in the area of efficient business costs. … South Australia has demonstrated that it has estimated efficient business costs; and, has explored the link between efficient business costs and the SA Water performance statement and customer charter, thereby providing greater transparency on the 'value-for-money' issue. (p. 6-29)*
>
> *The Commission notes that currently the performance of regional businesses in South Australia is not reported separately and so it may be difficult for South Australia to report on cost recovery for these businesses. Even so, the Commission recommends that South Australia continue to seek improvement in the reporting and analysis of data at a regional level, including through benchmarking efficient performance as required under the National Water Initiative. (p. 6-33)*

The 1994 principles included a clear statement on the need to demonstrate efficient business costs. Added to this, clause 65 of the NWI reaffirms the aim that water pricing should achieve various outcomes such as avoiding monopoly rents. It is therefore important that the information presented to Cabinet sufficiently enables Cabinet to conclude that the costs included are efficient.

The Commission also notes that clause 75 of the NWI requires jurisdictions to report independently, publicly and on an annual basis, benchmarking of pricing and service quality for urban water and wastewater service providers.

The NWIC pricing principles do not directly address the issues of efficient business costs, other than in relation to capital expenditure (which is discussed in section 3.3 below).

3.2.2 Transparency Statement – Part A Comments

In discussing efficient business costs, Transparency Statement – Part A includes information about:

- competitive tendering processes carried out by SA Water; and
- public disclosure as a source of efficiency.

The Transparency Statement – Part A also includes SA Water's Annual Efficiency Report, dated November 2008, as an appendix.

In terms of overall efficiency, Transparency Statement - Part A notes that:

> *The government acknowledges ESCOSA's comments in its 2008-09 Final Report that improvements could be made to increase SA Water's incentive to further improve*

efficiencies. While this is beyond the scope of this Transparency Statement, the government will continue to work with ESCOSA on this issue. (p. 18)

Competitive tendering

The information provided in the Transparency Statement – Part A is similar to that provided in the 2007-08 and 2008-09 Transparency Statement.

The key observations are that:

- SA Water, where possible, calls for competitive tenders for services or supplies in order to promote efficient business costs. In the past, approximately 60% of SA Water's OMA expenditures have been subject to competitive pressures;
- SA Water's most significant contract is with United Water International to manage Adelaide's water and wastewater systems. This competitively tendered contract, which commenced on 1 January 1996, has provisions for reviews to facilitate major price resets every five years. Transparency Statement – Part A notes that the Department of Prime Minister and Cabinet has commented favourably on the impact of the contract on customer service levels; and
- SA Water's costs are also subject to the Government budget process.

Public disclosure as a source of efficiency

Transparency Statement – Part A notes that public disclosure of key drivers and performance trends across Australian water utilities, through the National Performance Report (NPR), prepared by the NWC and Water Services Association of Australia (WSAA), contributes to efficiency.

Transparency Statement - Part A shows, for a number of key cost and service performance indicators, SA Water's relative 2006-07 performance against its 'peer' water utilities both for its metropolitan and regional operations.[9]

Unlike the 2008-09 Transparency Statement – Part A, the 2009-10 Transparency Statement - Part A does not include information on key OMA cost drivers.

Annual Efficiency Report

The structure of the Annual Efficiency Report, prepared by SA Water, has changed compared to the previous year's report. The most important change is that the report includes not only NPR information, but also internal performance information. While the NPR information only includes data up to 2006/07 (2007/08 information was not available at the time) the internal performance information is

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[9] The 2007-08 NPR is now available having been released in April 2009.

for 2006/07 and 2007/08 and also includes targets for 2012/13 (but none of the intervening years).

Internal performance information is provided in respect of:

- compliance with certain customer service standards in the draft customer charter (separate metropolitan and regional)
- compliance with customer contact service standards in the draft customer charter
- compliance with new connections service standards in the draft customer charter
- customer satisfaction index
- an index of compliance with Australian Drinking Water Guidelines
- the number of type 1 drinking water quality notifications to the Department of Health
- an incident response index in relation to drinking water quality
- number of properties with more than 3 unplanned water interruptions (metropolitan and regional)
- number of sewer overflows inside and outside building (metropolitan and regional)
- total water consumption (metropolitan and regional)
- compliance with water extraction limits and licence conditions
- EPA licence compliance
- number of type 1 and 2 wastewater notifications
- various key water and wastewater supply statistics

In terms of the NPR performance indicators, the 2006/07 information generally shows

- SA Water has comparatively good performance in terms of water main breaks, leakage and water quality
- but has comparatively poor performance in relation to sewer main breaks and chokes, overflows and odour complaints

In terms of the internal performance information, SA Water's performance appears mixed, with no clear trend observable between 2006-07 and 2007-08.

3.2.3 The Commission's assessment

In its 2008-09 Inquiry report the Commission noted that there had been improvements in relation to the provision of information on efficient costs, and in particular the inclusion of NPR information. However, the Commission expressed concern regarding the lack of information on:

- disaggregated forward-looking costs
- total costs (and not just OMA costs)
- 'value for money', to the extent that this information includes comparative pricing information
- evidence for the proposition that the costs are efficient.

The Commission notes that the information provided in the 2009-10 Transparency Statement – Part A, and in particular the information included in the Annual Performance Report, represents another improvement in disclosure. This particularly relates to the inclusion of:

- internal performance information
- a broad discussion of trends in future operating costs
- information on total costs (OMA plus depreciation, which is an NPR performance indicator)

The Commission also notes that SA Water's historical customer service levels compare well with its peer water authorities. In terms of unit costs, the 2007/08 NPR results confirm that metropolitan SA Water had the lowest combined water and sewerage operating cost per property (operations, maintenance and administration) for the third consecutive year. Real costs per property have been relatively stable for 4 years while some interstate entities have had significant increases.

The Commission considers there is still insufficient forward-looking cost information. It is these forward looking costs that ultimately determine prices. None of the internal performance indicators or the NPR performance indicators are projected forward over the pricing outlook period, with the exception of the provision of 'targets' for internal performance indicators for 2012-13 only. Although there is some discussion regarding the increase in OMA costs between 2007-08 and 2008-09 (which is 20%), this is of a general nature and no specific cost information is provided.

The Commission also notes that while last year's efficiency report included separate information for a number of SA Water regions (Mt Gambier, Murray Bridge, Port Augusta, Port Lincoln, Port Pirie, Whyalla) separate information is only provided for Mt Gambier and Whyalla this year. Further, customer feedback information is only provided for 2008, rather than for previous years as was the case in last year's report.

In its 2007-08 Inquiry, the Commission repeated its previously stated view that:

> *the role of the historical performance reporting is to illustrate the impact of emerging trends and help explain the underlying cause-and-effect relationships that influence the utility's resource needs…The next vital step is to understand how key trends are going to impact on the utility over the next few years and the nature of the resource/revenue implications…The Commission believes that the absence of forward projections for both costs and key service standards would need to be addressed in order to enhance the pricing process. (p. 24)*

The Commission considers that this comment still applies.

As noted in Transparency Statement – Part A, the Commission looks forward to working with the Government to increase SA Water's incentive to improve efficiencies.

3.2.4 The Commission's view on application of the pricing principles

Adequacy of information: Did Cabinet receive information that would allow for adequate application of the pricing principles?

Based on the available performance comparison material, Transparency Statement – Part A makes statements about SA Water's OMA costs being efficient. This shows that the principle of efficient costs has been considered by Cabinet. However, in the material provided to Cabinet and to the Commission for review, there is insufficient information that would have reasonably enabled Cabinet to make pricing decisions consistent with the high level outcomes. The inadequacy relates primarily to showing that the forward looking costs, upon which a pricing decision must rely, are efficient.

The Government's response to the Commission's 2008 Inquiry report argued that the Government's pricing model provides forward looking cost information based on SA Water's approved budget, which is reflected in the indicative revenue direction. While the pricing model may contain more specific forward looking cost estimates, the relevant issue for the Commission is whether or not sufficient information was provided to Cabinet which would enable it to be satisfied that forward-looking costs are efficient. For the reasons described earlier, the Commission is of the view that the level of information provided to Cabinet was insufficient to enable it to form such a view.

Transparency of information: Does Transparency Statement – Part A adequately summarise the relevant information?

The Transparency Statement summarises the information received by Cabinet, although some additional information was provided to Cabinet that was not included in Transparency Statement – Part A.

3.3 Capital Expenditure

Capital expenditure is a key driver of increases in SA Water's prices.

3.3.1 Pricing Principles

In relation to efficient capital costs, Expert Group Report Recommendation 6 states that:

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

It is critical that the information presented to Cabinet addresses capital expenditure and does so sufficiently to enable Cabinet to conclude that the capital expenditure is efficient.

The NWIC draft principles for recovering capital expenditure do not directly address the issue of the efficiency of capital expenditure forecasts, other than in paragraph 22 which provides that the RAB should only reflect 'prudent' capital expenditure:

> *The RAB comprising prudent new investments and legacy investments should be rolled forward each year in accordance with the following formula, which can be expressed in nominal or real terms:*
>
> *RAB_t = (RAB_{t-1} + Prudent Capital Expenditure$_t$ – Depreciation$_t$ – Disposal$_t$ (discarded assets)). (Where t = the year under consideration).*

3.3.2 Transparency Statement – Part A Comments

Transparency Statement – Part A provides information on SA Water's capital program. Table 10 sets out the proposed capital expenditure in the roll-forward estimate, which is summarised in the table below.

Table 3.1. SA Water forecast capital expenditure ($m nominal)

	2008-09	2009-10	2010-11	2011-12	2012-13
Water	517	710	464	207	479
Wastewater	112	182	172	121	56
Total	629	892	636	328	534

Transparency Statement – Part A summarises the Waterproofing Adelaide (WPA) program, provides commentary on the Adelaide desalination plant and the North-South Interconnector and identifies that the government is investigating a number of other water resource developments.

In terms of the desalination plant, Transparency Statement – Part A indicates that spending will be $96.5 million in 2008-09. While the Commission was assured that information on the total estimated cost of the plant was provided to Cabinet, the Commission notes that the total estimated cost was not provided to the Commission, nor disclosed in Transparency Statement – Part A, where it is noted that:

> *Once the decision to build a desalination plant had been made it remained to factor the likely efficient cost of that plant into the regulatory model. Generally, estimates of future new capital assets are based in efficient estimated costs, escalated at 6% per annum until they are expected to be incurred. The escalation reflects current construction market conditions and is consistent with an independent review by consultants, KPMG.*
>
> *For the desalination plant, firmer estimates of future operating and capital expenditures will become available upon completion of all environmental and engineering studies and pilot plant testing – tender due to be completed in March [2009]. As firmer estimates become available, revisions will be made to the regulatory model and will be considered in subsequent annual price setting process, as appropriate. (p. 16)*

Transparency Statement – Part A also notes that a decision to accelerate the Adelaide desalination plant was made in September 2008.

Table 16 of Transparency Statement – Part A, includes 2008-09 and total expenditure information for a number of major projects.

3.3.3 The Commission's assessment

Capital expenditure (and the subsequent operating expenditure associated with capital projects) is the key driver of recent annual price increases. While capital expenditure forecasts for the period 2008-09 to 2012-13 have not changed significantly in the past year there has been a substantial bringing-forward of the capital program. Based on information contained in material presented to Cabinet, the majority of this appears to be due to the acceleration of the Adelaide desalination plant. The Commission notes, however, that its impact is not explicitly stated in Transparency Statement –Part A because full disclosure of all the capital projects and their timing is not provided.

In its 2008-09 review the Commission commented that, as in previous years, the Transparency Statement – Part A provided limited or in some cases no information regarding whether:

- well developed asset management planning and processes are in place and being followed
- projects, including projected WPA expenditure, 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.

While the 2009-10 Transparency Statement – Part A provides discussion around some of the capital projects, the Commission considers that the above observations continue to apply.

In terms of efficient costs, the Commission notes that capital projections again include an assumption that capital costs will escalate at 6% per annum in nominal terms. According to the Transparency Statement this escalation reflects current market conditions and is consistent with an independent review by KPMG.

The Commission notes that in recent years capital escalation in the water industry has been around 6% and this was the case until mid-2008. However, since this time there is some evidence of a real reduction in capital costs in the sector and forecasts of cost escalation have been sharply reduced. This has been brought about by significantly lower levels of capital construction in the Australian private sector and particularly in the mining sector. Contractors have high levels of spare capacity and hence there is greater competition in the market. Further, there have been strong reductions in the cost of key raw inputs such as steel and oil, leading to lower costs of materials. Increasing unemployment has led to reductions in real wage increases.

Signs of reductions in the absolute level of costs, and lower level of capital escalation, became apparent towards the end of 2008. It may be that at the time capital forecasts were being prepared for the purposes of determining 2009-10 prices there was insufficient information about the change in market conditions to adjust the forecasts. It may also be that the higher level of cost escalation is 'locked in' for some projects via agreed contracts.

However, based on the information available today it appears that an assumption of 6% capital escalation is likely to overstate the level of efficient capital costs. To some extent this illustrates some of the difficulties associated with the timing of the price setting process where gazettal requirements under the Waterworks Act 1932 mean that forecasts need to be established well before prices are implemented.[10] Nevertheless, there is some risk that prices are higher than they should otherwise be.

Importantly, however, the Commission acknowledges that the impact of applying an overstated escalation factor is not likely to be material, given that prices are

[10] It is noted that amendments to the *Waterworks Act 1932* have been proposed that, among other things, would lead to the price setting process being deferred by around five months (from December to April), which would alleviate some of the difficulties in establishing forecasts well before the prices take effect.

currently set annually, and actual capital expenditure will be rolled into the regulatory model in the following year.

The Commission notes that more information on capital costs was provided to Cabinet than is contained in Transparency Statement - Part A. In addition, further reports on the cost of the desalination plant were provided to Cabinet, with copies provided to the Commission. However, the Commission notes that the total estimated cost of the desalination plant was not provided in the Transparency Statement - Part A.

3.3.4 The Commission's view on application of the pricing principles

Adequacy of information: Did Cabinet receive information that would allow for adequate application of the pricing principles?

Based on the material provided to the Commission, there does not appear to be sufficient information that would have reasonably enabled Cabinet to make pricing decisions consistent with the high level outcomes. The inadequacy relates primarily to showing whether or not the proposed capital expenditure is efficient, and whether or not the proposed prices are reflective of forecast efficient costs.

Necessary steps to achieving adequacy include providing information to demonstrate that:

- well developed asset management planning and processes are in place and being followed
- projects, including projected WPA expenditure, 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 the Government addressed this issue in its response to the Commission's 2008 Inquiry report, stating that:

> *Cabinet was privy to a range of other information focussed specifically on the decision about water security. This included a comprehensive report from the Desalination Working Group, which included information on a large number of options to secure long term water requirements.*
>
> *KPMG was engaged to examine the comprehensiveness and reasonableness of cost information and the assumptions and methodology for the new water security projects.*

While the Commission acknowledges that Cabinet has received a significant amount of information relating to the proposed desalination plant and other water security projects, the Commission believes that it is important that Cabinet be satisfied of the efficiency of all forward looking capital expenditure. The lack of information to support the decision to continue escalating capital expenditure by 6% also raises doubts over the efficiency of capital costs.

Transparency of information: Does Transparency Statement – Part A adequately summarise the relevant information?

Based on the material that was presented to Cabinet with which the Commission has been provided, the Commission is satisfied that the information regarding capital expenditure is adequately summarised in Transparency Statement – Part A.

3.4 Asset Valuation

3.4.1 Pricing Principles

The Guidelines for applying Section 3 of the Strategic Framework state:

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

NWI Clause 66(i) states:

> *Metropolitan*
>
> *Continued movement towards upper bound pricing by 2008*

Added to this are the clause 65 outcomes, particularly the outcome "avoid monopoly rents", which suggest that the asset valuation information presented to Cabinet should address the deprival value methodology or the reasons for departure from that.

The NWIC draft pricing principles refer to the process for rolling forward the asset base, setting out the following formula for calculating asset values in each year:

> *RAB t = (RAB$_{t-1}$ + Prudent Capital Expenditure $_t$ – Depreciation $_t$ – Disposal $_t$ (discarded assets)). (Where t = the year under consideration).*

The draft pricing principles also state that:

- *Where assets are optimised, they should not be subject to further optimisation unless there are relevant changes in market circumstances.*
- *Where DRC or DORC is used as a basis for asset values, the RAB comprising new investments and legacy investments should be re-valued through an independent appraisal on a rolling basis in accordance with Accounting Policy Standards.*
- *Where a renewals annuity is used, asset values should not be depreciated.*

3.4.2 Transparency Statement – Part A Comments

Previous Transparency Statements have indicated that SA Water's assets are valued using a fair value method based on depreciated replacement costs. The 2009-10 Transparency Statement – Part A does not repeat this information, focussing instead on the approach for rolling forward the asset value and manner in which the inputs into the asset roll forward (capital expenditure, depreciation, return on assets) are derived.

Transparency Statement - Part A sets out the formula for the asset roll forward, which is consistent with the formula specified in the NWIC draft pricing principles. It explains that the asset values as at June 2006 have been rolled forward in nominal terms, using an escalation rate of 3.5% per annum, consistent with the inflation forecast assumption in the real WACC calculation.

3.4.3 The Commission's assessment

The Commission appreciates that, given the roll-forward approach that has been adopted, it is more relevant to discuss the inputs into the roll forward than focus on the valuation methodology that underpins the initial asset value. This valuation methodology has been discussed in previous inquiries, where the Commission has concluded that the fair value approach is adequate. The Commission's assessment of the Regulatory Asset Base in this Inquiry is therefore limited to the approach used to determine the inputs into the asset roll forward, which are discussed separately in this report.

3.4.4 The Commission's view on application of the pricing principles

Adequacy of information: Did Cabinet receive information that would allow for adequate application of the pricing principles?

The Commission has previously judged the fair value approach to be adequate and it is satisfied that the material provided to Cabinet included sufficient information to demonstrate how the asset value was rolled forward from the previous year.

Transparency of information: Does Transparency Statement – Part A adequately summarise the relevant information?

The Commission considers the current information in Transparency Statement – Part A to be adequate.

3.5 Contributed Assets

3.5.1 Pricing Principles

The Guidelines for applying Section 3 of the Strategic Framework state:

…transparency is required in the treatment of …, contributed assets,… .

NWI clause 65 specifies certain outcomes, particularly "avoid monopoly rents".

Principle 6 of the NWIC draft principles for recovering capital expenditure relates to contributed assets. Paragraph 26 provides that:

> *New contributed assets[i,ii,iii] (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[iv]. If a renewals annuity is used, it should include provision for replacement of contributed assets.*
>
> *Notes:*
>
> i. *For contributed assets other than developer charges, funding should be recognised as an asset contribution only where there is clear contractual or policy evidence that this funding was meant to be used to lower long-term prices, or for some other reason.*
> ii. *For the purposes of principle 6, contributed assets exclude gifts or grants where there is clear contractual or policy evidence that charges be set to achieve full cost recovery, inclusive of the value of the gift or grant.*
> iii. *Equity injections should be distinguished from grants /gifts /contributions.*
> iv. *It is acceptable for principle 6 to apply to legacy contributed assets if adequate information is available to identify them.*

Principle 10 of the NWIC principles for urban water tariffs suggests, in paragraph 18, that:

> *To avoid over-recovery, revenue from developer charges should be offset against the total revenue requirement either by excluding or deducting the contributed assets from the RAB or by offsetting the revenue recovered using other mechanisms.*

3.5.2 Transparency Statement – Part A Comments

Transparency Statement – Part A states that:

> *assets that are contributed to SA Water, for example by grant of gift from a government or by customers, are excluded from the RAB where sufficient information is available to identify and value them (p.15)*

3.5.3 The Commission's assessment

Although not stated explicitly in the Transparency Statement – Part A, the Commission understands that that the Government has not changed its approach to the treatment of prior years' contributed assets, which involves:

- the exclusion of post-1995 contributed assets from the RAB; and
- the inclusion of pre-1995 contributed assets in the RAB (equivalently, the amount that has been estimated for exclusion from the RAB is zero).

In the past the Government consistently defended this approach, despite the Commission's misgivings, on the basis that adequate information is not available to identify contributed assets prior to 1995. However the Government's approach has some support under Principle 6 of the NWIC which implies that contributed assets in respect of legacy assets should only be excluded from the RAB where adequate information is available to identify them. As indicated in previous inquiry reports, the Commission believes that there are some potential ways in which historical contributions could be estimated.

In respect of forecast contributed assets the approach set out in Transparency Statement – Part A makes clear that the RAB roll forward excludes contributed assets, which is consistent with the relevant NWIC principles.

3.5.4 The Commission's view on application of the pricing principles

Adequacy of information: Did Cabinet receive information that would allow for adequate application of the pricing principles?

The treatment of contributed assets in the information provided to Cabinet is adequate, in so far as it sets out the new NWIC Principle 6 and explains why the approach adopted in respect of legacy contributed assets is consistent with this Principle. However, the Commission remains of the view that there may be ways to estimate the value of historical contributions.

Transparency of information: Does Transparency Statement – Part A adequately summarise the relevant information?

Whereas the Cabinet material discusses the treatment of contributed assets in some detail, there is little discussion of this issue in Transparency Statement – Part A.

3.6 Depreciation

3.6.1 Pricing Principles

The Guidelines for applying Section 2 of the Strategic Framework state:

> *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 [weighted average cost of capital].[Emphasis added]*

As the Commission explained in its previous inquiry reports, provision for the cost of asset consumption refers to depreciation.

NWI Clause 66(i) states:

> *Metropolitan*
>
> *Continued movement towards upper bound pricing by 2008*

In addition, Clause 65 of the NWI refers to the outcome "avoid monopoly rents".

3.6.2 Transparency Statement – Part A Comments

Transparency Statement – Part A notes that the Government has continued to estimate depreciation in the upper bound using the straight-line method, based on the estimated useful lives of the assets.

The manner in which asset lives are estimated has changed in the 2009-10 pricing decision. Transparency Statement – Part A explains that:

> *Legacy assets, or those in existence as at 1 July 2006, are estimated to have an average useful life of 50 years. All other new or replacement assets have an estimated average useful life of 60 years except for water security related projects that are separately identifiable, for which individual depreciation schedules are used. (p17)*

Transparency Statement – Part A notes that, as part of the 2008-09 pricing decision, it was assumed that new assets had a useful life of 100 years. For legacy assets, the previous approach was based on a "modified financial depreciation rate". Transparency Statement – Part A states that the outcome of changing the approach to estimating the useful life of assets is a "relatively minor increase in the GFFCR".

It is also noted that regulatory depreciation is recognised at the time that a new asset is expected to be commissioned, and that work-in-progress is not depreciated.

3.6.3 The Commission's assessment

The Commission notes the inclusion of additional information on the method used to estimate asset lives, and supports a movement towards an approach that more explicitly distinguishes between asset classes, where asset lives may be different. The establishment of separate depreciation schedules for the water security projects is also a positive step.

3.6.4 The Commission's view on application of the pricing principles

Adequacy of information: Did Cabinet receive information that would allow for adequate application of the pricing principles?

The Commission is satisfied that the material provided to Cabinet included information about depreciation.

Transparency of information: Does Transparency Statement – Part A adequately summarise the relevant information?

Transparency Statement – Part A provides an adequate summary of the methodology for calculating regulatory depreciation.

3.7 Externalities

While issues associated with the infrastructure and operational aspects of water and wastewater service delivery dominate the text of pricing considerations, it is important to remember that water resource management is a key plank of the overall Water Reform Strategic Framework. The avenue for taking account of costs associated with the availability of the water resource, including management of environmental impacts, is, in part, through the consideration of "externalities".

The inclusion of externalities in the setting of water prices ensures that consumers can make decisions about water use, facing the full economic costs resulting from that water use. This means that the decision will be consistent with the principle of efficient use of water and water infrastructure.

3.7.1 Pricing Principles

The Guidelines for applying Section 3 of the Strategic Framework state:

> *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 [weighted average cost of capital]. [Emphasis added]*
>
> *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 … . [Emphasis added]*
>
> *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 …*
>
> *Externalities … means environmental and natural resource management costs attributable to and incurred by the water business.*
>
> *NWI Clause 65(ii)*
>
> *.. full cost recovery for water services to ensure business viability and avoid monopoly rents, including recovery of environmental externalities where feasible and practical.*

Furthermore, as noted by the Commission in previous inquiry reports, clause 73 of the NWI suggests that the NWI takes a broader (and arguably better) view of externalities than the narrow "costs attributable to and incurred by" applied under the 1994 principles. However, the Commission also notes that, for lower bound revenue purposes, the NWIC draft pricing principles adopt the narrow definition of externalities as per the 1994 principles. It is unclear whether or not this definition also applies for upper revenue bound purposes.

The NWC has identified the management of environmental externalities as an area requiring significant further work by South Australia as part of its 2007 *National Water Initiative First Biennial Assessment of Progress in Implementation.* In its

February 2008 *Update of Progress in Water Reform*, South Australia's progress in the management of environmental externalities was rated by the NWC as "started", although it was noted that progress was dependent on the timing of the development of principles through the NWIC.

3.7.2 Transparency Statement – Part A Comments

As stated in Transparency Statement – Part A, the Government has maintained its position that, until there is national agreement about the treatment of externalities, it will continue to include externality costs that are 'both attributable to and incurred by' SA Water in the upper revenue bound and lower revenue bound in compliance with CoAG guidelines and previous practice.

Consistent with previous practice, the 2009-10 Transparency Statement – Part A provides information on the Environment Protection Agency licence fee and levies to Natural Resource Management Boards, which are included as externalities.

There is also some discussion on the greenhouse gas emissions associated with SA Water's operations. It is noted that following the introduction of an emissions trading scheme, this environmental cost will be reflected in higher electricity prices paid by SA Water, which will flow through to water charges, thereby ensuring that water users face the cost of this externality.

3.7.3 The Commission's Assessment

The Commission notes that the Government continues to take a narrow view on the treatment of environmental externalities, while waiting for national clarity on this issue.

While the Commission appreciates this uncertainty, it also continues to have the view that the NWI currently requires more to be done on the identification and management of externalities. This is supported by the NWC February 2008 *Update of Progress of Water Reform*, where SA was rated as "started" on this issue, with a number of other jurisdictions being assessed as having made further progress. The NWC rated the ACT as "completed", referring to the existence of a specific water abstraction charge.

Therefore, the Commission does not consider that the work being undertaken through NWIC should prevent the Government from making further progress on the management of externalities in South Australia. The Commission still considers that, at the least, progress should be made to identify externalities. This would allow the Government to satisfy NWC's request that externalities be identified and examined as to whether or not they should be included in pricing.

3.7.4 The Commission's view on application of the pricing principles

Adequacy of information: Did Cabinet receive information that would allow for adequate application of the pricing principles?

The material provided to Cabinet does not contain information that would have reasonably enabled Cabinet to make pricing decisions consistent with the NWI principles. Further work is required to at least identify the relevant externalities.

Transparency of information: Does Transparency Statement – Part A adequately summarise the relevant information?

The Commission is satisfied that the information provided to Cabinet about externalities is adequately summarised in Transparency Statement – Part A.

3.8 Return on Assets

Water and wastewater businesses are highly capital intensive (that is, they require investment of large amounts of capital in sunk assets). Therefore, relatively minor variations in rates of return (also referred to as the weighted average cost of capital or WACC) and/or the asset values on which return is sought can have a significant impact on pricing. In addition, the inclusion or exclusion of contributed assets can have a considerable impact.

The inclusion of a return on assets component in pricing considerations ensures that the opportunity cost of funds invested is recognised in water and wastewater pricing, leading to efficient economic outcomes.

The cost of capital relates to the opportunity cost of investment. It represents a risk adjusted return that investors demand on their investment.

3.8.1 CoAG Principles

Clause 3 of the CoAG Strategic Framework provides:

> *... 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.*

The Guidelines for applying Section 3 of the Strategic Framework state:

> *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 [weighted average cost of capital].[Emphasis added]*

NWI Clause 66(i) is relevant in that it requires continued movement towards upper bound pricing by 2008.

The NWIC draft urban water pricing principles for recovering capital expenditure contain a number of clauses relevant to the cost of capital. Importantly, the principles distinguish between the WACC to apply to new capital expenditure and the WACC to apply to legacy capital expenditure (the initial asset base). In respect of the WACC to apply to new capital expenditure, paragraph 18 of Principle 1 states that:

> *The rate of return should be consistent with the Weighted Average Cost of Capital (WACC) with the cost of equity derived from the Capital Asset Pricing Model (CAPM).*

A footnote to this clause explains that the WACC should be consistent with the form of asset valuation methodology adopted. For example, a nominal WACC should apply to a historic cost valuation and a real WACC should apply to a current cost valuation.

In respect of the WACC to apply to legacy capital expenditure, paragraph 21 of Principle 4 states that:

> *The return earned should be no less than the return being achieved at the legacy date, and, if the return being earned before the legacy date is above the current WACC return, no more than the return being achieved at the legacy date.*

The legacy date set out in the Transparency Statement is 30 June 2006.

3.8.2 Transparency Statement – Part A Comments

Transparency Statement – Part A sets out the values of the respective WACCs used to determine the GFFCR. They are:

- for new and replacement assets, a 6% real pre tax real rate of return
- for legacy water assets, a 3.1% real pre-tax rate of return
- for legacy wastewater assets, a 7.2% real pre-tax rate of return

In determining the URB a 6% real pre tax rate of return has been used for all assets.

The Government has included in Appendix 4 to the Transparency Statement – Part A, a description of the WACC formula, a summary of the value of the WACC parameters, and brief definitions of the parameters. The Transparency Statement – Part A notes that the 6% WACC is the same as that used to determine SA Water's prices in 2007-08 and 2008-09. The WACC parameters are therefore based on historic observations: for example the risk free rate of interest was estimated at 24 October 2007.

3.8.3 The Commission's Assessment

The Commission believes that the information provided regarding the WACC is broadly satisfactory and, to the extent that the GFFCR incorporates a separate

WACC for new capital expenditure and legacy assets, is consistent with the NWIC draft urban water pricing principles.

The Commission notes that information presented to Cabinet contains some discussion on the changing market conditions leading to a higher cost of capital. The primary argument for retaining the current value of WACC is based on the long term nature of SA Water's assets. However, discussion relating to the risks of not reflecting market conditions in the WACC, and the relationship between the frequency of setting prices and debt refinancing should be made more explicit.

Transparency Statement – Part A does not contain any discussion on this issue.

The Commission also notes that it would have been useful for the Transparency Statement – Part A to set out the calculation of the 30 June 2006 returns on legacy assets.

3.8.4 The Commission's view on application of the pricing principles

Adequacy of information: Did Cabinet receive information that would allow for adequate application of the pricing principles?

Documents provided to Cabinet present information about the various WACCs adopted, including the derivation of the 6% real rate of return. Cabinet was provided with documentation discussing the merits of updating the 6% rate of return with more recent data, although this could have been more extensive.

The Cabinet documentation also states that the GFFCR amount in respect of legacy assets is based on a 3.1% real rate of return for water assets and 7.2% for wastewater assets.

However, as noted in the Commission's 2008-09 review, the material would be improved were more detailed information presented to explain the derivation of each WACC parameter. Further, it would be helpful to set out the calculation of the real rate of return on legacy assets at 30 June 2006.

Transparency of information: Does Transparency Statement – Part A adequately summarise the relevant information?

Subject to the Commission's comments regarding issues associated with updating the WACC, the Commission is satisfied that the information provided to Cabinet about the WACC is adequately summarised in Transparency Statement – Part A.

3.9 *Tax Equivalent Regime*

The tax equivalent regime (TER) relates to a regime whereby government owned enterprises are subject to an equivalent taxation regime that applies to the private sector. For state-owned enterprises, tax is paid to the State Government, not the Commonwealth.

3.9.1 Pricing Principles

The 1994 CoAG pricing principles require that taxes or TER payments be included in the calculation of both the maximum revenue and the minimum revenue.

The main reason for the TER is to ensure competitive neutrality. In the absence of TER, the public sector will have a cost advantage since it would not have to incorporate the business cost of taxes into prices.

The Guidelines for applying Section 3 of the Strategic Framework state:

> *To avoid monopoly rents, a water business should not recover more than the … taxes or Tax Equivalent Regime*
>
> *To be viable, a water business should recover, at least, … taxes or TERs (not including income tax)*
>
> *In determining prices, transparency is required in … tax equivalent regimes*

The outcomes of NWI Clause 65 are relevant to this issue, especially the avoidance of monopoly rents.

3.9.2 Transparency Statement – Part A Comments

Transparency Statement – Part A states that:

> *SA Water is liable for the full range of rates and taxes or their equivalents as if it were not a State owned business. This includes corporate tax and a range of land tax and council rates.*
>
> *It is unnecessary to include a separate taxation amount in the URB, as the return of assets…is estimated using a pre-tax WACC.*

A corporate tax rate of 30% is assumed in the pre-tax WACC calculations.

3.9.3 The Commission's Assessment

The inclusion of a 30% corporate tax rate in deriving a pre-tax WACC is common regulatory practice and is considered to be consistent with the combined pricing principles.

3.9.4 The Commission's view on application of the pricing principles

Adequacy of information: Did Cabinet receive information that would allow for adequate application of the pricing principles?

Information presented to Cabinet relating to the TER is adequate.

Transparency of information: Does Transparency Statement – Part A adequately summarise the relevant information?

The Commission is satisfied that the Transparency Statement – Part A included information about tax liability.

3.10 Efficient Resource Pricing

The tariff structure has an important role to play in achieving overall economic efficiency. Although the majority of a water utility's costs may be fixed (in the short to medium term), consumption based pricing sends a strong signal and can achieve allocative efficiencies. This is of particular importance at present given the proposals for new augmentations to water supply infrastructure in SA.

3.10.1 Pricing Principles

The CoAG Strategic Framework requires "the adoption of pricing based on the principles of consumption based pricing". Specifically, urban water providers are required to adopt prices "comprising of an access or connection component together with an additional component or components to reflect usage where this is cost effective."

The CoAG Expert Group recommended "economic regulators … should determine the level of revenue for a water business based on efficient resource pricing".

"Efficient resource pricing" is defined in the CoAG strategic framework as including "the need to use pricing to send 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 so that the correct pricing signals are sent."

Clause 65(i) of the NWI requires "… efficient pricing policies for water storage and delivery… that facilitate efficient water use … including through the use of (i) consumption based pricing…".

The Commission also observes that Clause 64 of the NWI states "the Parties agree to implement water pricing and institutional arrangements which (i) promote economically efficient and sustainable use of (a) water resources (b) water infrastructure assets."

Finally, the NWIC principles for urban water tariffs contain a number of principles related to efficient resource pricing and specifically, the adoption and calculation of two-part tariffs. These are as follows:

> *Principle 2*
>
> *10. Two-part tariffs (comprising a service availability charge and a water usage charge) should be used to recover the revenue requirement from retail residential and non-residential and bulk customers*[i,ii]

Notes:

i. *Unless this is demonstrated to not be cost effective.*

ii. *This does not preclude charging for peak capacity.*

Principle 3

11. *The water usage charge should have regard to the long run marginal cost of the supply of additional water[i].*

Notes:

i. *On economic efficiency grounds the water usage charge should comprise only a single usage charge. However, governments may decide on more than one tier for the water usage charge for policy reasons, e.g. sending a strong pricing signal to encourage efficient water use; and having regard to equity objectives.*

Principle 4

12. *The revenue recovered through the service availability chargei should be calculated as the difference between the revenue requirement and the revenue recovered through water usage charges and developer charges.*

Notes:

i. *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.*

Principle 7

15. *Water charges should be differentiated by the cost of servicing different customers (for example, on the basis of location) 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[i].*

Notes:

i. *Differential pricing may be achieved by upfront contributions, including developer charges.*

There are no equivalent NWIC principles for wastewater tariffs.

3.10.2 Transparency Statement – Part A Comments

Transparency Statement – Part A sets out the proposed tariff structure for water and wastewater in Tables 6 and 7. The tariff structure for water for 2009-10 has not changed, with the three tier usage charge for residential customers and two tier usage charge for non-residential customers being retained. However, within an overall 17.9% real increase in water tariffs there have been changes to relative tariff levels including:

- significant (36% to 37%) increases in the usage charges
- no change in the fixed charge for commercial customers and a $20 reduction in the fixed charge for residential customers.

The wastewater tariff structure for 2009-10 remains unchanged. The metropolitan wastewater charges are unchanged in real terms from those in 2008-09, while the regional wastewater charges have increased by 0.5% in real terms.

Water

As noted SA Water intends to change the relativities between the fixed and usage charges in 2009-10. The changes are summarised below.

TARIFF	2008-09	2009-10	% CHANGE
NON-COMMERCIAL			
Fixed charge ($)			
Residential	157.40	137.60	-13%
Non-residential (industry)	174.60	174.60	0%
Usage charge ($/kL)			
First tier (<120 kL)	0.71	0.97	37%
Second tier (>120 kL)	1.38	1.88	36%
Third tier (>520 kL - single residential dwellings only)	1.65	2.26	37%
COMMERCIAL			
Fixed charge			
Property rating scale	0.079%	TBD	na
Minimum ($)	174.60	174.60	0%
Usage charge			
First tier (<120 kL)	0.71	0.97	37%
Second tier (>120 kL)	1.38	1.88	36%

Transparency Statement – Part A provides the following explanation for the increase in usage changes:

> *In its 2009-10 pricing decision, the South Australian Government focuses on increasing water charges consistent with the estimate of LRMC…The current estimate of LRMC is based on a potential future expansion of the planned Adelaide Desalination Plant from 50 GL to 100 GL.*
>
> *SA Water has estimated LRMC based on Average Incremental Cost… LRMC is estimated to be about $2.30 per kL in 2008-09 dollars or $2.35 per kL in 2009-10 dollars.*

In relation to the fixed charge, the Transparency Statement - Part A makes the following observations:

> *COAG pricing principles require that water charges include a service availability charge that is calculated as the difference between the revenue requirement and the revenue recovered through water usage charges.*

> *The service availability charge could also vary between customer or customer classes, depending on service demands and equity considerations according to COAG pricing principles. Unattributable joint costs should be allocated such that total customer charges must not exceed stand-alone cost or be less than avoidable costs where it is practical to do so.*
>
> *In its 2009-10 decision the South Australian Government reduced the statewide uniform residential water service availability charge. For other non-commercial customers the water service availability charge is unchanged. The service availability charge for commercial customers continues to be based on property value with the same minimum charge. Any potential cross-subsidy of property based charges is discussed below.*
>
> *In its 2009-10 pricing decision the South Australian Government continues to adopt COAG pricing principles when setting service availability charges. (pp. 30-31.)*

Transparency Statement – Part A also provides additional discussion in relation to the Government's affordability, equity and customer impact considerations in setting water charges.

Under the Government's Statewide uniform pricing policy, the water charging structure is uniform between Adelaide and regional customers. This gives rise to cross subsidy and Community Service Obligation (CSO) issues, which are addressed below.

Wastewater

SA Water's tariff structure for wastewater charges is unchanged for 2009-10. All of SA Water's customers pay a charge based on property value (subject to a minimum charge). Transparency Statement – Part A notes that the property rating scale for 2008-09 is still to be determined (as is the rating scale for the water supply charge).

There is no consumption (or volumetric) wastewater component. Separate rates are applied between metropolitan and country customers, to adjust for the generally lower property values in country areas. While the general intent is that country customers should pay similar amounts to city customers, Transparency Statement – Part A notes that:

> *There is also a significant disparity between average residential wastewater revenue per customer in the metropolitan and regional areas of around 12% ($391 in regional areas compared to $447 in the city in 2007-08) despite higher costs per customer in regional areas. (p. 41)*

Transparency Statement – Part A therefore identifies that there will be an 0.5% relative increase in regional wastewater charges to move regional wastewater charges towards those in the metropolitan area.

Separate property value rates are also applied to residential and non-residential customers, resulting in generally higher payments by non-residential customers. However all customers, both metropolitan and regional, and residential and non-residential, pay the same minimum annual charge. This is proposed to be $298 in 2009-10, an increase of $7 or 2.4% from the 2008-09 minimum of $291.

3.10.3 The Commission's Assessment

Water

The advent of the NWIC principles for urban water tariffs has provided additional detail and clarity regarding aspects of efficient water pricing. In summary these principles require:

- two part tariffs to be applied
- the water usage charge to have regard to the LRMC of supply
- a single water use charge, with the caveat that governments may adopt more than one tier for policy reasons including equity or the need to encourage efficient water use
- the fixed charge to reflect the difference between the revenue requirement and revenue from usage charges
- water charges to be differentiated by the cost of servicing different customers where there are benefits of doing so and where the benefits outweigh the costs of identifying differences and the equity advantages of alternatives

In respect of the first requirement, SA water applies a two part tariff and therefore is compliant with the NWIC principles.

In respect of the second and third requirements, in 2008-09 SA Water made changes to its water tariff structure which included a greater emphasis on usage based charges and the introduction of a third pricing block for high usage single dwelling residential customers. These changes were made in response to calculations which suggested that the 2007-08 usage charges were well below the LRMC of supplying water, which was estimated at the time at $1.90 per kL. In its 2008-09 Inquiry report the Commission broadly supported the upward movement in usage charges towards LRMC, although it expressed some concern regarding the lack of information to support the introduction of the third tier as well as the lack of detail in showing how the LRMC of water was calculated.

In 2009-10 SA Water proposes to continue this trend by further increasing the usage charges and, for residential customers, decreasing the fixed charge. These changes will mean that for a residential customer using 250kL of water, the variable component of the bill will have increased from 57% in 2007-08 to 72% in 2009-10. Smaller users consuming 120kL will experience an increase from 28% to 46%. The Commission notes that these changes will move usage charges closer to the LRMC of water.

The LRMC of water has now been estimated at $2.35 per kL in 2009-10 dollars. Transparency Statement – Part A sets out some information on the calculation of the LRMC estimate, which is based on assumptions including:

- the Average Incremental Cost (AIC) approach is used to calculate LRMC
- a potential future expansion of the Adelaide Desalination Plant from 50 GL to 100 GL
- a capital cost of $640 million and operating costs of $60 million
- a WACC of 6%

This LRMC estimate is higher than each of the usage tiers (although the proposed third tier price for single residential dwellings of $2.26 is quite close). This implies that customers may not be making efficient resource decisions when choosing to consume an extra kilolitre of water. However, it would not be possible for volumetric charges to be set at the LRMC level without a significant over-recovery of revenue.

The Commission is satisfied that the Government has 'had regard' to the LRMC estimate when setting usage charges. Transparency Statement – Part A notes that:

> *Each tier of the usage charge will move significantly closer to LRMC in 2009-10. Increases in the estimated LRMC reinforced the need for an increase in water usage charges. This decision builds upon the 2008-09 water charges by continuing to move towards meeting the new LRMC estimates in the water usage charge. Further examination will be undertaken in subsequent annual price setting processes.*
>
> *To manage the transitional impacts to higher usage charges which are moving towards LRMC, the first tier usage charge was retained at a level below LRMC, although it was increased significantly. (pp. 39-40)*

The Commission notes that 2009/10 commercial water usage charges have increased significantly from 2008/09 levels. The second tier price has increased from $1.38/kL to $1.88/kL, although this is still well below the estimated LRMC of $2.35/kL. Based on information presented to Cabinet, it is not clear to the Commission what the rationale is for keeping commercial tariffs on a two tier usage charge, while having a three tier charge for single residential dwellings.

In its 2008-09 Inquiry report the Commission expressed concern and noted comments from other regulators that multi-tier usage charges are not necessarily consistent with efficient resource pricing. The Commission continues to hold this view. However, the NWIC principles do permit a multiblock approach to be adopted on equity grounds or to reduce water use. The Transparency Statement – Part A notes that:

> *The government's pricing decisions for 2009-10 involved consideration of many interrelated and complex economic, equity and environmental variables in the context of a comprehensive, multi-faceted strategy to address urban water security challenges… (p. 36)*

Therefore the Commission is satisfied that the multi-tier usage tariff is consistent with the NWIC principles to the extent that it reflects equity considerations.

In relation to the NWIC suggestion that water charges should generally be differentiated by the cost of servicing different customers, the Commission notes that SA Water has a common tariff structure across metropolitan and regional areas, despite higher costs in regional locations. The Transparency Statement – Part A notes that this statewide pricing policy is:

> *consistent with [the government's] view that any benefit that might accrue from locational pricing would be outweighed by the detriments of that approach. (p. 32)*

However, the Transparency Statement – Part A provides no direct information on what these 'detriments' might be, other than to imply that common statewide pricing is consistent with a view that the provision of water services to some small rural and regional communities will not be viable but is necessary to meet social and public health obligations.

The Commission notes that water charges vary on a locational basis in other Australian states, and in at least one case (Melbourne) across a single city. These variations in charges predominately reflect differences in the cost of supply, although they may also reflect factors such as different pricing methodologies.

The Commission considers that information on the 'detriments' of more cost – reflective pricing need to be provided for it to be fully satisfied that the relevant NWIC principle has been met.

The Commission also considers it is relevant to make the following comments regarding efficient resource pricing:

- the changes to the tariff structure, and in particular the reduction in the residential fixed charge, mean that the discrepancy between charges for residential customers and small commercial customers paying the minimum will widen. Although both customer groups will pay the same usage charges (noting that some residential customers may face a third-tier price whereas commercial customers will not) a residential customer will pay a fixed charge that is $37.00 less than for the commercial customer. The economic rationale for this is unclear given that the cost of serving commercial and residential customers is likely to be the same.

- in its 2008-09 Inquiry report the Commission noted that it is not possible to generate tariffs without making detailed assumptions about expected consumption. The Commission expressed concern about a lack of this information in Transparency Statement – Part A. Some limited additional information on aggregate usage forecasts has been included in Transparency Statement – Part A this year, although the Commission notes that more detailed information regarding assumptions and approaches was provided to Cabinet
- the Commission supports the introduction of quarterly rather than semi-annual billing of usage, together with improvements to billing information. Such moves will assist in ensuring that customers can more efficiently respond to pricing information and will assist SA Water with its cash flows and working capital requirements.

Wastewater

The Commission stated in its 2008-09 Inquiry report that:

> *SA Water does not apply consumption based pricing, other than to the largest dischargers. … this recognises the impracticality of metering direct usage for small customers and the minor benefit (and hence implications for efficient resource use) that price signals of this type would generate. (pp.55-56)*

However, the Commission also noted that while it believes that the tariff structure adopted is "not inconsistent with the pricing principles":

> *In relation to fixed wastewater charges (and fixed water charges for commercial customers) the Commission notes that the vast majority of urban water businesses in Australia have moved away from charging based on property values in recent years. Reasons for this include cost, equity and tariff understandability.*
>
> *The Commission has also previously commented that the equity explanation for this approach to wastewater charges is likely to be undermined by the high proportion of households paying the minimum charge, such that the effective rate per dollar of property value for low value properties is significantly higher than for high value properties. This seems at odds with the equity intention.*
>
> *While property based charges are not necessarily inconsistent with the pricing principles, the Commission suggests that it would be opportune to review the approach to the fixed charge. (p.56)*

Despite the Commission's comments there has been no change to the approach to setting charges for wastewater services. Moreover, Transparency Statement - Part A emphasises the CoAG principles and states that:

> *Where usage charges are not practical, the COAG pricing principles do not stipulate how wastewater charges should be apportioned. (p.31)*

The Commission again recognises that the Government's approach to charging for wastewater services is not necessarily inconsistent with the pricing principles. However, it continues to believe that, for the reasons set out previously, there would be value in reviewing the approach to charging for this service.

3.10.4 The Commission's view on application of the pricing principles

Adequacy of information: Did Cabinet receive information that would allow for adequate application of the pricing principles?

Documents provided to Cabinet contain information about water pricing, including the proposed price structure, although further information on the application of the third-tier usage charge to some customers and not others would have been beneficial. The Commission supports the greater use of consumption based pricing and the move towards pricing at LRMC.

Transparency of information: Does Transparency Statement – Part A adequately summarise the relevant information?

The Commission is satisfied that the information provided to Cabinet about consumption based pricing is adequately summarised in Transparency Statement – Part A.

3.11 Cross-subsidies

In a jurisdiction with the water supply logistics faced by South Australia, some cross subsidies are inevitable under a statewide pricing approach. The key to adherence to the 1994 CoAG pricing principles is ensuring that the cross-subsidies and community service obligations (CSOs) are transparent.

The NWI requirements go further than the CoAG requirements in relation to CSOs in that they specifically require consideration of alternative management arrangements aimed at removing the need for an ongoing CSO.

3.11.1 Pricing Principles

In relation to cross-subsidies, the CoAG principles require:

> *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.*

In relation to CSOs the CoAG Principles require:

> *that where service deliverers are required to provide water services to classes of customers 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*

The CoAG Expert Group also noted that "in determining prices transparency is required in the treatment of community service obligations …"

Finally, clause 66(v)(c) of the NWI requires that:

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

3.11.2 Transparency Statement – Part A Comments

Cross-subsidies

Consistent with previous years, the Transparency Statement – Part A argues that it is unlikely that there are any cross-subsidies in place, where cross-subsidies are defined under the Baumol test. Transparency Statement – Part A describes the Baumol cross-subsidy as where:

> *• some users are paying less than the avoidable costs (or LRMC) of service provision while others are paying more; and/or*
>
> *• some users are paying more than the full cost of service provision on a stand alone basis – stand alone cost (i.e. with a dedicated system).*

Transparency Statement – Part A also notes that the NWC, in its 2005 NCP Assessment, stated:

> *With regard to cross-subsidies, the Commission considers that South Australia has met its COAG commitments. South Australia has identified areas where cross-subsidies are likely to exist, and has reported that there are unlikely to be significant cross-subsidies in water and wastewater pricing. (NWC, 2006, p 6.30)*

Community Service Obligations

Table 9 in Transparency Statement – Part A sets out the estimated CSO payments to SA Water for 2008-09 and 2009-10. The 2009-10 estimates are shown below.

CSO PAYMENTS (IN NOMINAL TERMS)	2009-10
Statewide Uniform Pricing	
- Water Business	116.52
- Wastewater Business	25.43
Exemptions and Concessions	11.87
Water Proofing Adelaide	5.79
Emergency Functional Services	0.60
Rain Water Tank Rebate	0.04
River Murray Levy Administration	0.06

Government Radio Network	0.43
Administration of Pensioner Concessions	0.52
TOTAL CSO PAYMENTS	161.26

Transparency Statement – Part A provides the following discussion about alternative approaches to CSOs:

> *With regard to examining alternative management arrangements for statewide uniform pricing CSOs, one approach might be to write down the value of the regional RAB, similar to the 'line in the sand' approach. The regulatory asset value could, thus, be reset such that existing revenues from regional customers are equivalent to a 6% return on assets. In this way, CSO payments could be eliminated. Even though the regulatory asset value would be reset at the level of each water network that supplies an individual regional community, water charges would remain consistent across the State.*
>
> *However, substantially lower asset values mean substantially lower depreciation expense. This raises fundamental concerns about identifying the true costs of supplying regional communities and the consistency of revenues with the replacement of capital assets in future. (p.33)*

The approach to the calculation of CSOs is described in Transparency Statement – Part A as follows:

> *The Government therefore provides SA Water with a CSO payment to ensure full cost recovery. Since 2004, the CSO amount has been calculated as the shortfall between the revenue from regional customers and the URB cost of providing regional services. The URB cost consists of operating costs, depreciation and return on assets (ROA). The ROA is calculated using a pre-tax real WACC of 6%. The CSO payment ensures SA Water earns a 6% rate of return on its regulated assets and, thus, the URB is achieved for its regional business. (pp.32-33)*

3.11.3 The Commission's assessment

Information presented in Transparency Statement – Part A about cross-subsidies is similar to that presented in previous Statements.

The Government has continued to assess the possible existence of cross-subsidies in water supply using the Baumol approach. The Baumol approach has been endorsed by the NCC and is used in other jurisdictions.

The effect of using the Baumol approach is that prices that lie beneath the stand-alone cost of supply are not considered to represent a cross-subsidy. As noted by the Commission previously:

> *the Baumol Band is generally broad and may not reveal sufficient information about the major cost differences of serving different customers. (2006-07 Inquiry Final Report p.45)*

Using this approach, the Government can therefore continue to assert that there are no cross-subsidies. This is despite the Commission's repeated recommendations that the major cost differences of serving different customers be examined further.

In relation to CSOs, the Commission notes that Transparency Statement – Part A again limits its discussion of alternative strategies to the Statewide uniform pricing CSO.

Consistent with the Government's response to the Commission's Final Report for the 2007 and 2008 Inquiries, Transparency Statement – Part A states that a review of CSO payments is not required as one was undertaken by SA Water in 2004.

Noting this response, the Commission remains of the view that further work could be done in determining CSOs in a more transparent manner; it encourages the Government to undertake a further review to ensure continuous improvement in this area.

3.11.4 The Commission's view on application of the pricing principles

Adequacy of information: Did Cabinet receive information that would allow for adequate application of the pricing principles?

The Commission retains the view that the information provided to Cabinet could be improved by giving greater consideration to alternative management arrangements to CSOs and in reviewing the major cost differences of serving different customers.

Transparency of information: Does Transparency Statement – Part A adequately summarise the relevant information?

The Commission is satisfied that the information provided to Cabinet about cross-subsidies and CSOs is adequately summarised in Transparency Statement – Part A.

3.12 Movement towards the upper bound

3.12.1 Pricing Principles

NWI Clause 66(i) states:

> *Metropolitan*
>
> *Continued movement towards upper bound pricing by 2008*

The NWIC draft pricing principles differentiate between returns on historical assets and returns on new assets, thereby creating an alternative approach to the calculation of the upper bound (the GFFCR).

3.12.2 Transparency Statement – Part A Comments

The pricing decisions set out in Transparency Statement – Part A and the three year revenue direction are part of an intention to move toward full cost recovery, as defined by the GFFCR.

The application of the GFFCR approach to SA Water's water and wastewater revenues is discussed in Transparency Statement – Part A. It observes that the historical returns on water assets have been below the upper bound and that the historical returns on wastewater assets have been above the upper bound. Under the GFFCR approach, these historical returns would effectively be locked-in.

In moving towards GFFCR, Transparency Statement – Part A states that:

> *The immediate nature of some of the government's water security decisions, in particular the decision to purchase temporary water licences, means that GFFCR will increase sharply in the years before 2011-12. It could be argued that revenue should follow GFFCR and increase sharply as well. Although prices have not been set beyond 2009-10, the government has planned to smooth the increases in the target revenue over the next four years through an in-principle revenue direction. If average charges continue to increase at 17.9% p.a. (real), revenue will be below annual cost levels until 2011-12, rising marginally above it in 2012-13. This will provide increased certainty and predictability for customers, and GFFCR would be met in approximately 2011-12. (p.39)*

3.12.3 The Commission's assessment

The Commission notes that the requirement of NWI clause 66(i) is only for movement "toward" the upper bound by 2008. It is not clear when the upper bound should be met, although the Commission assumes that such movement should at least continue beyond 2008.

It still remains unclear to the Commission whether or not the GFFCR concept will effectively replace the upper bound concept, given that the NWIC draft pricing principles have still not been subjected to any public scrutiny and are yet to be endorsed by CoAG.

Nevertheless, consistent with its view in previous Inquiries, the Commission's main concern relates to the estimation of the upper bound (or GFFCR level) itself, in so far as the issues raised earlier in this report, especially around efficient costs, mean that doubt must exist about the location of the upper bound (or GFFCR level). Setting a pathway toward the upper bound presupposes that the upper bound has been identified satisfactorily. The NWC noted its concerns about movement toward an ill-defined upper bound, particularly in relation to contributed assets, in its 2005 NCP Assessment (see page 6.29).

3.12.4 The Commission's view on application of the pricing principles

Adequacy of information: Did Cabinet receive information that would allow for adequate application of the pricing principles?

Information presented to Cabinet shows an intention to move towards GFFCR (and the upper bound), which appears to be consistent with the combined pricing principles.

Transparency of information: Does Transparency Statement – Part A adequately summarise the relevant information?

The Commission is satisfied that the Transparency Statement – Part A adequately summarises the information supporting the movement towards GFFCR.

4 REVENUE DIRECTION TO 2012-13

Transparency Statement – Part A includes an in-principle revenue direction to June 2013 based on price increases of similar magnitude to those established for 2009-10. The revenue-direction for the period July 2010 – June 2013 is not a pricing decision *per se.* It is not binding, but rather an indication of intended movements over that period.

As the revenue direction is not a pricing decision, no assessment is offered in the context of the combined pricing principles. However, it is identified in the Terms of Reference and therefore the Commission provides the following comments in relation to it.

The Commission has previously indicated support for a move to longer term pricing decisions as this can provide appropriate incentives and certainty to SA Water. The existence of an in-principle revenue direction does not achieve this, given its nature, but the Commission sees it as a positive step.

The Commission notes the significant water price increases that have been announced for 2009-10, with the expectation of similar price increases over the following three year period. Transparency Statement – Part A links these price increases to the significant water security investments that are proposed over the next ten years. Given this situation, the Commission believes that the quality of the information provided to Cabinet to enable it to make a pricing decision in accordance with the relevant pricing principles, and to set a revenue path for the following four years, is of utmost importance. Information demonstrating that expenditure forecasts are prudent and efficient is critical to the making of such a decision.

The Commission observed in Chapter 3 that the actual information provided to Cabinet, as summarised in the Transparency Statement – Part A, would not enable a decision maker to conclude that forecast costs are prudent and efficient.