



INQUIRY INTO THE 2008/09 METROPOLITAN AND REGIONAL WATER AND WASTEWATER PRICING PROCESS ISSUES PAPER

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REQUEST FOR SUBMISSIONS

The Essential Services Commission of SA (the Commission) invites written submissions from interested parties in relation to the issues raised in this paper. Written comments should be provided by **4 April 2008**. It is highly desirable for an electronic copy of the submission to accompany any written submission.

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

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

Responses to this paper should be directed to:

Inquiry into the 2008/09 Water & Wastewater Pricing Process

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Public Information about ESCOSA's activities

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

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GLOSSARY OF TERMS

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

1 INTRODUCTION

Pursuant to section 35(1) of the *Essential Services Commission Act 2002*, the Acting Treasurer referred to the Commission an inquiry into the water and wastewater pricing processes followed by the Government in late 2007 in setting prices for metropolitan and regional South Australia for 2008/09. The Commission is required to assess whether 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.

The Commission received the Notice of Referral on 29 February 2008. It is required to submit a draft report to the Treasurer and the Minister for Water Security by 16 May 2008, with a final report to be delivered by 27 June 2008.

The following are the terms of reference for this inquiry:

- (a) *The Commission is to inquire into price setting processes undertaken in the preparation of advice to Cabinet, resulting in Cabinet making its decision on the level and structure of SA Water's water and wastewater prices in metropolitan and regional South Australia in 2008-09 and an indicative in principle revenue direction to 30 June 2013 having regard to:*
 - a. *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.*
- (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 National Water Initiative First Biennial Assessment of Progress in Implementation, August 2007, Attachment 1 'Summary progress on implementing NWI actions' relevant to Clauses 65, 66(i) and 66(v);*
 - c. *the attached Transparency Statement Metropolitan and Regional Water and Wastewater Prices in South Australia 2008 09 (Part A) dated January 2008.*
- (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 and the National Water Initiative was made available to Cabinet.*

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

Term of Reference (a) makes clear that the Commission is to review the processes undertaken by (and the provision of information to) Cabinet in coming to its 2008-09 water and wastewater pricing decisions, with regard to the application of the 1994 CoAG pricing principles and the NWI (and associated documents). This instruction is quite specific and



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

The Commission has previously conducted five inquiries into the equivalent pricing processes that led to Cabinet's two separate 2004/05 water and wastewater pricing decisions and the 2005/06, 2006/07 and 2007/08 water and wastewater pricing decisions. These previous inquiry reports are available on the water section of the Commission's website (www.escosa.sa.gov.au).

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

However, the Commission notes that a key issue that underpins the price setting process for 2008/09 is the impact of the existing drought conditions, which has led to greater focus being given to projects and initiatives to ensure that South Australia has access to sufficient water supply in the longer term. Over the next five years, the Government proposes to invest in a new \$1.1bn desalination plant, to be located at Pt. Stanvac subject to full testing and approvals. It has also proposed to construct a north-south water pipeline interconnector and to increase the amount of water storage in the Mt. Lofty ranges. The Government has explained that these investments are a major driver in the decision to increase water charges in 2008/09 on average by 12.7% in real terms.

The Commission's previous Inquiry was the first to consider pricing processes in the context of the NWI. Its assessment therefore put greater emphasis on whether or not the pricing process enabled Cabinet to make decisions consistent with the principles of the NWI.

As part of the current Inquiry, the Commission intends to examine the steps that the Government has taken to deal with the issues raised in the previous reports, and in meeting the relevant requirements of the NWI. The following section of this Issues Paper describes both the relevant 1994 CoAG pricing principles and the NWI.

The Commission also notes that the 2007/08 pricing decision included an indicative in-principle revenue direction to 2012/13. This is based on annual price increases of similar magnitude to 2008/09. While the Commission understands that the revenue direction is not binding, the manner in which 2008/09 prices have been set in reference to this direction, and in reference to the CoAG pricing principles and the NWI, will be of relevance to this Inquiry.

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

In accordance with the instructions in the Acting Treasurer's Notice of Referral, written submissions are due by 4 April 2008 (28 days after the publication of the Notice of Inquiry).

2 THE COAG PRICING PRINCIPLES

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

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

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

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

In relation to water resource policy, CoAG agreed:

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

3 *In relation to pricing:*

(a) *in general —*

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

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

(b) *urban water services —*

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

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

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

To complement these clauses, the Standing Committee on Agriculture and Resource Management (SCARM), through the Agriculture and Resource Management Council of

Australia and New Zealand (ARMCANZ), provided a detailed set of guidelines. This detailed set of guidelines is generally referred to as “the CoAG pricing principles”.

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

- 1 *Prices will be set by the nominated jurisdictional regulators (or equivalent) who, in examining full cost recovery as an input to price determination, should have regard to the principles set out below.*
- 2 *The deprival value methodology should be used for asset valuation unless a specific circumstance justifies another method.*
- 3 *An annuity approach should be used to determine the medium to long-term cash requirements for asset replacement/refurbishment where it is desired that the service delivery capacity be maintained.*
- 4 *To avoid monopoly rents, a water business should not recover more than the operational, maintenance and administrative costs, externalities, taxes or TERs (tax equivalent regime), provision for the cost of asset consumption and cost of capital, the latter being calculated using a WACC.*
- 5 *To be viable, a water business should recover, at least, the operational, maintenance and administrative costs, externalities, taxes or TERs (not including income tax), the interest cost on debt, dividends (if any) and make provision for future asset refurbishment/replacement (as noted in (3) above). Dividends should be set at a level that reflects commercial realities and stimulates a competitive market outcome.*
- 6 *In applying (4) and (5) above, economic regulators (or equivalent) should determine the level of revenue for a water business based on efficient resource pricing and business costs.*
- 7 *In determining prices, transparency is required in the treatment of community service obligations, contributed assets, the opening value of assets, externalities including resource management costs, and tax equivalent regimes.*

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

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

3 THE NATIONAL WATER INITIATIVE

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

The Terms of Reference for this inquiry identifies several specific clauses for assessment by the Commission:

Clause 65

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

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

Clause 66

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

Metropolitan

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

Rural and Regional

...

- (v): full cost recovery for all rural surface and groundwater based systems, recognising that there will be some small community services that will never be economically viable but will need to be maintained to meet social and public health obligations:*
 - a) achievement of lower bound pricing for all rural systems in line with existing NCP commitments*
 - b) continued movement towards upper bound pricing for all rural systems, where practical*
 - c) where full cost recovery is unlikely to be achieved in the long term and a CSO is deemed necessary, the size of the subsidy is to be reported publicly and, where practicable, jurisdictions to consider alternative management arrangements aimed at removing the need for an ongoing CSO.*



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

The Parties agree to use independent bodies to:

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

The Commission's final report on the 2007/08 Inquiry observed that the NWI pricing principles had a greater focus on outcomes than the 1994 CoAG pricing principles. It noted that discussions between the Commission and the NWC confirmed that the NWI is intended to build on the 1994 pricing principles, rather than simply restating them. The Commission's view is that the NWI, particularly clauses 65, 66(i) and 66(v), increase the scope of water pricing reform beyond that of the 1994 CoAG pricing principles, with the stated intent of achieving best practice water pricing.

The Terms of Reference for the current Inquiry again refer the Commission to the *South Australian National Water Initiative Implementation Plan*. It also requires the Commission to have regard to the National Water Commission's 2007 *National Water Initiative First Biennial Assessment of Progress in Implementation*. These documents provide further guidance for the Commission's assessment. Both documents can be found on the NWC website.

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

4 KEY ISSUES

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

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

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

Are the water and wastewater pricing processes consistent with the CoAG pricing principles and the relevant clauses of the NWI?

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

In reviewing the Government's process for determining 2008/09 water and wastewater prices, an important question that the Commission must consider is whether or not Cabinet had access to sufficient information in order for it to reach a decision that is consistent with the requirements of the CoAG and NWI pricing principles. For example, the Commission must review whether the material provided to Cabinet demonstrated that forecast costs are efficient, that an appropriate rate of return has been determined and that forecasts of demand are reasonable. The information should also enable Cabinet to be satisfied that the proposed prices are reflective of efficient costs, including any indirect costs/benefits associated with water usage (externalities). Where other factors have been taken into account in setting prices (eg. equity, affordability and regional issues), the impact of these factors on prices should be made transparent in the information.

The following sections of this Issues Paper discuss some of these key issues relating to the price-setting process adopted by Government, focusing on areas that the Commission has previously expressed some concern with and providing some preliminary comments on how these matters have been addressed in the 2008/09 Transparency Statement – Part A.



4.1 Efficient business costs

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

The Government has included additional information in response to these suggestions in the past, and this has continued on this occasion with the provision of a *2005/06 Annual Efficiency Report* prepared by SA Water and included as Appendix 5 of the Transparency Statement. The Commission will consider the merits of the information in terms of effective compliance with the CoAG pricing principles and the NWI, noting that the NWI includes an emphasis on the value of such information.

The Commission has also previously commented on the lack of information in past Transparency Statements concerning the efficiency of forward-looking costs. In relation to the 2007/08 Transparency Statement – Part A, the Commission concluded that it did not contain information that would have reasonably enabled Cabinet to make pricing decisions consistent with the NWI high level outcomes. For example, trend analysis of key cost drivers and a comparison of the costs and service levels in metropolitan and regional areas have not been addressed in previous Transparency Statements. The absence of sufficiently detailed information on forecast costs and their relationship to future prices and future levels of service was a key area of concern during the previous Inquiry and the Commission would welcome any comments from stakeholders on whether or not the 2008/09 Transparency Statement has improved in this area. Information regarding the efficiency of the costs associated with the major infrastructure projects proposed by the Government, and the deliverability of these projects, will be of particular interest to the Commission.

4.2 Asset values

The Commission previously suggested that the Government's treatment of contributed assets in calculating asset values was inadequate, and that it should provide an estimate of pre-1995 contributed assets to allow consistent and more transparent treatment of them. The Commission provided some suggestions as to how such an estimate might be generated.

The Government appears to have taken a similar approach to contributed assets in the 2008/09 Transparency Statement as in previous years. It has commented that the contributed assets issue has been overtaken by consideration of national principles for consistent approaches to pricing, pending finalisation of those principles. In addition, it argues that adequate information is not available to identify pre-1995 contributed assets.

The Commission is interested in views from stakeholders as to whether or not the continuation of previous practices in relation to contributed assets is consistent with the requirements of the CoAG and NWI pricing principles, noting that the potential impact of contributed assets on asset values and prices (especially upper bound prices) is not trivial.

4.3 Externalities

In its 2007/08 Final Report, the Commission suggested that the Transparency Statement – Part A does not address the broader view of externalities that the NWI introduces, focussing instead on just those externality costs that are attributable to and incurred by SA Water. While the Commission acknowledged that the incorporation of externalities into pricing decisions was difficult matter, and that the requirements of the NWI on externalities is somewhat uncertain, it recommended that the Government at least seek to identify relevant externalities.

In the 2008/09 Transparency Statement – Part A, the Government has stated that there is lack of clarity nationally about the appropriate regulatory treatment of externalities and that it has continued to adopt a narrow definition of externalities, pending the outcomes of a planned national review of this matter.

4.4 Return on Assets

The Commission previously suggested that the Government include information in the Transparency Statement to explain the derivation of each parameter of the Weighted Average Cost of Capital (WACC).

The Government has included some information within Appendix 6 of the 2008/09 Transparency Statement describing the approach used to determine the WACC. The Commission will review this information to examine whether or not this is sufficient to enable Cabinet to form a view on an appropriate rate of return.

4.5 Dividends and Tax Equivalent Regime

In its 2008/09 Final Report, the Commission concluded that there was insufficient information to demonstrate that the amount of dividends and taxation included in the lower bound revenue were appropriate. The Commission noted that the lower bound dividend represented 30 per cent of total lower bound revenue in 2006/07, which did not appear to reflect the commercial realities of a business operating at the lower bound. Similarly, it noted that the inclusion of “normal” tax liability (a liability applicable to a business well above the lower bound) is not appropriate for a business assumed to be at or near zero profit (that is, a business at the lower bound).



The 2008/09 Transparency Statement – Part A responds to these findings, stating that the lower revenue bound is based on achieving medium term financial viability in cash flow terms and, therefore, does not preclude profit generation and the payment of dividends or TER payments. Consequently, the Government has maintained its treatment of dividends and TER payments in the 2008/09 lower revenue bound calculations.

4.6 Efficient resource pricing

Clause 65 of the NWI includes a renewed focus on pricing structures for efficient water use.

In its 2007/08 Final Report, the Commission concluded that there was insufficient information in the Transparency Statement to demonstrate that volumetric water prices are consistent with the Long-Run Marginal Cost (LRMC) of supply and, hence, efficient resource pricing for water. The Commission notes that the 2008/09 Transparency Statement discusses the Government's decision to modify the water tariff structure, in which the volumetric charge is purported to reflect, in part, a revised higher LRMC estimate of \$1.90/kL.

It also suggested that the Government review its current approach to wastewater pricing, which is based on property values for all but the largest dischargers. While not inconsistent with the pricing principles, the Commission considered that the NWI emphasis on efficient resource pricing provided an opportunity for the Government to reconsider this pricing approach, particularly as the vast majority of urban water businesses in Australia have moved away from this approach in recent years.

The Commission notes that the 2008/09 Transparency Statement has again stated that the Government believes consumption based pricing for wastewater services, other than trade waste, to be inefficient and impractical.

4.7 Cross subsidies

The Commission previously suggested that the Government should provide detailed analysis of cost differences between customer categories, the calculation of Community Service Obligations (CSOs) and assessment of CSO alternatives.

The Government has responded to these concerns in the 2008/09 Transparency Statement. It has argued that full cost recovery for water and wastewater services in regional areas, and therefore compliance with the NWI, has been achieved via transparently reported CSO payments.

The Commission will be reviewing the information presented by the Government, to examine whether it addresses the particular concerns raised in the previous Inquiry, for example, the absence of information to determine how assets and operating costs have

been allocated to regional versus metropolitan customers in calculating the CSO for statewide uniform pricing.

4.8 Revenue direction

The 2007/08 Transparency Statement (and the pricing decision) included a projection of revenue needs to 2012. The 2008/09 Transparency Statement states that the previous water revenue direction has been superseded given the proposed Adelaide desalination plant, while the wastewater revenue direction has also been superseded and will not be determined until the implications of the Adelaide Coastal Water Study for future wastewater costs are clarified.

However, the Transparency Statement indicates that, for planning purposes, an in-principle water and wastewater revenue direction for 2009/10 to 2012/13 has been based on annual price increases of the same magnitude as applied in 2008/09.

The Commission notes that the proposed real increases in water prices are to take effect prior to the construction of the proposed new infrastructure. The Transparency Statement suggests that this approach has been taken to smooth water prices over the next five years, rather than increase charges by greater amounts in later years as the costs of the new projects are being incurred.

While the Government has asserted that there should be no benefit to the Government from increasing prices in advance of costs being incurred, the Commission intends to closely review this approach against the CoAG and NWI pricing principles.

5 NEXT STEPS

In accordance with the Treasurer's instructions, submissions are due by Friday, 4 April 2008 (28 days after the Commission publishes its Notice of Inquiry).

The Commission will consider all submissions received and prepare a draft report by 16 May 2008. In accordance with the requirements for the inquiry, the draft report will be submitted to the Treasurer and the Minister for Water Security.

A final report will be presented to the two Ministers by 27 June 2007.