

**INQUIRY INTO THE 2008-09
METROPOLITAN AND
REGIONAL WATER AND
WASTEWATER PRICING
PROCESS**
- OVERVIEW -

June 2008



Public Information about the Commission's activities

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

OVERVIEW

In February 2008, the Treasurer referred to the Essential Services Commission of South Australia (the Commission), pursuant to Part 7 of the *Essential Services Commission Act 2002*, a public 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 2008-09. The Commission's Inquiry was required to have regard to the application of certain pricing principles enunciated by the Council of Australian Governments (CoAG) in 1994 as well as through the National Water Initiative (NWI) in 2004.

In undertaking its Inquiry, the Commission was required to consider the report: *Transparency Statement Metropolitan and Regional Water and Wastewater Prices in South Australia 2008-09 (Part A)*, dated February 2008, which was prepared by the Department of Treasury and Finance. Information considered by Cabinet at the time of the pricing decision in late 2007 was also made available to the Commission on a confidential basis.

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

An important context to this Inquiry concerns the current water shortages in South Australia. The Government has announced that it will be investing in a number of water security projects over the next 10 years to address these shortages, including a proposed \$1.1 billion desalination plant. Largely as a result of these investments, the Government's decision was to increase water prices by 12.7% (in real terms) in 2008-09, with an in-principle decision to increase water prices by the same magnitude in each of the following four years. This Inquiry has therefore considered, among other things, the manner in which the proposed significant capital projects were taken into account during the process of setting 2008-09 water prices.

The Commission interprets its task in this Inquiry as being one of assessing the extent to which the price setting processes facilitated pricing decisions that were consistent with the CoAG and NWI pricing principles. This report indicates the extent to which information provided to Cabinet adequately set out and considered relevant aspects of the 1994 CoAG pricing principles and the NWI.

Consistent with the approach taken in previous inquiries, the Commission has considered whether or not each relevant input to the pricing decision was dealt with in a manner that could meet minimum requirements of the pricing principles. The Commission has also

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



identified improvements that could be made to the pricing process in order to achieve greater consistency with the relevant pricing principles.

In addition to the input-based, or “bottom-up”, approach to assessing the price setting process, the Commission has identified an alternative method of assessing the application of the CoAG and NWI pricing principles. This involves defining a framework for a best practice approach to price setting that seeks to maximise the efficiency objectives of the pricing principles. Key elements of the best practice framework have been outlined in this report, for the purpose of informing debate on this topic and with the view that the alternative assessment method could be applied in future inquiries.

In its 2007-08 Inquiry report, the Commission identified several high priority areas for improvement. These included a greater focus on demonstrating the efficiency of forecast operating and capital expenditure; the need to relate the water usage component of prices more closely to Long Run Marginal Cost (LRMC) of supply; and a stronger approach to the consideration of so-called “externalities”, i.e. costs associated with the availability of the water resource, including the management of environmental impacts. Progress in these areas is fundamental to achievement of the efficiency outcomes of the CoAG and NWI pricing principles.

In undertaking the present Inquiry, the Commission has noted some improvements in the price setting process in these high priority areas. For example, the approach to benchmarking of the performance of SA Water has been made more robust, while key cost drivers for metropolitan and regional water supply systems have been identified. In addition, the usage component of water prices is now more closely related to LRMC.

However, the Commission has concluded that further improvement to the pricing process is needed in such areas to ensure adequate application of the pricing principles. For example, in the demonstration of efficient resource pricing, it would be appropriate for Cabinet to be provided with more details regarding consumption forecasts and the calculation of LRMC. Furthermore, it is important that additional information is provided to demonstrate that forward-looking prices are based on prudent and efficient forecast costs.

The matter of efficient costs is particularly significant for the 2008-09 water pricing decision, given the impact of the proposed major capital projects on future water prices. The Commission acknowledges that these costs will be refined as greater certainty emerges about the details of the projects, but such refinements are no guarantee that costs will be efficient.