



# INQUIRY INTO THE 2007-08 WATER AND WASTEWATER PRICING PROCESSES 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 **Friday, 9 March 2007**. 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](http://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 2007-08 Water & Wastewater Pricing Processes**

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### ***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 the Commission's website at [www.escosa.sa.gov.au](http://www.escosa.sa.gov.au).



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## GLOSSARY OF TERMS

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ARMCANZ	Agriculture and Resource Management Council of Australia and New Zealand
CoAG	Council of Australian Governments
COMMISSION	Essential Services Commission of South Australia
CSO	Community Service Obligation
ESC Act	<i>Essential Services Commission Act 2002</i>
NCC	National Competition Council
NCP	National Competition Policy
NWC	National Water Commission
NWI	National Water Initiative
SCARM	Standing Committee on Agriculture and Resource Management
WACC	Weighted average cost of capital

# 1 INTRODUCTION

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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 2006 in setting prices for metropolitan and regional South Australia for 2007-08. 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 31 January 2007, and is required to submit a draft report to the Treasurer and the Minister for Water Security by 30 April 2007.<sup>1</sup>

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 2007-08 and an in principle revenue direction to June 2012 having regard to:*
  - a. *the adequacy of the application of 1994 CoAG pricing principles taking into account the recommendations, conclusions and proposals of the National Water Commission in its 2005 NCP assessment of water reform progress;*
  - 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 accredited South Australian National Water Initiative Implementation Plan with respect to Clauses 65, 66(i) and 66(v)*
- (b) *In undertaking this inquiry, the Commission is to consider the Transparency Statement Metropolitan and Regional Water and Wastewater Prices in South Australia 2007-08 (Part A) dated January 2007;*
- (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 Acting 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 2007-08 water

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<sup>1</sup> The Notice of Referral identifies the Treasurer and the Minister for Government Enterprises. Responsibility for SA Water transferred from the Minister for Government Enterprises to the Minister for Water Security on 6 February 2007.



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 four inquiries into the equivalent pricing processes that led to Cabinet's two separate 2004-05 water and wastewater pricing decisions and the 2005-06 and 2006-07 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](http://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, this inquiry differs in that it is the first in which specific requirements of the NWI are to be considered.

Therefore, the Commission will be interested to examine what steps the Government has taken to deal with the issues raised in the previous reports, as well as now examining the implications of the NWI (which may require change to previous approaches). 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 decision includes an in-principle revenue direction to 2011-12. The Commission understands that that revenue direction is not binding, in that the Government will still make pricing decisions for each year of that period. However, the manner of the revenue direction's construction in relation to the CoAG pricing principles and the NWI will be of interest to the Commission.

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 28 days after the publication of the Notice of Inquiry.



## 2 THE COAG PRICING PRINCIPLES

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In part, the Commission's assessment is against 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

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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](http://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 Terms of Reference also refers to the *South Australian National Water Initiative Implementation Plan* and the conclusions of the National Water Commission in its *2005 NCP assessment of water reform progress*. These 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

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In its previous inquiries the Commission raised a number of key issues that the Government should address to achieve compliance, or improve compliance, with the CoAG pricing principles. These Commission conclusions were made without reference to 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. Suggestions for improving compliance would also be welcome. Interested parties are, of course, welcome to address any other matter they consider relevant to the Terms of Reference set for the Commission.

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

*Do the water and wastewater pricing processes achieve compliance 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 effective in improving compliance?*

*Does the NWI affect the Commission's previous conclusions and the manner in which the Government should have conducted its pricing processes?*

Note that the "Government's response" includes information calculated and provided to Government by SA Water as part of the pricing processes.

### **4.1 Efficient business costs**

The Commission previously suggested that more effective compliance with the CoAG pricing principles 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 Appendix 4 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.

## **4.2 Asset values**

The Commission previously suggested that fuller compliance with the CoAG pricing principles would result if the Government were to 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 has further developed its view in respect of the merits of generating such an estimate. The Commission will consider the merits of the latest approach presented in the Transparency Statement. The potential impact of contributed assets on asset values and prices (especially upper bound prices) is non-trivial.

## **4.3 Depreciation**

The Commission earlier recommended that the Government should include a depreciation amount in the Transparency Statement. This has since been adopted.

## **4.4 Annuity**

The Commission earlier recommended that an annuity estimate should be determined and reported to enable compliance with the CoAG pricing principles. The Government has since responded with an annuity estimate.

## **4.5 Externalities**

The Commission previously suggested the provision of further information about the expected extent of future Environmental Enhancement Levy funded works and the specific goals of these works, noting that the difference between levy funded works and other wastewater investments was unclear. The Commission notes that the NWI includes a renewed focus on the treatment of externalities and will closely consider developments in this area.

## **4.6 Return on Assets**

The Commission previously noted the significant pricing impact of return on assets estimates. In this respect the Commission has suggested that the Government would be better to apply a single weighted average cost of capital (WACC) – using a post-tax approach (see also the discussion on tax equivalent regime below). The Commission also commented that it was not clear that the process the Government used to arrive at the WACC range necessarily accorded with that which the Commission would use if it were determining a WACC for price regulation purposes.

The Government has modified its approach in response to this, now selecting a point estimate from within a range. The Commission will consider the merits of this new approach – including examining the consistency of the decision with recent regulatory decisions on WACC for water utilities.

#### **4.7 Dividends**

The Commission previously reported some improvements required to achieve compliance in respect of dividends, including the separation of dividend policy and information to demonstrate the adequacy of the dividend policy.

The Government since approved and implemented a new ownership framework for Public Non-Financial Corporations, including SA Water, including a new dividend policy. The Transparency Statement sets out the dividend requirements now applying to SA Water.

#### **4.8 Tax equivalent regime**

The Commission previously concluded that tax equivalent requirements should be reported separately to achieve better compliance with the CoAG pricing principles. The Government subsequently reported tax equivalent requirements separately (with the separation of dividend policy).

The Commission also suggested that the Government use a post-tax WACC as this would allow tax to be included in the cash flows. The Government has not adopted this practice in determining prices for 2007-08.

#### **4.9 Efficient resource pricing**

The Commission previously concluded that water and wastewater price structures comply with the CoAG pricing principles, although it noted that further information could be included in relation to the structure chosen for wastewater charges. The Government has since presented such information.

Clause 65 of the NWI includes a renewed focus on pricing structures for efficient water use. The Commission will examine the pricing approach adopted by the Government in this context.

#### **4.10 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 provided some additional information relating to CSO treatment in response to the earlier comments. Clause 66(v) of the NWI includes a focus on and recognition of CSO situations.

#### **4.11 Revenue direction**

For the first time the Transparency Statement (and the pricing decision) includes a projection of revenue needs beyond one year – on this occasion to 2012. While this in-principle revenue direction is non-binding, such an outlook can provide further certainty to



the water business and consumers. The Commission will examine the basis for this revenue direction, and how the process aligns with the relevant pricing principles. The Commission notes that the revenue direction is not presented as replacing the need for future pricing decisions.



## **5 NEXT STEPS**

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In accordance with the Acting Treasurer's instructions, submissions are due by Friday, 9 March 2007 (28 days after the Commission publishes its Notice of Inquiry).

The Commission will consider all submissions received and prepare a draft report by 30 April 2007. 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 8 June 2007.