



INQUIRY INTO THE 2006-07 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, 30 September 2005**. 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 2006-07 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.

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

1 INTRODUCTION

Pursuant to section 35(1) of the *Essential Services Commission Act 2002*, the Treasurer has referred to the Commission an inquiry into the water and wastewater pricing processes followed by the Government in 2005 in setting prices for metropolitan and regional South Australia for 2006-07. The Commission is required to assess whether the processes complied with the 1994 CoAG pricing principles agreed to by all governments as the basis for water and wastewater pricing.

The Commission received the Notice of Referral on 6 September 2005, and is required to submit a draft report to the Treasurer and the Minister for Administrative Services by 31 October 2005.

The following are the terms of reference for this inquiry:

- (a) *The Commission is to inquire into the 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 for 2006-07, with respect to the adequacy of the application of 1994 CoAG pricing principles;*
- (b) *In undertaking this inquiry, the Commission is to consider the "Transparency Statement Metropolitan and Regional Water and Wastewater Prices in South Australia 2006-07 (Part A)" dated August 2005;*
- (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 principles 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 2006-07 water and wastewater pricing decisions, with regard to the application of the 1994 CoAG pricing principles. This instruction is quite specific and defines the scope of this inquiry. Most importantly, it means that the Commission is to examine the process that led to a pricing outcome. The Commission is not calculating a pricing outcome itself, nor is it examining or "approving" the actual pricing outcomes.

The Commission has previously conducted three inquiries into the equivalent pricing processes that led to Cabinet's separate 2004-05 water and wastewater pricing decisions and the 2005-06 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 have been combined; hence the Transparency Statement covers both water and wastewater prices. Accordingly, the issues that the Commission will examine in this inquiry are similar to those examined



previously. Indeed, the Commission will be interested to examine what steps the Government has taken to deal with the issues raised in the previous report.

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

In accordance with the instructions in the Treasurer's Notice of Referral, written submissions are due 14 days after the publication of the Notice of Inquiry.

The following section of this Issues Paper describes the 1994 CoAG pricing principles. The more recent National Water Initiative (NWI) has a modifying effect on these earlier principles. However, the 2006-07 pricing process being examined did not incorporate the NWI and hence the Commission is tasked to make its assessment against the 1994 CoAG pricing principles.

2 THE COAG PRICING PRINCIPLES

The Commission's assessment in this inquiry is against the 1994 CoAG pricing principles for water (including wastewater). These principles were developed by Australia's State 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 does not provide much 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 KEY ISSUES

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. The relevant sections of the Transparency Statement contain a summary of the Commission's 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 the CoAG pricing principles. Suggestions for improving compliance would also be welcome. Interested parties are, of course, welcome to address any other matter they consider to be relevant to the Terms of Reference set for the Commission.

The key areas examined by the Commission in 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?

Have Government responses to the earlier recommendations and suggestions of the Commission been effective in improving compliance?

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

3.1 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. This included trend analysis of cost drivers and exploration of the link between efficient business costs and service standards to allow more transparency on "value for money" issues.

The Government has included some additional information in this respect, including a review by the South Australian Centre for Economic Studies. It also notes that it intends to further explore the links between costs, prices and service standards. The Commission will consider the merits of the above information in terms of effective compliance with the CoAG pricing principles.

3.2 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 restated its view that there is no sound information upon which to base such an estimate. The Commission will consider the merits of this approach in terms of effective compliance with the CoAG pricing principles.

3.3 Depreciation

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

3.4 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.

3.5 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 will consider the merits of the Government's information in terms of effective compliance with the CoAG pricing principles.

3.6 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 continued to use a pre-tax real range of 6% – 7% for WACC, noting that it will continue to review regulatory practice in this area. The Commission will consider the merits of this approach in terms of effective compliance with the CoAG pricing principles – including examining the consistency of the decision with recent regulatory decisions on WACC for water utilities.

3.7 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 has since approved a new ownership framework for Public Non-Financial Corporations, including SA Water, which includes a new dividend policy. The application of the new framework has now been finalised and is incorporated in the latest pricing process. The Transparency Statement sets out the dividend requirements now applying to SA Water. The Commission will consider the merits of this new approach in terms of effective compliance with the CoAG pricing principles.

3.8 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 has since 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. As noted above the Government has not adopted this practice. The Commission will consider the merits of this approach in terms of effective compliance with the CoAG pricing principles.

3.9 Efficient resource pricing

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

Trade waste prices for 2006-07 involve a continuation of a three year transition discussed in the 2005-06 pricing process – hence there is no decision on this occasion. The main change is the removal of the transitional discounts available (except in one case subject to a community service obligation – CSO).

The Commission will consider the merits of these pricing approaches in terms of effective compliance with the CoAG pricing principles.

3.10 Cross subsidies

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



The Government has provided some additional information relating to changes to CSO treatment arising from its new policy applying to public non-financial corporations in combination with its new CSO policy. The Commission will consider the merits of these approaches in terms of effective compliance with the CoAG pricing principles.

4 NEXT STEPS

In accordance with the Treasurer's instructions, submissions are due by Friday, 30 September 2005 (14 days after the Commission publishes its Notice of Inquiry).

The Commission will consider all submissions received and prepare a draft report by 31 October 2005. In accordance with the requirements for the inquiry, the draft report will be submitted to the Treasurer and the Minister for Administrative Services.

A final report will be presented to the two Ministers by 30 November 2005.