



INQUIRY INTO THE 2005-06 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 **Thursday, 3 February 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 2005-06 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 ESCOSA 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
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 2004 in setting prices for metropolitan and regional South Australia for 2005-06. The Commission is required to assess whether the processes complied with the CoAG pricing principles agreed to by all governments as the basis for water and wastewater pricing.

The Commission received the Notice of Referral on 24 December 2004, and is required to submit a draft report to the Treasurer and the Minister for Administrative Services by 11 March 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 2005-06, with respect to the adequacy of the application of 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 2005-06 (Part A)" dated December 2004;*
- (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 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 2005-06 water and wastewater pricing decisions, with regard to the application of the CoAG 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 two inquiries into the equivalent pricing processes that led to Cabinet's separate 2004-05 water and wastewater pricing decisions. These previous inquiry reports are available from the What's New section¹ of the Commission's website (www.escosa.sa.gov.au).

On this occasion, the water and wastewater pricing decision processes have been combined; hence the Transparency Statement covers the combination of water and

¹ For the Water Inquiry look under 4 June 2004. For the Wastewater Inquiry look under 29 November 2004.



wastewater prices. However, in other respects this latest Transparency Statement is similar to the previous Transparency Statements.

Accordingly, the range of issues that the Commission will examine in this inquiry are similar to those examined previously. Indeed, the key interest for the Commission will be to examine what steps the Government has taken to address the deficiencies and areas for improvement identified previously by the Commission.

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.

2 THE COAG PRICING PRINCIPLES

The Commission's assessment in this inquiry is against the 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 the previous two 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 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 concluded, for both water and wastewater, that more effective compliance with the CoAG pricing principles would result if the Government were to undertake more comprehensive analysis (including benchmarking) of SA Water's costs to enable more reliable conclusions on cost efficiency to be reached. This included improved analysis of regional system costs.

The Government has included some additional information in this respect, and also comments on some constraints in this area (e.g. the availability of benchmarking data). The Commission will consider the merits of the above information in terms of effective compliance with the CoAG pricing principles.

An additional consideration arises in this inquiry now that the Transparency Statement combines both the water and wastewater pricing processes – whether the balance of revenue collections between water and wastewater reflects compliance with the CoAG pricing principles. This balance question touches on all of the issues listed below (see comment in 3.2 Asset values), but includes the question of whether the allocation of costs



(such as overheads) between the water and wastewater segments reflects efficient business costs.

3.2 *Asset values*

The Commission concluded, for both water and wastewater, that more effective compliance with the CoAG pricing principles would result if the Government were to separately identify contributed assets and remove them from pricing considerations.

Note that the effect of such a treatment of contributed assets may differ between water and wastewater assets. Therefore, the outcome may shift not only the level of charges but also the balance of revenue collection between water and wastewater.

The Government has responded by setting out an estimate for contributed assets, which is removed from pricing considerations. The Commission will consider the merits of this approach in terms of effective compliance with the CoAG pricing principles.

3.3 *Depreciation*

The Commission recommended in its water inquiry that the Government should include the depreciation amount in the Transparency Statement. This was done for the subsequent wastewater Transparency Statement and has occurred in this latest Transparency Statement for both water and wastewater.

3.4 *Annuity*

The Commission concluded, for both water and wastewater, that an annuity estimate should be determined and reported to enable compliance with the CoAG pricing principles.

The Government has responded with an annuity estimate. The Commission will consider the merits of this approach in terms of effective compliance with the CoAG pricing principles.

3.5 *Externalities*

In the water inquiry the Commission proposed the inclusion of information in the Transparency Statement, and hence to Cabinet, about extraction-based water resource management charges and certain Department of Water, Land and Biodiversity Conservation costs.

The Government has outlined its reasons for not taking this particular approach as yet, but has noted the inclusion of a long run marginal cost consideration arguing that this approach would ensure that water pricing structures reflect true water resource costs.

In the wastewater inquiry the Commission proposed the inclusion of further information about the expected extent of future Environmental Enhancement Levy funded works and

the specific goals of these works. The Government has included some information in relation to levy funded works.

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

3.6 Return on Assets

The Commission noted, for both water and wastewater, the significant pricing impact of return on assets estimates and the implications of the use of a range of 6% – 8% for the weighted average cost of capital (WACC). The Commission recommended that a single WACC be calculated, or at least a narrower range.

The Government has developed, presented and applied a narrower range (6% – 7%) on this occasion, based on the regulatory decisions of various regulators. The Commission will consider the merits of this approach in terms of effective compliance with the CoAG pricing principles.

3.7 Dividends

In the water inquiry the Commission 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. In the wastewater inquiry the Commission recognised some improvement in this area.

The Government has now approved a new ownership framework for Public Non-Financial Corporations, including SA Water, which includes a new dividend policy. The application of this new framework is to be finalised in January 2005. As such, the Transparency Statement provides a best estimate of dividends that would flow from the eventual application of the framework. The Commission will consider the merits of this approach, to the extent implemented, in terms of effective compliance with the CoAG pricing principles.

3.8 Tax equivalent regime

The Commission concluded, for both water and wastewater, that tax equivalent requirements should be reported separately to achieve better compliance with the CoAG pricing principles. The Commission also suggested that a post-tax WACC should be used for the calculation of maximum revenues – allowing tax to be included in the cash flows.

The Government has reported tax equivalent requirements separately (with the separation of dividend policy), but has not applied (and explains its reasoning) a post-tax WACC. The Commission will consider the merits of these approaches, to the extent applied, in terms of effective compliance with the CoAG pricing principles.



3.9 *Efficient resource pricing*

In the wastewater inquiry the Commission recommended the inclusion of some additional information in relation to the structure chosen for South Australian wastewater charging. The Government has included some such information. The Commission will consider and comment on the inclusions.

Trade waste charges were not a consideration in the previous wastewater inquiry, as a trade waste pricing decision was not being made (previous arrangements were in place). However, a trade waste pricing decision was made for 2005-06, and the Commission will consider this in terms of effective compliance with the CoAG pricing principles.

3.10 *Cross subsidies*

In the water inquiry the Commission recommended the inclusion of further analysis of the costs of servicing different customer categories in order to better address cross-subsidy issues. The Commission also proposed implementation of an increased incentive based structure for Community Service Obligation (CSO) payments.

The Transparency Statement addresses cross subsidies in the context of the Baumol band, as was done in the earlier water Transparency Statement.

The Transparency Statement reports that the Government has adopted a new CSO policy, which, among other things, provides incentives for efficient CSO provision. SA Water's CSOs are under review following the adoption of the new policy. The effects of this are expected to be more pronounced for 2006-07.

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 Thursday, 3 February 2005 (14 days after the Commission publishes its Notice of Inquiry).

The Commission will consider all submissions received and prepare a draft report by 11 March 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 8 April 2005.