INQUIRY INTO THE 2005-06 METROPOLITAN AND REGIONAL WATER AND WASTEWATER PRICING PROCESS

FINAL REPORT

March 2005

The Essential Services Commission of South Australia
Level 8, 50 Pirie Street Adelaide SA 5000
GPO Box 2605 Adelaide SA 5001
Telephone 08 8463 4444 Facsimile 08 8463 4449
E-mail escosa@escosa.sa.gov.au Website www.escosa.sa.gov.au

Public Information about the Commission's activities

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GLOSSARY OF TERMS

ANNUITY APPROACH	The constant annual provision (in real cost terms) that will cover the cost of replacing/rehabilitating all assets falling due within the period of the annuity/planning period, assuming retention of earnings from any accumulated annual surpluses
ARMCANZ	Agricultural and Resources Management Council of Australia and New Zealand
COAG	Council of Australian Governments
THE COMMISSION	Essential Services Commission of South Australia
CPA	Competition Principles Agreement
CSO	Community Service Obligation
DWLBC	Department of Water, Land and Biodiversity Conservation (SA)
EEL	Environmental Enhancement Levy
EIP	Environmental Improvement Program
EPA	Environment Protection Authority (SA)
EXPERT GROUP	The Expert Group on Asset Valuation Methods and Cost-Recovery Definitions for the Australian Water Industry
NCC	National Competition Council
NCP	National Competition Policy
NMU	Non-Major Urban (water authority)
NWC	National Water Commission
NWI	National Water Initiative
OMA	Operating, Maintenance and Administration
PNFCS	Public Non-Financial Corporations
SA WATER	South Australian Water Corporation
SCARM	Standing Committee on Agriculture and Resource Management
TER	Tax Equivalent Regime
WACC	Weighted average cost of capital
WSAA	Water Services Association of Australia

NOTICE OF REFERRAL FOR AN INQUIRY INTO WATER AND WASTEWATER PRICING IN METROPOLITAN AND REGIONAL SOUTH AUSTRALIA FOR 2005-06 PURSUANT TO PART 7 OF THE ESSENTIAL SERVICES COMMISSION ACT 2002

FROM: **The Hon Kevin Foley, Treasurer**

TO: **The Essential Services Commission of South Australia**

RE: **Water and Wastewater Prices in Metropolitan and Regional South Australia from 1 July 2005**

BACKGROUND:

1. Pursuant to section 35(1) of the *Essential Services Commission Act, 2002* (**the Act**), the Commission must conduct an inquiry into any matter that the Minister, by written notice, refers to the Commission.
2. The Act is committed to the Treasurer by way of *Gazettal* notice dated 12 September 2002 (p. 3393).
3. The South Australian Government proposes to publish a Transparency Statement each year on SA Water's water and wastewater prices. The Government has prepared the attached Transparency Statement.
4. The Transparency Statement links Cabinet's decision on water and wastewater prices to CoAG pricing principles, provides information on SA Water's financial performance in the context of pricing decisions and past and future expenditures, and addresses details of estimates of revenues, community service obligations, capital expenditure program, profit and its distribution.
5. SA Water is to meet the reasonable costs of the Commission in undertaking the inquiry.

REFERRAL:

I, Kevin Foley, Treasurer, refer to the Commission the matter described in paragraph (a) of the Terms of Reference for inquiry, in accordance with those matters in paragraphs (b) and (c) of the Terms of Reference and subject to the Directions set out in this Notice.

TERMS OF REFERENCE:

The following are the Terms of Reference for the inquiry referred pursuant to section 35(1) of the Act:

(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.

REQUIREMENTS FOR INQUIRY:

The following requirements are made pursuant to section 35(5) of the Act:

(a) I require that the Commission undertake its inquiry and submit a Draft Report to both myself and the Minister for Administrative Services by no later than 11 March 2005;

(b) I require that the Commission submit a Final Report on the inquiry to both myself and the Minister for Administrative Services by no later than 8 April 2005;

(c) In conducting the inquiry, the Commission is not required to hold public hearings, public seminars or workshops but may receive and consider any written submissions as it thinks appropriate and it must advertise to call for written submissions to be lodged no later than 14 days from the date of publication of the Notice of Inquiry as required pursuant to section 36 of the Act;

(d) If the Commission wishes to seek further information or guidance in relation to the conduct of this inquiry, it may contact the Director Infrastructure, Microeconomic Reform and Infrastructure Branch, Department of Treasury and Finance.

DIRECTIONS:

The following direction is made pursuant to section 35(5)(f) of the Act:

I direct that in undertaking its enquiry the Commission must preserve the confidentiality of any information, material or documentation provided by Government to enable the Commission to undertake its enquiry and stamped "Strictly Confidential".

OVERVIEW

In December 2004, the Treasurer directed that the Essential Services Commission of South Australia (the Commission) undertake an 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 2005-06. The focus of the inquiry is on the adequacy of the application of the CoAG pricing principles in these processes.

In undertaking its Inquiry, the Commission was to consider the: *Transparency Statement Metropolitan and Regional Water and Wastewater Prices in South Australia 2005-06* (Part A), dated December 2004, which was prepared by the Department of Treasury and Finance and endorsed by Cabinet.

In undertaking this Inquiry, the Commission is, for the second time, considering the adequacy of the application of the CoAG pricing principles by the South Australian Government in the process of setting SA Water's water and wastewater prices.

In the first half of 2004 the Commission undertook an inquiry in relation to the Government's processes for setting SA Water's 2004-05 urban water prices. Later in 2004 the Commission undertook a separate inquiry in relation to wastewater charges. Many of the analyses and conclusions arising from those previous inquiries are relevant to this inquiry and hence are repeated, summarised or referred to in this report. On this occasion the inquiry combines the water and wastewater pricing decisions.

This report indicates the extent to which information provided to Cabinet adequately set out and considered the CoAG pricing principles. The Commission has concluded compliance in the following areas:

- Efficient business costs
- Asset valuation
- Contributed assets
- Depreciation
- Annuity
- Externalities
- Return on Assets
- Dividends
- Tax Equivalent Regime
- Efficient resource pricing
- Cross-subsidies

However, the Commission has suggested improvements in some areas and particularly stresses the desirability of more significant development in the areas of efficient business costs and contributed assets.

1 INTRODUCTION

The South Australian Water Corporation (SA Water) is established under the *South Australian Water Corporation Act 1994* and is subject to the provisions of the *Public Corporations Act 1993*. SA Water provides water and wastewater services to domestic, retail and industrial customers throughout South Australia.

The South Australian Government wholly owns SA Water. The Minister for Administrative Services is responsible for setting the prices that SA Water charges for services provided. In doing so, the Government has committed to set prices such that they comply with pricing principles set by the Council of Australian Governments (CoAG).

The CoAG principles are related to the Competition Principles Agreement (CPA), which outlines a policy framework governing significant national reforms. The CoAG principles provide the framework for water and wastewater prices for jurisdictions that have signed the CPA – such as South Australia.

The CoAG principles relate to a broad range of issues, including the types of costs that may be recovered by SA Water, and specifically the application of a real rate of return that is commensurate with the equity arrangements of the entity. The CoAG principles also guide how a water entity is allowed to recover its costs from consumers, including how tariffs are structured.

The National Competition Council (NCC) was established in 1995 with the agreement of all Australian governments to, among other things, assess each jurisdiction's progress with implementing the National Competition Policy (NCP), which includes the CPA. The CoAG principles relating to water reform are part of the NCP.

The water role of the NCC is being subsumed by a new agency, the National Water Commission (NWC). The creation of the NWC arises from the National Water Initiative (NWI), which carries forward the water component of the NCP as well as broader water policy initiatives. The NWI impacts upon the CoAG principles, and may involve some reinterpretation of them. However, this inquiry has examined a pricing process based on the original CoAG principles, hence no reinterpretation has occurred.

1.1 Purpose of this paper

The South Australian Government has prepared a Transparency Statement: *Transparency Statement Metropolitan and Regional Water and Wastewater Prices in South Australia 2005-06* (Part A), dated December 2004, setting out the process and the matters that have been considered by the Government in setting 2005-06 water and wastewater prices. One of the purposes of Transparency Statement – Part A is to document the extent to which the Government's 2005-06 water and wastewater pricing decision complies with the CoAG principles.

To this end, the Treasurer has referred to the Commission an inquiry into the process undertaken in the preparation of advice to Cabinet to approve the 2005-06 water and wastewater prices. This includes an assessment of the extent that:

- the process resulted in Cabinet setting 2005-06 water and wastewater prices based on an adequate application of the CoAG principles; and
- relevant information on the CoAG principles was made available to Cabinet when it made its decision.

This report considers Transparency Statement – Part A as the government's explanation of its process and its justification that the 2005-06 water and wastewater prices comply with the CoAG principles. This report also comments, where possible, on the information that was made available to Cabinet in making its decision on 2005-06 water and wastewater prices (but is restricted given the confidential nature of Cabinet's consideration).

Importantly, it was the task of the Commission to examine only the process used to prepare advice to Cabinet with respect to the adequacy of the application of the CoAG principles and whether information relevant to the CoAG principles was made available to Cabinet when a decision on the level and structure of SA Water's 2005-06 water and wastewater prices was made. The Commission is not inquiring into water or wastewater prices themselves.

Ultimately, this report is to serve as Part B of the overall Transparency Statement, and has been prepared accordingly. This means that it often refers to Part A – rather than repeating the content of Part A.

1.2 Conduct of the inquiry

The Commission received the Notice of Referral of an Inquiry from the Treasurer on 24 December 2004 setting out the Terms of Reference for the Inquiry.

The Notice of Referral required the Commission to:

- advertise the Inquiry;
- provide 14 days for the lodgement of written submissions;
- provide a draft report by 11 March 2005; and
- provide a Final Report by 8 April 2005.

Pursuant to Section 36 of the *Essential Services Commission Act 2004*, a Public Notice of Inquiry was placed in *The Advertiser* on 20 January 2005, asking for written submissions by 3 February 2005.

The Commission received one submission in response to the Public Notice. The submission is available on the Commission website at www.escosa.sa.gov.au.

The Commission sought and received some additional information from the South Australian Government, including through discussions with representatives of the Micro Economic Reform and Infrastructure Branch of the Department of Treasury and Finance, and SA Water, in order to clarify its understanding of the processes surrounding the Cabinet approval of 2005-06 water and wastewater prices.

1.3 Link to the previous inquiries

In 2004, the Commission undertook similar but separate inquiries into the processes for determining the 2004-05 water and wastewater prices. Many of the analyses and conclusions arising from those previous inquiries are relevant to this one. As a result, this report often makes reference to the Commission's earlier reports. In some cases, elements of them are repeated or summarised.

The Commission's previous reports are available from its website: www.escosa.sa.gov.au.

1.4 Structure of this paper

Chapter 2 sets out the key elements of the CoAG principles.

Chapter 3 discusses the process for setting water and wastewater prices for 2005-06.

Chapter 4 deals with Transparency Statement – Part A's compliance with the CoAG principles and the extent that they have been adhered to in setting 2005-06 prices.

Chapter 5 summarises the Commission's conclusions.

2 THE COAG PRICING PRINCIPLES

The Commission's assessment in this inquiry is against the CoAG pricing principles for water. These principles were developed for application to water (including wastewater) by Australia's State and Commonwealth governments.

As is explained in Transparency Statement – Part A, the pricing principles 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 dedicated specifically 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 (pp. 103-104) are as follows:

> *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 are as follows:

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) are as follows:

- *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.*

2.1 The National Water Initiative

Appendix 4 of Transparency Statement – Part A sets out some of the elements of the NWI[1] that will impact upon the CoAG principles and their interpretation. Examination of the NWI indicates that it could have significant implications for the interpretation of the CoAG principles. This in turn could have implications for conclusions about compliance.

The submission received by the Commission addressed a number of issues relating to the NWI, providing some indication of the breadth of consideration that the NWI might trigger.

The South Australian Government reaffirmed its commitment to the NWI on 3 March 2005. However, it was not a consideration in the 2005-06 water and wastewater pricing process. Accordingly, the Commission's conclusions about compliance with the CoAG principles are based only on the principles as originally stated.

However, the Commission has included in this report some comment in particular areas where the NWI might have an impact in future.

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1 The complete text of the NWI is on the CoAG website at: http://www.coag.gov.au/meetings/250604/iga_national_water_initiative.pdf.

3 THE PRICE SETTING PROCESS

The 2005-06 water pricing decision outcomes were gazetted on 7 December 2004, in accordance with the *Waterworks Act 1932*. Actual wastewater rates will be gazetted in June 2005, in accordance with the *Sewerage Act 1929*. The delay for wastewater charges arises because they utilise property values, which are not available until that time.

3.1 Cabinet process

The key consideration for the Commission concerns the processes undertaken in the preparation of advice to Cabinet with respect to the adequacy of the application of the CoAG principles. The Commission's role is to advise on the extent to which adequate and relevant information on this matter was made available to Cabinet in its water and wastewater pricing decision.

As Transparency Statement – Part A documents, most notably in its Appendix 1, the decision making process for the 2005-06 water and wastewater prices involved a sequence of Cabinet submissions. The general nature of the sequence covered approval of the methodologies to be applied for pricing purposes, followed by approval of the 2005-06 prices. This approach was generally consistent with that used for 2004-05 prices, except that water and wastewater were considered together this time.

The business and decision making of Cabinet is completely confidential, as are all Cabinet documents and submissions. However, in order for the Commission to undertake this inquiry, it has been provided with copies of Cabinet Submissions and agency Cabinet comments which related to the setting of SA Water's water and wastewater prices for 2005-06. These documents are classified "Strictly Confidential" and the Commission is required to preserve the confidentiality of such documents.

The Commission has been able to compare the information provided in the Cabinet submissions with the information in Transparency Statement – Part A. It is satisfied that Transparency Statement – Part A adequately and reliably sets out the majority of the material which was available to Cabinet on the CoAG pricing principles and can therefore be used and analysed by the Commission as a proxy for the contents of the Cabinet submissions. For this reason this report refers to Transparency Statement – Part A when setting out the particular CoAG principle and the Government's assessment of its compliance with each principle.

3.2 Preparation of the Transparency Statement

The Part A Transparency Statements for the 2004-05 water and wastewater pricing decisions were not prepared and approved by Cabinet until well after the pricing decisions had been made. The Commission commented in its previous reports that it would be more useful for the Transparency Statement to be provided to Cabinet either prior to or, at the very latest, at the time it makes its pricing decision.

On this occasion, the bulk of Transparency Statement – Part A was presented to Cabinet for approval at the same time as the pricing decision. The exceptions were Chapters 7 and 8, which could not be finalised until Cabinet had made its pricing decisions.

4 COMPLIANCE WITH THE COAG PRICING PRINCIPLES

At the commencement of its first inquiry into water prices in 2004, the Commission sought clarification from the NCC about the appropriate documents that the Commission should consider in undertaking this inquiry. The NCC advised the Commission that "… the CoAG strategic framework and CoAG pricing principles are the key reference documents …".

The Compendium of National Competition Policy Agreements (2nd Edition, 1998)[2] provides details of the relevant CoAG agreements for the various industries, including water, the key components of which were set out in Chapter 2 of this report.

This chapter considers the CoAG principles and the compliance of the pricing process undertaken in the preparation of advice to Cabinet, with respect to these principles. As was noted earlier, the influence of the NWI is raised at certain points. However, the compliance conclusions do not incorporate the NWI as it does not yet have formal status in South Australia (and certainly did not at the time of the pricing decision).

In its previous inquiry reports the Commission included in each section a summary of comments by the NCC on that issue in its 2003 NCP Assessment Report. In October 2004 the NCC released its 2004 Assessment Report, Volume II[3] being dedicated to an assessment of water. In the main, the South Australian section of that latest NCC report reflects upon the Commission's 2004 water inquiry report. Therefore, the Commission has only included comments from the NCC's 2004 Assessment Report where there is a matter of specific relevance to this report.

As previously discussed the approach adopted by the Commission has been to assess the compliance of Transparency Statement – Part A with the CoAG principles, comfortable that it is a credible reflection of the information actually provided to Cabinet.

4.1 Operating, maintenance and administrative expenses – efficient business costs

Operating, maintenance and administration (OMA) costs are key components of the overall cost of delivering services and have been subject to keen attention in recent years.

The efficiency of business costs (or OMA expenditures) can be assessed in terms of:

- levels of expenditure;
- the consumption of assets (discussed in later sections); and
- impacts on service levels.

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2 This publication is available from NCC's website: www.ncc.gov.au.

3 National Competition Council, *Assessment of governments' progress in implementing the National Competition Policy and related reforms: 2004*, Volume Two: Water, October 2004.

One of the key reasons for considering the efficiency of business costs is to provide a foundation for explaining and justifying future actions and requirements. Particularly in the case of pricing proposals, it is necessary to establish a logical link between past performances, the factors influencing those performances and where the expected combination of movements in cost pressures/opportunities and management action will place the utility in the future. It is this future scenario that should be considered with regards to the level of revenue required from the pricing decisions.

The long-lived nature of the infrastructure employed in delivering water and wastewater services means that improvements in capital performance can take a long time to achieve and are seldom considerations in short-term management decisions. However, particularly as infrastructure assets age, it may be reasonable to expect to observe longer-term relationships, between the level of OMA expenditure and capital-based costs (reductions in service capacity).

4.1.1 CoAG Principles

In relation to efficient costs, the Guidelines for the application of Section 3 of the CoAG principles state that:

> *"In applying (the monopoly rent test) and (business viability test), economic regulators (or equivalent) should determine the level of revenue for a water business based on efficient resource pricing and business costs." (Emphasis added)*

4.1.2 Transparency Statement – Part A Comments

Transparency Statement – Part A addresses the issue of efficient business costs under four headings:

- Competitive tendering;
- Benchmarking of service performance;
- Benchmarking of business costs; and
- Key cost drivers of SA Water.

The key observations for these areas are:

Competitive tendering

> *"SA Water has contracted, by competitive tender, for services (eg electricity) or supplies (eg chemicals) in order to promote efficient business costs, where possible.*
>
> *Approximately 71% of all SA Water's water and wastewater OMA expenditure (excluding labour costs) are subject to competitive tendering arrangements.*
>
> *SA Water's most significant contract is the United Water International contract to manage Adelaide's water and wastewater systems. This 15-year contract, entered into in 1997*

following a competitive tender process, has provision for pricing reviews to reset the fixed-price component every five years." (p. 14)

Benchmarking of service performance (& benchmarking of business costs)

"WSAAfacts has been suggested for benchmarking major metropolitan performance. Although benchmarking of service providers in metropolitan areas is useful for broad indicative purposes, there are substantial differences between metropolitan areas in … (a number of factors) ... any conclusions based on benchmarking of service performance and costs across major metropolitan areas should be interpreted with caution.

Benchmarking by the Australian Water Association has been suggested for monitoring the performance of non-metropolitan providers. However, the Australian Water Association has not published a performance monitoring report for non-major urban (NMU) water utilities since 2000-01 due to the withdrawal of Commonwealth funds. Information from the NSW Water Supply and Sewerage Performance Monitoring Report and the Victorian Water Review has been adopted for comparisons in later years, where possible.

The issues outlined above that limit benchmark comparisons in metropolitan areas are also applicable to performance and cost benchmarking across regional areas. Additionally, the paucity of recent regional data means that conclusions based on regional benchmarking are tentative, pending more recent data." (pp. 14-15)

Key cost drivers of SA Water

"A number of key cost drivers influence the level of SA Water's costs of providing water and wastewater services relative to other providers. There are also trends and variability in these costs over time. This section, based on information provided by SA Water, analyses the trends in SA Water's real total costs and operating costs and the key drivers of variability around the trends.

The key drivers underlying the level of SA Water's system costs are:

- *access to water [resources]*
- *water quality*
- *topography*
- *environmental and customer service standards*
- *climatic conditions*
- *soil conditions."* (p. 19)

Transparency Statement Part A Conclusion on Benchmarking

"Benchmarking and cost comparisons of water utilities interstate and intrastate are limited by different markets, different regional conditions, different operating environments and data availability problems. Thus, conclusions based on benchmarking of service performance and costs for the metropolitan area should be interpreted with caution. Additionally, recognising the paucity of recent regional data, conclusions based on

benchmarking of service performance and costs for regional areas are tentative, pending more recent data.

Taking this into account, the Government considers that SA Water has generally achieved efficient business costs for water and wastewater services and therefore complies with CoAG principles.

The Government considers that the provision of this additional information has met ESCOSA's proposal." (p. 26)

4.1.3 The Commission's assessment

In comparison with previous Transparency Statements, particularly the initial one covering 2004/05 urban water pricing, significant progress has been achieved in the area of benchmarking/performance comparison.

It is not within the Commission's brief to assess the validity of the claims made in Transparency Statement – Part A with respect to the performance figures provided. However, it is appropriate to provide comment on the extent to which the approach utilised in Transparency Statement – Part A provides Cabinet with the information it requires in order to support price setting determinations.

Metropolitan services: historical performance

The annual performance review of the Australian urban water industry, WSAAfacts[4], remains the principal mechanism for comparative performance assessment of metropolitan water service utilities across Australia. In assessing the efficiency and effectiveness of SA Water metropolitan activities, the Government has adopted the core performance measures used in WSAAfacts. The documentation provides comparison with a number of peer water businesses, being principally those serving the capital cities in the other states and territories, with the exception of Tasmania, which does not have a participant in the WSAAfacts initiative.

In so far as the performance measures presented are an agreed set of measures between the participants, with a relatively high level of common understanding regarding definitions, the approach adopted appears an appropriate means of displaying the relative historical performance of SA Water in the provision of metropolitan water and wastewater services.

WSAAfacts is a published document that can be purchased by the general public. This gives interested parties access to a wider range of measures than published in Transparency Statement – Part A, covering a wider range of participants, which is beneficial to transparency.

[4] published by the Water Services Association of Australia.

Regional services: historical performance

In the absence of the Non-Metropolitan Urban (NMU) performance review, which last published results for 2000-01, the marshalling of suitable comparative performance data for SA Water's regional undertakings is more complex than for the metropolitan case.

Transparency Statement – Part A provides figures comparing outcomes for Mount Gambier, Outer Adelaide and Whyalla with data drawn from the NSW Water Supply and Sewerage Performance Monitoring Report (2001/02) and the Victorian Water Review (2002/03).

In utilising information from the various sources, it appears that the intent has been to provide performance measures that are as similar as possible to those used for the metropolitan comparisons.

The Commission believes that while progress has been made in gathering useful comparative data, current efforts could be further improved. In support of this contention, the Commission has identified the following data sources:

- Queensland local government comparative information 2002/03: Covering 125 Local Governments and including measures such as:
  - Properties per 100km of main;
  - Main breaks per 100km of main;
  - OMA Costs per property;
- Water Performance Information on 32 Major Western Australian Towns 1999/2003 (Economic Regulation Authority) including measures such as:
  - Leaks and bursts per 100km of main;
  - Water quality complaints per 1,000 properties;
- The NSW Water Supply and Sewerage Performance Monitoring Report (2002/03) – now published.

All three documents are available on the Internet and while still falling well short of the facility offered by WSAAfacts for metropolitan considerations, still provide the potential to better illustrate emerging trends for regional services.

The Commission also notes that the development of improved benchmarking data for the specific purpose of benchmarking efficient performance (across metropolitan, non-metropolitan and rural water delivery agencies) is listed under the NWI. This should provide some impetus to help overcome existing deficiencies.

Alignment of Reported Performance with Service Agreements

The performance measures reported in Transparency Statement – Part A do not align particularly well with those used in either the SA Water Performance Statement or its Customer Charter. This complicates any assessment of whether SA Water is, in fact, delivering value for money services in accord with agreed levels of service. It is also suggestive of a more general disconnect between prices and service standards which would not be conducive to efficient price setting.

The Commission considers that there would be some benefit in reconsidering the overall combination of performance reporting in Transparency Statement – Part A and those used in the Performance Statement and Customer Charter, in order to achieve a higher degree of alignment and provide a clearer picture to stakeholders of SA Water's performance.

Building a bridge from past performance to future requirements

In general terms, a pricing process should deliver a revenue outcome that will enable the well managed utility to meet its service goals, given an articulated set of delivery challenges. The outcome sought is to fund efficient future services.

In the above context, the role of historical performance reporting is to illustrate the impact of emerging trends and help explain the underlying cause-and-effect relationships that influence the utility's resource needs.

The next vital step is to understand how key trends are going to impact on the utility over the next few years and the nature of the resource/revenue implications. This is an aspect of 'internal' benchmarking that is absent from Transparency Statement – Part A, yet arguably should provide part of the foundation for pricing considerations.

There are a number of instances in the discussion on cost movements, where significant variations in cost outcomes for SA Water have been explained in terms of weather patterns or changes in service standards (particularly higher levels of sewage treatment). While the impact of climatic variation cannot be predicted, the likely impact of on-going and planned Environmental Improvement Programs (EIPs) can. It should also be possible to predict, with reasonable confidence, the underlying trends in service interruptions.

The Commission believes that the absence of forward projections for both costs and key service standards would need to be addressed in order to enhance the pricing process and enable more confident conclusions on efficient business costs.

Comparative revenue data – value for money

Clause 7(e) of the CoAG Framework requires:

> *"that water agencies should develop individually and jointly public education programs illustrating the cause and effect relationship between infrastructure performance, standards of service and related costs, with a view to promoting levels of service that represent the best value for money to the community."*

Clause 7(e) is not a CoAG pricing principle itself, but it is part of the broader CoAG agenda and clearly has a link to water and wastewater pricing. Assessment of value for money is likely to require some provision of comparative cost and income information, for example cost and income per customer, to supplement the service level comparisons and enable an understanding of value for money to evolve. Transparency Statement – Part A provides no such comparative information, effectively preventing it from playing a part in addressing Clause 7(e). While this does not cause the Commission to conclude a non-compliance in respect of the CoAG pricing principles, the Commission notes that having the Transparency Statement address Clause 7(e) would also improve the way efficient business costs are addressed.

4.1.4 The Commission's view on compliance with the CoAG principles

Adequacy of information: Does the information contained in the Transparency Statement comply with CoAG principles requiring prices to be based on efficient costs?

Based on the available performance comparison material, the Transparency Statement makes assertions about SA Water's costs being efficient. The Commission believes that the principle of efficient costs has been considered in the Transparency Statement.

Provision of information: Did Cabinet receive this information?

Cabinet received the same information that was included in the Transparency Statement, with some minor additions.

Sufficiency of information: Was the information provided sufficient to comply with the CoAG principles?

The Commission considers that the information provided in the Transparency Statement is still lacking in detail. The Commission believes that in order to more effectively comply with the CoAG principles on efficient business costs, the Transparency Statement should:

- continue to further develop the trend analysis of key cost drivers, and their likely impact in the short to medium-term; and

- explore the link between efficient business costs and the SA Water Performance Statement and Customer Charter, to better enable a conclusion to be drawn on efficient business costs by providing more transparency on the 'value-for-money' issue.

4.2 Asset valuation

4.2.1 CoAG Principles

The Guidelines for applying Section 3 of the Strategic Framework state:

> *"The deprival value methodology should be used for asset valuation, unless a specific circumstance justifies another method."*

4.2.2 Transparency Statement – Part A Comments

The Transparency Statement identifies that:

> *"The South Australian Government Accounting Policy Statement, APS 3, requires the fair value basis to be applied to the measurement of non-current assets as per Australian Accounting Standard AASB 1041 (July 2001) Revaluation of Non-Current Assets."* (p.27)

This is the same basis as in the 2004 water and wastewater inquiries.

Transparency Statement – Part A also reports the statement from APS 3:

> *"It is anticipated that in the majority of cases in practice, the valuation result derived under fair value will result in no material practical difference from the result obtained under deprival value (generally, both will be valued on a written-down current cost basis)." (APS 3, paragraph 6, p. 1)*

4.2.3 The Commission's assessment

The Commission concluded in its 2004 inquiries that SA Water had employed an approach to establishing asset values (the fair value method) that was consistent with the requirements of the CoAG principles (the deprival value method). The basis of the asset valuation has not changed on this occasion.

Of course, as the above quote from APS 3 implies, there may be situations where a valuation under fair value would differ from that under deprival value. However, significant differences are unlikely to arise when valuing water and wastewater assets. These assets are specialised assets which are unlikely to have observable market values (once installed). In such circumstances both fair value and deprival value should lead to a valuation based on the replacement cost of an asset's remaining future economic benefits.

The Commission has not conducted an asset valuation of SA Water (which would be beyond the scope of this inquiry), but has satisfied itself that a valuation based on fair value should be consistent with deprival value for these asset types.

Further comfort about the SA Water valuation was provided originally by its independent verification by and against the Hunter Water Corporation Pty Ltd. The *Transparency Statement – Urban Water 2004-05* (upon which the Commission's 2004 water inquiry was based) reported that a good correlation was found in that verification.

The Government will need to ensure that SA Water's application of fair value, or any subsequent method applied, remains consistent with the CoAG principles' deprival value on an ongoing basis. This might, at some point, require the development of separate asset valuations. It is important to recognise that a valuation method used for price setting need not be the same as that used for accounting purposes. Indeed, it is quite common in price regulation for a regulatory asset value to differ significantly from an accounting asset value.

4.2.4 The Commission's view on compliance with the CoAG principles

***Adequacy of information*: Does the information contained in the Transparency Statement comply with CoAG principles?**

Transparency Statement – Part A explains that the method of asset valuation is consistent with deprival value, hence complying with the CoAG principles.

***Provision of information*: Did Cabinet receive this information?**

The Commission is satisfied that the Cabinet submission included the necessary information about the method of asset valuation.

***Sufficiency of information*: Was the information provided sufficient to comply with the CoAG principles?**

Sufficient information was provided in respect of the method of asset valuation to comply with the CoAG principles.

4.3 Contributed assets

4.3.1 CoAG Principles

The Guidelines for applying Section 3 of the Strategic Framework state:

> *"…transparency is required in the treatment of …, contributed assets,… ."*

4.3.2 Transparency Statement – Part A Comments

The Transparency Statement identifies that:

> *"Given the broader acceptance by Australian regulators of removing contributed assets from the asset base, the Government has agreed to remove:*
>
> - *contributed assets from SA Water's regulatory asset base*
> - *the associated depreciation from the maximum revenue outcome*
> - *annual capital contributions from the forecast target revenue.*
>
> *An important issue is to determine the value of contributed assets to be excluded from the initial regulatory asset value, as at 1 July 2004.*
>
> *The assets held by the former Engineering and Water Supply Department (EWS) were transferred to SA Water upon corporatisation on 1 July 1995. Before then, the information held on contributed assets was very limited. Further, once SA Water recognised the contributed asset, there was no need to separately track contributed assets for other purposes. As a result, there is some subjectivity in estimating the value of contributed assets. SA Water has been able to determine the length of mains provided by subdividers since corporatisation, although similar information is not available for customer contributions.*
>
> *There is no sound information on which an estimate of contributed assets prior to corporatisation can be based. The Government, therefore, believes that the most appropriate course of action is to value contributed assets from the date of corporatisation.*
>
> *The Government has estimated the value of contributed assets provided to SA Water as $222 million as at 1 July 2004. To derive this estimate the Government reviewed SA Water's documents to determine the length of mains provided by subdividers and applied current construction rates to determine the value of contributed assets provided by subdividers, adjusted for depreciation. For customer contributions, only financial documentation was available. Therefore, the estimate of customer contributions is based on the value of contributions provided to SA Water and amended for depreciation and inflation."* (pp. 28-29)

4.3.3 The Commission's assessment

Previously, contributed assets were included in the asset base for pricing considerations and this fact made explicit. While the Commission accepted that this might comply with the CoAG principles, it also noted that it was neither a common, nor desirable, regulatory practice.

Given the predominantly long-lived nature of water and wastewater infrastructure, the on-going inclusion of contributed assets will boost depreciation expenses and the return on capital – allowing generation of significant free cash flows.

It is also significant that under the NWI, governments will be required to commit to moving toward (and probably to) maximum revenue case pricing by 2008. If the upper bound is based upon an unreasonably inflated asset base for pricing purposes then the result would be a lock-in of excessive prices.

The Government has responded to the Commission's earlier suggestions by making an assessment of contributed assets and removing them from the asset base for pricing purposes. Future contributed assets will also be tracked separately and removed. This approach is compliant with the CoAG principles and is certainly more in keeping with the intent of the CoAG principles.

However, the Government has only estimated and removed contributed assets since corporatisation in 1995. It argues that there is no "sound information" available prior to that time. The Commission recognises that it may be difficult to get an accurate picture of exactly which assets were contributed and that this can complicate their exclusion from pricing considerations. However, it is known that contributions of this type have been taking place for a very long time and that they possibly constitute a significant proportion of water and wastewater assets.

It is also possible that the removal of contributed assets would have a differential impact between water and wastewater, as contributed assets are likely to account for a higher proportion of total wastewater assets than total water assets. If this is the case, it would alter the apparent imbalance between water and wastewater prices, with wastewater currently near the maximum revenue case and water nearer the minimum, assuming that the target revenues for both were adjusted to remain below the new maximum revenues.

Combined with the possible risk of asset value lock-in arising through the NWI, it would be timely for the Government to now seek a best estimate of contributed assets pre-1995. An exact figure is unlikely to emerge, but it should be feasible to develop an estimate within a reasonable range based on data for past land and network developments. This would at least provide a more secure basis for adopting an estimate, rather than simply choosing a default of zero.

Some examples of potential methods might include:

1. Allotment survey-based estimation: information may be assembled to show that Adelaide has had, say, 100,000 new lots created over a particular period. Urban Development Institute of Australia data may show that the average cost per lot, in terms of water and wastewater assets handed over to SA Water, was $X per lot, with developer charges of $Y per lot. This would imply total non-corporation funded assets in today's terms of $(X+Y).

2. Statistical estimation: in particular, regression techniques based on the experience of peer utilities.

3. Expenditure ratios: where the proportion of total capital investment inferred by the estimated value of contributed assets is applied to the recorded physical quantities of assets installed for that year, for relevant assets (likely to be predominately small pumping stations and small diameter water mains and sewers). These estimates would be modified and/or augmented where sufficient information is available to specifically identify contributions for major works. Once established, this approach would facilitate up-dating of estimates in line with changes in replacement costs.

While it is recognised that no approach will deliver a perfect answer, it is believed highly likely that the relationship between achievable confidence levels and proportion of total assets represented by contributed assets will deliver a more appropriate outcome for pricing purposes than represented by the current approach. Estimate confidence would be increased using multiple approaches.

4.3.4 The Commission's view on compliance with the CoAG principles

***Adequacy of information*: Does the information contained in the Transparency Statement comply with CoAG principles?**

Given that the Transparency Statement is explicit about the treatment and removal of contributed assets from the asset values used for setting prices, it is in compliance with the CoAG principles.

***Provision of information*: Did Cabinet receive this information?**

The Commission is satisfied that the Cabinet submission included the necessary information that contributed assets were estimated and that estimate removed from the asset values that were used to calculate the water and wastewater prices.

***Sufficiency of information*: Was the information provided sufficient to comply with the CoAG principles?**

The Commission believes that fuller compliance with the CoAG principles would result if an estimate of pre-1995 contributed assets was also provided, thereby enabling consistent and more transparent treatment of all contributed assets.

4.4 Depreciation – provision for asset consumption (maximum revenue case)

4.4.1 CoAG Principles

The Guidelines for applying Section 2 of the Strategic Framework state:

> *"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 [weighted average cost of capital]."[Emphasis added]*

As the Commission explained in its previous inquiry reports, provision for the cost of asset consumption refers to depreciation.

4.4.2 Transparency Statement – Part A Comments

Key statements from Transparency Statement – Part A are:

> *"In the 2005-06 water and wastewater pricing process, SA Water has estimated depreciation on assets in the maximum revenue outcome using the straight-line method, based on the useful lives of the asset. This is consistent with previous pricing decisions.*
>
> *The method of calculation is consistent with APS 7: Depreciation of Non-Current Assets and AASB 1021: Depreciation. Infrastructure, buildings, plant and equipment and other assets are depreciated using the straight-line method over their estimated useful lives of 5–160 years." (p.32)*

4.4.3 The Commission's assessment

The straight line method is used to calculate depreciation and that amount is reported. The CoAG principles require the inclusion of depreciation but do not dictate the methodology.

4.4.4 The Commission's view on compliance with the CoAG principles

Adequacy of information: Does the information contained in the Transparency Statement comply with CoAG principles?

The Transparency Statement uses a straight line depreciation methodology to calculate depreciation. This is compliant with the CoAG principles, which do not dictate the depreciation methodology, except to say that an amount for depreciation should be included.

Provision of information: Did Cabinet receive this information?

The Commission is satisfied that the Cabinet submission included the fact that depreciation was included in the calculation of the maximum revenue case.

Sufficiency of information: Was the information provided sufficient to comply with the CoAG principles?

The Transparency Statement is consistent with the CoAG principles in its treatment of depreciation. The Transparency Statement includes the actual depreciation amount, in line with the Commission's recommendation in its 2004 water inquiry.

4.5 Provision for future asset refurbishment/rehabilitation (minimum revenue case)

The CoAG framework mandates the determination of the minimum revenues required to ensure that assets/service capacity can be replaced as that need arises, for those services where there is an ongoing requirement. The depreciation expense is not automatically accepted as providing this minimum funds requirement. This is because the magnitude of the depreciation expense may well be in excess of the actual asset replacement funding requirements experienced by the utility, chiefly due to timing issues.

The CoAG guidelines identify that this cost stream should be estimated in terms of the annual amount that would need to be put away each year, over a period of (say) 20-30 years, to ensure that the costs of all rehabilitation/replacement needs over that period would be met, provided annual surpluses were accumulated and interest income applied. This is referred to as the "annuity approach". For water and wastewater systems, the outcomes from the annuity approach are frequently materially less than the corresponding straight-line depreciation outcomes for the same assets.

4.5.1 CoAG Principles

Guideline 3, for applying Section 3 of the Strategic Framework states that:

> *"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."*

4.5.2 Transparency Statement – Part A Comments

In its 2004-05 pricing decisions the Government used straight-line depreciation for the minimum revenue case, but noted that it was pursuing an annuity approach for the 2005-06 decision.

Transparency Statement – Part A, observes:

> *"SA Water has since upgraded its asset management plans to produce a 25 year view of its asset replacement/refurbishment requirements, established on the basis of a model called NESSIE, which takes into account issues such as:*
>
> - *SA Water's initial 5 year asset management plan*
> - *the requirement for continuity of the service capability of the assets*
> - *adjustments for the actual scale of replacement costs*
> - *the effect of current replacement practices on asset lives.*

SA Water then reviewed the base case using the strategic management modelling approach. This approach assumes that the asset is replaced when the increased repair and running (wear out) costs over time equal the annualised cost of replacement, after which the cycle repeats itself. The additional repair and wear out costs are based on an analysis of cost drivers relevant to the specific asset group.

These results are reviewed to establish an optimal mix of capital and maintenance costs for SA Water to maintain appropriate service capacity and standards. This information is then incorporated into the NESSIE model to establish a revised asset management plan.

The annuity estimate is calculated by estimating the present value of annual cash flows, based on the NESSIE model predictions. The present value is then converted to an equivalent annual annuity over the planning horizon of 25 years. Calculations are estimated on the basis of a WACC of 7% pre-tax real. SA Water's modelling indicates that the annuity estimate is not sensitive to changes within the endorsed 6-7% pre-tax real WACC range.

The annuity estimate is considerably lower than the previous estimate of straight-line depreciation value used in the 2004-05 water and wastewater pricing decisions. Consequently, the minimum revenue outcome required to preserve the ongoing service capacity of water and wastewater infrastructure is lower than previously predicted." (pp.41-42)

4.5.3 The Commission's assessment

The inclusion of an annuity estimate in the 2005-06 pricing decisions is a considerable development over the 2004-05 pricing decisions, which relied on straight-line depreciation.

4.5.4 The Commission's view on compliance with the CoAG principles

***Adequacy of information*: Does the information contained in the Transparency Statement comply with CoAG principles?**

The Transparency Statement uses an annuity estimate in the calculation of the minimum revenue requirement. Hence, the Commission considers that the Transparency Statement complies with the CoAG principles.

***Provision of information*: Did the Cabinet receive this information?**

The information received by Cabinet included the annuity estimate. Hence, Cabinet did receive the relevant information.

***Sufficiency of information*: Was the information provided sufficient to comply with the CoAG principles?**

In the Commission's view, relevant information was provided, in terms of an annuity estimate, its derivation and implications, meaning that compliance with the CoAG principles was achieved.

4.6 Externalities

While issues associated with the infrastructure and operational aspects of water and wastewater service delivery dominate the text of pricing considerations, it is important to remember that water resource management is a key plank of the overall Water Reform Strategic Framework. The avenue for taking account of costs associated with the availability of the water resource, including its protection from pollution, is, in part, through the consideration of "Externalities".

4.6.1 CoAG Principles

The Guidelines for applying Section 3 of the Strategic Framework state:

"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 [weighted average cost of capital]."[Emphasis added]

"Externalities … means environmental and natural resource management costs attributable to and incurred by the water business"

4.6.2 Transparency Statement – Part A Comments

Water

"Methods of measuring, apportioning and charging for all water planning and management costs, and unpriced impacts relating to providing urban water services to individual beneficiaries, is complex and the subject of rigorous and ongoing theoretical, methodological and empirical debate throughout Australia.

The Government has agreed to work co-operatively at a State and Territory level towards adopting consistent approaches to pricing and attributing of water planning and management costs by the end of 2006.

The current South Australian approach is that water resource management is the responsibility of the Department of Water, Land and Biodiversity Conservation (except for SA Water retaining some responsibility for administering policy on water conservation by its customers). As the Department of Water, Land and Biodiversity Conservation is funded from consolidated revenue, water resource management costs are currently borne by the South Australian community.

Until a consistent Australia-wide approach is resolved, it would be pre-emptive at this stage to include all or part of the Department of Water, Land and Biodiversity Conservation costs in the upper bound. Additionally, the Department of Water, Land and Biodiversity Conservation costs include other programs relating to agricultural and community use." {pp.34-35}

"The Government considers that the inclusion in the estimated maximum revenue outcome of all environmental management costs attributable to and incurred by SA Water in the provision of water services is consistent with CoAG principles." {p.37}

Wastewater

"SA Water's costs in meeting all environmental requirements are difficult to separately identify. Nevertheless, capital and operating costs related to the EEL are identified in Table 6. Additionally, payments by SA Water to the EPA as licence fees in 2005-06 would be $1.5 million. This fee is applied as a fixed charge. The EEL on sewer rates was introduced in 1990 to accelerate the implementation of environmental improvement programs (EIPs) to minimise environmental impacts and meet legislative requirements. The levy, which is effectively 8.6% of total wastewater rate revenue, will raise $21.2 million in 2005-06." {p.36}

"All wastewater and trade waste is now fully processed to acceptable environmental standards set by the EPA. All environmental costs attributed to and incurred by SA Water are incorporated into the maximum and minimum revenue outcomes." {p.38}

4.6.3 The Commission's assessment

Water

The Commission understands that a key tenet of the CoAG water reform process was to include the true cost of resource management in water pricing. In the South Australian context this would include, for example, costs associated with some water resource management related activities of the Department of Water, Land and Biodiversity Conservation (DWLBC). As the Commission explained in its 2004 water inquiry, the NCC also supports such a view.

Further, the Expert Group recommended:

"any ongoing costs associated with water resource management be borne by water beneficiaries/impactors, except where the broad community is identified as a beneficiary, or where the activity is clearly a government responsibility, in which situations government might pay:"(Expert Group, 1995, p 6)

It is believed that the reference to government responsibility for payment is for activities associated with recreational use of the waterways, fishing and so on, rather than any significant proportion of costs incurred in the management of the water resource itself.

There is also the requirement under CoAG's strategic framework 5(c) that:

"where cross-border trading is possible, that the trading arrangements be consistent and facilitate cross-border sales where this is socially, physically and ecologically sustainable;"

Water resource management charges would also be an important adjunct to the costs of alternate technical solutions to providing services from different water sources. This is a situation that is likely to become more prevalent as traditional sources, such as the River Murray, become more stressed and technical advances make alternate sources, such as desalination, more cost effective/practical once true extraction costs are understood and incorporated.

However, as the Commission acknowledged in its 2004 water inquiry, the Guidelines definition for 'Externalities' emphasises that the requirement is to recognise resource management costs "….both attributable to and incurred by water businesses". As DWLBC does not invoice SA Water for its water resource management costs, they should not be incorporated in the cost considerations.

The Commission's conclusions here recognise this definition. However, the Commission also notes that under the NWI it is likely that the broader interpretation will prevail. This would require a change in approach and the eventual inclusion of extraction-based water charges.

Wastewater

Both EPA licence fee and Environmental Enhancement Levy (EEL) revenues are identified and explained in the Transparency Statement. It also provides additional information about EEL projects and expenditures, in response to Commission suggestions in its 2004 wastewater inquiry.

However, it is still not clear that EEL funded works necessarily deal with externalities any more or less than the other wastewater projects that SA Water must undertake.

4.6.4 The Commission's view on compliance with the CoAG principles

Adequacy of information: Does the information contained in the Transparency Statement comply with CoAG principles?

The inclusion of externalities that are "both attributable to and incurred by" SA Water in the Transparency Statement is compliant with the CoAG Principles.

Provision of information: Did Cabinet receive this information?

The Commission recognises that the Cabinet submission included information about externalities in their consideration of water and wastewater prices.

Sufficiency of information: Was the information provided sufficient to comply with the CoAG principles?

Sufficient information was provided in respect of externalities to comply with the CoAG principles. However, the Commission notes that changes to the treatment of water resource management costs may be required if/when South Australia commits to the NWI.

4.7 Return on assets

Water and wastewater businesses are highly capital intensive (that is, they require investment of large amounts of capital in sunk assets). Therefore, relatively minor variations in rates of return and/or the asset values on which return is sought can have a significant impact on pricing. In addition, the inclusion or exclusion of contributed assets can also have a considerable impact.

The inclusion of a return on asset component in pricing considerations is, and will remain, a sensitive issue, in that there is the potential for inefficient asset costs or excessive returns to underpin higher prices.

The Commission understands that this requirement was included in the CoAG principles to ensure that the opportunity cost of funds invested is recognised in water and wastewater pricing, leading to efficient economic outcomes.

The cost of capital relates to the opportunity cost of investment. It represents a risk adjusted return that investors demand on their investment.

Although the cost of capital is a straightforward theoretical concept, it is complex and controversial to apply. The two main reasons for this are that it:

(1) is impossible to determine the "true" future cost of capital for any company; and

(2) has one of the largest financial impacts for a regulated business.

For some Australian water utilities the issue has been confused further due to government ownership. However, ownership should have no impact in determining the cost of capital, which as mentioned, is an opportunity cost and not the accounting cost of financing.

4.7.1 CoAG Principles

The Guidelines for applying Section 3 of the Strategic Framework state:

> *"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 [weighted average cost of capital]."[Emphasis added]*

4.7.2 Transparency Statement – Part A Comments

The Transparency Statement Part A states:

> *"An estimated range of WACC was developed by evaluating individual input values against relevant independent regulatory decisions, and the research and analysis upon which those decisions were based. The views of independent regulators on appropriate input values were considered to represent efficient suppliers' benchmarks." {p. 30}*

"The Government adopted a narrower range of pre-tax real WACC for its 2005-06 water and wastewater pricing decisions of 6–7% (rounded from 6.09–7.16% above) on the basis of these input values. It was considered that selecting a single WACC, and/or figures specified more precisely than to the nearest 0.5 percentage point, was not appropriate given the estimation difficulties involved in each input value into the WACC calculation. New South Wales' IPART and the United Kingdom's Office of Water Services (OFWAT) have also adopted a WACC range, rather than a single WACC." {p. 31}

4.7.3 The Commission's assessment

WACC is one of the most crucial variables in setting regulated prices. This is because the revenue recovery amount is highly sensitive to the cost of capital used (in a 'building block' approach[5]).

Transparency Statement – Part A states that SA Water's total assets are valued at about $6.6 bn, with water assets about $4.2 bn and wastewater assets at $2.4 bn. This means that a change of 0.1% in the cost of capital applied to the assets results in a revenue requirement change of $6.6m annually for SA Water as a whole, or $4.2m for water, $2.4m for wastewater.

The Government previously applied a range of WACC across 2 percentage points (between 6% and 8%), reflecting a range of some $130m annually. This is clearly a significant range and the Commission considered it inappropriate.

The Government has now applied a narrower band of 1 per cent, has included presentation of the various components of WACC and has sought to review the calculation of WACC based on an efficient supplier's benchmark. This addresses many of the Commission's earlier concerns.

Notwithstanding these significant improvements, it is not clear that the process used to arrive at the WACC range necessarily accords with that which the Commission expects it would use if determining a WACC for price regulation purposes. A particular query surrounds the degree of reliance on other regulators' decisions for setting an efficient supplier's benchmark (though this is not to say that other regulators' decisions are irrelevant).

Of course, the Commission may itself have arrived at a WACC within the 6-7% range if it had been required to determined a pre-tax real WACC. Hence, in raising these queries, the Commission is not suggesting that the WACC range is necessarily wrong.

In the 2004-05 pricing decisions the range was a particular concern for wastewater, as the forecast target revenue sat midway between the 6%-8% based estimates for

5 The 'building block' approach relates to setting the revenue target as the sum of efficient cost, including operational & maintenance cost, depreciation and a return on assets. It may also include other incentive payments, such as an efficiency carry-over amount.

maximum revenue. The forecast target revenue for water was well below the maximum revenue.

This time both the maximum and minimum revenues have reduced (for both water and wastewater) due to the removal of the estimate for contributed assets, the narrowing of the WACC band to 6-7% and the introduction of an annuity (although the Commission observes that these reductions have not stopped a price rise from being approved). However, the concerns are similar for the 2005-06 forecast target revenues, as is shown in Figures 10-12 in Transparency Statement Part – A.

The forecast target revenue for wastewater is near the top of the new maximum revenue band. Considering the potential to further reduce asset values for price setting purposes to allow for improved treatment of contributed assets, it is possible that the Government is actually implementing charges that generate revenues in excess of the "true" maximum revenue outcome. The NWI requirement to move toward maximum revenue pricing by 2008 will add to concerns here.

4.7.4 The Commission's view on compliance with the CoAG principles

***Adequacy of information*: Does the information contained in the Transparency Statement comply with CoAG principles?**

Opportunity cost is recognised in the Transparency Statement as required by the CoAG pricing principles.

***Provision of information*: Did Cabinet receive this information?**

The Transparency Statement explains the derivation of the WACC range.

***Sufficiency of information*: Was the information provided, sufficient to comply with the CoAG principles?**

The Commission believes that, although compliant with the CoAG principles' requirement to include an opportunity cost, it would be preferable to determine an appropriate WACC, rather than a range.

4.8 Dividends

Dividend Policy relates to matters associated with the periodical returns made to the shareholders or owners of a business. Any decision on dividends to be paid is linked to the decision on the capital structure of the business. Retention of free cash flows (retained earnings) by the business increases the equity proportion of a business.

Dividend policy must be considered as a corporate wide issue due to its corporate-wide impact. Dividends cannot be allocated to business units. This is akin to allocating shares to specific parts of the business.

4.8.1 CoAG Principles

In relation to dividends, the guidelines for the application of Section 3 of the CoAG principles state that:

> *"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."*

Although the "level that reflects commercial reality" is not further explained, the NCC has previously provided some clarifying remarks[6]:

> *"The Council considers that a reasonable upper bound limit for dividend distribution by government water service businesses is the Corporations Law requirement that dividends may be paid only out of profits (profits include accumulated retained profits as well as the current year's profit). This approach would safeguard against water and wastewater service providers having insufficient financial resources to conduct business. This approach would also be consistent with competitive neutrality objectives."*

4.8.2 Transparency Statement – Part A Comments

Transparency Statement – Part A outlines the new dividend policy applying to SA Water. The new policy treats dividends separately, rather than as part of an overall contribution as was the case previously:

> *"The new policy framework for dividends incorporates the following key elements:*
>
> - *dividends would be calculated with consideration of the capital structure targets for each PNFC [Public Non-Financial Corporations]*
> - *dividends would be paid based on actual, rather than budgeted, outcomes*
> - *dividends would be paid on after tax profit, rather than on a cash basis. Special dividends may be paid if determined to be appropriate by the Treasurer. Dividends will not exceed the accumulated surplus of the PNFC*
> - *the dividend requirements of the Government as shareholder would be consistent with the approved capital structure bands for the PNFC*
> - *the timing, process of payment and revision of dividends would be on a consistent basis.*
>
> *The Government considers that dividends calculated on the basis of after tax profit and actual outcomes more closely reflect commercial realities, and provide appropriate incentives to the management and board.*

6 The 2003 NCP Assessment Framework for Water Reform, NCC, February 2003.

> *In November 2004 the Government also approved implementation of the new ownership framework, which is expected to be budget neutral in 2005-06. The Government will make a formal decision on the individual application of the new ownership framework, including the capital structure and dividend policies, for SA Water in January 2005." (pp. 45-46)*

The Transparency Statement also notes that the 2005-06 pricing decision is based on best estimates of this new policy, given that it had not been finalised at the time.

4.8.3 The Commission's assessment

In its earlier reports the Commission addressed NCC concerns about the dividend policy applied to SA Water, particularly concerns that the dividends were higher than commercial reality. The Commission provided analysis to allay those fears and showed that the dividend policy was not being used as a "backdoor means" for capital restructuring.

The Commission previously recommended several changes to the way dividends are explained in pricing decisions. These included:

- separating dividend policy from overall contributions policy (to separate it from the tax equivalent regime);
- stating the dividend policy; and
- explaining capital structure – given its relationship with dividend policy.

The Government has implemented these changes. The changes were facilitated by the Government's development of a new ownership framework for public corporations (including SA Water) which included new capital structure and dividend policies.

While the final details of the application of these new policies were still being determined at the time of the pricing decision, the dividend policy itself appears to better reflect a commercial reality standard, as is required.

4.8.4 The Commission's view on compliance with the CoAG principles

***<u>Adequacy of information</u>*: Does the information contained in the Transparency Statement comply with CoAG principles?**

The new dividend policy is stated in the Transparency Statement and a best estimate of its impact included in the minimum revenue case. This complies with the CoAG principles.

***<u>Provision of information</u>*: Did Cabinet receive this information?**

Cabinet received information about the dividend policy.

<u>Sufficiency of information</u>**: Was the information provided sufficient to comply with the CoAG principles?***

The information was sufficient to comply with the CoAG principles, although recognising that the final application of the new dividend policy had not been decided at the time of the decision.

4.9 Tax equivalent regime

The tax equivalent regime (TER) relates to a regime whereby government owned enterprises are subject to an equivalent taxation regime that applies to the private sector. For state-owned enterprises, tax is paid to the State government, not the Commonwealth.

4.9.1 CoAG Principles

The CoAG principles require that taxes or TER payments be included in the calculation of both the maximum revenue and the minimum revenue. However, the minimum revenue requirement calculation does not require the inclusion of income tax for those organisations which do not pay income tax.

The main reason for the TER is to ensure competitive neutrality. In the absence of TER, the public sector will have a cost advantage since it would not have to incorporate the business cost of taxes into prices.

4.9.2 Transparency Statement – Part A Comments

Transparency Statement – Part A states that:

> *"…the dividend and TER amounts were presented separately to Cabinet for the water and wastewater pricing decisions and are separately reported in this Transparency Statement." (p.38)*

It also says that:

> *"As in the 2004-05 water and wastewater pricing decisions, the pre-tax approach to estimating the required return on assets has been adopted. It is considered that the inclusion of a pre-tax return on assets in setting the maximum revenue outcome removes the requirement to include a separate allowance for income TERs when estimating the maximum revenue outcome." (p.39)*

4.9.3 The Commission's assessment

As was described in the section on dividends the Commission had previously recommended the separation of dividend and tax policy. As well as achieving CoAG principle compliance, reasons for this include that taxes are paid to the government, whereas dividends are paid to shareholders. For transparency, when the two are the same, the payments should be separately identified. Taxation is an outcome, whereas the dividend policy is an internal policy of the business. The tax outcome should not be mingled with an internal policy decision.

SA Water's inclusion of TER in the minimum revenue requirement calculation is considered to be appropriate and compliant with the CoAG principles.

With regard to maximum revenue calculation, it is appropriate that where a pre-tax WACC is used, taxation amounts should not be added on to cash flows as well, since this would lead to double counting.

That the CoAG principles require TERs to be included in both maximum and minimum revenue calculations implies that a post-tax WACC should be used, as it requires the taxation amount to be included in the cash flows – an improvement in transparency. The Commission also notes that it observes a regulatory trend towards post –tax cost of capital regimes.

4.9.4 The Commission's view on compliance with the CoAG principles

***Adequacy of information*: Does the information contained in the Transparency Statement comply with CoAG principles?**

In the Commission's view, the Transparency Statement includes TER and is compliant with the CoAG Principles.

***Provision of information*: Did Cabinet receive this information?**

The TER calculation was included in the Transparency Statement and made available to the Cabinet when making the pricing decision.

***Sufficiency of information*: Was the information provided, sufficient to comply with the CoAG principles?**

The information provided was sufficient. However, in the Commission's view the TER information would be presented more transparently if a post-tax WACC were used and the taxation amount included in the cash flows.

4.10 Efficient Resource Pricing – Tariffs and Rates

Tariff structure has an important role to play in achieving overall economic efficiency. Although the majority of a water utility's costs would be fixed (in the short to medium term), consumption based pricing sends a strong signal and can achieve allocative efficiencies.

A tariff structure comprising of a fixed charge and a usage (variable) charge, is referred to as a two-part tariff.

4.10.1 CoAG Principles

In the NCP water reform assessment framework, the NCC states that in setting prices for water, the water businesses are to:

> *"Set prices that reflect the volume of water supplied to encourage more economical water use. Businesses should implement a two-part tariff (comprising a fixed access component and a volumetric cost component), where this is cost effective."*

The Commission understands that the key driver for this requirement is to achieve a price signal leading to better asset utilisation, water resource conservation and overall allocative efficiency.

4.10.2 Transparency Statement – Part A Comments

Water

SA Water has two-part tariffs for all non-commercial customers as set out in Table 10 of Transparency Statement – Part A. There are different supply charges to residential and non-residential customers. Its variable charges have two blocks: 46c/kL for all consumption up to 125 kL, and $1.06/kL for all consumption greater than 125kL.

The Transparency Statement also describes a comparison of the usage charges against a CSIRO estimate of Adelaide's long run marginal cost (LRMC) for water, noting the applicability of LRMC for price signalling. It reports that:

> *"The second, higher tier, is consistent with current preliminary estimates of SA Water's Adelaide LRMC." {p. 48}*

For all commercial customers, the supply charge is based on a percentage of property value (with a minimum of $160). The usage charge is being phased in, with the transition being completed in 2006-07. The intent is that the increased revenue generated by the introduction of the usage charge will be offset by a reduction in the supply charge, such that SA Water remains revenue neutral.

The charging structure is uniform between city and country customers, which gives rise to cross subsidy and Community Service Obligation (CSO) issues, which are addressed in section 4.11.

Wastewater

SA Water's charges for wastewater services to all but its largest customers are on a single rate basis, where the rate is linked to the value of the property served. There is no consumption (or volumetric) component.

Separate rates are applied between metropolitan and country customers, to adjust for the generally lower property values in country areas. The intent is that country customers should pay similar amounts to city customers.

Separate rates are also applied to residential and non-residential customers, resulting in generally higher payments by non-residential customers.

A minimum annual charge, to be $269, also applies.

Transparency Statement – Part A (and the equivalent 2004 document) explain that the adoption of this approach is based upon a series of premises, including the:

- impracticality (non cost-effectiveness) of metering wastewater service usage;
- observation that the volume (and pollution load) of wastewater discharged by most customers has little impact on the cost of operating the sewerage system and hence price signalling in this respect would provide little benefit;
- risk of unregulated diversions from the sewerage system if consumption based pricing were to occur; and
- link between property values and ability-to-pay for equitable charging purposes.

The adoption of this approach also provides a relatively stable revenue stream, in so far as there is little divergence between forecast and actual collections.

Transparency Statement – Part A also addresses a trade waste charging decision arising because of the need to renegotiate discharge permits expiring in June 2005. The new arrangement involves a final transition to full cost recovery, with interim shortfalls continuing to be made up through explicit CSOs. Trade waste polluters are charged on a usage basis as their load warrants such an approach. SA Water's total revenues in this area are quite small, being under $2m per year.

CSOs are also used to address the wastewater charging arrangements between city and country customers. Where this amounts to a cross subsidy these are primarily addressed through a series of separately identified and funded CSOs, and through the application of the minimum charge, and hence do not give rise to issues of as great a significance as in water pricing.

4.10.3 The Commission's assessment

Water

SA Water uses consumption based pricing for all customers. The two-part tariffs being charged for non-commercial customers are consistent with CoAG principles. The lower first block tariff for non-commercial customers is not inconsistent with the CoAG principle. On the assumption that the variable charge for the second block is the true cost reflective charge, the first block may constitute a cross subsidy, which is transparent.

Cross subsidy issues are dealt with in the next section.

Wastewater

SA Water does not apply consumption based pricing, other than to the largest dischargers. The Commission acknowledges that this recognises the impracticality of metering direct usage for small customers and the minor benefit that price signals of this type would generate. Such an approach would not satisfy the "cost effectiveness" requirement set out above.

The CoAG principles do not specify the approach to be used where direct consumption charges are not cost effective; hence the tariff structure adopted is not inconsistent with the CoAG principles.

Transparency Statement – Part A describes the relationship between property values and ability-to-pay in deciding to adopt the rate based charging arrangements, in response to a Commission recommendation in its 2004 wastewater inquiry.

4.10.4 The Commission's view on compliance with the CoAG principles

Adequacy of information: Does the information contained in the Transparency Statement comply with CoAG principles?

The Transparency Statement outlines the water and wastewater pricing structures and the reasons for the pricing structures. The Commission considers both the structure and the reasons to be compliant with the CoAG Principles.

Provision of information: Did Cabinet receive this information?

Cabinet received the information on pricing structures that was included in Transparency Statement – Part A and was sufficiently informed in its decision-making for water and wastewater pricing.

Sufficiency of information: Was the information provided sufficient to comply with the CoAG principles?

All relevant material was available to Cabinet to make an informed compliant decision on this issue.

4.11 Cross-Subsidies

In a jurisdiction with the water supply logistics faced by South Australia, some cross-subsidies are inevitable under a Statewide pricing approach. The key to adherence to CoAG principles is ensuring that the cross-subsidies are transparent.

4.11.1 COAG Principles

In the NCP water reform assessment framework, NCC states that in setting prices for water, the requirements for water businesses are:

".. 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, …;"

"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;"

4.11.2 Transparency Statement – Part A

With regards to cross-subsidies generally, it was noted that:

"South Australia has adopted the Baumol Band (Figure 7), as suggested by the NCC, as the theoretical definition of cross-subsidies (NCC, 2001, p 127)."

Statewide pricing

"SA Water provides water and wastewater services to its customers in regional areas of South Australia at uniform prices, consistent with the South Australian Government's State-wide pricing policy.

Statewide pricing is an important element of the Government's equity and social justice policy and regional policy and was discussed extensively in the 2004-05 water and wastewater Transparency Statements.

The Government provides SA Water with a CSO to ensure SA Water's rates of return are similar between Adelaide metropolitan and country areas. This recognises the extra costs of providing water and wastewater services in country areas and that the Government's State-wide pricing policy places restrictions on SA Water's pricing regime." {p. 57}

Trade waste

"Some trade waste dischargers would be paying less than avoidable cost during the transition phase, for which SA Water receives a CSO. When current transitional discounts have been removed in June 2006, all significant trade waste dischargers will be paying charges sufficient to cover their avoidable costs.

The only exception is a company that has an agreement with the Government exempting it from the full charge until 2008. SA Water receives a CSO in compensation for the loss in revenue." {p. 57}

CSOs

Transparency Statement – Part A also lays out key elements of the Government's new CSO policy:

"The Government, as part of its review of ownership structure for PNFCs, has reviewed and approved a new CSO policy. The new CSO policy has adopted the following principles:

- *a CSO arises when a government specifically requires a public enterprise to carry out activities relating to outputs or inputs which it would not elect to do on a commercial basis, and which the government does not require other businesses in the public or private sectors to generally undertake or which it would only do commercially at higher prices (Industry Commission, 1994, p xi)*
- *CSOs are to provide incentives for the business to provide CSOs efficiently*
- *CSOs are to have a minimum impact on incentives on other parts of the business*
- *CSOs are to fund only best practice costs*
- *CSO payments are to be transparent and clearly reported*
- *performance management of the delivery of CSOs will be undertaken*
- *CSOs will be subject to an annual review*
- *CSOs will be valued on a 'cost per unit of output' approach."{p. 68}*

The new policy has been adopted, and SA Water's CSOs are now being reviewed against the policy. The effects of any changes are likely to be seen in 2006-07.

4.11.3 The Commission's assessment

Statewide pricing

At the suggestion of the NCC, the SA Government has assessed the possible existence of cross-subsidies in water supply, using the "Baumol Band" approach (Transparency Statement – Part A, pp. 53-54). The Commission notes that the Baumol band is generally broad and may not reveal sufficient information about the major cost differences of serving different customers.

While the Government commitment to Statewide pricing may not merit a more in-depth understanding of the extent of customers paying less than avoidable cost, such an understanding is important in the context of recognising the recipients of any cross-subsidies and the impact on CSO requirements. Under the new CSO policy this may assist to focus the attention of existing service providers and potential competitors[7] on those areas where innovation may achieve the greatest cost savings. This should then reduce CSOs.

Trade waste

The Commission recognises a very minor potential for the continued existence of cross-subsidies among trade waste. However, there appears to be no obvious cause for additional action and notes that the nature of these customers suggests that they should be better placed to seek redress than small customers.

4.11.4 The Commission's view on compliance with the COAG principles

Adequacy of information: Does the information contained in the Transparency Statement comply with CoAG principles?

The Transparency Statement addresses the issue of cross subsidies using the "Baumol Band" to define cross subsidy.

Although this complies with the CoAG Principles, the Commission believes that the Government will be better served if the major cost differences of serving different customers are examined further. The new CSO policy should assist in this regard.

Provision of information: Did Cabinet receive this information?

Cabinet received information leading to the conclusion that cross-subsidies do not exist or, in the case of wastewater, are addressed through CSOs.

Sufficiency of information: Was the information provided sufficient to comply with the CoAG principles?

All relevant material was available to Cabinet to make an informed compliant decision on this issue.

The Commission believes that although compliant with the CoAG principles, the Transparency Statement should provide detailed analysis of cost differences between customer categories, the calculation of CSOs and assessment of CSO alternatives.

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7 The submission received by the Commission noted the emergence of alternative water suppliers to SA Water, and the potential emergence of competition for wastewater services.

5 CONCLUSION

This is the first time that the SA Government has introduced and published a combined Transparency Statement for its water and wastewater pricing decisions. The efforts made by the Government since the previous, separate statements represent major steps towards compliance with the COAG water reform strategic framework.

This report highlights a number of issues that deserve further consideration. Some of these are common issues identified in the Commission's 2004 wastewater and water inquiries. Most (by number) of the outstanding issues from those earlier inquiries have been substantially addressed for the 2005-06 water and wastewater pricing decision.

Overall, the Commission considers that Transparency Statement – Part A is a significant step forward in complying with the CoAG principles. The changes and additions proposed in this report, if implemented in future Transparency Statements, would bring water and wastewater pricing into fuller compliance with the CoAG principles.

With regard to the Terms of Reference:

(1) The Commission has reviewed the processes undertaken in the preparation of advice to Cabinet and concludes general compliance with the CoAG principles.

(2) The Commission notes that the Transparency Statement is a fair representation of the actual advice provided to Cabinet.

The Commission has set out in this report additional information that it believes would further demonstrate compliance with CoAG principles if adopted in future price setting processes.

5.1 Statement of Compliance

The Commission has concluded compliance in the following areas:

- Efficient business costs (section 4.1);
- Asset Valuation (section 4.2);
- Contributed Assets (section 4.3);
- Depreciation (section 4.4);
- Annuity (section 4.5);
- Externalities (section 4.6);
- Return on Assets (section 4.7);
- Dividends (section 4.8);

- Tax Equivalent Regime (section 4.9);
- Efficient Resource Pricing (section 4.10); and
- Cross-subsidies (section 4.11).

Notwithstanding this, the Commission has suggested improvements in some areas. In particular, the Commission has concluded a need for more significant development in respect of efficient business costs (section 4.1) and contributed assets (section 4.3). A revised treatment of contributed assets could have a significant effect on water and wastewater prices.

The Commission also notes that the advent of the NWI may mean that methods and approaches considered compliant until now may no longer be so.