

TRANSPARENCY STATEMENT — Part C

**GOVERNMENT RESPONSE TO ESCOSA'S FINAL
REPORT**

ON

**INQUIRY INTO 2005-06 METROPOLITAN AND
REGIONAL WATER AND WASTEWATER PRICING
PROCESSES**



**Government
of South Australia**

May 2005

GOVERNMENT RESPONSE TO ESCOSA'S FINAL REPORT

1 Introduction

By letter dated 24 December 2004, the Treasurer referred to the Essential Services Commission of South Australia (ESCOSA) an Inquiry into water and wastewater pricing processes in 2005-06, pursuant to Part 7 of the *Essential Services Commission Act 2002*.

In undertaking the Inquiry, ESCOSA considered the document *Transparency Statement Water and Wastewater Prices in Metropolitan and Regional South Australia 2005-06* dated December 2004. That document forms Part A of this Transparency Statement. The Terms of Reference of the referral to ESCOSA are contained in Appendix 4 of Part A.

On 31 March 2005, the Treasurer received ESCOSA's *Final Report – Inquiry into the 2005-06 Water and Wastewater Pricing Process*. ESCOSA's Final Report forms Part B of this Transparency Statement.

Part C of this Transparency Statement outlines the Government's Response to ESCOSA's Final Report.

2 ESCOSA's Conclusions

ESCOSA concluded that compliance with CoAG pricing principles has been achieved in the following areas:

- efficient business costs;
- asset valuation;
- contributed assets;
- depreciation;
- annuity;
- externalities;
- return on assets;
- dividends;
- tax equivalent regime;
- efficient resource pricing; and
- cross-subsidies.

Although compliance is acknowledged, ESCOSA has suggested a need for more significant development in two areas:

- efficient business costs; and
- contributed assets. (pages 47 – 48)

3 South Australian Government Response

As CoAG compliance has been achieved, the two areas suggested for more significant development are based on ESCOSA's judgement of more recent (and sometimes developing) regulatory practices. These two matters, and a number of other matters, are discussed below.

3.1 Efficient Business Costs - Operating, Maintenance and Administrative Expenses

ESCOSA concluded that CoAG compliance has been achieved with respect to efficient business costs and noted that significant progress has been achieved in the area of benchmarking / performance comparison. Nevertheless, ESCOSA indicated that 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. (pages 21 and 22)

Government Response

Although compliance has been achieved, the Government continues to develop its approach to incorporating assessments of SA Water's operating, maintenance and administrative (OMA) expenses into the pricing process. The intention is to demonstrate 'value for money' as far as possible.

An independent consultant will analyse the trends and key drivers of SA Water's business costs and service / performance in the metropolitan and regional areas to support Cabinet's 2006-07 pricing decisions. Benchmarking of service performance and costs will be undertaken against major interstate urban water and wastewater service providers with similar characteristics to SA Water. Average and median benchmarks will be created, with outlier data values removed, as appropriate. Comparative trends in performance over time and comparative cross-section analysis will be identified and examined. Additional data sources for regional benchmarking, as suggested by ESCOSA, will be examined. Benchmark categories will be identified.

It is, however, generally agreed that there are real difficulties in benchmarking analysis of water and wastewater service providers. The information available for regional areas is patchy and somewhat inconsistent. Even where there are authoritative, reliable data sources (as for the metropolitan area) there are substantial interregional differences that affect the standards of services provided and the costs of providing those services.

This benchmarking analysis will aim to demonstrate the relative efficiency of SA Water's service delivery up to the present time, albeit to the extent possible given the current data limitations.

This information will be provided in the *Transparency Statement Water and Wastewater Prices in Metropolitan and Regional South Australia 2006-07*.

Improvements to current benchmarking will be considered in the context of the development of a nationally consistent framework for benchmarks of pricing and service quality, arising from the obligations of all State and Territory Governments under Clause 75 of the National Water Initiative. Improvements to current benchmarking will be addressed in the Government’s implementation plan for the National Water Initiative (NWI). It should be noted that proceeding in advance of other jurisdictions could increase costs when later refinements are made to achieve inter-jurisdictional consistency.

In terms of demonstrating future “value for money”, the Government intends, to the extent possible, to further explore links between:

- service / performance standards (this will be informed by the development of nationally consistent benchmarks, as indicated above);
- operating and capital costs in metropolitan and regional areas; and
- prices.

Links with the SA Water Performance Statement and Customer Charter will also be explored.

A 12 – 18 month development period seems likely, given the substantial nature of these matters. The timeframes are dependent on all jurisdictions participating fully in the development of nationally consistent benchmarks. It would not be possible to include this work for consideration in the Government’s 2006-07 pricing decision.

3.2 Contributed Assets

ESCOSA has concluded that CoAG compliance has been achieved with respect to the explicit treatment and removal of contributed assets from asset values used for setting prices, given that the *Transparency Statement Water and Wastewater Prices in Metropolitan and Regional South Australia 2005-06* is explicit about this treatment. Nevertheless, ESCOSA indicated that:

... an estimate of pre-1995 contributed assets ... [would enable] consistent and more transparent treatment of all contributed assets. (page 26)

Government Response

The Government is unambiguously CoAG compliant with respect to the treatment of contributed assets in SA Water’s asset base for pricing purposes.

In recognition of current regulatory practices, however, the Government carefully reviewed the treatment of contributed assets. This resulted in a new treatment of contributed assets in SA Water’s asset base for the purposes of establishing 2005-06 water and wastewater pricing arrangements. (Full details are outlined in Part A of this Transparency Statement, pages 27 – 29.)

This new treatment excludes contributed assets received after SA Water’s corporatisation in 1995 from the asset base for pricing purposes.

Economic principles suggest that, for pricing purposes for a regulated business, there is a wide band of potential values for assets, including contributed assets, viz:

- “an upper value that reflects the costs that would be incurred if an efficient firm was to enter the market to provide the services (ie, the stand alone cost); and
- a lower value that represents the opportunity cost or scrap value of the existing assets.”¹

Adopting a regulatory asset value, including contributed assets, for pricing purposes involves making a number of assumptions and using broad judgement. CoAG principles provide some guidance in that asset values should be based on deprival value, or equivalent, and the treatment of contributed assets should be transparent. The value of SA Water’s assets and the treatment of contributed assets, for pricing purposes, comply with these CoAG principles. The Government has removed contributed assets (post-1995) from the asset base for pricing purposes.

The Government concluded that there was no sound information to determine the possible range of values or useful lives of pre-1995 contributed assets. There are insufficient records prior to 1995 to identify contributed assets. Other methods of estimating pre-1995 contributed assets are dependent upon crucial, and sometimes arbitrary, assumptions. Any estimates of pre-1995 contributed assets would not be sufficiently accurate or reliable.

Attempting to distinguish, and value, one specific element (viz, contributed assets) of SA Water’s entire asset base using statistical techniques, also seems a somewhat partial, and arbitrary, exercise.

It is noted that the Victorian Minister for Water did not seek to distinguish contributed assets from non-contributed assets when setting the initial regulatory asset bases of the various metropolitan and urban water businesses in Victoria.

In summary, the Government’s approach is CoAG compliant, in so far as its treatment of contributed assets is transparent. Nevertheless, in 2005-06 the Government moved beyond CoAG compliance by adopting more recent regulatory practice. Where a sufficiently accurate and reliable estimate of contributed assets could be made (i.e., post-1995), this was excluded from SA Water’s asset base for pricing purposes. On balance, it is not intended to re-consider the estimate of contributed assets for future pricing processes, at this time. This difference of approach between the Government and ESCOSA would, however, be kept under review.

3.3 Other Matters

3.3.1 Return on Assets: Weighted Average Cost of Capital

ESCOSA acknowledges CoAG compliance with respect to the treatment of the opportunity cost of capital but suggests it would be preferable to determine an appropriate weighted average cost of capital (WACC), rather than a range (page 35).

¹ *Advice to the Minister for Water: Regulatory asset values for the Victorian water businesses*, Essential Services Commission, Victoria. March 2005, p4

ESCOSA also expresses a preference for the adoption of a post-tax WACC, rather than a pre-tax WACC (page 39).

Government Response

For its 2005-06 pricing decisions, the Government adopted a narrower range of pre-tax real WACC of 6% - 7%. Selecting a single WACC was not considered appropriate, given the estimation difficulties involved in each input value into the WACC calculation. Further, New South Wales' IPART and the United Kingdom's Office of Water Services also adopt a WACC range, rather than a single WACC. Similarly, a number of regulators adopt a pre-tax, rather than a post-tax, WACC.

Given CoAG compliance and the variable WACC treatment by other regulators, the Government has no plans at this time to move to a single, post-tax WACC. This difference of approach between the Government and ESCOSA would, however, be kept under review.

3.3.2 Cross Subsidies

ESCOSA acknowledges CoAG compliance with respect to the treatment of cross subsidies but suggests:

...the Transparency Statement should provide detailed analysis of cost differences between customer categories, the calculation of CSOs and assessment of CSO alternatives. (page 45)

Government Response

The Government recently approved a set of key elements in its Public Non-Financial Corporations policy (viz, capital structure, dividend and CSOs) that are now being implemented in SA Water. This is expected to result in improved transparency in the calculation of regional and other SA Water CSOs. The exploration of links between service / performance standards, costs and prices (as discussed above) will also need to consider CSO estimates.

3.3.3 Overall CoAG Compliance

ESCOSA acknowledges CoAG compliance with respect to all the elements of the maximum and minimum revenue outcomes (page 47), but suggests:

... it is possible that the Government is actually implementing charges that generate revenues in excess of the "true" maximum revenue outcome. (page 35)

Government Response

The estimated real maximum revenue bound adopted by the Government is currently the best available estimate. Water and wastewater revenues are within the estimated real maximum and minimum revenue bounds, as is required by the CoAG pricing principles.