



INQUIRY INTO URBAN WATER PRICING PROCESS ISSUES PAPER

March 2004

REQUEST FOR SUBMISSIONS

The Essential Services Commission of SA (ESCOSA) invites written submissions from interested parties in relation to the issues raised in this paper. Written comments should be provided by **15 March 2004**. It is highly desirable for an electronic copy of the submission to accompany any written submission.

It is ESCOSA policy to make all submissions publicly available via its website (www.escosa.sa.gov.au), except where a submission either wholly or partly contains confidential or commercially sensitive information provided on a confidential basis and appropriate prior notice has been given.

ESCOSA may also exercise its discretion not to exhibit any submission based on their length or content (for example containing material that is defamatory, offensive or in breach of any law).

Responses to this paper should be directed to:

INQUIRY INTO URBAN WATER PRICING

Essential Services Commission of SA
GPO Box 2605
Adelaide SA 5001

E-mail: escosa@escosa.sa.gov.au

Facsimile: (08) 8463 4449

Public Information about ESCOSA's activities

Information about the role and activities of ESCOSA, including copies of latest reports and submissions, can be found on the ESCOSA website at www.escosa.sa.gov.au.

TABLE OF CONTENTS

Request for Submissions	iii
Public Information about ESCOSA's activities	iii
1. Introduction	1
2. Full Cost Recovery	3
3. Community Service Obligation	7
4. Next Steps	9



1. INTRODUCTION

Pursuant to section 35(1) of the *Essential Services Commission Act, 2002 (the Act)*, the Treasurer has referred to ESCOSA an inquiry into the urban water pricing process in South Australia. The Commission received the referral on 26 February 2004, and is required to submit a draft report to the Treasurer and the Minister by 24 March 2004.

The following are the terms of reference for this inquiry:

- (a) *The Commission is to inquire into the processes undertaken in the preparation of advice to Cabinet, resulting in Cabinet making its decision on the level and structure of SA Water's urban water prices for 2004-05, 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 - (Part A) Urban Water Prices in South Australia 2004-05" dated January 2004;*
- (c) *In considering the processes undertaken for the preparation of advice to Cabinet, the Commission is to advise on the extent to which information relevant to the CoAG principles was made available to Cabinet.*

The Transparency Statement provided by the Treasurer provides the basis for the inquiry. This issues paper seeks submissions on the transparency statement generally, and particularly on some of the issues outlined in the paper.

Although this is not the normal practice for ESCOSA, due to the short time available to the Commission to conduct this inquiry, time for submissions is restricted to about two weeks.



2. FULL COST RECOVERY

The National Competition Policy provides a detailed guideline¹ on what is considered to be full cost recovery. Comments are sought on a number of specific issues under the guideline, including:

- (i) There is a jurisdictional regulator in South Australia (ESCOSA) for economic regulation of essential services, but water and wastewater services have not been prescribed as essential services for the purpose of the ESC Act. However, the government has started the process of publishing a “Transparency Statement” to:
 - a. document the extent of compliance with the COAG principles,
 - b. provide an open and transparent process for water price setting, and
 - c. keep a record on the processes used.

ISSUE: Is this approach consistent with the COAG Guidelines for the Application of Section 3 of the COAG Strategic Framework?

- (ii) The COAG principles require a deprival value methodology to be used for asset valuation. The Transparency Statement uses a “fair value” for its asset base, and states “there is no practical difference between the asset valuation using the ODV approach and the fair value method”.

ISSUE: Is the asset valuation methodology, as outlined in the Transparency Statement, consistent with the COAG principles? In particular, how should contributed assets and customer contributions for the construction and/or acquisition of infrastructure be treated to ensure consistency with the COAG principles?

¹ *Compendium of National Competition Policy Agreements (Second Edition 1998)*, National Competition Council, June 1998, pg 112 (the document can be accessed from the National Competition Council’s web site: <http://www.ncc.gov.au/pdf/PIAg-005.pdf>).

- (iii) The COAG principles require an annuity approach to determining the cash requirements for asset replacement/refurbishment where it is desired that the service delivery capacity be maintained.

The Transparency Statement uses the straight line method for calculating the depreciation, stating that this is consistent with other regulatory decisions.

ISSUE: Is there a material difference between the two methodologies? Can the straight line method be taken to be a good proxy for the annuity method to satisfy the COAG principles, particularly with regard to Guideline 5 (viability)?

- (iv) The COAG principles state that the total revenue recovery must lie between the maximum amount (to avoid monopoly rents) and a minimum amount (to ensure financial viability). Common costs under the two amounts are:

- a) efficient operating, maintenance and administrative expenses,
- b) externalities,
- c) taxes and TERs.

In addition, the maximum revenue includes:

- d) a risk adjusted return on assets, and
- e) provision for the cost of asset consumption

The minimum revenue includes:

- f) provision for future asset refurbishment (based on the annuity approach)
- g) dividends, and
- h) interest cost of debt.

In relation to the operating costs, the Transparency Statement uses the WSAA data to show that SA Water's operating costs "compare favourably". It also states that "the competitively tendered contracts for managing the water and waste water services suggest SA Water's operating, maintenance and administrative costs are based on efficient operations".

ISSUE: It is believed the first '5-year' instalment of the facilities management contract between United Water International and SA Water concluded in June 2002.

As negotiations for the second 5-year term were non-competitive, what process was employed to ensure best-practice costs to SAW.

- (v) The Transparency Statement does not provide the operating, maintenance and administrative costs of previous years, or the forecast used in determining the prices for 2004/05.

The COAG principles require that a level of revenue is determined based on efficient resource pricing and business costs.

ISSUES:

- **Is the benchmarking on a consistent basis? For example, is the definition of Urban used in the Transparency Statement compatible with the systems reported on for SA Water and its peer water businesses in WSAA facts?**
- **To the extent that the information in WSAA facts is not relevant to the SAW Country Systems, on what basis has the cost effectiveness of Country Services been assessed?**

- (vi) With regard to the risk-adjusted rate of return, the Transparency Statement uses a range of pre-tax real WACC, between 6% and 8%. Due to the use of pre-tax WACC, it does not use tax or TER in the Transparency Statement.

ISSUE: Is the use of a pre tax, real WACC between 6% and 8% for the calculation of the maximum revenue, in accordance with the COAG principles?

- (vii) Externalities include only the actual environmental expenses.

ISSUE: Is it sufficient to include only the actual environmental expenses, due to difficulty in determining the full cost of “externalities” as defined in the COAG principles? What is a reasonable timeframe to expect a more comprehensive treatment of ‘Externalities’ charges?

ISSUE: Should a water abstraction charge, similar to the one in ACT, be included as part of the ‘Externalities’ charges?

- (viii) For compliance with the dividend policy, the Transparency Statement states that SA Water’s policy is to provide 55% of Earnings before interest, taxes, depreciation and amortisation (EBITDA) as total contribution (eg. dividends and the income tax equivalent) to SA Government. EBITDA is used as a proxy for free cash flow.

ISSUE: Is 55% of EBITDA a relevant measure of total contribution, including dividends that reflect ‘commercial realities’, as required in the COAG principles?

- (ix) The asset roll forward was stated as being “broadly consistent with recent South Australian and national regulatory determinations, including the Electricity Pricing Order.” An explanation of the roll forward methodology was provided, and table 7 of the Transparency Statement demonstrated the use of this methodology.

Table 8 presents SA Water’s opening and closing balances, and the average asset base in real terms. The average real asset base was used to calculate the maximum revenue outcomes.

Given the significance of the asset values in determining required revenue base, a more detailed and transparent adjustments of asset values may be warranted. For example, details of:

- a) the inflation index used,
- b) the efficient capital expenditure incurred, and
- c) the conversion into “real” asset base that was used in the calculations of the maximum revenue outcomes

has not been provided.

ISSUE: Is the methodology appropriate for the purpose of complying with the COAG principles? What further information may be required to make this decision?

- (x) The Transparency Statement provides a graph showing (a range of) maximum and minimum revenue determined in accordance with the pricing principles. However, it does not provide a detailed building block that determines its revenue requirement.

ISSUE: Should a detailed breakdown of the revenue requirement be made transparent to ensure consistency with the COAG principles?

- (xi) The COAG principles require transparency in determining the community service obligation, contributed assets, the opening value of assets, externalities including resource management costs and tax equivalent regimes.

ISSUE: Is the information provided in the Transparency Statement sufficient to meet the COAG principles’ requirement?

3. COMMUNITY SERVICE OBLIGATION

Section 3(a)(ii) of the COAG principles states:

“that where service deliverers are required to provide water services to classes of customer at less than full costs, the cost of this be fully disclosed and ideally be paid to the service deliverer as a community service obligation”.

The Transparency Statement lists CSOs in a number of categories, as follows:

CSO payments (in nominal terms)	2002-03	2003-04	2004-05
	(\$ million)	(\$ million)	(\$ million)
Statewide pricing/country operations	64.9	64.9	64.9
New country investments	6.3	7.9	9.5
Service charge exemptions	2.8	2.8	2.8
Water restrictions support/ communication		2.2	
Pensioner concession scheme*	0.4	0.4	0.4
Subsidies			
Free water (Councils)	1.2	1.2	1.3
Emergency services	0.1	0.1	0.1
Water filtration	2.5	-	-
EDS*	0.9	0.9	0.2
Total CSO (water) payments	79.1	80.4	79.2

* Apportioned between water and wastewater

With regard to materiality, the main CSO relates to Statewide pricing.

ISSUE: Should further break-down of CSO relating to Statewide pricing be provided to meet the requirements of the COAG principle? For example, should the cost of service to customers in different geographical areas be made transparent?



4. NEXT STEPS

Due to the short time frame available to ESCOSA to conduct this inquiry, submissions are sought on this issues paper by 15 March 2004.

ESCOSA will consider all submissions received and prepare a draft report by 24 March 2004. In accordance with the requirements for the inquiry, the Draft report will be submitted to the Treasurer and the Minister for Administrative Services.

A final report will be presented to the two Ministers by 7 April 2004.