



INQUIRY INTO THE 2004-05 WASTEWATER PRICING PROCESS FINAL REPORT

October 2004

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GLOSSARY OF TERMS

AMP	Asset Management Plan
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
CAPEX	Capital Expenditure
CoAG	Council of Australian Governments
THE COMMISSION	Essential Services Commission of South Australia
CPA	Competition Principles Agreement
CPI	Consumer Price Index
CSO	Community Service Obligation
DTF	Department of Treasury and Finance (SA)
DWLBC	Department of Water, Land and Biodiversity Conservation (SA)
EEL	Environmental Enhancement Levy
EPA	Environment Protection Authority (SA)
EBITDA	Earnings before interest, taxes, depreciation and amortisation
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
OMA	Operating, Maintenance and Administration
NMU	Non-Major Urban (water authority)
PNFCs	Public Non-Financial Corporations
RAB	Regulatory Asset Base
SA WATER	South Australian Water Corporation
SCARM	Standing Committee on Agriculture and Resource Management
TER	Tax Equivalent Regime
UIG	Urgent Issues Group
UU	United Utilities Australia Pty Ltd
UWI	United Water International Pty Ltd
WACC	Weighted average cost of capital
WSAA	Water Services Association of Australia
WWTP	Wastewater treatment plant



**NOTICE OF REFERRAL FOR AN INQUIRY INTO WASTEWATER
PRICING 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: Wastewater Prices from 1 July 2004

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 sewerage prices. The Government has prepared its first Transparency Statement on wastewater prices (i.e. 2004/05).
4. The Transparency Statement links Cabinet's decision on 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 wastewater 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) Wastewater Prices in South Australia 2004-05" dated June 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 30 September 2004;
- (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 14 October 2004;
- (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".

Kevin Foley MP
TREASURER

OVERVIEW

The Treasurer has requested that the Essential Services Commission of South Australia (the Commission) undertake an inquiry into the processes involved in the preparation of advice to Cabinet resulting in Cabinet making its decision on the level and structure of SA Water's wastewater prices for 2004-05, with respect to the adequacy of the application of CoAG pricing principles, and to advise on the extent to which information relevant to the CoAG principles was made available to Cabinet. In undertaking its Inquiry, the Commission was to consider the Transparency Statement – Part A: Wastewater Prices in South Australia 2004-05.

In undertaking its Inquiry, the Commission is, for the first time, considering the application of the CoAG pricing principles by the SA Government to SA Water's wastewater prices.

In the first half of 2004 the Commission undertook a similar inquiry in relation to the Government's processes for setting SA Water's 2004-05 urban water prices. Many of the analyses and conclusions arising from that previous inquiry are relevant to this inquiry and hence are repeated, summarised or referred to in this report.

This report indicates the extent to which information available to Cabinet did adequately set out and consider the CoAG pricing principles, and in some areas, suggests either more detailed information that could be considered, or a different approach that could be adopted, in future. In particular, the Commission considers that a more detailed analysis of the revenue building block components should be considered, including appropriate adjustments to the recognition and quantification of asset values for pricing considerations and the use of an appropriate single cost of capital. This cost build up should be matched with the revenue collection forecast for the relevant year and used to determine prices.



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 can charge 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 setting water and wastewater prices (among other things) for states that are a signatory to the CPA. The South Australian government is a signatory to the CPA and is therefore committed to adopting the CoAG principles.

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 govern the manner by which the 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 assess each state's progress with implementing the National Competition Policy (NCP) and Related Reforms. The CoAG principles relating to water reform are part of the NCP and related reforms with which South Australia has committed to comply.

1.1 Purpose of this paper

The South Australian Government has prepared a Transparency Statement (initially only Part A) setting out the process and the matters that have been considered by the Government in setting 2004-05 wastewater prices. One of the purposes of the Transparency Statement is to document the extent to which the Government's 2004-05 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 2004-05 wastewater prices. This includes an assessment of the extent that:

- ▲ the process resulted in Cabinet setting 2004-05 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 on 2004-05 wastewater prices.

This paper considers the Transparency Statement as the government's explanation of the process it followed and its justification that the current wastewater prices comply with the CoAG principles. This paper also comments where possible, on the information that was made available to Cabinet in making its decision on 2004-05 water prices (but is restricted in its ability to comment given the confidential nature of Cabinet's consideration).

Importantly, this inquiry relates to wastewater prices only, which are the prices charged to sewer serviced customers in urban and certain rural areas throughout the state. Furthermore, it was the task of the Commission only to examine the **process** used to prepare advice to Cabinet with respect to the adequacy of the application of the CoAG pricing 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 2004-05 wastewater prices was made. The Commission is not inquiring into wastewater prices themselves.

Ultimately, this paper is to serve as Part B of the overall Transparency Statement.

1.2 Conduct of the inquiry

The Commission received the Notice of Referral of an Inquiry from the Treasurer on 17 August 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 30 September 2004; and
- ▲ provide a Final Report by 14 October 2004.

Consistent with normal Commission procedures and as required by the Terms of Reference, a public consultation process was undertaken. Pursuant to Section 36 of the *Essential Services Commission Act 2004*, a Public Notice of Inquiry was placed in the Advertiser on 27 August 2004 asking for written submissions by 10 September 2004.

The Commission received no submissions in response to the Public Notice.

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 (Department of Treasury and Finance) and SA Water in order to clarify its understanding of the processes surrounding the Cabinet approval of 2004-05 wastewater prices.

1.3 Link to the water inquiry

The Commission undertook an equivalent review into the process for determining 2004-05 water prices earlier in 2004. Many of the analyses and conclusions arising from that previous inquiry are relevant to this one – particularly where an issue relates to SA Water as a whole and hence would affect water and wastewater pricing alike. As a result, this paper often makes reference to that earlier report. In some cases, elements of the previous report are repeated or summarised.

The Commission's previous report is available from its website at www.escosa.sa.gov.au.¹

1.4 Structure of this paper

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

Chapter 3 discusses the process for setting wastewater prices for 2004-05.

Chapter 4 deals with the Transparency Statement's compliance with the CoAG Pricing Principles and the extent that they have been adhered to in setting 2004-2005 prices.

Chapter 5 presents the Commission's conclusions.

¹ Refer 'What's New', 4 June 2004. Inquiry into 2004-2005 Urban Water Pricing Process: Final Report (<http://www.escosa.sa.gov.au/resources/documents/040405-R-WaterInquiryFinalReport.pdf>)



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 the Transparency Statement, the pricing principles for water are contained in the strategic framework for water, as set out in the Compendium of National Competition Policy Agreements (NCC 1998, 2nd Edition).

Section 3 of the strategic framework is specifically dedicated to pricing issues. However, it is a very broad pricing statement and does not provide much detail (see below).

Relevant clauses of the CoAG Strategic Framework 1994 (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.*



3 THE PRICE SETTING PROCESS

Under the *Sewerage Act 1929*, sewerage/wastewater prices to apply to SA Water customers were gazetted in the South Australian Government Gazette on 30 June 2004.

3.1 Cabinet Submissions – Wastewater Pricing 2004-05

In 2004, there were five key Cabinet submissions dealing with wastewater pricing for 2004-05.

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 its Inquiry, it has been provided with copies of Cabinet Submissions and agency Cabinet comments which relate to the setting of SA Water's wastewater prices for 2004-05. These documents are classified "Strictly Confidential" and the Commission is required to preserve the confidentiality of such documents. The Commission has also been provided with a document called the Transparency Statement – Part A: Wastewater Prices in South Australia 2004-05. This document sets out the processes involved in the wastewater pricing decision, documents the extent to which the Government considers its wastewater pricing decision complied with CoAG principles, and provides greater transparency about the 2004-05 price setting processes.

As stated previously, the key consideration for the Commission is with the processes undertaken in the preparation of advice to Cabinet with respect to the adequacy of the application of the CoAG pricing principles, and its role is to advise on the extent to which adequate and relevant information on this matter was made available to Cabinet in its wastewater pricing decision making.

Various Cabinet submissions were considered in the process of setting wastewater prices for 2004-2005. The key submissions were as follows:

CABINET MEETING DATE	AGENDA NUMBER
29 March 2004	103
29 March 2004	105
07 June 2004	106
15 June 2004	110
09 August 2004	101

The Commission has been able to compare the information provided in the Cabinet submissions with the information in the Transparency Statement. It is satisfied that the 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 will refer to the Transparency Statement when setting out the particular CoAG principle and the Government's assessment of its compliance with these principles. However, it is important that the Commission documents the actual process used by Cabinet to come to its 2004-05 wastewater pricing decision, which was as identified in the above table.

3.2 Preparation of the Transparency Statement

The Commission notes that while each Cabinet Submission made reference to the fact that a Transparency Statement would be prepared, the Statement itself was not prepared until after Cabinet had made its 2004-05 wastewater pricing decision.

The Transparency Statement was considered by Cabinet almost two months after the Cabinet decision on pricing.

The Transparency Statement Part A and the Notice of Referral of an Inquiry was received by the Commission on 17 August 2004.

The Commission's task in this Inquiry is to examine the process used to prepare advice to Cabinet and what information was available to Cabinet when it made its 2004-05 wastewater pricing decision. The documents which tell this story are the Cabinet documents themselves, and as the Commission has stated above, these documents are properly confidential and so the Commission has used the Transparency Statement as a proxy for those documents. The Commission observes it would be useful in future for a document such as the Transparency Statement to be provided to Cabinet either prior to or at the very latest, at the time it makes its wastewater pricing decision. The Transparency Statement should not be prepared at a later time.

4 COMPLIANCE WITH COAG PRICING PRINCIPLES – THE MAXIMUM AND MINIMUM REVENUE CASES

At the commencement of the previous Inquiry into Urban Water Prices, the Commission sought clarification from the National Competition Council (NCC) about the appropriate documents that the Commission should consider in running this inquiry. Amongst other things, the NCC stated that²:

“Finally, the CoAG strategic framework and CoAG pricing principles are the key reference documents that ESCOSA should have regard to in undertaking its work.”

The Compendium of National Competition Policy Agreements (Second Edition 1998)³ provides details of the National Competition Policy Agreements for the various industries, including water, the key components of which are set out in Chapter 2, above.

This chapter of the report considers the “CoAG Pricing Principles” and the compliance of the pricing process undertaken in the preparation of advice to Cabinet, with respect to these principles.

As previously discussed the approach adopted by the Commission has been to assess the compliance of the Transparency Statement with the CoAG pricing 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 an area of keen attention in recent years.

Given the long-lived nature of the infrastructure employed in delivering wastewater services, opportunities to improve the performance of the capital-based component of the total economic costs of service delivery 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 the emergence of longer-term trend cause and effect relationships between the level of OMA expenditure and the capital-based costs (reductions in service capacity).

Achievement of efficient business costs should also be assessed in terms of both outright levels of expenditure and the impact of those expenditures on levels of service and the

² Letter from Executive Director, Mr John Feil, NCC, to Chairperson, ESCOSA, dated 9 March 2004.

³ This publication is available from NCC's website, <http://www.ncc.gov.au/publication.asp?publicationID=99&activityID=39>

consumption of assets. (The consumption of assets is discussed in sections 4.3 and 4.4 below.) It is more difficult to review some aspects of capital efficiency, as replacement costs can be specific to particular locations. Comparison of OMA outcomes and the 'Total Cost' per service parameter used in the WSAAfacts (Total Cost = OMA + Current Cost Depreciation + (4% x Written-down replacement cost of assets))⁴ provides a useful indicator for comparison, as will relative movements in OMA outcomes and asset consumption annuities.

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

In Part A of the Transparency Statement for Urban Water Pricing, the SA Government established that:

"SA Water participates in industry benchmarking analysis, most notably by WSAA. WSAAfacts compares the performance of the 23 major urban waterbodies in Australia and New Zealand using a range of measures."

"SA Water must also comply with its Customer Service Charter and minimum water quality standards that are monitored by the Department of Human Services."

"SA Water has outsourced a number of functions, including the management of water and wastewater services for the Adelaide metropolitan area and the operation of regional water treatment plants. These services were opened to competition in order to promote their economically efficient delivery."

In that context, the key paragraphs from Part A of the Wastewater Transparency Statement are:

"Approximately 78% of all SA Water's wastewater operational, maintenance and administrative expenditure (i.e. non labour costs) are subject to competitive tendering arrangements." (p.11)

⁴ WSAAfacts 2003, P 121.

In addition (based on WSAAfacts extracts from Appendix 6 to Part A of the Transparency Statement) the Government has stated:

“SA Water is one of if not the most efficient operator in terms of wastewater operating and total costs per property. There is no clear indication that all other significant service providers are decreasing their costs over the reporting period. In fact, over the last three years most providers have indicated that their operating and total costs per property have increased.” (p.14)

and

“SA Water appears to be significantly behind other selected service providers in the number of property connection sewer breaks and chokes per 1000 properties. The reasons for this apparently poor result are currently being examined.

Interestingly most of the other service providers’ performance deteriorated in 2002-03, in the benchmarks of wastewater reticulation and property connection breaks and chokes per 1000 properties; wastewater overflows per 100 km, and average connection time to telephone operators.” (p.14)

4.1.3 NCP Assessment Report 2003 Comments

In its 2003 assessment report for South Australia, the NCC observed that:

“The absence of service quality regulation reduces the scope for scrutiny aimed at protecting water and wastewater consumers from the potentially adverse consequences of a run down in financial viability.”

4.1.4 The Commission’s assessment

Comparative performance framework

As identified in the Urban Water Transparency Statement review, inclusion in the WSAAfacts annual performance review is a recognised part of the Water Reform process. However, the data provided to WSAAfacts from SA Water refers only to the Adelaide Metropolitan area, or more exactly, the area covered by the Facilities Management Contract between SA Water and United Water International.

The WSAAfacts data is broadly appropriate for considering the performance of SA Water in delivering services to a major metropolitan area, compared to the performance of those Utilities providing similar services to the other major metropolitan areas around Australia, principally the other Capital cities. However, it does not cover those SA Water operations outside of the Adelaide Contract area, the Country Systems.



Further, the Country Systems are the ones that attract Community Service Obligation (CSO) payments. An underpinning principle of the South Australian Government's 1996 CSO Policy framework is that CSOs should be contestable. The CSO policy framework also promotes the concept that CSO funding should be provided to meet "best practice costs". An avoidable costing methodology is the recommended approach to apply to the costing of CSOs.

In the above context, the WSAAfacts data has clear limitations in terms of coverage and should ideally be augmented with additional comparative information that specifically addresses SA Water performance for the Country Systems.

As part of discussions held during this review, the South Australian Government and SA Water identified factors making performance comparison problematic for SA Water Country wastewater systems. However, it did indicate that it was pursuing additional information in this area.

The Commission believes that while initial selection of some benchmarking partners may be onerous, some useful comparative data is probably available, both in terms of cost performance and service standards.

For part A of the Wastewater Transparency Statement, significant additional effort was observed with respect to the provision of performance comparisons for the Adelaide Systems. Both cost and standard of service outcomes were identified, along with future actions to improve understanding of the apparent trends. However, the Transparency Statement commentary, particularly that on the performance of the SA Water Country wastewater systems identifying favourable operating cost outcomes for some key centres in 2001 (drawn from the Australian Water Association's 2000-2001 Performance Monitoring Report on Australian Non Major Urban Water Utilities), falls short of what might reasonably be expected.

Given the relatively brief period of time that has elapsed since the completion of the Urban Water Transparency Statement, the Commission acknowledges that progress on establishing a suitable performance comparisons framework for SA Water Country systems would have been limited. However, the importance of establishing such a framework is reiterated and the following commitment from Part C of the Urban Water Transparency Statement noted.

"The Government intends to provide additional information on SA Water's country systems, service standards, and cost drivers to Cabinet in support of the 2005-06 pricing decisions. This information will also be provided in the 2005-06 Urban Water and Wastewater Pricing Transparency Statement, except where this information is commercial-in-confidence. In this case, the information will remain confidential to the Government and ESCOSA".

Performance outcomes

With regards to the cost performance and standards of service reported for SA Water, the Commission notes the continued trend of generally better than average service levels achieved at favourable cost levels. The Commission also notes the argument that SA Water is an effective service provider reflecting efficient costs.

The one area of perceived poor performance reported in the Transparency Statement Part A relates to the incidence of chokes/blockages in household connections, expressed in terms of chokes per 1000 properties.

As foreshadowed in the Transparency Statement Part A, investigations into this aspect of SA Water performance have been taking place during the course of this review. Early indications from those investigations are that:

- ▲ the high number of chokes inferred by the performance measure appears to stem from a unique combination of system age, system materials and system logistics;
- ▲ with no suitable technology available, preventive maintenance on household connections is not cost-effective and is not pursued by the water industry in general;
- ▲ the management of these events is focused on providing timely response, for which SA Water is reported as achieving very favourable outcomes in comparison with its peers; and
- ▲ SA Water also reported receiving very low numbers of complaints from its customers in this area.

4.1.5 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 cost recovery 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 additions regarding Country Systems performance.

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. As a minimum, the Commission believes that in order to comply with CoAG's pricing principles on efficient cost, the Transparency Statement should:

- ▲ Include information on costs and performance for both the Adelaide Systems (WSAAfacts) and the Country Systems; (and)
- ▲ Further develop the trend analysis of key cost drivers, in the short to medium-term.

4.2 Asset Values

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

With regard to the key building blocks for determining a return on assets (provision for the cost of capital), the Transparency Statement identified:

"Each of these aspects of the estimated return on wastewater assets has been treated in the same manner as in the Government's decision on 2004-05 urban water pricing." (p.15)

Asset values:

"The valuation of SA Water's land, buildings and infrastructure assets is based on the fair value method, to comply with Accounting Policy Statement 3: Valuation of Non-Current Assets and AASB 1041: Revaluation of Non-current Assets." (p.15)

Contributed assets:

"Consistent with professional accounting standards, contributed assets are included in the asset base and recognised as revenue when SA Water gains control of the asset. This revenue is included in forecast target revenue."

The Government is currently reviewing the treatment of contributed assets for water and wastewater pricing purposes. The significant issues include:

- *whether to remove contributed assets from the asset base, as recommended by ESCOSA*

- *whether to include contributed assets in the asset base and provide some offsetting mechanism to account for the contribution (Queensland Competition Authority approach)*
- *the treatment of revenue from contributed assets*
- *an appropriate treatment for asset replacement/refurbishment of contributed assets.” (p.16)*

4.2.3 NCP Assessment Report 2003 Comments

No comments were made with regard to Asset Values or Contributed Assets for the purpose of wastewater pricing in the NCC’s assessment report 2003.

4.2.4 The Commission’s assessment

Asset values:

As is the case for Urban Water Supply, SA Water has employed an approach to establishing asset values that is consistent with the requirements of the CoAG Guidelines and has had the outcomes independently verified by Hunter Water Corporation through (in part) comparison with values for similar assets belonging to water utilities in New South Wales.

Contributed assets:

As the inclusion of contributed assets in the asset base for pricing considerations has been made explicit, it could be considered to be in compliance with the CoAG principles, although not necessarily a common regulatory practice.

The Commission recognises that it is very difficult to get an accurate picture of exactly which assets were contributed, complicating their exclusion from pricing considerations. However, these contributions have been taking place for a very long time and now possibly constitute a significant proportion of wastewater network assets. Contributed assets are likely to be a higher proportion of total assets in wastewater than urban water, given the absence of any wastewater equivalent to the Country Lands (Water) Mains Networks.

Given the predominantly long-lived nature of the infrastructure, the on-going inclusion of contributed assets in the quantification of both depreciation expenses and return on capital adds significantly to the opportunity to generate significant free cash-flows. This issue forms part of the discussion on Dividends in section 4.7 below.

It is noted that the Government has commenced a review into the treatment of contributed assets to address the key issues.

4.2.5 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 inclusion of the contributed assets in the asset value 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 the contributed assets were included in the asset values that were used to calculate the maximum and minimum range for wastewater prices.

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

The Commission does not believe that it is sufficient to provide only the fact that the contributed assets are included in the asset base.

In the Commission's opinion, more effective compliance with the CoAG principles will be achieved when the contributed assets are valued (or a best estimate is determined), and removed from pricing considerations (or equivalent treatment, if available). This may require SA Water to maintain a separate asset register for pricing purposes and to estimate past contributions.

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

It is vital that water utilities have the capacity to maintain service capacity through augmenting and replacing assets as needed over time. One means of ensuring a capacity to maintain services is through the depreciation expense. While strictly a return of capital to the owners (in recognition of previous investments), the funding of the depreciation expense is frequently viewed as a key source of funding for the eventual replacement of assets, or their service potential, as the need arises.

4.3.1 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]

It is noted that the term depreciation is not used directly. However, in the Report of the Expert Group (P 23) it is stated that:

“4.20 Notwithstanding the differences in the timing of providing for either the economic loss of service potential or when replacement investment might need to be undertaken, the Expert Group is of the view that as a matter of principle amounts should be included in charging to take account of the economic loss of service potential when this is assessed to have occurred (that is, depreciation of assets which are valued on deprival value methodology).”

4.3.2 Transparency Statement Part A Comments

Key statements from the Transparency Statement Part A are:

“SA Water has estimated depreciation on all assets, including contributed assets, in the maximum revenue outcomes on a straight-line basis, as in the 2004-05 urban water pricing decision. The method of calculation is consistent with Accounting Policy Statement 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 to 160 years.”

“The method of depreciation has regard to the underlying nature of the assets and their expected use in SA Water operations.” (p.18)

4.3.3 NCP Assessment Report 2003 Comments

No comments were made with regard to Depreciation for the purpose of wastewater pricing in the NCC’s assessment report 2003.

4.3.4 The Commission’s assessment

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

4.3.5 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 pricing principles, which does 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 amount of revenue recovery for wastewater services.

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 Commission notes that, in line with recommendations made regarding the Urban Water Transparency Statement, the actual depreciation amount has been provided in the Wastewater Transparency Statement.

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

In the previous section, the focus of discussion was on the determination of a cost associated with the return of capital from previous investments. As identified earlier, the depreciation expense is sometimes viewed as providing the capacity for a water business to replace assets/service capacity as assets age. However, as discussed below, 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.

Regardless of the timing issues, the (straight-line) depreciation expense is consistent with the determination of the upper-bound of revenue that is acceptable under CoAG Guidelines for an urban water supplier, acting commercially.

The CoAG framework also mandates the determination of the minimum cost to be met to ensure that assets/service capacity can be replaced as that need arises, for those services where there is an ongoing requirement. The CoAG Guidelines identify that this cost stream 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 urban 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.

4.4.1 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.”

4.4.2 Transparency Statement Part A Comments

The Transparency Statement Part A, observes:

“The Government proposes to expedite the development of an appropriate annuity-based estimate of the provision for asset refurbishment/replacement in the minimum revenue outcome. In the interim, SA Water has continued to use the forecast depreciation expense, based on the straight-line depreciation method, as a broad estimate of the expenditure required to maintain the asset base in the minimum revenue outcome.” (p.21)

4.4.3 NCP Assessment Report 2003 Comments

No comments were made with regard to provisions for asset replacement/rehabilitation for the purpose of water pricing in the NCC’s assessment report 2003.

4.4.4 The Commission’s assessment

Understanding the difference between straight-line depreciation for the infrastructure assets supporting the provision of water supply services and the annuity approach for associated asset replacement, is crucial to understanding the ability of a water utility to maintain service capacity, reduce revenue requirements and/or make contributions to the Government as owners. In the case of SA Water, the difference between the straight-line depreciation expense and the likely ‘annuity’ figure goes to the issue of the sustainability of the water business in the face of contributions to Government that have sometimes been in excess of 100% of after tax profits.

Given the potential magnitude of the margin, SA Water should progress its Asset Management Plans (AMPs) to a point where an annuity can be identified, as soon as possible. As a result of further discussions with SA Government officials during both the Urban Water review and this review, it is anticipated that indicative figures should be available in the near future.

4.4.5 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 straight line depreciation as a “broad estimate” for the annuity in the calculation of the minimum revenue requirement. In the Commission's view, the two are likely to be materially different in a water utility and should not be substituted. Hence, the Commission considers that the Transparency Statement does not strictly comply with the CoAG Pricing Principles (although the information necessary to do this is not currently available).

Provision of information: Did the Cabinet receive this information?

The information received by Cabinet was based on the calculation of straight-line depreciation and not the annuity, although some information about the likely implications of this approach was provided. Hence, Cabinet did not receive the relevant information in this case.

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

In the Commission's view, sufficient relevant information was not provided (nor has the work yet been completed to enable it to be made available), meaning that strict compliance with the CoAG principles was not possible. The Commission considers that SA Water should establish estimates for annuity-based provisions for asset replacement/rehabilitation and report this in the next Transparency Statement.

4.5 Externalities

While issues associated with the infrastructure and operational aspects of water 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.

In the above context, it is noted that the avenue for costs associated with the availability of the water resource, including its protection from pollution is, in part, through the consideration of “Externalities”.

4.5.1 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”

4.5.2 Transparency Statement Part A Comments

The key paragraphs from the Transparency Statement Part A are:

“SA Water’s costs in meeting environmental requirements ... include payments by SA Water to the EPA as licence fees. In 2002-03 those payments amounted to \$990,000, with fees increasing by around 10% per annum.”

“An Environmental Enhancement Levy on sewer rates was introduced to accelerate the implementation of projects (environmental improvement programs (EIP)) as agreed between SA Water and the EPA, which will minimise environmental impacts and meet legislative requirements. The levy, which is effectively 8.6% of total wastewater rate revenue, will raise \$20.5 million in 2004-05.” (p.19)

4.5.3 NCP Assessment Report 2003 Comments

There was no direct comment on Externalities.

4.5.4 The Commission’s assessment

Both EPA licence fee and Environmental Enhancement Levy (EEL) revenues are identified and explained in the Transparency Statement. However, it is not clear that EEL funded works necessarily deal with externalities any more or less than the other wastewater projects that SA Water must undertake. Further information could be provided on EEL funded works to clarify this situation.

4.5.5 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 costs 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 the minimum necessary information about externalities in their consideration of wastewater prices.

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

The Commission considers that further enhancement to the information included in the Transparency Statement should be made. In particular, Cabinet should be provided with more specific information about the expected extent of future EEL funded works and the specific goals of these works.

4.6 Return on assets

Seeking a positive rate of return on assets employed in the provision of water services is an articulated CoAG requirement for the Urban Sector. In view of the fact that the water utilities are highly capital intensive (that is, they require investment of large amounts of capital in sunk assets), 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 may 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 pricing principles to ensure that the opportunity cost 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 water utilities in Australia, the issue has been confused further due to the government ownership of these utilities. However, the 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.

4.6.1 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]

4.6.2 Transparency Statement Part A Comments

The Transparency Statement Part A states:

"Given (current) uncertainties, a single WACC for SA Water has not been determined at this stage. In the meantime, it has been resolved to use two WACCs, one at an upper level (8%) and one at a lower level (6%). Accordingly, the Government considered two estimates of maximum revenue outcome: one using 8% pre-tax real and the other using 6% pre-tax real.

The Government is currently reviewing SA Water's WACC." (p.17)

4.6.3 NCP Assessment Report 2003 Comments

No comments were made with regard to Asset Values, Contributed Assets or the WACC for the purpose of water pricing in the NCC's assessment report 2003.

4.6.4 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' approach⁵).

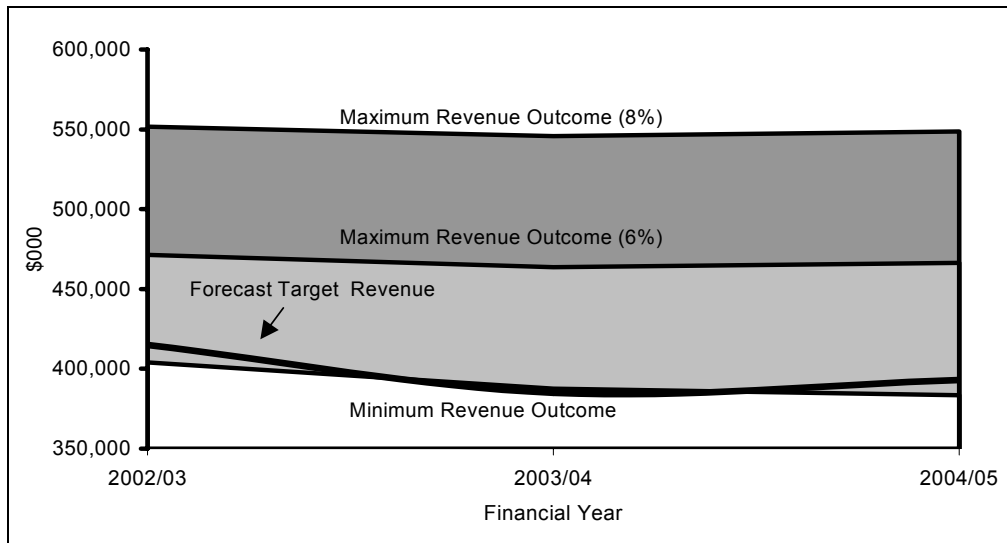
The Wastewater Transparency Statement Part A stated that the SA Water total assets are valued at about \$6.7 bn, and the wastewater assets at \$2.5 bn. This means that a change of 0.1% in the cost of capital applied to the assets results in a revenue requirement change of \$6.7m annually for SA Water, as a whole, or \$2.5m annually for the wastewater business.

A range of WACC that stretches across 2 percentage points (between 6% and 8%) reflects a range of \$50m annually for the wastewater business. This is clearly a significant amount that, in the Commission's view, requires the further consideration foreshadowed by the South Australian Government.

In the case of Urban Water, use of such a broad range in the Transparency Statement Part A was not immediately critical, because the WACC was used only to determine the maximum revenue, and since the Urban Water Transparency Statement Part A concludes that the revenue generated by SA Water is well below the maximum revenue, it did not matter whether the WACC was 6% or 8%. Figure 2 of the Urban Water Transparency Statement is reproduced for illustration:

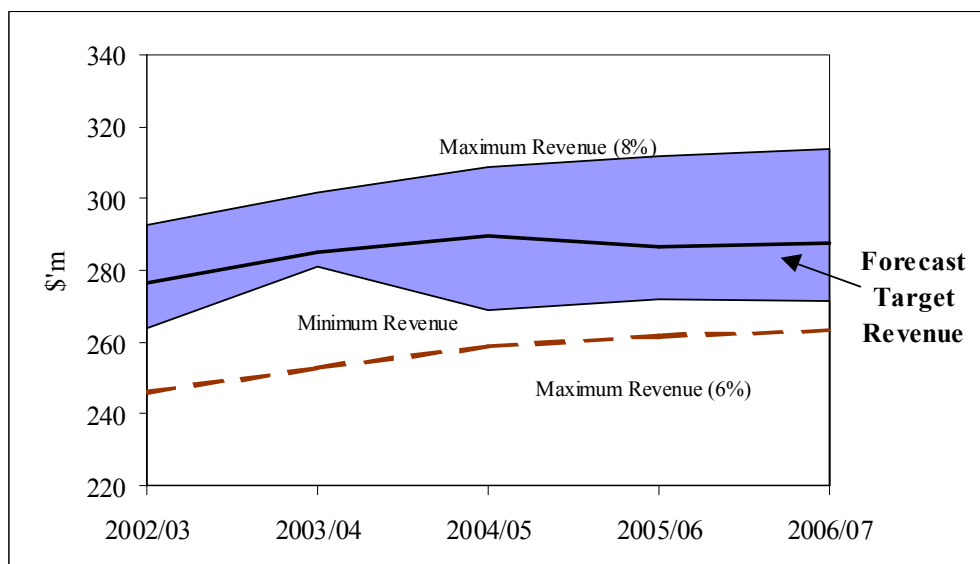
⁵ The 'building block' approach relates to setting the revenue target as the sum of efficient cost, including operational & maintenance cost, depreciation and a return on assets. It may also include other incentive payments, such as an efficiency carry-over amount.

Figure 2 (Urban Water Transparency Statement; Part A)



However, for the case presented in the Wastewater Transparency Statement Part A, the Forecast Target Revenue lies approximately mid-range between the 6% WACC and 8% WACC based estimates for maximum revenue. (See the following Figure 4 from the Wastewater Transparency Statement; Part A):

Figure 4 (Wastewater Transparency Statement; Part A)



Taken in conjunction with the identified potential to either reduce the value of the asset-base, or (effectively) discount WACC to allow for an equitable treatment of contributed assets, in the case of wastewater services, it is possible that the SA Government is at risk of implementing charges that ultimately generate revenues in excess of the “true” maximum (allowable) revenue outcome under the CoAG guidelines.

4.6.5 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?

Although the opportunity cost is recognised in the Transparency Statement as required by the CoAG pricing principles, in the Commission's view, the range of WACC used is too broad. Moreover, very limited details of the WACC calculations have been included in the Transparency Statement. For example, no information on any of the input variables that were used in deriving the 6% to 8% range was provided, although some broad benchmarking of WACC was included.

Provision of information: Did Cabinet receive this information?

The information in the Transparency Statement was very limited.

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

The Commission believes that, although compliant with the CoAG pricing principles requirement to include an opportunity cost, the Transparency Statement does not provide sufficient information on WACC. The Commission continues to believe that in future Transparency Statements, an appropriate WACC should be determined for setting maximum revenue, or at the very least, a much smaller range should be provided for the Cabinet to make an informed decision on wastewater pricing.

The Commission also considers that the WACC calculation should be based on an efficient supplier's benchmark, rather than actual conditions of SA Water. For example, the capital structure of an efficient water utility should be used, rather than the actual capital structure of SA Water. The Commission notes that the SA Government is currently reviewing the WACC for SA Water.

4.7 Dividends

Dividend Policy relates to matters associated with the periodical returns made to the shareholders or owners of a business. The decision on the amount of dividends that should be paid is inextricably 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.

Due to its corporate-wide impact, dividends (per-se) cannot be allocated to business units. This is akin to allocating shares to specific parts of the business. Clearly, the sourcing of funds and their use are two different issues. Accordingly, the allocation of a contribution to dividends from the wastewater business in the Transparency Statement (Table 15) would be more appropriate.

Dividend policy must be considered as a corporate wide issue.

4.7.1 CoAG Principles

In relation to dividends, the guidelines for the application of the 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, NCC has previously provided some clarifying remarks in its assessment framework⁶:

“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.”

4.7.2 Transparency Statement Part A Comments

The Transparency Statement does not outline SA Water’s dividend policy on a standalone basis. However, it does state that SA Water’s dividend policy is part of the total contribution made to the government. The policy stated in the Transparency Statement Part A is to provide:

“...a total contributions target (eg dividends and income tax equivalent) of 55% of free cash from operations, (Earnings Before Interest, Taxes, Depreciation and Amortisation) EBITDA less that level of capital expenditure agreed with the Treasurer as necessary to maintain the ongoing business operations of the Corporation.” (p.22)

The Transparency Statement also notes that:

“While the Government considers that the dividends paid by SA Water are consistent with commercial realities, the Government acknowledges that it would be more appropriate to develop a separate dividend policy that can be clearly identified as being consistent with commercial realities and with competitive neutrality principles.

The Government is currently reviewing its Dividend Policy for all South Australian public non-financial corporations (PNFCs), including SA Water. This review is part of the ownership structure review, which also covers capital structure and CSO policies. The

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

Government expects to have a new Dividend Policy finalised in the second half of 2004.”
(p.24)

4.7.3 NCP Assessment Report 2003 Comments

The, NCC identified some concerns with SA Water’s dividend policy. It stated that:

“A dividend policy based on 55 per cent of EBITDA may result in dividends consistently in excess of 100 per cent of after tax profits, which could have unintended impacts on the business’s capital structure and financial resources.”

It went on to say that:

“The council considers that the dividend policy for SA Water does not sufficiently address the CoAG requirement that dividends reflect commercial realities and simulate a competitive market outcome. The current target of 55 per cent of EBITDA means that dividend could exceed 100 per cent of after tax profit (which occurred in 2001-02) and potentially undermine the long term sustainability of SA Water.”

The report suggested that:

“Reporting by SA Water of the dividend it pays as a percentage of after tax profits would provide greater transparency.”

It noted its concern by saying that:

“There is a danger, however, that the ability of SA Water to provide adequate services may be compromised if it is required year after year to provide dividends in excess of 100 per cent of after tax profits.”

4.7.4 The Commission’s assessment

The policy of providing a total contribution (tax and dividends) of 55% of EBITDA, less that level of capital expenditure agreed with the Treasurer as necessary to maintain the ongoing business operations of the Corporation, should be changed to separate the tax amount (based on a tax equivalent regime) from the dividends (see section 4.8).

In practice, the Commission understands that the policy is applied in accordance with section 30 of the *Public Corporations Act 1993*.

The Commission considered the process as part of the review of the Urban Water Transparency Statement Part A and concluded that both SA Water’s and NCC’s positions are valid. However, in SA Water’s case, the measures used (by SA Water) and proposed (by NCC) are deceptive. This is mainly due to issues discussed in

some detail under asset values. The Commission believes that mainly due to the existence of contributed assets, the asset valuation is held artificially high, leading to artificially high depreciation rates.

The Commission is not in a position to determine what the impact of removal of contributed assets would be on the asset value, but envisages that it could have a significant impact on the asset values used by SA Water. Should the asset values be adjusted downwards, the depreciation amounts will consequently also reduce significantly. A significant reduction in depreciation amounts will lead to significant increases in the after tax profits. However, it will have no impact on EBITDA (since EBITDA is a before depreciation amount). Hence, the same payments that SA Water makes currently (based on EBITDA amount) would result in a smaller proportion of after tax profit (a measure proposed by NCC).

It is foreseeable that the impact of these corrections in the asset value would lead to a dividend payout ratio that is well within acceptable limits, reflecting commercial reality. Although this would lead to a larger proportion of the total payment being classified as taxes, the two should be separate issues, even when the government is the owner of the SA Water. This indicates that although the actual cash payments made as dividends may lie within a range reflecting commercial reality, the current “accounting” measure used to demonstrate compliance with the CoAG principles, may lead to an inaccurate conclusion.

Furthermore, for reasons discussed under depreciation versus the annuity approach, SA Water’s free cash flows are fairly large at this time. These large cash flows lead to large payout in the form of dividends. It is arguable that a typical company operating in a competitive environment does not have the same asset refurbishment characteristic, and hence is not directly comparable.

The concern, discussed in the water inquiry, regarding the potential use of dividend policy to restructure the balance sheet has now been addressed in the Transparency Statement Part A, with the inclusion of a trend analysis comparing SA Water’s capital structure, the level of debt and the dividends. Table 4 “SA Water’s financial data” and supporting text argue the case that the dividend policy is not being used as a “backdoor means” for capital restructuring.

The Commission notes that under the current arrangement SA Water consults with its Minister on appropriate capital expenditure requirements going forward. The separation of dividend policy (and tax equivalent policy as discussed in section 4.8 below) is not intended to preclude such consultations between the parties.

4.7.5 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 Wastewater Transparency Statement is a significant improvement over the Urban Water Transparency Statement in the extent to which it addresses the issue of whether the dividend payments meet the 'commercial reality' test, in accordance with the CoAG Principles.

Issues relating to capital structure have yet to be finalised, but are currently being addressed.

An actual dividend policy is not stated in the Transparency Statement – only the policy on total contribution to the Government (which incorporates the combination of the dividend and tax equivalent payments). In the Commission's view, this does not comply with the CoAG principles, and should be addressed when the current study is concluded.

Provision of information: Did Cabinet receive this information?

Cabinet did not receive information about the dividend policy – it only received advice on the maximum total contribution to the SA Government.

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

In the Commission's view, the following changes would assist in the process for making wastewater pricing decisions compliant with the CoAG Principles:

- (1) Dividend policy is stated transparently and not as a combined contribution to the government.
- (2) Depreciation is calculated in accordance with adjusted asset values (see recommendation under asset valuation)

4.8 Tax equivalent regime

The tax equivalent regime (TER) relates to a regime whereby government owned enterprises are subject to the same taxation regime that applies to the private sector. However, for state owned enterprises, this amount is paid to the state government and not the federal government, whereas most of the private sector taxation is paid to the federal government.

4.8.1 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.

4.8.2 Transparency Statement Part A Comments

The transparency statement includes all relevant taxes paid by SA Water. However, the taxes are combined as total contributions to the government (55% of EBITDA). Also, with regard to inclusion of TER amounts in the maximum revenue requirement calculation, the Transparency Statement Part A states that:

“As in the 2004-05 urban water pricing decision, the pre-tax approach to estimating the required return on assets has been adopted. 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.” (p.20)

4.8.3 NCP Assessment Report 2003 Comments

NCC made no comment on the TER issue for South Australia in its 2003 report.

4.8.4 The Commission’s assessment

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 outcome must be reported as such, and 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 NCC’s pricing 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.

However, it should be noted that the regulatory trend is to move towards a post –tax cost of capital regime. Also, the fact that the pricing principles require TERs to be included in both maximum and minimum revenue calculation implies that a post-tax

WACC is more appropriate, and the taxation amount should be included in the cash flows.

In the above context, it is noted that in the Urban Water Transparency Statement Part C, it was identified that:

“The Government intends to finalise a Dividend Policy (which is distinct from tax equivalent payments) by August 2004. The review would be implemented to the extent possible, prior to the 2005-06 Urban Water and Wastewater pricing decision.”

4.8.5 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?

In the Commission’s view, although the information was sufficient to comply with the CoAG principles, it could be better presented to achieve greater transparency and consistency. To achieve this:

- ▲ the taxation amount should be split separately from the dividend amount, when presenting the information to Cabinet for the water pricing decision.
- ▲ a post-tax WACC should be used for the purpose of calculating the maximum revenue and the taxation amount should be included in the cash flows.

4.9 Efficient Resource Pricing – Wastewater rates

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.

4.9.1 Transparency Statement Part A Comments

SA Water charges for wastewater services to all but the 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 as 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, currently \$261, also applies.

Transparency Statement Part A explains that the adoption of this approach is based upon a series of premises, including the:

- ▲ impracticality (non cost-effectiveness) of metering wastewater 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.

Some element of price discrimination may be inherent in the approach adopted, as the ultimate charges may not necessarily be cost reflective at the individual customer class level. Trade waste charging aside (see below), the major issues are those 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.

Usage charges are applied to SA Water's largest wastewater customers (trade waste customers), where the volume and pollutant load are sufficient to warrant direct metering. The charging arrangements for these customers are subject to pre-existing arrangements and hence were not part of the 2004-05 decision.

4.9.2 NCP Assessment Report 2003 Comments

The NCC accepted the wastewater tariff structure as having complied with the CoAG principles, recognising the difficulties associated with metering and the weak relationship between consumption and cost.

The only issue of concern raised by the NCC was the issue of possible cross subsidy that may exist in trade waste charges. The assessment report noted that:

“South Australia’s arrangements may imply ... a cross-subsidy to large trade waste dischargers during the period of transition to new trade waste charges. (NCC, 2003 Assessments, Vol. 3, page 6.9)

Note again, however, that trade waste charges were not the subject of the 2004-05 decision.

4.9.3 The Commission’s assessment

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.

The Transparency Statement indicates that significant weight was given to there being a close relationship between property values and ability-to-pay in deciding to adopt the rate based charging arrangements.

It is also noted that differing tariff approaches are adopted in other jurisdictions, some of which include proxy consumption measures. The Transparency Statement mentions some of these but further specific assessment of them may improve understanding of the reasons for selecting the adopted approach.

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?

The Transparency Statement outlines the pricing structure and the reasons for the pricing structure. 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 tariff structures that was included in the Transparency Statement and was sufficiently informed in their decision-making for wastewater pricing.

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

No change is necessary to accord with the CoAG principles in relation to consumption based pricing for wastewater. All relevant material was available to Cabinet to make an informed compliant decision on this issue.

Trade waste charges were not part of the 2004-05 decision, but they were explained to give context to the decision.

Further information should be provided to improve the understanding of the selection of the adopted approach over those applied in other jurisdictions.

5 CONCLUSION

This is the first time that the SA Government has introduced and published a Transparency Statement for its wastewater pricing decision. It is also the first time that the Commission has been involved in any aspect of wastewater pricing in South Australia. This, in itself, is a major step towards compliance with the COAG water reform strategic framework.

This report highlights a number of issues that need further consideration. Many of these are common issues identified in the Commission's earlier water inquiry. Most, if not all, of the outstanding issues should be addressed in the government's 2005-06 water and wastewater pricing decisions, and in the corresponding Transparency Statement being prepared for that process.

Overall, the Commission considers that the Transparency Statement 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 wastewater pricing into better compliance with the CoAG pricing 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 (for the first such process).
- (2) The Commission notes that the Transparency Statement is a fair replication of the actual advice provided to Cabinet. However, in future, Cabinet should consider the Transparency Statements at or before the Cabinet meeting in which the pricing decisions are made. (The Commission understands that this is occurring in relation to the upcoming 2005-06 water and wastewater pricing process).

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.

Statement of Compliance

The Commission has concluded compliance in the following areas:

- ▲ Efficient business costs (section 4.1);
- ▲ Asset values (section 4.2);
- ▲ Depreciation (section 4.3);
- ▲ Externalities (section 4.5);
- ▲ Return on Assets (section 4.6);



- ▲ Tax Equivalent Regime (section 4.8); and
- ▲ Efficient Resource Pricing (section 4.9).

In some of the above cases the Commission has suggested areas for improvement.

The Commission has concluded a need for more significant development in respect of dividends (section 4.7) and the development of an annuity estimate (section 4.4). The Commission acknowledges that the Government is already addressing these areas.