

TRANSPARENCY STATEMENT — Part C

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

ON

**INQUIRY INTO THE 2004-05 WASTEWATER PRICING
PROCESS IN SOUTH AUSTRALIA**



**Government
of South Australia**

October 2004

GOVERNMENT RESPONSE TO ESCOSA'S FINAL REPORT

1 Introduction

By letter dated 16 August 2004, the Treasurer referred to the Essential Services Commission of South Australia (ESCOSA) an Inquiry into wastewater pricing processes in 2004-05 pursuant to Part 7 of the *Essential Services Commission Act 2002*.

In undertaking the Inquiry, ESCOSA considered the document *Transparency Statement Wastewater Prices in South Australia 2004-05* dated June 2004. That document forms Part A of this Transparency Statement. The Terms of Reference of the referral to ESCOSA are contained in Appendix 4 of Part A.

On 15 October 2004, the Treasurer received ESCOSA's *Final Report - Inquiry into the 2004-05 Wastewater Pricing Process*. ESCOSA's Final Report forms Part B of this Transparency Statement.

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

2 ESCOSA's Conclusions

ESCOSA concluded (page 41) that:

Overall... the Transparency Statement is a significant step forward in complying with the CoAG principles. The changes and additions proposed... if implemented in future Transparency Statements, would bring wastewater pricing into better compliance with the CoAG pricing principles.

ESCOSA concluded compliance with CoAG pricing principles in the following areas:

- efficient business costs;
- asset values;
- depreciation;
- externalities;
- return on assets;
- tax equivalent regime; and
- efficient resource pricing.

Although compliance is acknowledged, ESCOSA has suggested areas for improvement in some of these matters, many of which are common to those identified in ESCOSA's previous *Final Report - Inquiry into Urban Water Pricing Process*, completed in April 2004.

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ESCOSA acknowledges that the Government is already addressing the two issues that, in ESCOSA's view, need "more significant development". These issues are:

- an annuity value to make provision for future asset refurbishment / rehabilitation (Minimum Revenue Outcome case); and
- a separate dividend policy, rather than a broader contribution policy.

3 South Australian Government Response

The Government is committed to ensuring that future wastewater pricing decisions fully comply with the CoAG principles, to the extent possible.

Given that ESCOSA released its *Final Report - Inquiry into Urban Water Pricing Process* in April 2004, it was not possible to address all of ESCOSA's conclusions in the Government's decision on wastewater prices (made in early June 2004). The matters that were addressed in the *Transparency Statement Wastewater Prices in South Australia 2004-05* (Part A) related to additional information disclosure in the areas of operating, maintenance and administrative costs, depreciation and dividend.

As a result, there is an unavoidable degree of duplication in ESCOSA's *Final Report - Inquiry into the 2004-05 Wastewater Pricing Process* and its previous *Final Report - Inquiry into Urban Water Pricing Process*. It follows that this Government response (in this Part C) also confirms most of the conclusions and recommendations previously made in May 2004 in the Government Response to ESCOSA's Final Report on water pricing processes.

The Government's *Transparency Statement Wastewater Prices in South Australia 2004-05* (Part A) acknowledged that further work is being undertaken in a number of areas and that these matters will be addressed, to the extent possible, in the forthcoming *Transparency Statement Water and Wastewater Prices in Metropolitan and Regional South Australia 2005-06*. To simplify the pricing process for urban water and wastewater services, the Government has decided to make the 2005-06 urban water and wastewater pricing decisions concurrently.

The timeframes are extremely short in which to address all of the substantive regulatory issues and for them to be taken into account in its forthcoming 2005-06 water and wastewater pricing decisions.

3.1 Process Issues

ESCOSA (page 14), stated:

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.

A similar comment was made by ESCOSA in its *Final Report - Inquiry into Urban Water Pricing Process*.

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Government Response 1

The Government confirms that the Treasurer will provide a draft Transparency Statement to Cabinet at the time of making the 2005-06 water and wastewater pricing decisions.

The Government confirms its intention that, after taking into consideration the decision of the Government, the *Transparency Statement Water and Wastewater Prices in Metropolitan and Regional South Australia 2005-06* would be finalised for publication and referred to ESCOSA by December 2004.

3.2 Technical Issues

3.2.1 Demonstration of Efficient OMA Costs (4.1 – Page 15)

ESCOSA has concluded compliance with respect to efficient business costs and noted the significant additional information provided with respect to the provision of performance comparisons for the Adelaide wastewater systems (page 18). Nevertheless, ESCOSA indicated that 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. (page 20)

Government Response 2

The Government confirms its intention 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 *Transparency Statement Water and Wastewater Prices in Metropolitan and Regional South Australia 2005-06*, except where this information is commercial-in-confidence. In this case, the information will remain confidential to the Government and ESCOSA.

3.2.2 Asset values (4.2 – page 20)

ESCOSA has concluded compliance with respect to asset values and with respect to the transparent reporting of the current treatment of contributed assets in the price setting processes. Nevertheless, ESCOSA's opinion (page 22) is that contributed assets should be:

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... 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.

Although unambiguously CoAG compliant with respect to the treatment of contributed assets, the Government recognised that the current treatment is not consistent with recent regulatory determinations interstate. In the previous *Transparency Statement Urban Water Prices in South Australia 2004-05*, and in the latest *Transparency Statement Wastewater Prices in South Australia 2004-05*, the Government indicated its intention to reconsider the treatment of contributed assets in price setting processes, in light of recent regulatory determinations.

Government Response 3

The Government confirms its intention to develop an appropriate methodology for the treatment of contributed assets in SA Water's asset base for the purpose of establishing water and wastewater pricing arrangements.

The Government confirms its intention that this would be finalised for inclusion, to the extent possible, in the 2005-06 water and wastewater pricing decision.

3.2.3 Annuity (Minimum Revenue Outcome) (4.4 – page 24)

ESCOSA has concluded that “more significant development” is required in estimating the provision for future asset refurbishment / rehabilitation, ie, an annuity amount, for inclusion in the Minimum Revenue Outcome and stated (page 26) that:

SA Water should establish estimates for annuity-based provisions for asset replacement/rehabilitation and report this in the next Transparency Statement.

In the previous *Transparency Statement Urban Water Prices in South Australia 2004-05* (Part A and C), and in the latest *Transparency Statement Wastewater Prices in South Australia 2004-05* (Part A), the Government indicated that SA Water is continuing to enhance its asset replacement forecast which would allow the annuity approach to be adopted in the future.

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Government Response 4

The Government confirms its intention to develop an appropriate methodology for the inclusion of the annuity approach, rather than straight-line depreciation, as the estimate of asset refurbishment / rehabilitation when determining the Minimum Revenue Outcome for the purpose of establishing water and wastewater pricing arrangements.

The Government confirms its intention that this would be finalised for inclusion, to the extent possible, in the 2005-06 water and wastewater pricing decision.

3.2.4 Externalities (4.5 – page 26)

ESCOSA concluded compliance with respect to externalities. Nevertheless, ESCOSA considers (page 28) 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 (Environmental Enhancement Levy) funded works and the specific goals of these works. [brackets added]

Government Response 5

The Government intends to report on the Environmental Enhancement Levy, including details of the funded works, for inclusion, to the extent possible, in the forthcoming *Transparency Statement Water and Wastewater Prices in Metropolitan and Regional South Australia 2005-06*.

3.2.5 Return on Assets (Weighted Average Cost of Capital) (4.6 – page 28)

ESCOSA concluded compliance with respect to return on assets. Nevertheless, with regard to the opportunity cost of investment (specifically the weighted average cost of capital (WACC)), ESCOSA considers (page 31) that:

the Transparency Statement does not provide sufficient information on WACC.

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 water pricing.

the WACC calculation should be based on an efficient supplier's benchmark... For example, the capital structure of an efficient water utility.

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In the previous *Transparency Statement Urban Water Prices in South Australia 2004-05* (Part C), the Government agreed that it is preferable to adopt a narrower range for the WACC to be used to determine SA Water's water and wastewater prices, based on an efficient supplier's benchmark.

Government Response 6

The Government confirms its intention to develop an appropriate WACC for the purpose of establishing water and wastewater pricing arrangements.

The Government confirms its intention that this would be finalised for inclusion, to the extent possible, in the 2005-06 water and wastewater pricing decision.

3.2.6 Dividends (4.7 – page 31)

While noting the additional information on dividends (eg, providing financial data and various ratios and addressing the “commercial reality test” proposed by the National Competition Council) that was provided in the *Transparency Statement Wastewater Prices in South Australia 2004-05*, ESCOSA has concluded that “more significant development” is required with respect to dividends.

ESCOSA proposes (page 35) that in future:

- (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.

With regard to the first point, the Government's Dividend Policy is presently under review as part of the overall review of the Government's Ownership Policies, as reported previously in the *Transparency Statement Urban Water Prices in South Australia 2004-05* (Part C). Best estimates of the application of the new Ownership Policies, including a Dividend Policy, to SA Water would be available to Cabinet for its 2005-06 water and wastewater pricing decisions.

With regard to the second point, the Government appreciates the ESCOSA argument (made in its *Final Report - Inquiry into Urban Water Pricing Process* (pages 40 – 41) and in its *Final Report - Inquiry into the 2004-05 Wastewater Pricing Process* (page 34)) and understands that ESCOSA's example of the adjustment to depreciation and revenue for contributed assets reduces the dividend payout ratio.

In terms of the treatment of depreciation in the Maximum Revenue Outcome for pricing purposes, CoAG guidelines are strictly adopted.

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In terms of the treatment of depreciation in the formal accounting records of SA Water, professional accounting standards, the Treasurer's Instructions and Accounting Policy Statements issued under the *Public Finance and Audit Act 1987* are strictly adopted. No distinction is made between depreciation on contributed assets, and depreciation on assets funded by SA Water.

The Government's view continues to be that dividends paid by SA Water are consistent with commercial realities. The Government is also finalising a new Dividend Policy, within the context of a new Government Ownership Policy. With these new policies in mind, it is unnecessary to undertake additional reporting (ie, additional to formal accounting records) through adjusting depreciation and revenue (to take account of contributed assets), with flow-on effects on dividend, to achieve a different dividend payout ratio.

Government Response 7

The Government confirms its intention to finalise a Capital Structure Policy and a Dividend Policy (which is distinct from tax equivalent payments) as part of the Government's Ownership Policies, which would be reported, to the extent possible, in the 2005-06 water and wastewater pricing decision.

3.2.7 Tax Equivalent Regime (4.8 – page 35)

ESCOSA concluded compliance with respect to the regulatory treatment of tax equivalents under the Tax Equivalent Regime. Nevertheless, in ESCOSA's opinion (page 37):

- 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.

With regard to the first point, the Government's Dividend Policy is presently under review as part of the overall review of the Government's Ownership Policies, as reported in the previous *Transparency Statement Urban Water Prices in South Australia 2004-05* (Part C). These policies will supercede the Government's current total Contribution Policy.

With regard to the second point, the Government continues to believe that it is appropriate to use a pre-tax WACC. As reported in the previous *Transparency Statement Urban Water Prices in South Australia 2004-05* (Part C):

A recent IPART Discussion Paper on WACC also indicated that a pre-tax WACC is appropriate for government owned businesses where the taxes and dividends are paid to the government (IPART, 2002, p 5).

Nevertheless, the Government will continue to monitor regulatory developments and interstate pricing reviews in the water industry with regard to the use of pre or post tax WACC.

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Government Response 8

The Government confirms its intention to include additional information separately disclosing, to the extent possible, dividends and income tax equivalent payments to Cabinet and in the *Transparency Statement Water and Wastewater Prices in Metropolitan and Regional South Australia 2005-06*.

3.2.8 Efficient Resource Pricing (4.9 – page 37)

ESCOSA concluded compliance with respect to efficient resource pricing. Nevertheless, in ESCOSA's opinion (page 40):

Further information should be provided to improve the understanding of the selection of the adopted approach (property based charging) over those applied in other jurisdictions. [brackets added]

Government Response 9

The Government intends to include additional information on the selection of the current South Australian approach to wastewater pricing, compared to other jurisdictions, to the extent possible, in the *Transparency Statement Water and Wastewater Prices in Metropolitan and Regional South Australia 2005-06*.