

GOVERNMENT RESPONSE TO ESCOSA'S FINAL REPORT

ON

**THE INQUIRY INTO 2006-07 METROPOLITAN AND REGIONAL
WATER AND WASTEWATER PRICING PROCESSES**



**Government
of South Australia**

South Australian Government

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1. Introduction

In September 2005, The Treasurer referred to the Essential Services Commission of South Australia (ESCOSA) an inquiry into water and wastewater pricing processes in 2006-07, pursuant to Part 7 of the *Essential Services Commission Act 2002* (the ESC Act).

In undertaking the inquiry, ESCOSA considered the document *Transparency Statement on Water and Wastewater Prices in Metropolitan and Regional South Australia 2006-07*, dated August 2005. That document will form Part A of the Transparency Statement. The Terms of Reference of the inquiry are contained in Appendix 3 of Part A.

On 30 November 2005, the Treasurer received ESCOSA's *Final Report – Inquiry into the 2006-07 Metropolitan and Regional Water and Wastewater Pricing Process* which will form Part B of the Transparency Statement.

Section 38(4) of the ESC Act requires ESCOSA's Final Report to be tabled in both Houses of Parliament within twelve sitting days or, where Parliament is not sitting, copies of the Final Report must be made available for public inspection within 28 days after receipt of the report, pursuant to section 38(5).

In the normal course of events, the Government would consider the matters raised in ESCOSA's Final Report and prepare its formal response. The Government Response to ESCOSA's Final Report would form Part C of the Transparency Statement. All parts of the Transparency Statement would then be tabled in Parliament within twelve sitting days of receipt of ESCOSA's Final Report. In this way, a complete picture is publicly available of:

- details of the Government's urban water and wastewater pricing decisions (Part A);
- ESCOSA's Final Report from its inquiry into price setting processes (Part B); and
- the Government Response to ESCOSA's Final Report (Part C).

Parliament is, however, not currently sitting and these standard procedures cannot be followed. On this occasion, ESCOSA's 2006-07 Final Report must be available for public inspection within 28 days of its receipt (i.e. by 28 December 2005).

To coincide with the release of ESCOSA's 2006-07 Final Report (Part B) the Treasurer prepared an Interim Response.

In January 2006, the Government approved this Government Response to ESCOSA's Final Report (Part C). It is also intended that the *Transparency Statement on Water and Wastewater Prices in Metropolitan and Regional South Australia 2006-07* (Part A), ESCOSA's 2006-07 Final Report (Part B) and the Government Response (Part C) will be tabled in Parliament.

Many of the analyses and conclusions arising from ESCOSA's previous inquiries are relevant to its 2006-07 inquiry into the processes for determining water and wastewater pricing, as acknowledged by ESCOSA (page 5). Accordingly, this Government Response to ESCOSA's 2006-07 Final Report reflects, to a substantial extent, the Government Response to those previous inquiries.

2. ESCOSA'S conclusions

Similar to its 2005-06 inquiry, ESCOSA concludes in its 2006-07 Final Report (pages 3, 49, 50) that compliance with 1994 CoAG pricing principles has been achieved in the following areas:

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

Nevertheless, as in its 2005-06 inquiry, ESCOSA has suggested further development in the areas of:

- efficient business costs
- contributed assets.

3. Government response

As CoAG compliance has been achieved, the two areas suggested by ESCOSA for further development are based on ESCOSA's judgement of developments in regulatory practices. These two matters and a number of other matters raised in ESCOSA's 2006-07 Final Report are discussed below.

3.1. Efficient business costs – operating, maintenance and administrative expenses

ESCOSA acknowledged that an independent assessment of SA Water's performance by the South Australian Centre for Economic Studies (SACES), contained in the 2006-07 Transparency Statement, is a positive step.

ESCOSA concluded that the Government should:

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

expedite its current plans to explore the link between efficient business costs and the SA Water Performance Statement and Customer Charter, to better enable a conclusion

to be drawn on efficient business costs by providing more transparency on 'value-for-money' (page 23).

Government response

As foreshadowed in the Government Response to ESCOSA's 2005-06 Final Report, the Government engaged SACES to undertake an independent assessment of trends and key drivers of SA Water's costs and performance. It is intended to continue to explore the development of the analyses of trends and key drivers of SA Water's costs and performance, including the matters identified by ESCOSA.

In response to ESCOSA's query concerning the exclusion of comparisons of total cost per property in the 2006-07 Transparency Statement, it is noted that SACES (page 19) decided to focus on operating costs per property as an interjurisdictional comparator because:

- total cost measures are difficult to determine (e.g. differences in asset valuation and depreciation methods, difficulties in determining an appropriate rate of return)
- capital costs are the legacy of past decisions to a significant degree.

Nationally consistent frameworks for performance benchmarks developed in accordance with the Government's obligations under the National Water Initiative will be relevant in future.

ESCOSA presented revenue, operating, maintenance and administrative (OMA) cost and total cost information, drawn from *WSAAfacts*. While acknowledging some of the limitations of this data, ESCOSA concluded that:

...SA Water has some of the highest margins over costs in Australia (page 22).

In addition:

... the Commission has concerns that the asset value used for SA Water's charges may be too high. [because of an insufficient allowance for contributed assets] (page 23)

A major driver of the reported revenue per property is the asset bases used for pricing (i.e. regulatory asset base). The regulatory asset base in some jurisdictions will be less than the depreciated replacement cost because, aside from the quantum of allowance for contributed assets, a discounted cashflow asset value has been adopted at commencement of regulation.

On the other hand, the reported total cost per property, sourced from *WSAAfacts*, is based on asset valuation methods which may vary among jurisdictions. In South Australia asset values are based on depreciated replacement cost which is consistent with the 1994 CoAG pricing principles. As discussed above, SACES, an independent consultant, abandoned interjurisdictional comparisons of total cost because of the difficulties associated with asset values.

As stated in the Government Response to ESCOSA's 2005-06 Final Report, the Government intends, to the extent possible, to demonstrate value for money by exploring the links between:

- service/performance standards
- operating and capital costs in metropolitan and regional areas
- prices.

3.2. Contributed Assets

ESCOSA concluded that compliance with 1994 CoAG principles has been achieved as the 2006-07 Transparency Statement is explicit about the treatment and removal of contributed assets from the asset values used for setting prices.

ESCOSA also reiterated that:

...an estimate of pre-1995 contributed assets...[would enable] consistent and more transparent treatment of all contributed assets (page 27).

Government response

As indicated in the Government Response to the 2005-06 Final Report, the Government's approach to contributed assets is compliant with 1994 CoAG principles in so far as the treatment of contributed assets is transparent. Further, the Government has adopted more recent regulatory practice by excluding post-1995 contributed assets from the asset base for pricing purposes.

Although it is not intended to reconsider the estimate of contributed assets at this time, the difference of approach between the Government and ESCOSA will be kept under review.

3.3. Return on assets: weighted average cost of capital

ESCOSA concluded that:

...although compliant with the 1994 CoAG pricing principles' requirement to include opportunity cost, it would be preferable to determine an appropriate WACC, rather than a range (page 35).

ESCOSA again expressed its preference for the adoption of a post-tax WACC, rather than a pre-tax WACC (page 40).

ESCOSA also indicated that:

...sole reliance on analysis of other regulatory decisions for various regulated businesses is not, in the Commission's view, a sufficient approach...The timing of other regulators' decisions also needs to be taken into account as some components of WACC will change over time (page 35).

Government response

As indicated in the Government Response to ESCOSA's 2005-06 Final Report:

Given CoAG compliance and the variable WACC treatment by other regulators, the Government has no plans at this time to move to a single, post-tax WACC. This difference of approach between the Government and ESCOSA would, however, be kept under review (page 5).

Further, other regulators' decisions were not solely relied upon to calculate the input values of the WACC. The Government considered other sources of information such as market research, relevant reports and research. Where common regulatory practice was used to establish input values (e.g. inflation, risk-free rate of interest), the input value was estimated from current market data, not other regulator's decisions.

3.4. Cross-subsidies

ESCOSA acknowledged CoAG compliance with respect to the treatment of cross subsidies but suggested:

...the Transparency Statement should provide detailed analysis of cost differences between customer categories, the calculation of CSOs and assessment of CSO alternatives (page 47).

ESCOSA also raised:

... the need to ensure that all options are reasonably assessed. This will provide some assurance that CSO costs are being minimised (page 46).

Government response

The most significant CSO arises from the Government's Statewide pricing policy that, in turn, is an important element of the Government's regional, equity and social justice policy.

SA Water generally seeks private sector involvement for the construction of new projects and, where appropriate, the operation of the infrastructure. Given the extensive competitive tendering undertaken by SA Water, the CSO for Statewide pricing is minimised. The majority of the Statewide pricing CSO relates to the return on sunk capital investments, in which case market testing is irrelevant.

The Government and the SA Water Board impose extensive approval (including economic evaluation) and competitive tendering processes for all new substantive capital expenditure projects both metropolitan and country (such as the new pipeline for the Eyre Peninsula).