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Essential Services Commission of South Australia  
Level 8, 50 Pirie Street  
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Dear Dr Walsh

## **INQUIRY INTO 2009-10 METROPOLITAN AND REGIONAL WATER & WASTEWATER PRICING PROCESS – GOVERNMENT RESPONSE**

Thank you for ESCOSA's Final Report 'Inquiry into the 2009-10 Metropolitan and Regional Water and Wastewater Pricing Process' (Final Report) in relation to the inquiry I referred to you on 31 March 2009.

The Government recently published its water security plan, Water for Good, and endorsed the appointment of ESCOSA as the independent economic regulator for monopoly suppliers of urban and regional water and wastewater services in South Australia. A number of the issues raised in the Final Report will be addressed more appropriately in the transition to independent economic regulation.

### **CONDUCT OF THE INQUIRY (1.2)**

The Final Report notes that *'the low level of stakeholder engagement in this inquiry is consistent with the Commission's experience in earlier water inquiries'* and that *'the Commission continues to hold the view that the current form of inquiry, being a retrospective inquiry into processes for establishing prices, is not conducive to meaningful consultation.'*

The issue of stakeholder engagement and public consultation will be addressed in the transition to independent economic regulation.

### **EFFICIENT BUSINESS COSTS (3.2) & CAPITAL EXPENDITURE (3.3)**

The Final Report suggests in respect to both operating costs and capital expenditure *'in the material provided to Cabinet and to the Commission for review, there is insufficient information that would have reasonably enabled Cabinet to make pricing decisions consistent with the high level outcomes.'* This comment relates to demonstrating, in the context of the annual pricing decision, that forward looking costs are efficient.

The Government is satisfied that Cabinet has received sufficient information in relation to efficient business costs and capital expenditure. Cabinet decisions in respect of the base

efficient business costs and capital expenditure of SA Water are taken separately from the annual pricing decision. They are consolidated and reconfirmed each year in the context of the Budget process preceding the annual pricing decision, updated by various Cabinet decisions made throughout the year. Additional operating and capital expenditure included in Cabinet Submissions outside the Budget process is subject to Cabinet approval, with submissions including detailed analyses of costs and commercial justification, not only for the forward estimates but for the life of a project.

SA Water's forward estimates are reviewed by the Department of Treasury and Finance on an ongoing basis. Not all of this information relating to operating and capital project approvals is forwarded to ESCOSA for review in connection with the annual pricing decision. Market testing is one means used to ensure that the projected costs of the various proposals are efficient. Procurement information is typically included in the material provided to Cabinet as it makes each decision.

### **CAPITAL EXPENDITURE ESCALATION (3.3.3)**

The Final Report notes *'that capital projections again include an assumption that capital costs will escalate at 6% per annum in nominal terms'* and that this assumption:

- mirrored previous years' assumptions in the water industry;
- reflected current market conditions at the time of the decision, and
- was consistent with an independent review by KPMG.

The Final Report also states that, while this assumption *'was the case until mid 2008...there is some evidence of a real reduction in capital costs in the sector and forecasts of cost escalation have been sharply reduced.'*

On this basis, the Final Report concludes *'that an assumption of 6% capital escalation is likely to overstate the level of efficient capital costs.'* However, the report also acknowledges that *'the impact of applying an overstated escalation factor is not likely to be material, given that charges are set annually.'*

The Government notes that the 2008-09 pricing decision foreshadowed new capital expenditure to be escalated at 6% per annum until it was expected to be incurred, at which time the estimated actual costs were included in the regulatory model. The Government will address this issue when making its 2010-11 pricing decision.

### **CONTRIBUTED ASSETS (3.5)**

The Final Report acknowledges that the Government's *'treatment of contributed assets in the information provided to Cabinet is adequate, in so far as it sets out the new National Water Initiative Committee (NWIC) Principle 6 and explains why the approach adopted in respect of legacy contributed assets is consistent with this principle.'* However, the report notes *'there is little discussion of this issue in Transparency Statement – Part A.'*

Nevertheless, the Final Report notes that *'The Transparency Statement – Part A remains a largely incremental document'* and that *'...it focuses in areas of change or new information.'* The issue of contributed assets has been dealt with at length in previous Transparency Statements.

### **EXTERNALITIES (3.7)**

ESCOSA is of the view that *'the Government continues to take a narrow view on the treatment of environmental externalities, while waiting for national clarity on this issue'*, but also acknowledges that it *'appreciates this uncertainty'*.

However, ESCOSA considers that *'at least, progress should be made to identify the relevant externalities'*, recommending *'that externalities be identified and examined as to whether or not they should be included in pricing.'* ESCOSA's view is supported by the National Water Commission's (NWC) February 2008 *Update of Progress of Water Reform*.

Further, ESCOSA believes that *'the material provided to Cabinet does not contain information that would have reasonably enabled Cabinet to make pricing decisions consistent with NWI principles'* in respect of externalities.

In the context of national developments regarding externalities still being at an early stage, the Government remains of the view that it is implementing pricing with respect to externalities consistent with COAG pricing principles. That is, these costs are included where feasible on the basis that they are both attributable and incurred by SA Water. Transparency Statement Part A identifies the items where this is the case (e.g. greenhouse gas emissions, Natural Resource Management levies, etc).

While work on these national developments is progressing, the Government through its Water for Good Plan aims to identify the costs of providing water planning and management, to introduce an associated cost-recovery framework and to set charges in accordance with the framework by 2011-12.

It is appropriate to continue to reflect externality costs to the extent actually incurred by SA Water.

### **RETURN ON ASSETS (3.8)**

In the Final Report, ESCOSA states that *'the information provided regarding the Weighted Average Cost of Capital (WACC) is broadly satisfactory and, to the extent that go forward full cost recovery incorporates a separate WACC for new capital expenditure and legacy assets, is consistent with the NWIC draft urban water pricing principles.'*

However, ESCOSA's report states that improvement could be made by including a *'discussion relating to the risks of not reflecting market conditions in the WACC, and the relationship between the frequency of setting prices and debt refinancing'*.

Also, the report notes that it would have been useful for the Transparency Statement to set out the calculation of the rate of return on legacy assets as at 30 June 2006.

The Government will address these matters in the consideration of the 2010-11 pricing decision and in the drafting of the corresponding Transparency Statement.

### **EFFICIENT RESOURCE PRICING (3.10)**

In its Final Report, ESCOSA notes that it *'is satisfied the Government has 'had regard' to the Long Run Marginal Cost (LRMC) estimate when setting usage charges'* and *'that the multi-tier tariff is consistent with NWIC principles to the extent that it reflects equity considerations.'*

However, the report notes that *'further information on the application of the third-tier usage charge to some customers and not others would have been beneficial.'* Water For Good

(action 71) indicates that the Government will initiate, over the period 2011-2016, a move to a single potable water use price for SA Water's non-residential customers.

Further, the report notes that *'the economic rationale for [increasing the difference between fixed charges for residential customers and the minimum charge for commercial customers] is unclear given that the cost of serving commercial and residential customers is likely to be the same.'* With regard to fixed charges, Water For Good (action 72) states the Government will transition, over the period 2011 to 2016, to a (fixed) service availability charge based on the number and size of meters.

With respect to ESCOSA's comments regarding statewide pricing, that *'information on the 'detriments' of more cost-reflective pricing [i.e. the justification for statewide pricing] should be provided for it [the Commission] to be fully satisfied that the relevant NWIC principle has been met'*, the Government has endorsed the consideration of this issue in the transition to independent economic regulation.

### **CROSS SUBSIDIES (3.11)**

In the Final Report, ESCOSA retains the view that the *'information provided to Cabinet could be improved by giving greater consideration to alternative management arrangements to community service obligations (CSOs) and in reviewing the major cost differences of serving different customers'* by recommending that *'the major cost differences of serving different customers be examined further.'*

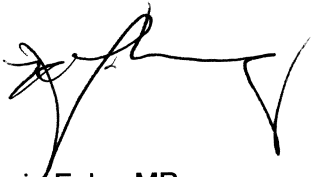
The Government considers that a review of CSOs is not required at this stage. However, the Government is in the process of developing more detailed regional information in the National Performance Report process.

### **CONCLUSION**

ESCOSA's views presented in its Final Report have been evaluated by the Government, and where appropriate, these will be considered in the context of setting 2010-11 charges.

I note that, with the transition to independent economic regulation, many of these issues where relevant will be reviewed and, given ESCOSA's involvement in that process, its views will be taken into account.

Yours sincerely



Kevin Foley MP  
**DEPUTY PREMIER**  
**TREASURER**