GOVERNMENT RESPONSE TO ESCOSA'S FINAL REPORT

INQUIRY INTO 2007-08 METROPOLITAN AND REGIONAL WATER AND WASTEWATER PRICING PROCESSES

<table>
<tr><th>AREA</th><th>ESCOSA OBSERVATIONS and GOVERNMENT RESPONSE</th></tr>
<tr><td>GENERAL INTRODUCTION & PROCESSES</td><td>ESCOSA OBSERVATION
ESCOSA's interpretation of the definition of the upper bound includes no 'double recovery' of contributed assets and removal of redundant assets. (p18)
GOVERNMENT RESPONSE
Interpretation of the definition of upper bound should ultimately be guided by the outcome of processes guided by the NWI.
New pricing principles are being developed by the inter-jurisdictional Steering Group on Water Charging, chaired by the National Water Commission (NWC) and are due for publication in late 2007.</td></tr>
<tr><td></td><td>ESCOSA OBSERVATION
ESCOSA's Report should not be construed or represented as relating to NWI clause 77(ii). (p10)
GOVERNMENT RESPONSE
ESCOSA observes that the Terms of Reference are to review price setting processes only and that as a result, its Report should not be construed as relating to clause 77(ii) of the National Water Initiative (NWI) as follows:
publicly review and report on pricing in government and private water service providers to ensure that the principles in paragraphs 65 to 68 above are met.
The Government notes that the references to processes only is terminology applied for a number of years to indicate that the Government retains responsibility for the substance of decisions on water charges. It is not apparent why the Report's relevance to meeting the obligations of Clause 77(ii) is significantly limited, given that ESCOSA's Final Report is effectively a public review and report on pricing. In any event, the Government would consider alterations to the Terms of Reference for future inquiries to ensure relevance to Clause 77 of the NWI.
It is noted that references in the Terms of Reference to Clauses 65, and 66(i) and 66(v) are indeed comprehensive in so far as SA Water charges are concerned.
The role of an independent body, in reviewing the application of Clauses 67 and 68, which deal with cost recovery for water resource planning and management, may need to be considered separately.</td></tr>
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	ESCOSA OBSERVATION The current form of inquiry, being a retrospective inquiry into processes for establishing prices, is not conducive to meaningful public consultation. (p5) There would have been merit in a 'clean sheet' approach to pick up the NWI. (p16) **GOVERNMENT RESPONSE** The Government considers there is little point in developing new processes or revising the content of the Transparency Statement (Part A) in advance of new nationally consistent pricing principles that may be agreed through the inter-jurisdictional Steering Group on Water Charging.
AREAS FOR IMPROVEMENT (HIGH PRIORITY)	
Efficient business costs (OMA)	**ESCOSA OBSERVATION** Insufficient information to show OMA cost projections are efficient. (p2) Inadequacy with respect to efficient forward-looking costs. Minimum steps to adequacy include: o provision of disaggregated forward-looking cost information; and o reasonable evidence for the proposition that costs are efficient. (p25) **GOVERNMENT RESPONSE** The Government's view is that neither the CoAG guidelines nor NWI pricing obligations specify consideration of 'forward looking' costs, other than in relation to long run marginal cost. Trend analysis in key cost drivers will become apparent over time in the NWI national benchmarking project, including comparative information across jurisdictions. Cabinet received some additional information relating to future OMA cost trends. Further discussion on demonstrating efficient costs is provided in the Capital Expenditure section below. The Government's pricing model provides forward looking cost information based on SA Water's approved Budget.
Capital expenditure	**ESCOSA OBSERVATION** Insufficient information to show capex projections are efficient. (p2) Inadequacy with respect to efficient capital expenditure. Minimum steps to adequacy are information on: o asset management planning and process in place and being followed o projects (including WPA projects) that are efficient and least cost o unit rates consistent with efficient external benchmarks o capital program is consistent with customer requirements or regulatory obligations o capital expenditure program is deliverable in the timeframes proposed. (p28) **GOVERNMENT RESPONSE** The Government does not accept that an efficient level and composition of investment spending is, in real terms, more or less or different than that which

	is undertaken by SA Water, and previously approved by the SA Water Board, Ministers and / or Cabinet. Incentive based regulation, which may allow charges to be set to recover some of non-incurred costs or disallow charges to recover some incurred costs, is not considered appropriate under principles of public finance. That said, the Government does seek value-for-money and technical efficiency and, to that end, will draw on enhanced performance measurement both comparative across jurisdictions and available over time from the NWI national benchmarking project.
Contributed assets	**ESCOSA OBSERVATION** Pre-1995 contributed assets not estimated, nor is the absence of an estimate explained sufficiently. (p2) Inadequate treatment of contributed assets in so far as no reasonable estimate of pre-1995 contributed assets has been generated, nor is information presented to reasonably explain the position on contributed assets. (p33) **GOVERNMENT RESPONSE** The Government recently considered its decision with respect to the treatment of contributed assets. The Government continues to be of the view that its approach is consistent with interstate pricing approaches that lock-in earnings in respect of previously contributed assets as a ‘legacy issue’ – noting that the SA approach, in fact, is more tangible than the line-in-the-sand approach adopted in other States.
Externalities	**ESCOSA OBSERVATION** Broader NWI approach to externalities not adopted, nor has sufficient explanation been provided as to the derivation of costings. (p2) The inadequacy should be addressed by commencing identification of relevant externalities. (p39) **GOVERNMENT RESPONSE** Further developed principles, as the outcome of NWI processes managed by the NWC, are expected for recovery of water planning and management costs and, at a later stage, new pricing principles for consideration of externalities. Until there are agreed new pricing principles, consideration of externalities must be based on a continuation of the current CoAG pricing principles. In the meantime the Transparency Statement provides additional information on the range of externalities ‘attributable to and incurred by’ SA Water. In the interests of transparency, details of the Save the River Murray Levy (which is not retained by SA Water or recorded as SA Water’s funds) are also provided in the Transparency Statement. Note that, if the current charges were no longer classified as externalities, SA Water’s costs would remain the same (as the actual charges to SA Water would remain). There would only be a reduction in the information provided.

Efficient resource pricing	**ESCOSA OBSERVATION** Insufficient demonstration that the water usage component of prices is consistent with LRMC and hence that efficient resource pricing can be achieved. (p2) Does not consider the information presented is sufficient to meet the requirements of pricing principles, in particular how volumetric prices are consistent with LRMC. (p50) **GOVERNMENT RESPONSE** LRMC is difficult to quantify, as acknowledged by ESCOSA, and is indeed contingent on assumptions about sourcing of future supplies. In addition, for 2007-08 the price setting process was undertaken at a time when the severity of the drought and its impact on the River Murray was only just becoming evident. This uncertainty remains given that the impact of the Federal Government's National Water Plan on the reliability of future River Murray flows will not become clear for some time. ESCOSA's purported LRMC range of $1.00 - $3.00/kL suggests a similar range for water usage charges.
Cross subsidies & CSOs	**ESCOSA OBSERVATION** Insufficient demonstration that no cross subsidies exist; nor is evidence provided that alternative CSO arrangements have been considered. (p2) The information is inadequate in that: o insufficient information has been provided to demonstrate that no cross-subsidies are in place; and o no evidence is provided to suggest that alternative management arrangements for CSOs have been examined. (p54) **GOVERNMENT RESPONSE** There is scope for cross subsidy due to the Government's Statewide pricing but would be very difficult to identify and demonstrate. The Government's view is that, consistent with Statewide pricing, the CSO payment is calculated on a whole of non-metropolitan business basis. The requirement that alternative management arrangements for CSOs be examined is new. In late 2004 the Government introduced a new Public Non-Financial Corporations (PNFC) ownership framework that included a new CSO policy. The CSO payments to SA Water were reviewed and the methodology used to calculate the CSO related to Statewide pricing was changed. Further, the new PNFC framework, as applied to SA Water, requires that CSOs resulting from new major capital projects are clearly identified and tracked. The Government considers that it has already undertaken a review of CSO payments to SA Water, and that another review is not required at this stage. This review was reported in 2005-06.

AREAS FOR MINOR IMPROVEMENT	
Asset valuation	**ESCOSA OBSERVATION** Should better explain the link between fair value and deprival value for SA Water. (p2) Acknowledged that the fair value method of asset valuation is consistent with deprival value. (p30) **GOVERNMENT RESPONSE** Details of asset valuation were provided in 2004-05 and have not been repeated in subsequent Transparency Statements. The detailed information can be repeated in future.
Depreciation	**ESCOSA OBSERVATION** Additional information on asset lives should be provided. (p2) Improved if information provided on asset lives (p34) **GOVERNMENT RESPONSE** Details of the useful lives of SA Water's assets were provided in 2005-06 and have not been repeated in subsequent Transparency Statements. The detailed information can be repeated in future.
Return on Assets	**ESCOSA OBSERVATION** The derivation of the weighted average cost of capital (WACC) parameters should be explained. (p2) Improved if information provided on derivation of each WACC parameter (p41) **GOVERNMENT RESPONSE** Details of each parameter in the return on asset (WACC) estimate were provided in 2005-06 and have not been repeated in subsequent Transparency Statements. The detailed information can be repeated in future.
Upper bound movement	**ESCOSA OBSERVATION** Intention to move toward the upper bound is shown, but location of the upper bound is uncertain. (p2) Adequate but not confident that the upper bound has been identified satisfactorily. (p55) **GOVERNMENT RESPONSE** The Government welcomes ESCOSA's acknowledgement that movement towards the Upper Revenue Bound (URB) is being achieved. The Government notes that while both downward movement to the wastewater URB and upward movement to the water URB is slow, such movements are consistent with full cost recovery based on 6% WACC for investment in new and replacement water and wastewater assets. With substantial new investment to secure Adelaide's water supply, this has non-trivial implications for increases in water charges over a number of years. It is noted that the reference to deficiencies in identification of the URB is a reference primarily to efficient costs and treatment of contributed assets, discussed above.

LOWER REVENUE BOUND ISSUES (LOWER PRIORITY)	
Annuity approach	**ESCOSA OBSERVATION** Information about the derivation of the annuity is absent, hence unclear whether it meets requirements of lower bound. (p2) Minimum steps to adequacy include providing information to explain the derivation of the annuity in the context of the lower bound. (p36) **GOVERNMENT RESPONSE** Details of the annuity estimate were provided in 2005-06 and updates have not been repeated in subsequent Transparency Statements. The detailed information can be repeated in future.
Dividends	**ESCOSA OBSERVATION** How the dividend allowance reflects commercial reality in the context of the lower bound is not explained. (p2) Insufficient information is provided to demonstrate that the dividend amount is suitable for the lower bound case. (p42) **GOVERNMENT RESPONSE** There appears to be a misunderstanding of the nature of the lower revenue bound. The definition of the lower revenue bound requires the inclusion and recovery of dividends, where dividends are paid. It should not be assumed that the lower revenue bound only measures a zero annual profit position (with the consequent assumption of a zero dividend). Lower revenue bound is based on achieving medium term financial viability in cash flow terms and therefore does not preclude profit generation and hence scope for payment of dividends and income tax equivalents.
Tax Equivalent Regime (TER)	**ESCOSA OBSERVATION** How the TER allowance is suitable for the lower bound is not explained. (p2) Insufficient information is provided to demonstrate the tax amount is suitable for the lower revenue bound case. (p44) **GOVERNMENT RESPONSE** The definition of lower revenue bound requires the inclusion of taxes (TERs), where taxes (TERs) are paid. It should not be assumed that the lower revenue bound only measures a zero annual profit position. Elsewhere, ESCOSA notes that the inclusion of a tax allowance in the lower bound is reasonable. (p43)

Four Year Revenue Direction	**ESCOSA OBSERVATION** Little historical outturn information makes difficult an informed assessment of forecasts. (p57) **GOVERNMENT RESPONSE** Regulatory price modelling is to be modified to facilitate presentation of expected and historical out-turn information.