

GOVERNMENT RESPONSE TO ESCOSA'S FINAL REPORT

INQUIRY INTO 2008-09 METROPOLITAN AND REGIONAL WATER AND WASTEWATER PRICING PROCESS

AREA	ESCOSA OBSERVATION and GOVERNMENT RESPONSE
<p>OVERVIEW</p>	<p>ESCOSA OBSERVATION</p> <p>ESCOSA identifies an alternative 'top-down' approach to an input based, or 'bottom –up', approach to price setting that it describes as 'best practice'. It holds the view that this alternative assessment method could be applied in future inquiries. (p2, 17)</p> <p>In particular ESCOSA favours an independent review of the need for particular major capital projects as least cost solutions (p32, 72). The costs of projects would only be incorporated in charges if the project were endorsed by that review.</p> <p>GOVERNMENT RESPONSE</p> <p>Best practice water pricing has effectively been defined as per the National Water Initiative (NWI). The National Water Commission (NWC) indicated in its submission to this Inquiry that the Inquiry process accords with NWI commitments.</p> <p>Although it was not a matter that ESCOSA was required to consider under its Terms of Reference, the Government notes the information on alternative assessment methods, including a view of what does (or does not) constitute a 'best practice' price setting framework.</p> <p>Consideration will be given to future Terms of Reference as to the provision of further information on alternative assessment methods.</p> <p>The Government considers it appropriate that water charges be set to recover fully the incurred costs of projects such as the desalination plant – no more and no less. Unlike a profit motivated regulated entity the Government seeks to minimize SA Water's asset base and thus consumer impacts and only approves investment in the desalination plant, for example, if necessary for the security of the water supply.</p>
<p>PRICING PRINCIPLES Chapter 2</p>	<p>ESCOSA OBSERVATION</p> <p>As in its 2007-08 Report, ESCOSA continues to observe that the current form of inquiry, being a retrospective inquiry into processes for establishing prices, is not conducive to meaningful public consultation. (p11)</p> <p>ESCOSA suggests it is unlikely the draft pricing principles for nationally consistent approaches to prices will be finalised before the end of 2008, making it difficult to take them into account for this Inquiry. (p12)</p> <p>GOVERNMENT RESPONSE</p> <p>Because charging decisions are taken annually, relevant information obtained from public consultation and reflected in the ESCOSA Review can be brought to bear in future decision making.</p> <p>Recently announced CoAG water reforms require the development of an enhanced urban water reform framework taking into account principles for water pricing.</p> <p>The Government is operating in accordance with the draft pricing principles prepared by a NWC chaired working party in anticipation of them being endorsed nationally by Ministers. An approach which seeks at a minimum to achieve full cost recovery for all go forward investment decisions is considered appropriate.</p>

<p>ASSESSMENT METHOD Chapter 3</p>	<p>ESCOSA OBSERVATION</p> <p>Based on consideration of each pricing principle and information provided to Cabinet, ESCOSA’s approach is to consider whether Cabinet could be reasonably enabled to make pricing decisions. (p16)</p> <p>ESCOSA acknowledges that the extent of applicability of its alternative assessment method depends on the corporate governance framework in place and the role of [profit] incentives. (p19)</p> <p>GOVERNMENT RESPONSE</p> <p>Cabinet received substantial documentation when determining water and wastewater charges. Other pertinent reports were considered by Cabinet, including the Desalination Working Group Report.</p> <p>The Government considers the overall governance framework in place for SA Water to be appropriate for a statutory body. For example, there are extensive and transparent public reporting requirements to Parliament by statutory authorities, including oversight by the Public Works Committee (a bipartisan Parliamentary Committee), Ministerial responsibility and regular Parliamentary reporting. The Public Works Committee has extensive responsibilities and focuses particularly on project costs. Cabinet makes its price setting decisions in the context of this governance framework.</p>
<p>APPLICATION OF THE PRICING PRINCIPLES: Chapter 4</p>	
<p>Efficient business costs (OMA)</p>	<p>ESCOSA OBSERVATION</p> <p>Acknowledges some improvements in the information provided in relation to key cost drivers. (p2, 28)</p> <p>Acknowledges that costs will be refined as greater certainty emerges about the details of water security projects ‘but such refinements are no guarantee that costs will be efficient’. (p2)</p> <p>Seeks information about SA Water’s total cost per property for benchmarking purposes, while acknowledging difficulties with this measure. (p27)</p> <p>The price and quantity forecast is not linked to the revenue forecast and there is a ‘simplifying assumption’ of no revenue impact from water restrictions. (p29)</p> <p>Inadequacy with respect to efficient forward-looking costs. Necessary steps to adequacy include:</p> <ul style="list-style-type: none"> ○ provision of disaggregated forward-looking cost information; and ○ reasonable evidence for the proposition that costs are efficient. (p30) <p>GOVERNMENT RESPONSE</p> <p>The extent of public Parliamentary scrutiny means there will be an extremely high level of public transparency around the efficiency of future costs related to all major water security investments.</p> <p>Trend analysis of key cost drivers will become apparent over time in the NWI national benchmarking project, including comparative information across jurisdictions.</p> <p>The Government’s pricing model provides forward looking cost information based on SA Water’s approved Budget and is provided in the Transparency Statement in respect of Indicative Revenue Direction to 2012-2013.</p> <p>The different methods used by jurisdictions to measure asset values makes any total cost comparisons of limited value. That said, SA Water’s total cost</p>

	<p>per property for both water and sewerage in 2006-07 was lower than most other major authorities.</p> <p>The impacts of temporary water restrictions were removed from revenue forecasts but not for reasons of simplicity. These impacts were removed to ensure customers did not pay extra in the short term in response to the drought and, accordingly, prices were set on a normal consumption year basis. Cabinet is made aware of impacts from water restrictions on revenue through the Budget process.</p> <p>As contained in the Cabinet Submission, consumption forecasts were based on the following consumption estimates:</p> <table border="1" data-bbox="491 555 1469 712"> <thead> <tr> <th></th> <th>2007-08</th> <th>2008-09</th> <th>2009-10</th> <th>2010-11</th> <th>2011-12</th> <th>2012-13</th> </tr> </thead> <tbody> <tr> <td>Consumption GL</td> <td>231</td> <td>223</td> <td>220</td> <td>219</td> <td>218</td> <td>217</td> </tr> </tbody> </table> <p>These consumption estimates allowed for permanent reductions in water consumption from Waterproofing Adelaide initiatives, but not the impact of temporary water restrictions. The Government's view is that Cabinet was provided with information that would reasonably enable it to consider that SA Water is operating efficiently.</p> <p>Further discussion on demonstrating efficient costs is provided in the Capital Expenditure section below.</p>		2007-08	2008-09	2009-10	2010-11	2011-12	2012-13	Consumption GL	231	223	220	219	218	217
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<p>Capital expenditure</p>	<p>ESCOSA OBSERVATION</p> <p>No information is provided to demonstrate that these projects are least cost solutions. (p32)</p> <p>Acknowledges that estimates of major capital projects are still at a preliminary stage and that a due diligence program will result in firmer estimates of future costs. (p32)</p> <p>Notes that the full risk of uncertainty of future cost estimates would be passed through to consumers and suggests that the current [pricing] process does not provide incentive to minimize and actively manage cost variations. (p33)</p> <p>Inadequacy with respect to efficient proposed capital expenditure. Necessary steps to adequacy are information on:</p> <ul style="list-style-type: none"> ○ well developed asset management planning and process in place and being followed ○ projects, including projected desalination plant expenditure, are efficient and least cost solutions ○ unit rates consistent with efficient external benchmarks ○ capital program is consistent with customer requirements or regulatory obligations ○ capital expenditure program is deliverable in the timeframes proposed. (p34) <p>GOVERNMENT RESPONSE</p> <p>The primary drivers of the expected increases in future operating and capital costs over the next five years are related mainly to water security initiatives, particularly the proposed Adelaide desalination plant, the north – south pipeline interconnector and preliminary work on increasing water storage capacity in the Adelaide Hills.</p>														

	<p>The Government confirms it is undertaking a comprehensive due diligence program examining, in particular, the operating and capital expenditures arising from the proposed Adelaide desalination plant.</p> <p>Cabinet was privy to a range of other information focussed specifically on the decision about water security. This included a comprehensive report from the Desalination Working Group, which included information on a large number of options to secure long term water requirements.</p> <p>KPMG was engaged to examine the comprehensiveness and reasonableness of cost information and the assumptions and methodology for the new water security projects.</p> <p>The Government's due diligence program will result in firmer estimates of future efficient and prudent operating and capital costs.</p> <p>In future price setting processes, the Government will take into account adjustments for firmer estimates of efficient and prudent operating and capital costs as they become available, through the \$10m pilot desalination plant, the settled business case, the tendering process, any changes in timing and any Commonwealth Government grants. The Adelaide Desalination Project Steering Committee with an independent Chairman has also been established to oversee this significant project.</p> <p>Final decisions by Cabinet on all major investments will be taken with the best available information.</p> <p>At this very early stage of defining operating and capital expenditures (around 2 years in advance of construction of the Adelaide desalination plant), it would be unacceptable to tie any party to 'achieving' highly uncertain future cost estimates. (This would indeed encourage over estimates of costs and inefficiencies.) In any event, 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 would be undertaken by SA Water, and approved by the SA Water Board, Ministers and / or Cabinet.</p> <p>'Incentive based regulation' of charges which may allow charges to be set to "recover" non-incurred costs or disallow charges to recover some incurred costs (to try and deal with the revenue maximisation motivation of profit motivated companies) is not considered appropriate in respect of public sector expenditure.</p> <p>That said, the Government does seek value-for-money and technical efficiency as demonstrated in the due diligence processes outlined above.</p>
<p>Asset valuation</p>	<p>ESCOSA OBSERVATION</p> <p>The fair value method of asset valuation is adequate. (p36)</p>
<p>Contributed assets</p>	<p>ESCOSA OBSERVATION</p> <p>Continues to hold the view that the treatment of contributed assets is inadequate. (p37)</p> <p>GOVERNMENT RESPONSE</p> <p>The Government considered the treatment of contributed assets in 2007-08. 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 and transparent than the line-in-the-sand approach adopted in other States.</p>

<p>Depreciation</p>	<p>ESCOSA OBSERVATION Adequate application of the pricing principles. (p39)</p>
<p>Externalities</p>	<p>ESCOSA OBSERVATION Continues to hold the view that a broader approach to externalities should be adopted, seeks information about the derivation and costing of listed externalities and adoption of narrow definition of externalities. Inadequacy should be addressed by including identification of relevant externalities. (p45)</p> <p>GOVERNMENT RESPONSE Draft national principles for the recovery of water planning and management costs arising from NWI processes are expected to be further developed and would take into account any ACCC activities with respect to rural water planning and management costs. Until there are agreed new pricing principles, the Government's view continues to be that consideration of externalities must be based on a continuation of the current CoAG pricing principles. In the meantime the Government is considering the impact of wastewater discharges on Adelaide's coastal marine environment, and the potential to reduce SA Water's greenhouse gas emissions in accordance with the Kyoto Protocol and South Australian legislation. Further, 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.</p>
<p>Return on Assets</p>	<p>ESCOSA OBSERVATION Adequate in the past and remains so now, although would be improved if information provided on derivation of each WACC parameter. (p46)</p> <p>GOVERNMENT RESPONSE Information on each parameter in the return on asset (WACC) estimate was provided in the Transparency Statement (Appendix 6).</p>
<p>Efficient resource pricing</p>	<p>ESCOSA OBSERVATION Supports the greater use of consumption based pricing and the move towards pricing at LRMC, although more information should be provided regarding consumption forecasts and the calculation of LRMC. (p2, 56) No information is provided in the Transparency Statement on the derivation of the LRMC estimate. (p57)</p> <p>GOVERNMENT RESPONSE LRMC is difficult to quantify, as previously acknowledged by ESCOSA. LRMC is a forward-looking concept and is contingent on assumptions about sourcing of future supplies. The approach adopted for calculation of LRMC, which would promote efficient water use in the future, has been to identify the costs that would be incurred beyond the water security initiatives already announced. This would involve an expansion of the Adelaide desalination plant from 50GL to 100GL pa. This is identified in the Transparency Statement (at p37).</p>

	<p>Discussion of the information made available to Cabinet on consumption forecasts is provided in the Efficient business costs (OMA) section above.</p>
<p>Cross subsidies & CSOs</p>	<p>ESCOSA OBSERVATION</p> <p>Acknowledges improved information but continues to hold the view of insufficient information on alternative CSO arrangements aimed at removing the need for ongoing CSOs. (p60, 61)</p> <p>The information is inadequate in that:</p> <ul style="list-style-type: none"> ○ insufficient information has been provided to demonstrate that no cross-subsidies are in place; and ○ insufficient information to demonstrate CSO payments are appropriate. (p61) <p>GOVERNMENT RESPONSE</p> <p>The Government considers that a review of CSOs is not required at this stage.</p> <p>Consistent with Statewide pricing, the CSO payment is calculated on a whole of non-metropolitan business basis. Details of the calculation of the Statewide pricing CSO (which completely dominates the total CSO payments) are contained in the Transparency Statement. (p41)</p>
<p>Movement towards the upper revenue bound</p>	<p>ESCOSA OBSERVATION</p> <p>Adequate but not confident that the upper bound has been identified satisfactorily. (p63)</p> <p>GOVERNMENT RESPONSE</p> <p>Prices are set with reference to SA Water's 'go-forward' full cost recovery position. Where revenues are set to achieve 'go-forward' full cost recovery, then, as existing assets are replaced, revenues will gradually adjust over a very long transition period, until the WACC is earned on the depreciated replacement cost of all assets and the URB is achieved.</p> <p>Thus, while movement towards SA Water's 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 results in large increases in water charges over a number of years (ie, recent water price increases are not linked to historical / legacy assets but to increased capital expenditure to secure South Australia's water supply).</p> <p>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, which are discussed above.</p>
<p>LOWER REVENUE BOUND ISSUES (LOW PRIORITY)</p>	
<p>Provision for future asset refurbishment</p>	<p>ESCOSA OBSERVATION</p> <p>Expects the annuity estimated to be adjusted at some point to account for the increased asset base. (p40, 41)</p> <p>GOVERNMENT RESPONSE</p> <p>Noting that the annuity estimate does not impact on water and wastewater charges, this estimate will be adjusted once new water security projects have been installed.</p>

<p>Dividends</p>	<p>ESCOSA OBSERVATION</p> <p>Interprets the lower revenue bound to imply that it represents a scenario where a business is just maintaining financial viability. (p48)</p> <p>Insufficient information is provided to demonstrate that the dividend amount is suitable for the lower bound case. (p48)</p> <p>GOVERNMENT RESPONSE</p> <p>There appears to be a misunderstanding of the nature of the lower revenue bound.</p> <p>The CoAG definition of the lower revenue bound is quite precise and has been applied precisely. The lower revenue bound requires the inclusion 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.</p> <p>An interpretation based on a business that is just maintaining financial viability, is irrelevant to SA Water. If SA Water’s financial viability is an issue, there are many sophisticated and relevant financial indicators available to assess this.</p> <p>For several years, the Government has set a dividend payout ratio of 95% of net after tax profit and not from retained earnings. The Government’s approach is clearly within both the NCC’s view of a dividend that reflects commercial reality and the Corporations Law.</p> <p>Further, the lower revenue bound is irrelevant, in practice, to price setting which takes account of go-forward full cost recovery requirements and the upper revenue bound.</p>
<p>Tax Equivalent Regime (TER)</p>	<p>ESCOSA OBSERVATION</p> <p>It is unclear why a ‘normal’ tax liability is suitable for the lower bound. (p50)</p> <p>Insufficient information is provided to demonstrate the tax amount is suitable for the lower revenue bound case. (p50)</p> <p>GOVERNMENT RESPONSE</p> <p>The CoAG 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 scenario where a business is just maintaining financial viability, ie, a zero annual profit position, as discussed above.</p>
<p>REVENUE DIRECTION TO 2012-13: Chapter 5</p>	
<p>Four Year Revenue Direction</p>	<p>ESCOSA OBSERVATION</p> <p>As the revenue direction is not a pricing decision, no assessment is offered in the context of the CoAG and NWI pricing principles. (p65)</p>