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Date: 24 NOV 2010

Mr John Hill
A/Chairperson
Essential Services Commission of South Australia
Level 8, 50 Pirie Street
ADELAIDE SA 5000

Dear Mr Hill

INQUIRY INTO 2010-11 METROPOLITAN AND REGIONAL WATER & WASTEWATER PRICING PROCESS – FINAL REPORT – GOVERNMENT RESPONSE

Thank you for ESCOSA's Final Report *Inquiry into the 2010-11 Metropolitan and Regional Water and Wastewater Pricing Process (Final Report)* in relation to the inquiry I referred to you on 16 June 2010.

I now provide the Government's response to that report. This letter constitutes Part C of the *Transparency Statement – 2010-11 Potable Water and Sewerage Prices in South Australia*.

The Government is currently working on the *Water Industry Bill*. If enacted, it will appoint the Essential Services Commission of South Australia (ESCOSA) as the independent economic regulator for the water industry.

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 (Section 1.2)

The Final Report notes that: *The Commission did not receive any submissions in response to the Public Notice and Issues Paper. As a result, in conducting this Inquiry the Commission is principally informed by Transparency Statement – Part A and associated information provided.*

ESCOSA notes in the Final Report that: *the proposed pricing reforms set out in Water for Good are more likely to encourage stakeholder engagement than the current Inquiry process.*

The Government notes that proposed provisions in the *Water Industry Bill* will require the establishment of a customer advisory committee.

The proposed advisory committee would provide advice to ESCOSA in relation to the performance of ESCOSA's proposed licensing function. The proposed committee would also be able to provide advice to ESCOSA, either at its own initiative or at ESCOSA's request, on

any matter related to the water industry. The proposed committee will more likely encourage stakeholder consultation than the current Inquiry process.

EFFICIENT BUSINESS COSTS (Section 3.2) and CAPITAL EXPENDITURE (Section 3.3)

The Final Report suggests, in respect to both operating costs and capital expenditure, that: *ESCOSA remains concerned that the level of information presented to Cabinet does not demonstrate that forward-looking prices are based on prudent and efficient forecast costs. This deficiency is particularly significant, given the impact of the proposed major capital projects on future water prices.*

The Government's view is that Cabinet was provided with information that would reasonably enable it to consider that SA Water is operating efficiently. 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 and the Mid Year Budget Review. Additional information on costs is provided as part of the budget approval process.

Operating and capital expenditure outside the Budget process is subject to Cabinet approval. These submissions include detailed analyses of costs and commercial justification for both the forward estimates and the life of a project. Not all of the information relating to operating and capital project approvals is forwarded to ESCOSA for review in connection with the annual pricing decision.

Specifically, on the issue of capital expenditure information provided to Cabinet, all requests for capital expenditure by SA Water of \$4 million and greater are provided to Cabinet for approval. The Government is satisfied that the detail provided on these projects to Cabinet for approval includes information which ESCOSA recommends should be provided.

The Government notes ESCOSA's comparison of forecast operating maintenance and administrative costs and capital expenditure in the 2009-10 and 2010-11 Transparency Statements. A lot of changes to the operating environment have been occurring in SA Water in recent years. These are approved by Cabinet as they arise. Nevertheless, a detailed record is not available at this time. ESCOSA's requirements in future will have to be met by SA Water under the independent economic regulation framework.

CAPITAL EXPENDITURE ESCALATION (Section 3.3.3)

The Final Report notes that: *the Government has revised its assumption of 6% escalation to forecast capital expenditure not subject to full financial approval down to 3.5%.*

The Final Report also states that: *It may be more appropriate to base the escalation rate on a more recent forecast if the intention is to escalate forward capital expenditure assumptions consistent with market expectations.*

The matter about an escalation rate based on a more recent forecast of inflation will be addressed in the transition to independent economic regulation.

EXTERNALITIES (Section 3.7)

The Final Report notes that: *the Government of South Australia continues to take a narrow view on the treatment of environmental externalities, while waiting for national clarity on this issue, but also acknowledges that: While the Commission appreciates this uncertainty, it also continues to have the view that the NWI currently requires more to be done on the management of externalities.*

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. Further work is required to at least identify the relevant externalities.*

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

RETURN ON ASSETS (Section 3.8)

The Final Report notes the information provided in Appendix 6 of Transparency Statement – Part A regarding the Weighted Average Cost of Capital (WACC) methodology, however: *the Commission remains concerned about the lack of information on the derivation of the parameters used to calculate the WACC.*

The Government considers that the issue about the derivation of the WACC will be dealt with in the transition to independent economic regulation.

EFFICIENT RESOURCE PRICING (Section 3.10)

In its Final Report, ESCOSA notes that, with respect to the water usage charge having regard to the long run marginal cost of the supply of additional water, *in previous Inquiries the Commission has expressed concerns about the lack of information provided to support the estimate of LRMC.*

The Final Report also notes that: *while the usage charge for the second tier is now relatively close to the LRMC estimate, the third tier is now significantly above the LRMC estimate. The Commission notes the statement in Transparency Statement – Part A justifying the third tier charge on the basis of discouraging excessive water use in residential premises.*

The Final Report further states that: *If the LRMC provides an accurate reflection of the costs associated with water consumption (including externalities), then there is limited justification for charging prices well in excess of the LRMC. Such an outcome would be likely to lead to an inefficient allocation of resources in terms of customers' decisions about using water and SA Water's decisions about investing in infrastructure. However the Commission notes that the Water for Good plan outlines the Government's policy intention (in the short to medium term) to retain a three tier inclining block structure for residential water consumers.*

The pricing principles provide for more than one tier for the water usage charge for policy reasons (e.g. sending a strong pricing signal to encourage efficient water use).

The Final Report acknowledges that under action 71 of the Water for Good Plan, the Government will initiate a move to a single potable water use price for SA Water's non-residential customers over the period 2011-16.

CROSS SUBSIDIES – COMMUNITY SERVICE OBLIGATIONS (Section 3.1.1)

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.

ESCOSA continues to recommend that the major cost differences of serving different customers be examined further.

The Government considers that the issue about cross subsidies and CSOs will be dealt with in the transition to independent economic regulation.

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 2011-12 charges and the transition to independent economic regulation.

Yours sincerely



Kevin Foley MP
DEPUTY PREMIER
TREASURER