

TRANSPARENCY STATEMENT — Part C

**GOVERNMENT RESPONSE TO ESCOSA'S FINAL
REPORT**

ON

**INQUIRY INTO 2004-05 URBAN WATER PRICING
PROCESS IN SOUTH AUSTRALIA**



**Government
of South Australia**

May 2004

GOVERNMENT RESPONSE TO ESCOSA’S FINAL REPORT

1 Introduction

By letter dated 25 February 2004, the Treasurer referred to the Essential Services Commission of South Australia (ESCOSA) an Inquiry into Urban Water Pricing in 2004-05 pursuant to Part 7 of the *Essential Services Commission Act 2002*.

In undertaking the Inquiry, ESCOSA considered the document “Transparency Statement – Urban Water Prices in South Australia 2004-05” dated January 2004. That document forms Part A of this Transparency Statement. The Terms of Reference of the referral to ESCOSA are contained in Appendix 4 of Part A.

On 7 April 2004, the Treasurer received ESCOSA’s “Final Report - Inquiry into Urban Water Pricing Process”. ESCOSA’s Final Report forms Part B of this Transparency Statement - Urban Water Prices in South Australia 2004-05.

This Part C of the Transparency Statement outlines the Government’s Response to ESCOSA’s Final Report.

2 ESCOSA's Conclusions

ESCOSA concluded (page 54) that:

Overall... the Transparency Statement is a significant step forward in complying with the CoAG principles. The changes and additions proposed... if implemented in future Transparency Statements, would clearly achieve compliance with the CoAG pricing principles for urban water pricing.

In particular, ESCOSA concluded that:

... [ESCOSA] has reviewed the processes undertaken in the preparation of advice to Cabinet and concludes general compliance with the CoAG principles (for the first such process).

... in future, Cabinet should consider the Transparency Statements at or before the Cabinet meeting in which the pricing decisions are made.

... certain additional information... [ESCOSA] believes would further demonstrate compliance with CoAG principles if adopted in future price setting processes.

In summary, ESCOSA considered ten issues. Although the Report found broad compliance with most of the issues reviewed, ESCOSA qualified its findings or requires additional information on a number of issues for future pricing processes. The issues considered to comply with (or at least have considered the) CoAG principles are:

- asset values (including contributed assets)
- efficient business costs
- depreciation (Maximum Revenue Outcome)
- externalities
- return on assets (WACC)
- tax equivalent regime
- efficient resource pricing – tariff structure
- cross subsidies.

The issues where ESCOSA concluded that the Government has not fully complied with the CoAG principles are:

- using an annuity value to make provision for future asset refurbishment / rehabilitation in determining the Minimum Revenue Outcome (although it is acknowledged by ESCOSA that the information required to comply is not currently available)
- dividends, where ESCOSA considers that the Government has not addressed the 'commercial reality' test and has highlighted that the Government does not have a separate dividend policy.

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The additional information that ESCOSA concluded would further demonstrate compliance with CoAG principles are divided, by ESCOSA, into matters that require relatively minor additions or changes and could be addressed in the short term, or, require more significant work over a longer time horizon (pages 53 and 54).

The relatively minor, short term technical and informational issues, and ESCOSA's proposals for further consideration of those issues, are:

- Demonstration of efficient operating, maintenance and administrative (OMA) costs
ESCOSA's proposal - further benchmarking
- Depreciation amount
ESCOSA's proposal - more transparent calculation and revelation of amount (in the Maximum Revenue Outcome)
- Cross subsidy identification
ESCOSA's proposal - identification of cost differences
- Tax Equivalent Regime
ESCOSA's proposal - move away from 'total contributions' to tax payments.

ESCOSA considers that the longer term technical and methodological issues that require further consideration, are:

- Asset values
ESCOSA's proposal - removal of contributed assets
- WACC
ESCOSA's proposal - narrower range
- Annuity
ESCOSA's proposal - determine the annuity value for inclusion in the Minimum Revenue Outcome
- Externalities
ESCOSA's proposal - development of water resource charging
- Dividends
ESCOSA's proposal - demonstration of commercial reality.

3 South Australian Government Response

The remainder of this document responds to these findings by ESCOSA, including the specific technical issues outlined above. Section 3.1 discusses ESCOSA's recommendations on the process involved in the Government setting of 2004-05 urban water prices. Section 3.2 discusses the issues ESCOSA proposes should be addressed in the short term. Section 3.3 discusses the issues to be addressed over a longer time horizon.

3.1 Process Issues

The Government is committed to ensuring that future water pricing decisions fully comply with the CoAG principles, to the extent possible.

The Government, in Part A of the Transparency Statement, acknowledged that further work was required in a number of areas. Likewise, amongst the issues identified by ESCOSA, the same broad issues as the Government's were covered.

Due to the timing of the wastewater pricing decision, which is required by June 2004, the Government is unable to accommodate most of ESCOSA's suggestions in the 2004-05 wastewater pricing process, as Cabinet has already considered and approved the process (methodology) for its 2004-05 wastewater pricing decision.

To simplify the pricing process for urban water and wastewater services, the Government has decided to make the 2005-06 urban water and wastewater pricing decisions concurrently. Due to legislative requirements, the Government is required to approve urban water prices by 7 December in the preceding financial year. Therefore, the Government intends to make the 2005-06 pricing decision, for both urban water and wastewater, before December 2004.

The Government also notes that there is a trade-off between providing extensive detail and the readability of the Transparency Statement. Nevertheless, where further information would assist the reader, it will be provided in the 2005-06 Urban Water and Wastewater Pricing Transparency Statement.

Further Action 1

<p>The Government proposes to determine by December 2004 both urban water and wastewater prices applicable in 2005-06.</p>
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ESCOSA (page 7), stated:

as a matter of process, the Transparency Statement should be available to Cabinet prior to or at the time of making the water pricing decision.

The Government has agreed to the following revised process for Cabinet decisions on 2005-06 urban water and wastewater pricing:

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Further Action 2

It is intended to prepare the methodology for setting 2005-06 urban water and wastewater prices by August 2004.

The Treasurer will provide a draft Transparency Statement to Cabinet at the time of making the 2005-06 water and wastewater pricing decision. The draft Transparency Statement will assess the extent to which the pricing submission is consistent with the CoAG Principles.

It is intended, after taking into consideration the decision of the Government, the 2005-06 Urban Water and Wastewater Pricing Transparency Statement would be finalised for publication and referred to ESCOSA by December 2004.

The Government is currently reviewing its Public Non-Financial Corporations (PNFCs) Dividend, Capital Structure and Community Service Obligations (CSOs) Policies (collectively referred to as the Government's 'Ownership Policies'). It is expected that these Ownership Policies will be settled and agreed by August 2004.

The Ownership Policies will not be agency-specific. Their purpose is to establish the overarching principles and guidelines for subsequent implementation in key PNFC agencies during 2004-05, to support the development of Government's 2005-06 Budget.

Subject to Government's agreement to the Ownership Policies and a proposed implementation program, and as part of the development of the 2005-06 water and wastewater pricing arrangements, priority will be given to the implementation of the Government's Ownership Policies with regard to SA Water and, in particular, resolution of the policy issues specifically identified in the ESCOSA Report.

Further Action 3

The Government intends to finalise its Ownership Policies by August 2004, which would allow the 2005-06 urban water and wastewater pricing decision to be considered in the context of the revised Dividend, Capital Structure and CSO Policies, to the extent possible.

3.2 Technical Issues to be addressed in the Shorter Term

3.2.1 Demonstration of Efficient OMA Costs (4.2 – Page 18)

ESCOSA (page 23) considered that:

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the information provided in the Transparency Statement is lacking in detail. As a minimum, the Commission believes that in order to comply with CoAG's pricing principles on efficient cost, the Transparency Statement should include:

- information on costs for both the Adelaide systems (WSAAfacts) and the Country Systems;
- information on both cost performance and level of service for these regions; and
- an analysis of the differential impact of cost drivers on the retail versus wholesale (treatment & transmission) activities.

The Government acknowledges ESCOSA's concerns. During ESCOSA's inquiry, the Government provided ESCOSA with a considerable amount of confidential information indicating trends in SA Water's OMA costs over time and breaking down cost components.

Further Action 4

The Government intends to provide additional information on SA Water's country systems, service standards, and cost drivers to Cabinet in support of the 2005-06 pricing decisions. This information will also be provided in the 2005-06 Urban Water and Wastewater Pricing Transparency Statement, except where this information is commercial-in-confidence. In this case, the information will remain confidential to the Government and ESCOSA.

3.2.2 Depreciation Amount (4.3 – page 24)

ESCOSA (page 25) noted that:

the actual calculation of depreciation and the depreciation amount has not been provided in the Transparency Statement.

The Government acknowledges ESCOSA's concern with regard to the depreciation amount in the Maximum Revenue Outcome calculations.

Further Action 5

The Government intends to include additional information on the amount and method of calculating depreciation in the Maximum Revenue Outcome calculations to Cabinet in support of the 2005-06 pricing decisions and in the 2005-06 Urban Water and Wastewater Pricing Transparency Statement.

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3.2.3 Cross subsidy identification (4.10 – page 49)

ESCOSA (page 51) considered that:

although compliant with the CoAG principles, the Transparency Statement should provide detailed analysis of cost differences between customer categories and the calculation of CSOs.

The Commission also believes that in order to be consistent with the broader intent of the CoAG Strategic Framework, an increased incentive based CSO structure should be implemented that would encourage SA Water to seek out efficiencies in its water operations in non-metropolitan areas.

The Government acknowledges ESCOSA's concerns with regard to providing further information on cross-subsidies and the calculation of CSO's. As indicated in the Transparency Statement (Part A) (Conclusion and Recommendation 20, page 36)

any potential cross-subsidies arising from its policy of Statewide pricing are addressed through CSOs.

With regard to an incentive based CSO structure, the Government is currently reviewing the current CSO policy, which was developed in 1996. As stated in the Transparency Statement (Part A) on page 41:

The South Australian Government, as part of its review of ownership structure for PNFs, is currently reviewing its CSO policy. The review aims to adopt explicit guidelines for identifying, costing and funding CSOs in the future. The objective of the CSO policy review is to create a whole of government policy, with guidelines on how CSOs should be determined, priced and administered.

Further Action 6

The Government intends to provide additional information to Cabinet and in the 2005-06 Urban Water and Wastewater Pricing Transparency Statement on the basis of CSO payments to SA Water consistent with the revised CSO Policy, to the extent possible, following finalisation of the Policy by August 2004 and its subsequent implementation in SA Water.

3.2.4 Tax Equivalent Regime (4.8 – page 44)

ESCOSA's (page 45) considered that:

although the information [on TER] was sufficient to comply with the CoAG principles, it could be better presented to achieve greater transparency and consistency. To achieve this:

- the taxation amount should be split separately from the dividend amount, when presenting the information to Cabinet for the water pricing decision.
- a post-tax WACC should be used for the purpose of calculating the maximum revenue and the taxation amount should be included in the cash flows.

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With regard to the Government using a post or pre-tax WACC, the Transparency Statement (Part A) highlights (page 21) that:

A recent IPART Discussion Paper on WACC also indicated that a pre-tax WACC is appropriate for government owned businesses where the taxes and dividends are paid to the government (IPART, 2002, p 5).

The Government considers that it is appropriate to continue to use a pre-tax WACC.

Further Action 7

The Government intends to include additional information separately disclosing dividends and income tax equivalent payments to Cabinet and in the 2005-06 Urban Water and Wastewater Pricing Transparency Statement.

3.3 Technical Issues to be addressed in the Longer Term

3.3.1 Asset values (4.1 – page 16)

ESCOSA (page 17), stated that it:

does not believe that it is sufficient to provide only the fact that the contributed assets are included in the asset base.

ESCOSA considers it more appropriate to remove contributed assets from the asset base.

The Government recognised this issue in the Transparency Statement (Part A) (Conclusion & Recommendation 7, page 21), which states that:

It is considered, however, that the treatment of contributed assets in future price setting processes should be reviewed in the light of recent regulatory determinations.

Further Action 8

The Government intends to develop an appropriate methodology for the treatment of contributed assets in SA Water's asset base for the purpose of establishing water and wastewater pricing arrangements.

It is intended that this would be finalised for inclusion, to the extent possible, in the 2005-06 Urban Water and Wastewater pricing decision.

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3.3.2 WACC (4.6 – page 33)

ESCOSA (page 36), considered that:

in future Transparency Statements, an appropriate WACC should be determined for setting maximum revenue, or at the very least, a much smaller range should be provided for the Cabinet to make an informed decision on water pricing.

The WACC calculation should be based on an efficient supplier's benchmark... For example, the capital structure of an efficient water utility.

The Government noted in the Transparency Statement (Part A) (page 22):

To resolve an appropriate WACC would involve assessing the appropriateness of each element of the WACC and the issues concerning the choice of those elements, such as franking credits, credit rating, the risk-free rate, market premium and capital structure.

The Transparency Statement (Part A) also stated (Conclusion and Recommendation 8, page 23) that:

The current review of the ownership structure for all PNFCs, including capital structures, dividends and CSO policies, may lead to adjustment of SA Water's capital structure and, at that time, a single WACC could be defined.

The Government agrees with ESCOSA that it is preferable to adopt a narrower range for the WACC to be used to determine SA Water's water and wastewater prices, based on an efficient supplier's benchmark.

Further Action 9

The Government intends to develop an appropriate WACC for the purpose of establishing water and wastewater pricing arrangements.

It is intended that this would be finalised for inclusion, to the extent possible, in the 2005-06 Urban Water and Wastewater pricing decision.

3.3.3 Annuity (4.4 – page 26)

ESCOSA (page 29) considered that:

SA Water should establish estimates for annuity-based provisions for asset replacement/rehabilitation and report this in the next Transparency Statement.

The Government stated in the Transparency Statement (Part A) (page 27) that:

SA Water has indicated that it is continuing to enhance its asset replacement forecast, which would allow the annuity approach to be adopted in the future.

The Government acknowledges ESCOSA's concerns and is improving SA Water's Asset Management Plans to a point where an annuity estimate, for the estimate of asset refurbishment / rehabilitation when determining the Minimum Revenue Outcome, can be calculated reliably.

Further Action 10

The Government intends to develop an appropriate methodology for the inclusion of the annuity approach, rather than straight-line depreciation, as the estimate of asset refurbishment / rehabilitation when determining the Minimum Revenue Outcome for the purpose of establishing water and wastewater pricing arrangements.

It is intended that this would be finalised for inclusion, to the extent possible, in the 2005-06 Urban Water and Wastewater pricing decision.

3.3.4 Externalities (4.5 – page 30)

ESCOSA (page 32) considered that:

Cabinet should be informed about the extraction-based water resource management charges and its application to all relevant beneficiaries, including SA Water. This should form part of the Transparency Statement.

The Commission further considers that the DWLBC charges be identified in terms of key catchments, and that the charges related to the supply of water to regions attracting CSOs be differentiated.

The Government is currently investigating the appropriate funding options for promoting improved environmental practices and funding of environment expenditures. A draft report is being finalised on “Sharing the Services and Costs of Managing the River Murray in South Australia”, which is expected to be released for discussion in June 2004. This report sets out a framework that allocates River Murray water management costs to the general community, SA Water and irrigators based on beneficiary / impactor pays principles. In addition, the Water Proofing Adelaide strategy will provide a strategic policy framework for water resource management for metropolitan Adelaide. A draft strategy is expected later in 2004 for completion by March 2005.

ESCOSA’s Report implies that the Government would be imposing an extraction charge on SA Water. This is pre-empting the outcome of these reviews and policy decisions by Government in response to these reviews. As the reviews are at an early stage of development, **no** decisions have been made yet.

These reviews are being undertaken separately from the 2005-06 urban water and wastewater pricing process. It is not considered appropriate to report all outcomes of these reviews in the Transparency Statement, which only relates to urban water and wastewater pricing in SA.

Further Action 11

The Government is currently developing water resource management policies, which may affect the costs associated with provision of water and wastewater services.

This is being undertaken separately from the 2005-06 urban water and wastewater pricing process. The outcomes, in so far as they affect future urban water and wastewater pricing decisions, would be addressed in future Transparency Statements.

However, the Government will report on the Policy outcomes, including implications for all relevant beneficiaries, as part of the review process.

3.3.5 Dividends (4.7 – page 37)

ESCOSA (page 43) stated:

In the Commission's view, the following changes would assist in the process for making urban water pricing decisions compliant with the CoAG principles:

- (1) Dividend policy is stated transparently and not as a combined contribution to the government.
- (2)
- (3) Capital structure policy is outlined and it is demonstrated that the dividend policy is not leading to changes to capital structure.
- (4) The Transparency Statement should include a statement from the Minister of Administrative Services as to the level of capital expenditure considered necessary to maintain the ongoing business operations of SA Water.

With regard to the first point, the Government's current Dividend Policy, which is part of a broader contribution policy, is stated in the Transparency Statement (Part A). As discussed above, Dividend Policy is presently under review as part of the overall review of the Government's Ownership Policies.

Further Action 12

The Government intends to finalise a Dividend Policy (which is distinct from tax equivalent payments) by August 2004. The review would be implemented to the extent possible, prior to the 2005-06 Urban Water and Wastewater pricing decision.

With regard to the third point, the Government is not using the current dividend policy to change SA Water's capital structure.

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Further Action 13

The Government intends to finalise a Capital Structure Policy, which would be implemented to the extent possible, prior to the 2005-06 Urban Water and Wastewater pricing decision. Additional information will be provided in the 2005-06 Urban Water and Wastewater Pricing Transparency Statement on the relationship between dividend policy and capital structure.

With regard to whether the estimated capital expenditure is sufficient to maintain the ongoing business operations of SA Water, SA Water's Board develops forward capital expenditures in the first instance. SA Water's capital expenditure proposals are then subject to review by the Minister for Administrative Services, the Treasurer and Cabinet, via the Budget and other Government decision-making processes. SA Water's capital program is published in the annual Budget Paper: *Capital Investment Statement*. Further, the Public Works Committee currently reviews capital expenditure proposals over \$4 million. This is an extensive review process, designed to ensure transparency and accountability of capital expenditure.

Further Action 14

The Government believes the current processes for consideration of capital expenditure proposals provides adequate transparency. Coupled with the new Ownership Policies and the use of an annuity for Minimum Revenue Outcome purposes, the Government believes there is no requirement for the Minister for Administrative Services to make any statements on SA Water's capital expenditure requirements.