CABINET - SUBJECTS FOR CONSIDERATION, 28 AUGUST 2006 11:00 AM

1 New Initiatives/Policy Matters

Not relevant

104	TF06/040CS	Treasurer's Item (Kevin Foley) **APPROVED**

Not relevant

104

LOCKED

CABINET COVER SHEET

1.	**TITLE:**	National Water Initiative Urban Water and Wastewater Pricing Obligations: Discussions with the NWC
2.	**MINISTER:**	Kevin Foley **MP** **DEPUTY PREMIER** **TREASURER**
3.	**PURPOSE:**	To obtain approval for discussions with the National Water Commission (NWC) in respect of meeting National Water Initiative (NWI) obligations for metropolitan water and wastewater charges.
4.	**IDENTIFY THE RELEVANT GOVERNMENT POLICY AND/OR SA's STRATEGIC PLAN TARGET:**	The NWI requires jurisdictions to continue to set water and wastewater charges in accordance with the 1994 CoAG pricing principles and regulatory framework. The NWI also requires '*continued movement towards upper bound pricing by 2008*' for metropolitan revenues although 'movement towards' is not defined. Other related NWI obligations are to bring into effect consistent approaches to water planning and management costs and, where feasible, externality costs. The NWC is expected to conduct the first biennial assessment of progress by jurisdictions in meeting NWI obligations during 2006-07. There is some urgency in being able to demonstrate some progress in meeting NWI obligations. In order to provide some guidance for discussions by officials with the NWC, Cabinet could endorse the following: "*NWC requirements should desirably not result in the State needing to increase water prices by more than 20% in real terms over 5 years. The implications for wastewater prices should be little or no increase in nominal prices.*" (para 3.75.4 in the Submission proper)
5.	**ICT COMPONENT**	Does the submission have a material ICT Component? ☐ Yes ☒ No
6.	**RESOURCES REQUIRED FOR IMPLEMENTATION:**	There are no direct funding requirements as a result of this submission.

7. COMMUNITY AND ENVIRONMENTAL IMPACT:

The submission itself has no direct community or environmental impacts.

8. RISKS:

The consequences of non compliance with NWI obligations on the upper revenue bound, or a degree of shortfall in compliance in moving towards the upper revenue bound, should be considered.
Although there are no direct penalties under the NWI for non compliance, the State's ability to access funding from the $2b Australian Water Fund may be restricted. In this regard, it is understood the NWC has proposed to the Prime Minister $12.970m funding for the implementation of the NWI in South Australia, which funding would be tied to a number of conditions, including that the NWC must be satisfied that South Australia is '*making sufficient progress on the NWI requirements for reform of water pricing*'.

Also important is the Government's timely adherence to its commitments to the NWI which Initiative is in the State's long term interest.

There would be potential for criticism if there were a substantial increase in water charges. The response would need to set out the justification for any increase in terms of broader policy objectives.

9. CONSULTATION:

Given the sensitivity of potentially large increases in water charges, circulation of this submission has been limited to Treasury and Finance, SA Water and the Department for Water, Land and Biodiversity Conservation.

10. COMMUNICATION STRATEGY:

Confidential and should remain internal to Government at this stage.

11. URGENCY:

10 day rule

12. RECOMMENDATION:

It is recommended that Cabinet:

12.1 endorse the guidance set out in paragraph 3.75.4, viz:

> National Water Commission requirements should desirably not result in the State needing to increase water prices by more than 20% in real terms over 5 years.

12.2 note that it may be possible to reach agreement with the National Water Commission on strategies that involve either a net increase or net

reduction in total water and wastewater revenues but still meet National Water Initiative "upper bound pricing" obligations;

12.3 authorise the Department of Treasury and Finance (involving consultation with the Department of Water, Land and Biodiversity Conservation) to meet with the National Water Commission to discuss acceptable positions on:

- asset valuation, including contributed assets and the scope for maximum allowable revenue to include a provision for a management fee or risk premium for those contributed assets; and
- transition periods.

12.4 note that a further Cabinet Submission outlining detailed options will be prepared based on the outcome of those discussions.

I declare that I have no actual or potential conflict of interest in relation to the proposals contained in this submission.

Kevin Foley **MP**
DEPUTY PREMIER
TREASURER

22 / 8 / 2006

MINUTE

MINUTES forming ENCLOSURE to T&F06/040CS

To The Premier For Cabinet

Re **NATIONAL WATER INITIATIVE URBAN WATER AND WASTEWATER PRICING OBLIGATIONS: DISCUSSIONS WITH THE NWC**

1 PROPOSAL

1.1 To obtain approval for discussions with the National Water Commission (NWC) in respect of meeting National Water Initiative (NWI) obligations for metropolitan water and wastewater charges.

2 BACKGROUND

2.1 Water and wastewater charges are set in accordance with the 1994 CoAG pricing principles and regulatory framework. The NWI requires jurisdictions to continue to meet the 1994 CoAG framework (Clause 6).

2.2 The NWI requires *'continued movement towards upper bound pricing by 2008'* for metropolitan revenues (clause 66) although "movement towards" is not defined.

2.3 The NWI also requires jurisdictions to:

- *'bring into effect consistent approaches to pricing and attributing costs of water planning and management by 2006'* (Clause 67);
- *'implement pricing that includes externalities where found to be feasible'* (Clause 73);

2.4 The NWC is expected to conduct the first biennial assessment of progress by jurisdictions in meeting NWI obligations during 2006-07 (Clause 106). There is therefore some urgency in being able to demonstrate some progress in meeting NWI obligations.

3 DISCUSSION

Contextual Background

3.1 Comparative benchmark information tends to suggest that SA Water operating costs per customer are among the lowest in Australia while revenues per customer are among the highest (Attachment 1).

3.2 A CSIRO report (May 2006: led by Mike Young) suggests that over the period to 2032, urban water prices in Australia could increase substantially as water supply reduces and population increases. Increases for Adelaide would be considerably less than other cities, although in some scenarios by up to 30%.

3.3 Waterproofing Adelaide initiatives aim to address long-term water demand and supply issues. Estimates of costs, revenues and charges herein do not

contain any Waterproofing Adelaide initiatives. The costs of these initiatives can be expected to add further pressure on charges. A separate Submission on Waterproofing Adelaide is being prepared by SA Water.

CoAG and NWI Urban Pricing Framework

3.4 The upper revenue bound comprises an appropriate return on assets, operating, maintenance and administrative expenses, depreciation, and externalities.

3.5 Key variables driving the calculation of the upper revenue bound are the rate of return on assets (ie, the weighted average cost of capital (WACC)) and the asset base, including allowance for contributed assets. Other possible new charges on SA Water also need to be considered (eg, NWI obligations relating to water planning and resource management charges and externalities).

3.6 The upper and lower revenue bounds and revenues earned by SA Water are calculated at the four business segment level, viz, metropolitan water, non-metropolitan water, metropolitan wastewater and non-metropolitan wastewater.

3.7 Current actual returns are 4% for metropolitan water and 7% for metropolitan wastewater (on the 'regulatory' asset base).

3.8 The current 6% - 7% pre-tax real WACC range adopted in previous pricing decisions, while defensible, has effectively been designed to accommodate the divergent actual returns in the water (4%) and wastewater (7%) business segments.

3.9 There is legitimate uncertainty about the correct WACC value. Given the risk profile of the SA Water business and the recent Essential Services Commission of South Australia (ESCOSA) rate of return final decision for Envestra of a 6.14% WACC, it may be difficult to justify a figure much above 6%. A WACC of 6% is used in this Submission.

3.10 The NWC and ESCOSA have proposed a single post-tax WACC. The use of a post-tax WACC, rather than pre-tax, is very much a (potentially complicated) second order issue.

3.11 The value of the regulatory asset base is also a key component of the upper revenue bound. Aside from the issue of contributed assets, as discussed below, in South Australia the regulatory asset base is the same as asset values based on written down replacement cost as reported in SA Water's financial statements.

3.12 In New South Wales and Victoria, independent regulators have determined initial regulatory asset values on the basis of a methodology known as 'line in the sand'. This methodology involves 'reverse engineering' the starting regulatory value to be consistent with a desired outcome for charges. In those States, asset values have been revised downwards so as to validate current low revenue levels.

3.13 Essentially, an asset value is calculated that would justify existing charges. That value is adopted as a starting point 'regulatory' value of assets, regardless of what the true asset value might be. Going forward this artificial 'regulatory' value is depreciated each year and any new assets added to it.

After a very long period of time the 'regulatory' asset value aligns with the correct asset value. In situations where current revenues are too low, this approach results in a very gradual increase in prices to the correct level. If revenue is too high, it results in a very gradual decrease in prices to the correct level.

3.14 As noted above, independent regulators in New South Wales and Victoria have approved this approach to managing prices increases. To-date, this 'line in the sand' approach has not been used to transition to lower prices. That is, there is no precedent for asset values being written *up* to support high revenue and charges. Regulators tend to be concerned about validating prices that may be too high.

3.15 In South Australia, a 'line in the sand' approach would involve a gradual increase in water charges but a gradual decrease in wastewater charges.

3.16 A new water planning and resource management charge (NWI Clause 67) would increase SA Water's costs and thus the upper revenue bound and, potentially, further impact on water charges.

3.17 The Department for Water, Land and Biodiversity Conservation has submitted a revenue raising budget proposal for a **$10**m pa charge in **2007-08** in total for SA Water and irrigators. Given the NWI obligation, recovery of water planning and resource management charges may need to be substantially greater than this. However, given SA Water's relatively small share of total River Murray water extractions, a reasonable planning assumption is a charge on SA Water of no greater than **$5**m pa.

3.18 SA Water would have concerns about the introduction of a further water planning and resource management charge given that SA Water customers already pay a substantially greater contribution for the relevant activities through the Save the River Murray Levy. Treasury and Finance do not regard this as a valid argument.

3.19 The Save the River Murray levy is excluded from SA Water revenues for the purposes of the upper revenue bound calculation.

3.20 Community Service Obligation (CSO) payments ensure a 6% return is achieved in non-metropolitan segments.

3.21 Although the NWI commitment to move towards upper bound pricing is in respect of metropolitan revenues, Statewide uniform pricing in South Australia would see all SA Water customers affected.

Key Issue – Contributed Assets

3.22 A critical issue in considering the options available is with respect to contributed assets.

3.23 The generally accepted treatment of contributed assets by regulators is that, because part of an entity's assets include assets previously contributed or gifted by subdivision developers, the entity should not be required to earn a rate of return on those contributed / gifted assets.

3.24 The higher the contributed assets figure, the lower is the upper revenue bound.

3.25 Assets contributed to SA Water since corporatisation in 1995 can be reliably estimated. Assets contributed prior to 1995 have to be estimated more indirectly and so the estimates are subject to greater degrees of uncertainty.

3.26 SA Water understands that the first year that E&WS received contributed assets was 1966. SA Water's annual reports from 1987-88 recorded the revenue received from contributed assets. Prior to corporatisation in 1995, E&WS Department did not keep a formal record of contributed assets within its asset register. After 1995, SA Water recorded only free assets in its asset register. A full record of all contributed assets has only been kept since 2004-05.

3.27 Thus, specific details of individual contributed assets, whether relating to an asset as a whole, or part thereof, are not known prior to 2004-05. It is, therefore, difficult to identify whether contributed assets initially in service, remain in service, and to what extent. Further, it is virtually impossible to specifically value each individual contributed asset, or part thereof, at its depreciated, fair value.

3.28 In October 2004 SA Water produced the following estimates of contributed assets as at 1 July 2004.

3.29 Methodology 1 – Post-1995: For this option, SA Water identified the 'free assets' element of contributed assets from 1995 and estimated their current value by applying current 'large scale' contract rates, current costs and known depreciation patterns. For the 'contributions to mains extensions' element of contributed assets, estimates were based on revenue received, adjusted appropriately. The resultant $220m estimate was favoured, even though it only dates from 1995.

3.30 Methodology 2 - Average Method: The average method is based on the assumption that the average annual value of assets contributed during the period 1995-2004, adjusted for depreciation, is a fair representation of the annual average value of assets contributed during 1966-1995.

3.31 This pre-1995 'average' estimate was added to the "post-1995" estimate. The resultant estimate was $830m of contributed assets.

3.32 Methodology 3 - Indexation Method: The first reported value of the stock of contributed assets was in E&WS's 1987-88 financial accounts of $262m (historic cost). This value was averaged and allocated across the 1966 to 1988 period. These annualised values were then indexed to 2003-04 dollars and depreciated. To complete the time series, the reported annual (flow) values between 1988 to 1995 were also indexed to 2003-04 dollars, depreciated and added to the 1966 – 1988 values.

3.33 This pre-1995 'indexation' estimate was added to the "post-1995" estimate. The resultant estimate was $1,225m of contributed assets.

3.34 These estimation methods were outlined in a Policy Paper *Evaluation of Contributed Assets for Water and Wastewater Pricing Purposes*, which was approved by Cabinet in November 2004. In that submission, Cabinet was advised that, given the degree of subjectivity in the estimation of contributed assets, it was considered that the post-1995 estimate of contributed assets of $220m (in a total asset base of $6.5b) was '*robust and defensible*'.

3.35 Subsequently, in its 2005-06 and 2006-07 Inquiries, the Essential Services Commission of South Australia (ESCOSA) commented on the Government's treatment of contributed assets. In its view, the $220m contributed asset estimate was too low. Nevertheless, ESCOSA concluded that South Australia had complied with CoAG pricing principles in relation to calculation of the upper revenue bound, given that the treatment of contributed assets was transparent, which is the sole CoAG requirement for contributed assets. As CoAG compliance had been achieved, it was not considered necessary to revise the contributed assets estimate.

3.36 However, in its 2005 National Competition Policy (NCR) Assessment Report, the NWC has repeated the ESCOSA view that the current (low) value of contributed asset may '*unreasonably*' inflate asset values and lead to a '*lock-in of excessive prices*' when moving towards the upper revenue bound. The NWC recommended that South Australia '*seek a best estimate of contributed assets pre-1995... before implementing further price increases required to bring prices closer to the upper bound.*'

3.37 None of the methodologies could be regarded as capable of producing a robust estimate.

3.38 Contributed assets, once estimated, are split between water and wastewater business segments on the basis of a known split in one year assumed to apply to all years. Once again this could not be regarded as an authoritative estimate.

3.39 The implications of a range of values for contributed assets are shown in Table 1.

Table 1: Revenue Impacts: Pre-1995 and Post-1995 Contributed Assets Estimates

Contributed metro and non-metro asset value deducted from SA Water asset base		Change in *metro* revenue to achieve upper revenue bound based on 6% return		Corresponding change in total SA Water revenue *including non-metro*	
		Water	Wastewater	Water	Wastewater
Post-1995*	$220m	$47m	-$23m	$68m	-$26m
Average Method Including Pre-1995	$830m	$34m	-$45m	$49m	-$50m
Indexation Method Including Pre-1995	$1,225m	$25m	-$59m	$36m	-$65m

* Currently deducted from 'regulatory' asset base in Transparency Statements.

3.40 As Table 1 shows, the higher the estimate of contributed assets, the smaller the required increase for water charges, and the larger the required reduction in wastewater charges. The net revenue impact changes from a positive $42m pa to a negative $29m pa as the estimate of contributed assets increases. Given the lack of good quality data there would be a large element of judgement involved in adopting any estimate of contributed assets. In this context the NSW and Victorian 'line in the sand' approach becomes more understandable but is still an entirely arbitrary response.

3.41 It should be noted that there is a conflict in the NWC's approach to contributed assets in South Australia at the same time as accepting as NWI compliant water charges in New South Wales and Victoria which have been determined in those States on the basis of the 'line in the sand / reverse engineering' asset valuation methodology.

3.42 In principle, a 'line in the sand / reverse engineering' asset valuation methodology (albeit which has been applied particularly to validate charges for water businesses) quite clearly overtakes or submerges the issue of contributed assets prior to establishing a starting regulatory value.

3.43 The contributed assets issue is a significant one that will have to be resolved with the NWC, either on the basis of the (albeit suspect) New South Wales and Victorian 'line in the sand' precedent or by negotiation of a contributed assets amount.

Three Illustrative Examples of Urban Water and Wastewater Charges

3.44 Example 1 – low contributed assets (eg, $220m including post-1995 contributed assets only).

3.45 Example 2 – high contributed assets (eg, $830m including pre-1995 contributed assets).

3.46 Example 3 – based on an equivalent to the 'line in the sand / reverse engineering' precedent in New South Wales and Victoria.

3.47 Table 2 shows the percentage and $ impact on charges for various contributed asset estimates.

Table 2: Indicative Impacts of Achieving the Upper Revenue Bound

	Indicative One off Real increases	Average Residential Increase / Decrease** $	Revenue Impact $m
1. Low Contributed Assets $220m			
Wastewater	-11%	-51	-30
Water	20%	69	+60
Total		18#	30
2. High Contributed Assets $830m			
Wastewater	-21%	-97	-55
Water	14%	48	+45
Total		-48#	-10
3. Line in the Sand Equivalent*			
Wastewater	-7%	-34	-20
Water	23%	79	+70
Total		45#	+50

*eventual impact in the very long term when SA Water has funded the replacement of initially contributed assets
**based on (a) water: 250kL pa usage and (b) wastewater: metropolitan house value of $300,000
for Adelaide metropolitan customers receiving water supply and wastewater services

3.48 The examples outlined allow a buffer between actual water revenues and the upper revenue bound of up to $8m pa and a buffer between actual wastewater revenues and the upper revenue bound of up to $5m pa. Unforeseen events could increase revenues or reduce costs, taking actual revenues over the upper revenue bound. This would be a monopoly pricing outcome under the CoAG pricing principles and should be avoided.

Example 1

3.49 This example adopts the current contributed assets value of $220m. The net revenue impact is positive, estimated at around $30m pa.

Example 2

3.50 This example would substantially increase the value of contributed assets to $830m.

3.51 The negative net revenue impact could be reduced with a lower buffer. For an average residential customer in the metropolitan area, the reduction in wastewater charges would be greater than the increase in water charges, compared with Example 1.

3.52 Even though the adjustments between water and wastewater charges are large, there would be no net revenue increase.

Example 3

3.53 This example has an eventual net revenue impact of $50m pa. It applies the full logic of the 'line in the sand' approach to both water and wastewater, in so far as current revenue levels are to be regarded as consistent with the upper revenue bound.

3.54 Under this approach, there would be a very long (up to 100 years) and very mild adjustment of revenues and charges to the 6% return on assets target. In effect, the upper revenue bound would be adjusted so that it is based on a 6% return on all *new* assets, but current 4% and 7% returns on *existing* metropolitan water and wastewater assets, respectively, would be retained, or 'grandfathered'. As a result, there would be no disparity between the upper revenue bound and actual revenues. Both would adjust together very slowly over a long period towards the 6% target. This is the essence of the 'line in the sand / reverse engineering' approach, albeit not normally deployed to lock in above target rates of return.

Customer Incidence Impacts

3.55 The examples outlined above involve significant changes and would have significant impacts on consumers.

3.56 Minimising customer incidence impacts will be difficult, even if wastewater charges are reduced, as water charges are based on a flat supply charge plus a volumetric usage charge, while wastewater charges are based on property values. Owners of low value residential properties might be relatively disadvantaged.

3.57 In terms of regional impacts, under Statewide uniform pricing all SA Water customers are affected. Further, around 140,000 SA Water customers receive and pay for water services but not wastewater (mostly in the country). These customers would be charged the same water charge increases as metropolitan customers, but would not receive any 'offsetting' impact from lower wastewater charges.

3.58 Of all the examples, example **3** has the least immediate customer incidence impacts. Very small adjustments could be merged with the impacts on charges of any increased capital and operating expenditures (eg, arising from the implementation of Waterproofing Adelaide).

3.59 This approach might not, however, achieve acceptance by the NWC, particularly in respect of limiting falls in wastewater charges.

3.60 There are numerous ways of achieving increases in water charges. The customer incidence impacts would depend on exactly how the revenue increases were achieved. Careful design of the adjustments would mitigate some, but not all, impacts.

3.61 The customer incidence and budget impacts will be important for the South Australian Housing Trust. The pensioner concession may also need to be adjusted.

3.62 The further development of options for meeting NWI obligations will entail full consideration of customer incidence impacts.

Transition Periods

3.63 Transition periods are important in terms of annual real increases and budget impacts. The possible scenarios, in Table **3** below, are developed on the examples shown in Table 2.

Table 3: Indicative transition period scenarios for changes in water and wastewater charges (for the examples shown in Table 2)*

Charges	Real increase / decrease % pa	Phase in Period Years	Revenue Increase by 2009-10 (ie, by end of current forward estimates period) $m pa (2006-07 prices)
Example 1			
Scenario (a)			
Wastewater	-1.0	12	-7.8
Water	1.5	12	14.4
Total			**6.6**
Scenario (b)			
Wastewater	-2.5	5	-19.3
Water	3.0	**6**	29.3
Total			10.0
Example 2			
Scenario (a)			
Wastewater	-4.5	5	-34.0
Water	2.75	5	26.8
Total			-7.2
Scenario (b)			
Wastewater	-2.5	10	-19.3
Water	1.25	10	12.0
Total			**-7.3**
Example 3			
Wastewater	-0.10	70+	-0.9
Water	0.30	70+	2.8
Total			1.9

*Note that estimates are subject to rounding

Timeframes

3.64 Every effort will be made to advise further detail on implementation of options, modelling, variables, customer incidence effects and budget impacts for reporting to Cabinet in the 2006-07 budget context.

3.65 If details are not finally resolved by then (which seems more likely), in principle Cabinet approval for adjusting water and wastewater charges would be sought within the 2006-07 Budget timeframe. Final decisions by Cabinet are required by end November 2006, which is the latest date for setting 2007-08 prices.

3.66 It is proposed that Treasury and Finance (consulting with SA Water as necessary) works on options, modelling, variables, customer incidence effects and budget impacts.

3.67 Given the sensitivity of potentially large increases in water charges, it would be inappropriate to consult widely with other agencies during the first phase of development of options. Once options and impacts are more advanced for inclusion in a Cabinet Submission, it would be intended to consult with other agencies.

Other related matters

3.68 ESCOSA would continue to review price setting processes as required by the NWI (Clause 77) and, as in the past, a Transparency Statement would be prepared for ESCOSA's consideration.

3.69 Previously when setting water and wastewater prices, Cabinet has first approved the adoption of specific processes (submitted by the Treasurer), and a proposal for a price-setting methodology (submitted by the Minister for SA Water).

3.70 On this occasion there are substantive policy matters impacting on charges, such that Cabinet approval is first required to develop new options.

3.71 When recommendations are submitted to Cabinet on 2007-08 charges, there will be full reporting within the context of the CoAG pricing principles and the regulatory model, as on previous occasions.

3.72 The matters submitted to Cabinet and the details of Cabinet's decision would, ultimately, be reported in a Transparency Statement, as on previous occasions. Given the very tight timeframes, preparation of the Transparency Statement may be subsequent to Cabinet's pricing decision, rather than at the same time as that decision. As long as there is sufficient advice to Cabinet on the CoAG pricing principles and the regulatory model when reaching its pricing decision, there would be no loss in rigour. This change of approach would need to be carefully managed with ESCOSA.

3.73 Apart from reporting on pricing, the Transparency Statement would also need to address other non-pricing matters raised by the NWC in its 2005 NCR Assessment Report (eg, further reporting of Community Service Obligations) and commitments made in previous Transparency Statements.

3.74 This Cabinet Submission will not be made available to ESCOSA when it undertakes its review of price setting processes.

3.74.1 Economic, financial and budgetary implications

The various NWI obligations with respect to urban water pricing, particularly the requirement to move towards upper revenue bound pricing, may have substantive economic, financial and budget effects. These implications will be further explored in the development of options for Cabinet's consideration within 2006-07 budget timeframes to the extent possible.

3.74.2 Required resources

Nil additional resources for the implementation of recommendations in this submission. Any increased costs from implementing these recommendations will be met from within existing budgets.

3.74.3 South Australia's Strategic Plan

Appropriate water and sewerage pricing supports the priority action of South Australia's Strategic Plan to 'maintain a responsible budget strategy and target spending to areas of greatest need and / or benefit to the community.

3.74.4 Information and Communication Technology Requirements

Nil for the implementation of recommendations in this submission.

3.74.5 Staffing implications

Nil for the implementation of recommendations in this submission.

3.74.6 Impact on the community and the environment

Community and environmental impacts will be further explored in the development of options for Cabinet's consideration.

3.74.7 Risk Management Strategy

The consequences of non compliance with NWI obligations on the upper revenue bound, or a degree of shortfall in compliance in moving towards the upper revenue bound, should be considered.
Although there are no direct penalties under the NWI for non compliance, the State's ability to access funding from the $2b Australian Water Fund may be restricted. In this regard, it is understood the NWC has proposed to the Prime Minister $12.970m funding for the implementation of the NWI in South Australia, which funding would be tied to a number of conditions, including that the NWC must be satisfied that South Australia is '*making sufficient progress on the NWI requirements for reform of water pricing*'.
Also important is the Government's timely adherence to its commitments to the NWI which Initiative is in the State's long term interest.
There would be potential for criticism if there were a substantial increase in water charges. The response would need to set out the justification for any increase in terms of broader policy objectives.

3.74.8 Consultation

Given the sensitivity of potentially large increases in water charges, circulation of this submission has been limited to Treasury and Finance, SA Water and the Department for Water, Land and Biodiversity Conservation.

3.74.9 Implementation Plan

The matters raised in this submission will be further explored in the development of options for Cabinet's consideration within 2006-07 budget timeframes to the extent possible.

3.74.10 Communication Strategy

Confidential and should remain internal to Government at this stage.

3.74.11 Executive Council

Consideration in Executive Council is not required.

3.75 Conclusions

3.75.1 Longer term resource constraints almost certainly require real increases in the price of water. The NWI requirements provide the opportunity to do this under the banner of a national policy. The same policy would require some decrease in wastewater prices.

3.75.2 Additionally, water charges may have to increase on account of:

(a) a separate NWI requirement to recover water planning and resource management costs from water extractors (SA Water and irrigators), to an estimated maximum for SA Water of $5m pa; and

(b) at a later time, recovery of costs (including a return on investment) of implementing Waterproofing Adelaide initiatives.

3.75.3 Cabinet needs to decide on its willingness to see SA Water water prices rise and over what period. This will then underpin discussions with the NWC in regard to asset valuations and transition periods. There is a longer term need for water charges to rise. An increase in the volumetric water usage charge is indicated by the fact that the long run avoidable cost of supplying an incremental unit of water has been greatly increased with Waterproofing Adelaide initiatives as the source of additional future supply, rather than purchase of extraction entitlements from the River Murray. Some increase could be justified by NWC requirements in respect of moving towards the upper revenue bound, which potentially gives rise to a net revenue benefit.

3.75.4 In order to provide some guidance for discussions by officials with the NWC, Cabinet could endorse the following:

NWC requirements should desirably not result in the State needing to increase water prices by more than 20% in real terms over 5 years. The implications for wastewater prices should be little or no increase in nominal prices.

Discussions by officials would not commit the State to any course of action but the intention would be to encourage the NWC to reach a position consistent with Cabinet's guidance.

4 RECOMMENDATIONS

It is recommended that Cabinet:

4.1 endorse the guidance set out in paragraph **3**.75.4, viz:

National Water Commission requirements should desirably not result in the **S**tate needing to increase water prices by more than 20% in real terms over 5 years.

4.2 note that it may be possible to reach agreement with the National Water Commission on strategies that involve either a net increase or net reduction in total water and wastewater revenues but still meet National Water Initiative "upper bound pricing" obligations;

4.3 authorise the **D**epartment of Treasury and Finance (involving consultation with the **D**epartment of Water, Land and Biodiversity Conservation) to meet with the National Water Commission to discuss acceptable positions on:

- asset valuation, including contributed assets and the scope for maximum allowable revenue to include a provision for a management fee or risk premium for those contributed assets; and
- transition periods.

4.4 note that a further Cabinet **S**ubmission outlining detailed options will be prepared based on the outcome of those discussions.

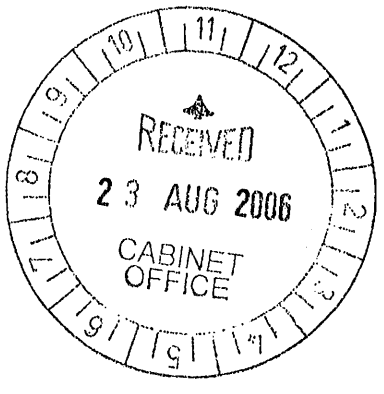
Kevin Foley MP
DEPUTY PREMIER
TREASURER

22 / 8 / 2006

In Cabinet

28 AUG 2006

APPROVED
PREMIER



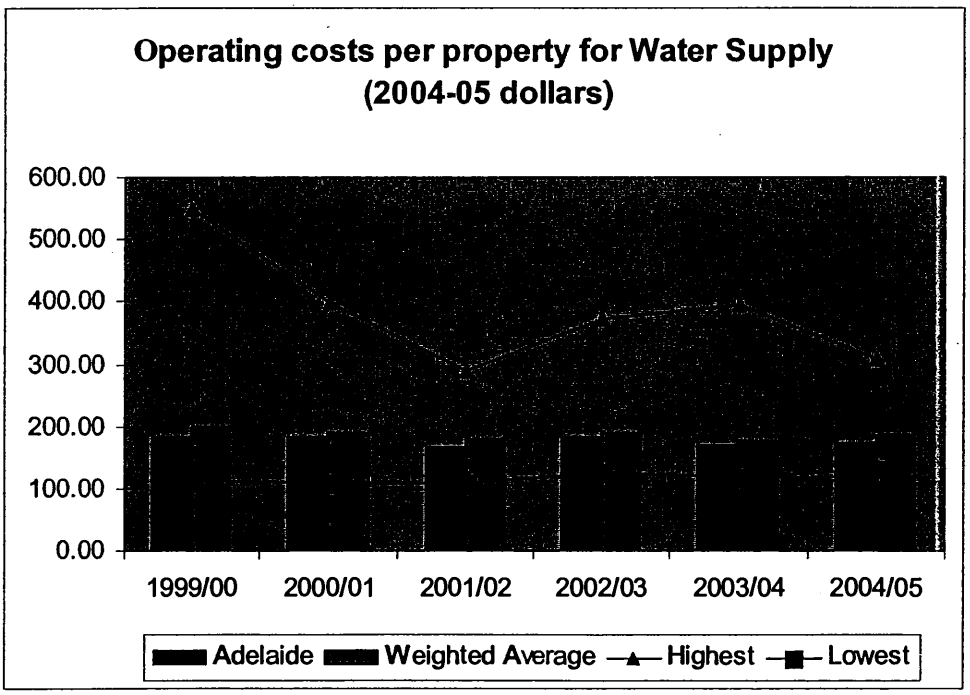
ATTACHMENT COST, REVENUE AND PRICE BENCHMARKS

1. OPERATING COST PER PROPERTY – WATER SUPPLY

Operating cost per property for water supply services (2004-05 dollars)

	1999/00	2000/01	2001/02	2002/03	2003/04	2004/05
Canberra	208.02	230.44	266.94	270.47	291.08	297.85
Brisbane	205.43	208.69	221.51	197.88	196.15	210.58
Gold Coast	121.79	118.54	125.90	167.28	183.77	155.23
Hunter	184.12	179.57	190.50	195.02	156.11	161.69
Melbourne	111.33	108.28	110.54	124.20	119.18	131.11
Darwin	548.02	399.37	289.97	370.61	393.90	307.05
Adelaide	182.36	181.56	167.51	183.12	169.77	172.02
Sydney	295.62	277.54	239.90	250.64	221.17	230.05
Perth	161.28	156.66	157.44	152.50	161.04	172.90
Weighted Average	198.72	190.80	180.25	188.82	177.47	184.88

Note: A weighted average has been used to recognise the substantially different number of properties served in each city eg Darwin has substantially higher costs that the other cities but has little impact on the weighted average given its size.

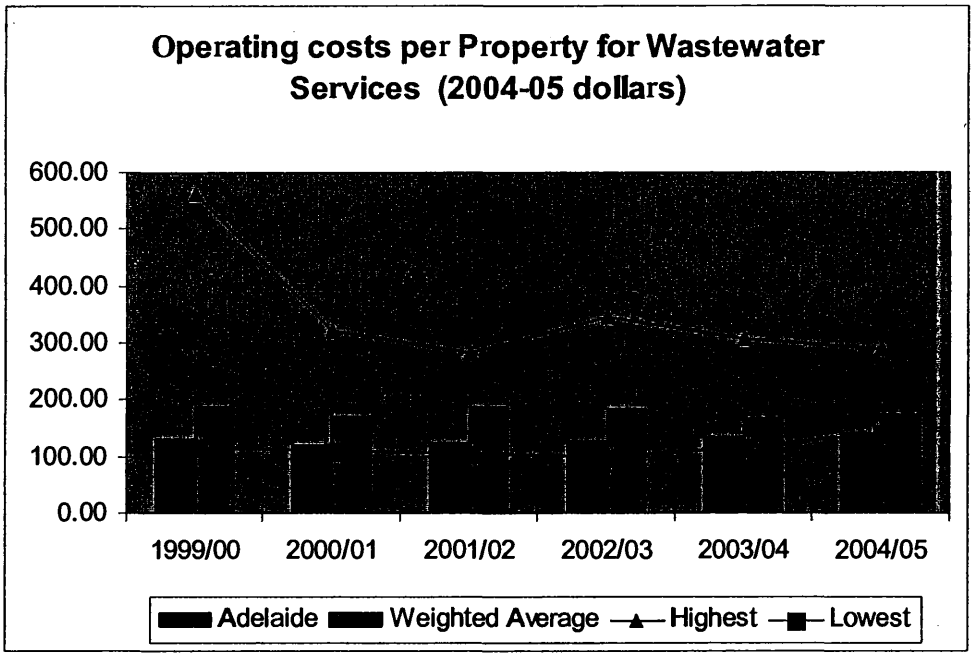


2. OPERATING COST PER PROPERTY- WASTEWATER SERVICES.

Operating cost per property for wastewater services (2004-05 dollars)

	1999/00	2000/01	2001/02	2002/03	2003/04	2004/05
Canberra	244.22	247.90	262.18	267.56	277.45	270.18
Brisbane	157.54	139.86	186.57	196.53	169.26	160.39
Gold Coast Water	173.48	176.01	176.17	183.00	201.98	196.01
Hunter	158.82	149.30	183.59	181.87	157.61	155.49
Melbourne	115.03	109.40	107.47	99.61	117.41	141.94
Darwin	562.12	322.92	280.81	347.41	305.57	291.14
Adelaide	132.32	120.16	124.84	126.50	134.94	142.63
Sydney	275.73	244.23	283.72	272.89	198.95	199.14
Perth	161.19	148.61	147.25	150.80	166.59	172.34
Weighted Average	188.14	170.41	188.25	184.57	165.46	172.44

Note: A weighted average has been used to recognise the substantially different number of properties served in each city eg Darwin has substantially higher costs that the other cities but has little impact on the weighted average given its size.

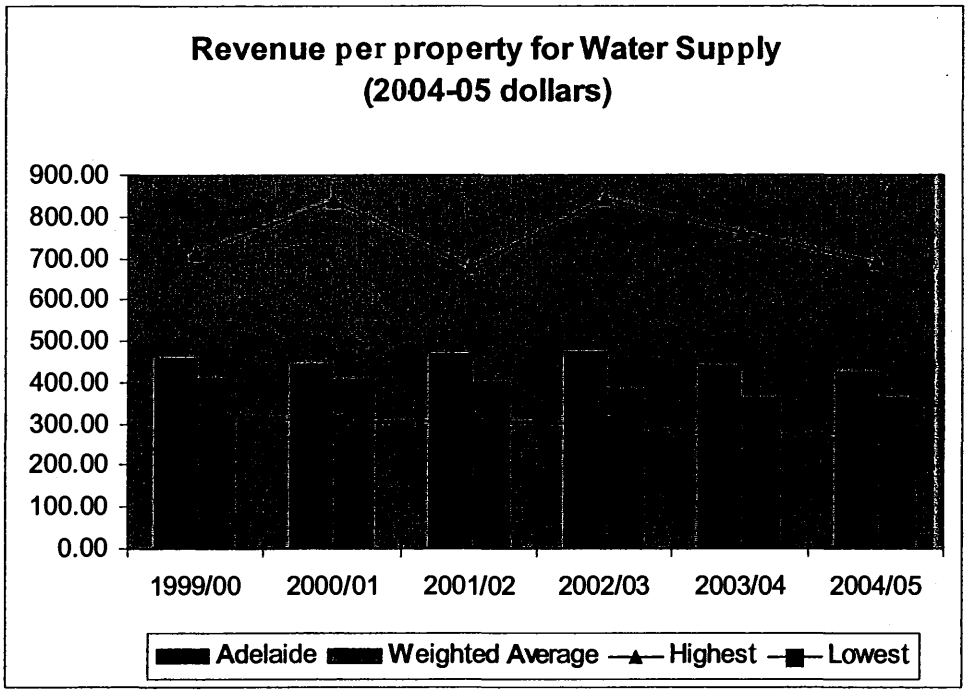


3. REVENUE PER PROPERTY FOR WATER SUPPLY SERVICES

Revenue per Property for Water Supply Services (2004-05 dollars)

	1999/00	2000/01	2001/02	2002/03	2003/04	2004/05
Canberra	446.77	502.57	523.99	530.44	475.95	482.01
Brisbane	467.86	516.49	462.51	443.17	421.43	437.48
Gold Coast	402.11	416.23	496.66	394.49	405.54	451.10
Hunter	343.94	329.41	311.07	331.67	312.57	297.04
Melbourne	327.40	304.14	308.58	297.40	270.58	281.18
Darwin	710.52	836.77	676.90	840.40	758.24	688.81
Adelaide	457.32	440.44	465.27	472.17	438.26	424.10
Sydney	425.93	414.48	426.72	404.37	360.72	348.52
Perth	488.14	474.30	410.59	366.52	413.63	409.70
Weighted Average	410.22	402.58	400.51	382.32	359.30	358.56

Note: A weighted average has been used to recognise the substantially different number of properties served in each city eg Darwin has substantially higher revenues that the other cities but has little impact on the weighted average given its size.

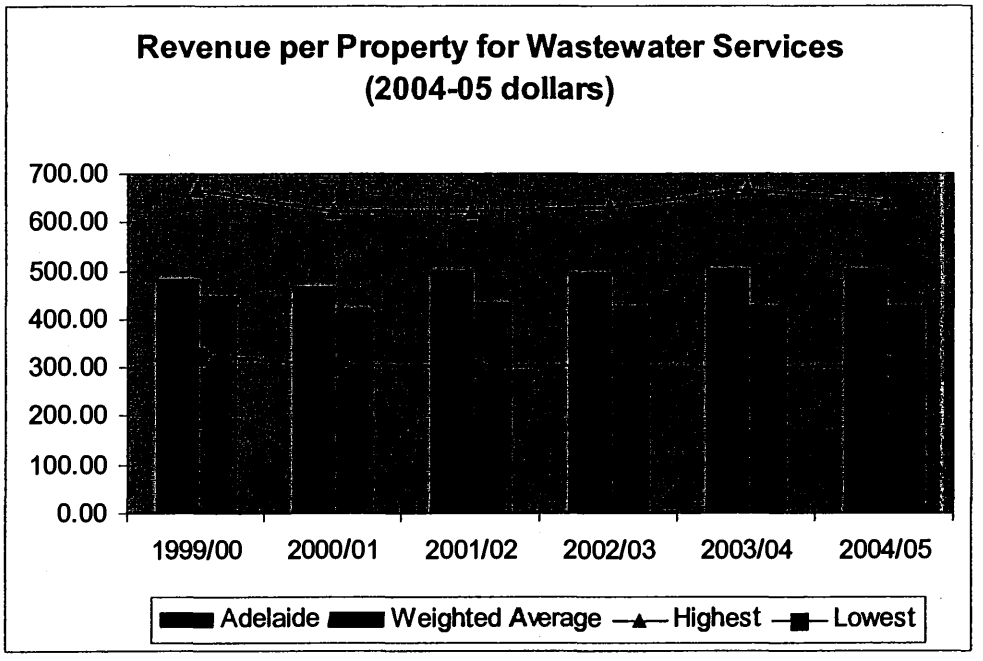


4. REVENUE PER PROPERTY FOR WASTEWATER SERVICES

Revenue per Property for Wastewater Services (2004-05 dollars)

	1999/00	2000/01	2001/02	2002/03	2003/04	2004/05
Canberra	518.40	485.16	478.62	483.39	487.39	506.60
Brisbane	480.22	514.78	489.47	489.95	493.76	485.78
Gold Coast Water	501.43	516.41	542.97	520.66	513.28	546.56
Hunter	323.76	303.33	301.32	305.27	306.18	303.80
Melbourne	336.23	315.29	310.31	309.27	295.81	307.17
Darwin	473.48	463.72	363.21	575.06	403.43	399.24
Adelaide	482.27	465.83	499.08	495.35	500.42	502.77
Sydney	455.40	411.42	439.27	418.53	415.58	412.91
Perth	666.19	620.48	621.32	631.76	666.31	643.50
Weighted Average	446.40	421.64	430.93	426.01	424.42	425.71

Note: A weighted average has been used to recognise the substantially different number of properties served in each city

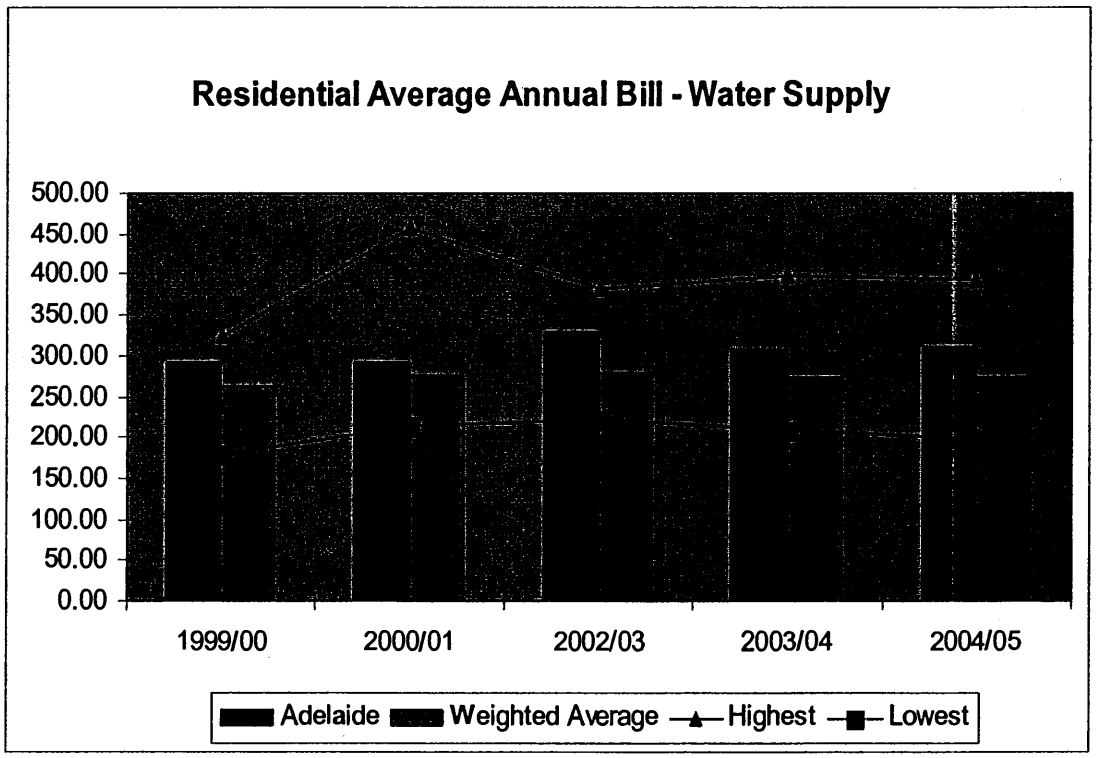


5. RESIDENTIAL AVERAGE ANNUAL BILL – WATER SUPPLY

Residential Average Annual Water Bill

	1999/00	2000/01	2001/02	2002/03	2003/04	2004/05
Canberra	266.02	245.00		284.60	276.75	311.50
Brisbane	280.60	318.15		313.00	316.72	329.46
Gold Coast	259.00	284.40		300.40	311.53	360.80
Hunter	177.85	213.16		233.68	228.41	197.04
Melbourne	215.93	243.55		220.65	209.54	203.23
Darwin	323.48	456.00		381.75	399.05	298.35
Adelaide	291.08	291.00		329.38	307.50	309.30
Sydney	284.62	293.66		310.55	293.95	291.36
Perth	294.25	284.20		276.35	302.39	298.35
Weighted Average	261.31	276.37		279.40	272.47	271.20

Note: WSAA did not produce data for the 2001-2002 year

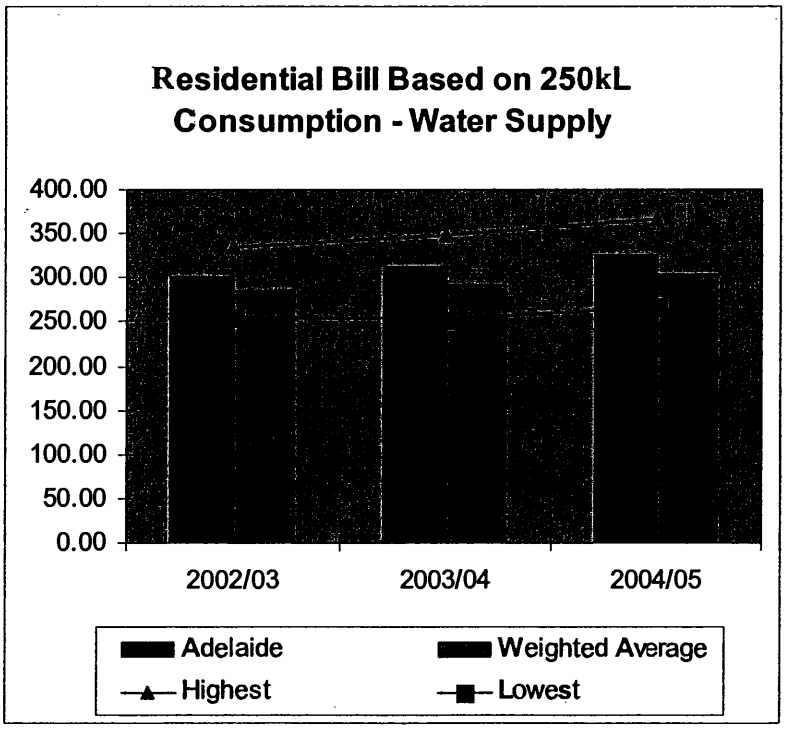


6. RESIDENTIAL BILL BASED ON 250kL CONSUMPTION – WATER SUPPLY

Annual Water Bill based on 250kL consumption

	2001/02	2002/03	2003/04	2004/05
Canberra		255.50	279.00	276.50
Brisbane		305.00	310.00	317.50
Gold Coast Water		335.50	348.00	366.50
Hunter		261.30	271.05	277.87
Melbourne		254.31	253.37	266.48
Darwin		272.24	272.24	278.80
Adelaide		301.00	312.50	324.75
Sydney		310.03	338.54	330.87
Perth		269.85	278.80	278.80
Weighted Average		285.54	298.15	302.09

Note: WSAA (Water Services Association of Australia) did not produce data for the 2001-2002 year. Furthermore, for the years 1999/00 and 2000/01 WSAA's figures were based on consumption of 200kL and are therefore not comparable to the subsequent years' figures.



7. RESIDENTIAL AVERAGE ANNUAL BILL – WASTEWATER

Residential Average Annual Wastewater Bill

	1999/00	2000/01	2001/02	2002/03	2003/04	2004/05
Canberra	310.50	317.60		339.20	354.20	375.32
Brisbane	243.80	273.04		315.00	340.00	347.80
Gold Coast Water	359.00	374.00		393.00	401.00	413.20
Hunter	230.42	230.13		247.19	254.25	260.14
Melbourne	224.74	236.60		229.77	233.15	236.94
Darwin	285.00	299.25		322.06	322.06	443.47
Adelaide	325.19	331.21		363.54	379.53	390.77
Sydney	284.75	301.44		328.36	338.54	346.66
Perth	382.95	400.00		242.87	441.16	443.47
Weighted Average	279.96	294.45		292.79	323.08	331.03

Note: WSAA did not produce data for the 2001-2002 year