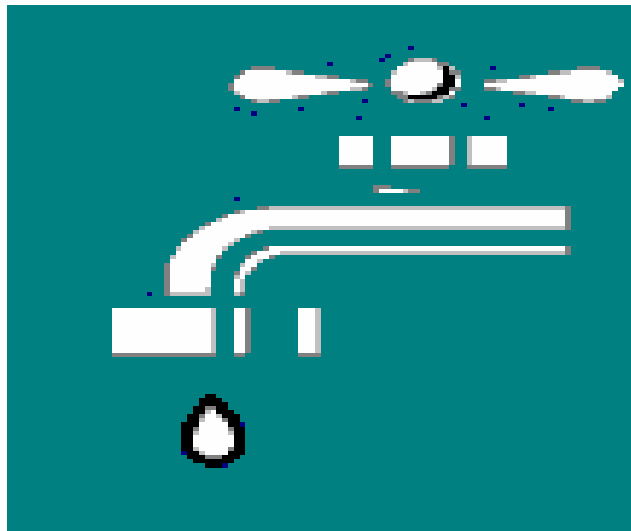




INDEPENDENT CONSUMER & COMPETITION COMMISSION

REVIEW OF EDA RANU'S CURRENT PRICING
ARRANGEMENT

DRAFT REPORT



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16th November 2007

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PREFACE

The Minister for Treasury has on the 3rd of July 2007 lodged an application with the Independent Consumer & Competition Commission (“Commission”) pursuant to Section 25A(2) of the *Prices Regulations Act* (hereinafter called the “PR Act”) to review Eda Ranu’s current pricing arrangement with a particular focus on the capital expenditure requirements which Eda Ranu committed to undertake between the period of the current price path, being from 2005 to 2009.

The Commission is undertaking this review in accordance with Sections 25B and 25C of the PR Act. These sections mandate the Commission to undertake this review in an open and transparent manner which will involve a wider stakeholder and public consultation prior to making any determination on the current pricing arrangements going forward. As part of this stakeholder consultation process, the Commission released an Issues Paper on the 8th August 2007 detailing the various issues of relevance on which submissions and comments were invited from the industry stakeholders and other interested parties. A schedule of those respondents who provided submissions is set out in Appendix C of this Draft Report.

It is also important to state at the outset that this Review is not intended to be an ‘opening-up’ or a comprehensive review of the current price path of Eda Ranu, but more focused towards a revisitation of the capital expenditure aspects of the current price path. In that regard, the Commission’s primary focus on this review which is reflected in this Draft Report (“Draft Report”) is focussed on the commitments made by Eda Ranu in 2004 in respect to the amount of capital expenditure (and more particularly those relating to the Port Moresby Sewerage Upgrading Project) which it committed to undertake within the period of the price path. Under the current pricing arrangements, this proposed capital expenditure has been factored into the price path in order to allow Eda Ranu to recoup its cost of depreciation whilst concurrently realising an appropriate return of these proposed capital investments. While the additional revenue associated with the Sewerage Upgrading Project has been received, the capital expenditure has not yet commenced. This is one reason for the application for review from the Minister of Treasury to the Commission.

The price path methodology used by the Commission was based on a penalty/incentive arrangement and the reason for the Commission to adopt such an approach to include the future capital expenditure commitments in the pricing arrangement was to provide Eda Ranu with the incentives to invest into its water and sewerage networks. These incentives over time will result in efficient infrastructure investments which will in turn result in water and sewerage prices which are reflective of the efficient costs incurred in the provision of reticulated water and sewerage services in Port Moresby going forward.

Eda Ranu has responded to the Commission by providing certain information on this matter and these are further discussed in this Draft Report including comments and submissions received from other stakeholders and interested parties. In addition, the Commission takes the opportunity to publish a Section 20A notice outlining the draft Prices Order which would result should the recommendations of this Draft Report be adopted.

I take this opportunity to urge all stakeholders including members of the public as well as the rate payers of Port Moresby to make comments and submissions on this Draft Report and to further participate in the remaining stages of this important Review. The Commission will release the Final Report which will, among other things, detail the final pricing arrangements that will apply to Eda Ranu for the remaining period of the price path going forward after thoroughly assessing the comments and submissions made to this Draft Report and on the draft Prices Order.

Submissions to the Commission will be available for public inspection unless the Commission agrees that all or part of the submission should remain confidential. However, in accordance with the applicable provisions of the PR Act, the Commission intends to make the Review process as transparent as possible and to this end, submissions would normally be available for public inspection unless there are exceptional commercial-in-confidence reasons why submissions should be held in confidence.

Submissions to the Draft Report should be received by 26th November 2007 and should be directed to:

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All enquiries relating to any aspects of this Draft Report including the overall Review should be addressed to:

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Finally, copies of the Draft Report are available at the Commission's office at 1st Floor, Garden City Complex, Angau Drive, Boroko. Electronic copies can be obtained through the Commission's website at www.iccc.gov.pg or by emailing the email address stated above.

Thomas Abe
Commissioner & Chief Executive Officer
16th November 2007

1. EXECUTIVE SUMMARY

This Review has been undertaken by the Commission in accordance with the provisions of Section 25 of the PR Act pursuant to a formal application lodged by the Minister for Treasury under the applicable provisions of the said Act.

This executive summary sets out to provide an overview of the Commission's key findings and its draft recommendations that will apply to the pricing arrangements of Eda Ranu going forward till 2009. These key findings and recommendations are based on the submissions and comments received by the Commission as part of the stakeholder consultation process to date, including the publication of an Issues Paper dated 7th August 2007.

1.1 Key Findings

In terms of the sewerage infrastructure, Eda Ranu, under the existing price path, was to have incurred K252 million as its capital expenditure on its sewerage infrastructure over the period of the price path (from 2005 to 2009). The Commission made the assumption that this expenditure would occur uniformly over the five year regulatory period. However, the Review has established that Eda Ranu has not incurred the capital expenditure it committed to undertake on its sewerage and water infrastructure over the last 2 and half years from 2005 to June 2007. The Commission notes that Eda Ranu has only incurred about K2.3 million as at the date of this Report which is about 0.8% of the total capital expenditure earmarked to be undertaken by Eda Ranu.

Notwithstanding the above, the Review has also established that Eda Ranu is moving forward to implement the project, and that there were certain factors that affected Eda Ranu's ability to incur the capital expenditure which were outside Eda Ranu's immediate control. A major factor being the delay in the government's negotiation for the securing of an external concessional loan which constitutes a significant proportion of the up-front capital expenditure earmarked to be undertaken.

The Commission therefore considers it appropriate that certain changes within the price path including the respective tariffs will need to be made in order to reflect the current circumstances and to ensure that there is a balance between the commercial objectives of Eda Ranu and the welfare of the consumers of water and sewerage services in Port Moresby. This is detailed in the Commission's draft recommendation set out below.

1.2 Key Draft Determination

For this draft determination, the Commission has adopted the recommendation developed within the Commission, that Eda Ranu's tariffs be reduced such that they be adjusted annually over the last two years of the regulatory period based on CPI-2.5% in line with the considerations outlined in option D of this draft determination. The resulting potential reduction in Eda Ranu's revenue and ultimately profit levels will need to be managed by two operational measures which are within the control of Eda Ranu. These measures are:

- A reduction of costs (the forecast costs in these remaining two years of this regulatory period are still likely to be above the ramp-up capital expenditure costs, once project financing is completed, and there are remaining opportunities to have operational & maintenance expenditure outcomes below those forecast for the price path); and
- An increase in the revenue collected by Eda Ranu (which can be achieved through reducing revenue leakage from "losses" including reduction in un-metered delivery, better billing collection and through reduction in physical water loss).

As such Eda Ranu's future prices for water and sewerage services for the remaining two years of the regulatory period will be determined by movement in the CPI (excluding bettlenut, tobacco and alcoholic beverages) and the X factor of -2.5%.

2. INTRODUCTION & BACKGROUND

2.1 Overview of Commission & Legislative Arrangements

The Commission is a statutory body, established under the provisions of the *Independent Consumer and Competition Commission Act 2002* (“ICCC Act”), which has been given responsibility for the promotion of competition and fair trading, the regulation of prices for certain goods and services, and the protection of consumers’ interests and other related purposes.

The Commission is also responsible for the administration of the Prices Regulation Act (“PR Act”) relating to the price regulation of certain goods and services declared by the Minister for Treasury for the purposes this Act. As part of the economic regulatory reforms undertaken in 2002, certain amendments were made to the PR Act which saw the inclusion of certain provisions that effectively allowed for the review into the pricing aspects of certain goods or services declared under this Act. The Commission as the authorised regulatory body can undertake such a review on its own volition or upon any written request from the Minister responsible for the Act, or the supplier of the declared good or service concerned.

The Commission is undertaking this review in accordance with the amended provisions of the PR Act, having regard to the following:

- Sections 10, 20A & 20B and 25A, 25B & 25C of the amended PR Act; and
- Confidentiality and public disclosure provisions of the PR Act relating to information received from stakeholders and other interested parties.

The appropriate provisions of the PR Act are attached as Appendix B to this Draft Report.

2.2 Overview of Review

2.2.1 Background

Water and Sewerage services are among the list of goods and services declared for the purposes of price regulation. The Commission in 2004 undertook a comprehensive review into the pricing arrangements of water and sewerage services provided by PNG Waterboard and Eda Ranu. In its final determination, the Commission, amongst other things, structured a price path for Eda Ranu, which was intended to allow Eda Ranu to recover its efficient costs to meet its cost of capital and the cost of depreciation. The Commission’s final determination, inclusive of the price path, was to be applied over a five (5) year regulatory period commencing 1st January 2005 and ending on 31st December 2009.

2.2.2 Minister's Application

On the 3rd July 2007, the Minister for Treasury, who is the Minister responsible for the PR Act, formally lodged an application with the Commission to review Eda Ranu's current pricing arrangements. The Minister's application contends that Eda Ranu has not incurred the necessary capital expenditure it committed to undertake for the last two and half years since the inception of the current pricing arrangements. The Minister's application is more focused on the capital expenditure Eda Ranu earmarked to be undertaken for the purposes of the Port Moresby Sewerage System Upgrading Project ("PSSUP"). Accordingly, the Minister submits that the current pricing arrangements will have to be reviewed by the Commission with a view towards a downward adjustment in the annual allowable revenues including the subsequent impact on customer tariffs to reflect Eda Ranu's failure in incurring this capital expenditure in line with the original forecasts.

2.2.3 Purpose of this Review

Consistent with the initial application from the Minister, the principal objectives of the Review are to:

- Review and identify Eda Ranu's capital expenditure and other capital works undertaken by Eda Ranu to date since 2005;
- Assess and establish whether the forward capital expenditure detailed under the current price path of Eda Ranu has been incurred or otherwise including its proposed capital expenditure (if any) for the remaining period of the current price path; and
- Make appropriate determination as to whether the current capital expenditure detailed in the current price path including the overall pricing arrangement be continued, varied, or terminated for the remaining period of the price path including its subsequent tariffs going forward.

2.2.4 Format of this Review

The format in which this Review has been undertaken is structured to be as open and transparent as much as possible consistent with the applicable provisions of the PR Act relating to the conduct of such Reviews.

As part of this process the Commission has already made a public announcement regarding the commencement of the review and further released an Issues Paper on the 8th August 2007 outlining the key issues that will be considered as part of the Review process. This Draft Report is based on comments and submissions received on the Issues Paper as well as comments received from stakeholder meetings and other relevant information independently gathered by the Commission. This Draft Report

and a Notice of a draft Prices Order, based on the recommendations in this Draft Report are released for comments and submissions from stakeholders and interested parties on which the Final Report and a final Prices Order will be based and released accordingly.

2.2.5 Timeframe of this Review

Pursuant to Section 25C of the PR Act, the Commission is allowed a period of 90 days from the date of the receipt of the application to complete the Review. The application from the Minister for Treasury was lodged with the Commission on the 3rd July 2007, therefore the 90 day period would lapse on the 1st October 2007. However, in view of a request by Eda Ranu and to give ample time for other interested persons or parties to contribute to this review, the Commission under Section 25C(2) of the PR Act sought an additional 30 days extension of the review period which has accordingly extended the review period up to 31st October 2007. As a requirement of the relevant legislative provision, the statutory instrument for extension is published in the National Gazette No. G140 of 6th September 2007. Another extension was made and sought on the 25th October 2007 and published in the National Gazette No. G165. Such extension was considered necessary in order to enable the Commission to fully assess the submissions including the assessment of the various options available to be adopted by the Commission relating to the current price path going forward.

The revised timeframe for the Review is as follows:

Events	Timeframe
Release of Draft Report & Notice of draft Prices Order	16 th November 2007
Deadline for Submissions to the Draft Report & draft Prices Order	26 th November 2007
Release of Final Report & final Prices Order	30 th November 2007

The Commission may seek further extension to the dates detailed above as and when necessary and appropriate, however in the meantime, the Commission will work towards the deadlines and deliverables set out in the table above.

3. EDA RANU'S CAPITAL EXPENDITURE COMMITMENTS

3.1 Current Capital Expenditure Commitments

Consistent with the Commission's Final Report of the 2004 water and sewerage industry review ("2004 Review"), Eda Ranu has agreed to undertake certain capital works over the period of the price path (2005-2009) which includes forward estimates of capital expenditure on both its water and sewerage infrastructure in Port Moresby. As part of its commitment, Eda Ranu committed to undertake an upgrading of its sewerage infrastructure to the value of K245 million within the five year regulatory period. In addition to the major sewerage upgrading, Eda Ranu also planned to undertake sewer extensions on rateable land and sewerage lagoons amounting to the value of K7 million.

In the Commission's final determination in the 2004 Review, the amount of K245 million was combined with K7 million and was spread out in equal instalments of K50.4 million on an annual basis over the five year regulatory period. Such was considered necessary by the Commission in order to avoid price shocks in any one particular year, even when the expenditure amount was lumped into one year or major instalments occurred in any two or more years within that period. Further details of the capital expenditure programs committed by Eda Ranu to be undertaken as part of its pricing arrangements are set out below under water and sewerage.

3.1.1 Water

From the 2004 Final Report, Eda Ranu identified five capital works projects for its water infrastructure. This represented about 18% of its total capital expenditure program. These projects which were planned to be completed over the regulatory period to maintain and improve its water network are set out in the table below together with the projected costs:

Table 1 - Capital Works project for Water

Project Description	Project Costs (Kina million)
Bulk meter & measuring point chambers in network	0.40
Trunk main valve replacement of network	0.525
New pipeline extensions of network	0.50
Touguba pump station pump replacement (new pump house & rising main)	0.43
Marine line to Napa Napa oil refinery	1.0
Balance of works under BOT contract (raw water main, treatment plant upgrade, distribution trunk mains laying, reservoirs pipe upgrade & telemetry)	50.0
Total	52.855

Source: ICCC Final Water Report, 2004 p36: Eda Ranu proposed capital expenditure program for water

3.1.2 Sewerage

Under its sewerage program, Eda Ranu identified four major projects, representing the remaining 82 percent of its total capital expenditure program to upgrade and improve the sewerage network. These are detailed in the table below together with the projected costs for each project:

Table 2 - Capital Works for sewerage

Project Description	Project Costs (Kina million)
Sewerage pump station perimeter fencing	0.15
Stanley Esplanade pump station upgrade	0.60
Network extension at Touguba & Ela Makana	0.60
Port Moresby sewerage upgrade project	245.00
Total	246.35

Source: ICCC Final Water Report, 2004 p36: Eda Ranu proposed capital expenditure program for sewerage

The Port Moresby Sewerage Upgrading Project (“PSSUP”) totalling an estimated K245 million is to a larger extent, the primary focus of this Review. Eda Ranu committed to undertake this expenditure on the PSSUP and therefore was factored into the current price path by the Commission in the 2004 Review. The table below shows the aggregate capital expenditure program as outlined in the current price path of Eda Ranu.

Table 3 - Aggregate Capital Expenditure Program

Year ending 31 December (nominal K'000)	2005	2006	2007	2008	2009
Commission’s Final Decisions on Eda Ranu’s capital expenditure review	56,600	56,440	56,440	56,440	56,440

Source: ICCC Final Water Report, 2004 p37: Eda Ranu capital expenditure program

Based on Table 2 and 3, Eda Ranu had committed to incur a total capital expenditure of K282.36 million on its sewerage infrastructure alone over the five year period, of which K245 million or about 87% of the total sewerage capital expenditure represents the capital expenditure to be incurred specifically on the PSSUP.

In the 2004 Review, the Commission used the above capital expenditure together with other financial information and developed a five year price path for Eda Ranu. The Commission allowed Eda Ranu to earn a Maximum Average Revenue (“MAR”) for both its water and sewerage services as a bundled service. Over the period of the price path, the Commission ensured that Eda Ranu’s MAR grew in line with the rise in the general price levels in the economy (as measured by the CPI) together with an efficiency factor to ensure that it recovers its cost of capital and depreciation incurred for the capital employed in its infrastructure. Some of this return on capital and depreciation relates to the new capital expenditures during the regulatory period, including the PSSUP.

In particular, the MAR for its water and sewerage services was to grow by CPI+11% and CPI+10% in 2005 and 2006 respectively and to subsequently grow by a further CPI+5% annually over the next three years till the end of 2009. These price directions would have allowed Eda Ranu to recover its efficient operating costs, to meet the costs of capital and recover the costs for depreciation.

3.1.3 Regulatory Asset Base (“RAB”)

The Regulated Asset Base (“RAB”) is the value of the asset base on which Eda Ranu’s pricing are determined by the Commission. In a sense it is the value of its asset base in which Eda Ranu receives a return on and of its capital employed in its business. The RAB is usually determined in a two step process. The first step involves the Commission determining the appropriate value of the opening RAB for Eda Ranu through the use of appropriate asset valuation methodologies. The second step requires the Commission to then roll forward the opening RAB for the subsequent years including the following:

- The forecasts of capital expenditure, to determine whether they are prudent and efficient, and hence can be included in the forecast capital base for the new regulated period; and
- Forecasts of depreciation, disposals, inflation and asset redundancy (if any) over the new regulation period.

Hence, based on the 2004 review, Eda Ranu’s initial and subsequent RAB are set out in Table 4 below:

Table 4 -Opening and subsequent Regulatory Asset Base

Year ending 31 December (nominal kina '000')	2005	2006	2007	2008	2009
Opening Value	20,734	80,167	143,230	210,303	281,624
Capital Expenditure/Addition (net of cap cons)	56,600	56,440	56,400	56,440	56,400
Disposals/assets written off	Nil	Nil	Nil	Nil	Nil
Depreciation	1,086	2,049	3,083	4,201	5,408
Indexation	3,923	8,671	13,716	19,082	24,787
Closing value	80,167	143,230	210,303	281,624	357,444

Source: ICCC Final Water Report, 2004 p43: Eda Ranu roll forward of initial RAB

Given that the annual capital expenditure commitments of Eda Ranu (and more particularly the PSSUP) constitutes a significant portion of the company's asset base, an adjustment of the capital expenditure value for the years 2007 to 2009 is likely to significantly impact upon the RAB value in the subsequent years. This will subsequently impact on Eda Ranu's MAR and its tariffs going forward. It will also have implications for the current project financing arrangements being negotiated for the PSSUP.

3.2 Actual Capital Expenditure Incurred

Eda Ranu submitted that while it has not commenced work on the PSSUP, it has already incurred some capital costs to date in relation to the project. These costs are detailed in the table below:

Table 5. Actual Capital Expenditure incurred

Actual Capital Expenditure incurred by Eda Ranu from January 2004 to July 2007					
Project Descriptions	Jan-Dec 2004	Jan-Dec 2004	Jan-Dec 2004	Jan-Dec 2004	Total <i>In Millions K</i>
Port Moresby sewerage system upgrade project	503,809.15	695,734.83	561,449.47	268,536.46	2,029,529.91
Prepaid Water meter Project			34,984.18	22,500.00	57,484.18
Water bottling Project			633,962.71	49,501.55	683,464.26
Trade Waste Policy Project				194,288.70	194,288.70
Lands and buildings	48,707.82				48,707.82
Motor vehicles	500,499.00	248,474.00	781,465.68		1,530,388.68
Plant and Equipment	141,398.73	129,206.61	657,359.52	221,047.72	1,149,012.58
Furniture and Fittings	15,436.36	68,412.74	8,532.95	18,187.85	110,569.90
Total (In millions kina)	1,209,801.06	1,141,828.18	2,677,754.51	774,062.28	8,803,446.03

Source: Eda Ranu's submission to page 2 of Issues Paper, 200. Table A

For the past regulatory period ending June 2007, Eda Ranu spent a total of K2.03 million for the PSSUP against the originally projected capex of K165 million within that period. This is about 1.2% of the projected capital expenditure accumulated to 2007. Unless specified by Eda Ranu, all other Capital expenditure incurred over the last 3 years appears not to be directly related to the PSSUP but appear more to be related to its water infrastructure. Nonetheless, even if the capital expenditure is incurred for its water infrastructure, it is still much lower than the overall capital expenditure commitments for its water infrastructure.

From the information provided in Table 5 above, the Commission notes that Eda Ranu, in the first two and half years of the five year period, actually incurred only 0.8% of the K245 million capital expenditure planned for the sewerage upgrade project.

3.3 Planned Capital Expenditure

Eda Ranu has submitted that it believes the project will still go ahead once project financing arrangements are negotiated and agreed. Eda Ranu, in its submission to the Commission has revised its projected capital expenditure to be undertaken during the remainder of the regulatory period from August 2007 to December 2009. These revised projections are shown in Table 6 below. It should be noted that Eda Ranu did not indicate whether the planned capital expenditure is inclusive of the external loan currently under negotiation; however from the figures provided, it appears the projections are made excluding the bulk of the proposed loan.

Table 6 - Forecast Capital Expenditure

Planned Capital Expenditure for August 2007 to December 2009				
Project Description	Aug-Dec 2007	Jan-Dec 2008	Jan-Dec 2009	Total In Million K
Port Moresby sewerage system upgrade project	5,669,330	1,248,880	11,457,160	18,375,370
Prepaid Water meter Project	100,000	1,500,000	500,000	2,100,000
Water bottling Project	500,000	5,000,000	5,000,000	10,500,000
Trade Waste Policy Project	200,000	150,000	150,000	500,000
Lands and buildings	200,000	1,300,000	500,000	2,000,000
Motor vehicles				
Plant and Equipment	300,000	600,000	300,000	1,200,000
Furniture and Fittings	20,000	20,000	20,000	0.06
Total (In millions kina)	6,989,330	9,818,880	17,927,160	34,735,370

Source: Eda Ranu's submission to Issues Paper, 2007 p.5. Table B

The revised capital expenditure on the Port Moresby sewerage project is estimated to be K18.4 million for the remainder of the 5 year regulatory period. This represents about 7.5 % of the total capital expenditure (K245

million) initially earmarked by Eda Ranu. Combining the K2.3 million already incurred by Eda Ranu together with the K18.4 million, Eda Ranu over the 5 year regulatory period would incur a total of K20.4 million as capital expenditure on its sewerage infrastructure which is K221 million below what was initially committed and factored into the current price path.

Hence, the original and revised capital expenditure commitments by Eda Ranu for its sewerage infrastructure are detailed in Table 7 below:

Table 7 - Capital Expenditure Commitments against Revised

POM Sewerage Upgrade	2007 (K' 000)	2008 (K '000)	2009 (K' 000)	Total (K' 000)
Original Capex	56,440	56,440	56,440	169,320
Revised Capex	5,938	1,249	11,457	18,399
Difference	50,502	55,191	44,983	150,921

It is thus evident that the revised capital expenditure are significantly lower than the initial capital expenditure committed by Eda Ranu.

3.4 Submissions

The Commission has received four (4) submissions on the Issues Paper. Details of the respondents are detailed in Appendix C of this Draft Report. Consistent with the key issues outlined in the Issues Paper, the submissions received mainly commented on the potential options that are available to the Commission to be adopted with respect to the capital expenditure aspects of Eda Ranu's current pricing arrangement.

An overview of each of the submission is set out below.

National Research Institute

The National Research Institute ("NRI") in its submission provided two main alternatives to be considered by the Commission for purposes going forward. These are briefly set out below in bullet points:

- That if Eda Ranu has partially or fully incurred the capital expenditure it committed under the current price path, then the Commission should:
 - Maintain the current price path if the capital expenditure is fully incurred; and
 - If the capital expenditure is partly incurred, then main the current price path to allow Eda Ranu to realise the allowable revenues to incur the capital expenditure, however if it fails, then the Commission should adjust downwards the allowable revenues after 2009 to reflect Eda Ranu's inaction.
- That if Eda Ranu has not incurred the capital expenditure it committed, then the Commission should:

- Apply a downward adjustment if it appears that Eda Ranu is unlikely to incur the full capital expenditure; and
- If the Commission is satisfied that Eda Ranu is most likely to incur the capital expenditure then the current pricing arrangements should be allowed to continue but with added conditions for Eda Ranu to incur the capital expenditure. If Eda Ranu fails then the Commission should effect the downward adjustment in 2009.

PNG Waterboard

PNG Waterboard, who is also in the business of providing water and sewerage services in certain parts of the country, submits that from its experiences in securing offshore financial assistance in implementing projects of this magnitude, there are many factors that can cause delays in the implementation of these projects. Some of which include delays in obtaining statutory approvals and the availability of counterpart funding for the purposes of drawing down the loan. Therefore, PNG Waterboard submits that offshore financing is a long drawn process that can take up to five years before implementation.

PNG Waterboard further submits that the legitimate factors causing the delay are beyond Eda Ranu's control and a fair and just consideration should be given by the Commission to ensure that Eda Ranu is making an appropriate return to maintain its operations. PNG Waterboard suggests that while the Commission may consider penalties to be applied to Eda Ranu for the non-implementation of the PSSUP, considerations should also be given to other priority projects in which the PSSUP funds could be diverted to these projects.

Independent Public Business Corporation

The Independent Public Business Corporation ("IPBC") contends that the National Executive Council ("NEC") has already approved the PSSUP and it is mindful of Eda Ranu's commitment on the project and that the capital expenditure will be realised when the project is implemented. IPBC further states that the stakeholders are in the process of implementing the NEC decision which is expected to be finalised at the end of October 2007.

Eda Ranu

Eda Ranu concurs in its submission that it has not implemented the PSSUP since the commencement of the current price path. However Eda Ranu contends that it is committed to the undertaking of the PSSUP however the delay experienced in the implementation of the project is beyond its control and not of its own making. Eda Ranu further submitted that the NEC has approved the project and that most of the funds to be incurred will be sourced from the Japanese Bank for International Co-operation ("JBIC") under an external financing arrangement, however the negotiations

between the external financier and the government has been the major cause of the delay.

Even though it has not implemented the PSSUP, Eda Ranu in its submission stated that money it collected in its price path which relates to the forecast PSSUP capital expenditures has been put aside in a separate bank account to meet the cost of borrowing when it is finalised and that it had already incurred some capital cost¹ relating to the PSSUP. Furthermore, Eda Ranu submitted that it has taken the steps necessary to prepare for the implementation of the PSSUP once the negotiations are finalised and the offshore loan is drawn down.

Accordingly, given the backing of the NEC and the delay experienced which Eda Ranu contends is outside its control, Eda Ranu proposed for the Commission not to amend the prices downward as it may affect the implementation of the project. Eda Ranu stated in its submission that in the first two years of the regulatory period, the Commission gave significant adjustments to improve the financial performance of Eda Ranu, thus a decision to amend the prices further downward now would be unwise.

In regards to Eda Ranu's financial position for the purposes of financing the PSSUP, Eda Ranu submitted that an independent financial assessment conducted by the IPBC suggests that it is capable to sustain the loan on a concessional basis but may not do so if the loan were to be sourced on commercial terms.

Eda Ranu suggests that if the Commission sees a need to amend the price path downward, then the Commission should freeze the CPI and the X factor component of the sewerage services only for the remainder of the regulatory period but not the pricing components relating to reticulated water. Eda Ranu asserts that such is the case since the capital expenditure on the PSSUP is highly subsidised by income earned from the water rates as from the total charges of Eda Ranu, water constitutes about 80% of the total charges whilst sewerage generates only 20% of total charges.

As part of its submission, Eda Ranu points out that its non-water revenue is about 20% and it sells less than 50% of the total water produced and sold and the remainder is lost through villages, settlements, illegal connections and leakages through the system. Furthermore, given that the current tariff applied to sewerage is very minimal compared to water, Eda Ranu contends that any downward adjustment would adversely affect Eda Ranu's overall financial position.

Therefore, in view of the comments stated above and given that the PSSUP is a major capital expenditure project which Eda Ranu will embark to undertake and regardless of the delay's being encountered, Eda Ranu urges the Commission not to consider changing the current price path but to allow

¹ Refer to Table 5

it to remain in place for the remaining period of the current regulatory price path.

3.5 Discussion

The relevant issue of pertinence which the Commission will need to establish is whether or not Eda Ranu has incurred or partly incurred the capital expenditure it committed to undertake under the existing price path. Considerations will also be extended to establish the likelihood of Eda Ranu's capacity to incur the full amount of the capital expenditure within the remaining period of the price path or otherwise.

The Commission will then consider the available options it has under the current circumstances with regards to the pricing arrangements for the remainder of the price path with a view towards obtaining a balance between Eda Ranu's commercial interests (including securing and servicing the concessional loan to undertake the PSSUP) and the welfare of the consumers of water and sewerage services provided by Eda Ranu.

In order for the Commission to decide on the type of option to apply to Eda Ranu's current price path with regards to the PSSUP capital expenditure, it has to consider the following issues;

- Reasons for the PSSUP delay.
- The likelihood of PSSUP being implemented within the remaining regulatory period.
- Suggested approach the Commission would take on dealing with the revenues collected which relate to the deferred PSSUP capital expenditure.

3.5.1 Reasons for the PSSUP delay

The Commission notes that one of the major factors which is restricting Eda Ranu's ability to incur the capital expenditure on the PSSUP is the delay experienced in the negotiation of the offshore concessional loan. Both Eda Ranu and its shareholder, IPBC, are adamant the loan will be agreed to and the funds will be sourced in time to implement the PSSUP within the regulatory period.

Pursuant to NEC Decision No. 87/2007, an Inter-Agency Working Committee has been formed and tasked to facilitate the processes involved in securing the offshore concessional loan.

3.5.2 Likelihood of PSSUP implementation

The Commission notes from Eda Ranu's submission that the delay in implementing the PSSUP is beyond Eda Ranu's control as the terms of the loan are still being negotiated by the key stakeholders with the international financier, JBIC.

In this circumstance where the PSSUP has not been implemented as planned and given the request made by the Minister for a review of the capital expenditure associated with the project, it is imperative for the Commission to be advised as to the indicative commencement of the project. In addressing this matter, Eda Ranu submitted that it has received political backing that the government will support the PSSUP and it is expected to be implemented by the end of this year. Independent Public Business Corporation (“IPBC”) also supported Eda Ranu’s view that arrangements are underway for the implementation of the PSSUP which is expected to be finalised by end of October 2007. The Commission notes both IPBC and Eda Ranu’s optimism on the date of implementation of the PSSUP, however this would be subject to agreement within the government agencies tasked to discuss and firm up the terms of the loan agreement with the international financing institution. The PNG Waterboard, however stated that the process of finalising the loan terms, securing funding and implementation of such projects take much longer period than expected.

Apart from stating that the delay is beyond its control and that loan negotiation are still on-going, Eda Ranu has not provided a detailed update on what has been achieved and what is yet to be done as this will give an indication as to when will be the indicative time of implementation. Negotiation between Eda Ranu, relevant government departments and the Japanese Bank of International Corporation on loan repayment arrangement is still on-going and at this stage there has been no agreement reached as yet. In addition, the technical aspect of the PSSUP may also take awhile to be finalised.

The Commission agrees with NRI’s suggestion that the likelihood and Eda Ranu’s financial capacity to fully implement the capital commitments on the PSSUP need to be considered before any downward adjustments are made. Nonetheless, the Commission further notes that a comprehensive review of the current pricing arrangements will be undertaken in 2009 in which any inaction by Eda Ranu can be addressed. This is one of the suggestions provided in NRI’s submission. However for the purpose of this review and consistent with its legislated roles, the Commission will need to be made a decision as to whether Eda Ranu will access the offshore loan in time to undertake part or all of the capital works on the PSSUP before the end of 2009 and whether the actual capital expenditure will be incurred within the remaining period of the price path, or be extended into the following regulatory period.

While both Eda Ranu and IPBC contend that the project will be implemented towards the end of this year, the forward capital expenditure for the remainder of the regulatory period provided by Eda Ranu in its submission is significantly less than what has been initially projected and this would indicate that all of the PSSUP capital expenditure may not have been included in the forward capital expenditure. This indicates that the likelihood of the PSSUP being implemented within the next two years of the

current regulatory period is not possible but may continue into the next regulatory period.

After considering all the arguments put forward and from its own assessment of the issue, the Commission considers that the possibility of the project being implemented within the last two years of the regulatory period is unlikely, although Eda Ranu would likely commence the project and incur minimal expenses for the project.

3.5.3 Suggested approaches

In response to the Issues Paper, the Commission received submissions from Eda Ranu, National Research Institute and PNG Waterboard on the type of option for the Commission to consider in view of the deferred PSSUP capital expenditure. IPBC on the other hand has not provided comments on this issue.

The options provided to the Commission in the submissions are set out below.

(a) Price path where Eda Ranu fully incurs the capital expenditure

Firstly, the Commission considers one of options provided by the NRI that if Eda Ranu fully incurred the PSSUP capital expenditure, the price path should remain unchanged. It should be noted that the review stems from the main issue as to whether Eda Ranu had incurred the expected capital expenditure as captured in the price path. Eda Ranu advised that the project is yet to be fully implemented, thus confirming in its submission that it has not fully incurred the capital expenditure. Hence, the Commission does not consider this option as a likely outcome of the review.

Fundamentally, consumers should not be asked to pay for services which have yet to be delivered, and where there is some risk (albeit small) that the project will not proceed as planned. This is supported by Sections 21 (2A) (a), (b) and (i) of the Act, which suggests efficient costs should be recovered but market power should not be misused, to the detriment of economic and social outcomes.

(b) Price Path where Eda Ranu does not fully incur the capital expenditure

Under this option, it has been proposed that no changes be made to the current price path despite Eda Ranu partly incurring some capital costs towards the sewerage project. To advance this option, it is important to compare the actual capital expenditure against the expected capital expenditure in the current price path

Submissions were made by NRI and PNG Waterboard, that the current price path should remain and be reviewed at the end of the current price path if Eda Ranu partly incurs the capital expenditure. Further comments were made that while Eda Ranu has not implemented the PSSUP, projected revenue generated for the PSSUP should be diverted to other priority projects. To form a view on this matter, the Commission must assess the extent of actual capital expenditure incurred against the expected capital expenditure, and whether or not the alternative projects are considered necessary and are efficiently delivered.

The Commission is of the view that it would not be prudent to divert funding to other alternative priority areas or projects as the PSSUP is a major Government initiative aimed at improving the sewerage infrastructure and to do so, would seriously derail Eda Ranu's ability to finance the loan if the project is implemented at a later date. Secondly, the Commission has factored the cost of this project in the current price and of which the forecasted capital expenditure were rolled into Eda Ranu asset base on which it realises its return on capital as well as recouping depreciation through its tariffs. Also, the Commission would need to re-look in-detail at the alternative projects which could bring benefits to consumers and hence legitimately be part of the regulatory asset base and also look at other variables (for example operating & maintenance expenditure which would not longer relate to the PSSUP) which would not be identical to the current price path. The time frame allowed under the Act for this Review does not allow such a detailed review process to be undertaken. Therefore, it is incumbent on Eda Ranu to undertake this project, and for any alternative capital expenditure to be reviewed for inclusion into the regulatory asset base at the detailed review planned for 2009, prior to the next regulatory period.

From its assessment of the capital expenditure on the PSSUP, the Commission is concerned that the capital expenditure is not substantially incurred to a level where the Commission can consider allowing the price path to remain without alteration for 2008 and 2009. In analysing the actual capital expenditure in Table 5 against those in Table 3, the Commission notes that Eda Ranu in 2004 incurred more capital costs than what was captured in the price path. However from 2005 to mid 2007, capital costs incurred by Eda Ranu were much lower than expected capital expenditures. From the analysis of the above tables, Eda Ranu has incurred only 18% of the total capital expenditure originally forecast.

Also, when taking into consideration capital costs of other projects undertaken by Eda Ranu to validate PNG Waterboard's comments, the Commission finds that capital costs of other water projects do not match the capital expenditure earmarked for the PSSUP. Generally, Eda Ranu underspent the forward capital expenditure in the first two and half years of the regulatory period.

Eda Ranu strongly argues that the Commission should not amend the current price path as its decision to adjust prices down would have serious financial implications on the project. In addition, Eda Ranu points out to the Commission that in the first two years of the regulatory period, the Commission gave significant upward adjustments to tariffs to improve the financial performance of Eda Ranu and the decision to amend the prices downward now would indicate a shift in the trend of the price adjustments from the last 2 years.

It should be noted that the Commission allowed these significant price adjustments at the start of the regulatory period to place Eda Ranu in a sound financial footing, thus allowing the entity to improve and provide efficient services going forward. It has also allowed Eda Ranu and the government the opportunity to explore the opportunity for concessional project financing for the PSSUP, which might otherwise have been unavailable.

Under its earlier decision for the 2005 to 2009 regulatory period, the Commission has expected Eda Ranu to be able to return a profit over each year of the regulatory period including the assumption that the capital expenditure for the PSSUP would occur. Where this capital expenditure did not occur, there should have been an over recovery of capital which was not spent and Eda Ranu's profitability should have risen. However, the actual position has been that Eda Ranu's costs have risen to absorb this over recovery. From the information provided in the submission, Eda Ranu's profit was lower than what would have otherwise been expected. This is despite the lower capital costs incurred over the regulatory period and despite the Commission's allowance for significant price increases. This causes the Commission concern as it suggests a level of inefficiency in Eda Ranu's operations.

Eda Ranu further supports its proposal not to amend the prices by submitting that the capital expenditure on the PSSUP is highly subsidised by income earned from the water rates and only 20% of water produced is charged to sewerage income using the current tariff structure. Eda Ranu then claims that as such the impact of adjusting the current tariff due to non-implementation of the PSSUP would have no effect on its income base as 8% of water produced is charged as sewerage rates. Contrary to its proposal not to amend the price path, Eda Ranu submits that if the Commission assess a need to amend the price path, then the Commission should freeze the CPI and the X factor for the sewerage only for the remainder of the regulatory period.

It is imperative to note that the PSSUP forms a larger component of the total capital expenditure. The capital expenditure for water and sewerage are combined and spread over the five year period and the calculation of the average asset base and the return on asset flow on from the total capital expenditure. The return on asset for water and

the X factor are derived from the PSSUP capital expenditure as well. The PSSUP has a significant bearing on both water and sewerage rates and would affect the income base of water as much as it affects sewerage income base, hence the suggestion to freeze the CPI and X factor for sewerage only for the remainder of the regulatory period is not a possible outcome. Effectively, not enough information on the separate asset bases of Eda Ranu's water and sewerage assets is available to support an analysis to see whether this approach is reasonable. Such information might be available for the 2009 detailed review, and the commission would encourage Eda Ranu to submit further detailed information on this issue at that time.

Under the current pricing arrangements, water and sewerage services provided by Eda Ranu are bundled and priced accordingly. Therefore the Commission does not agree with Eda Ranu's suggestion that the Commission should only adjust the sewerage prices and not water quite simply because it is impossible to do that under the current pricing arrangements. Furthermore, whilst sewerage charges may reflect only 20% of the total charges levied by Eda Ranu, the capital expenditure attributable to sewerage infrastructure constitutes a significant portion of Eda Ranu's RAB under the current price path. Hence, the current prices are driven predominantly by the forward capital expenditure on the PSSUP. Therefore, even if it was possible to isolate sewerage charges, the sewerage RAB would need to be re-adjusted accordingly, hence major adjustments to the current price path would be inevitable.

On the issue of non-revenue water, Eda Ranu submits that its non-water revenue is about 20% and it sells less than 50% of the total water produced and delivered, and the remainder is lost through un-metered off-take for villages and settlements and from leakages through the system. It further submits that given that the current tariff applied to sewerage is very minimal, any price decrease would badly affect Eda Ranu's financial position.

The Commission also notes Eda Ranu's concerns relating to leakages, uncollectible debts and water lost in villages and settlements. Under the current circumstances in PNG and more particularly with the law and order situation, collection of debt and related actions in settlements and villages would pose significant risk to the employees of Eda Ranu and is potentially an issue that will have to be carefully revisited in the next major review in 2009. Nonetheless, with respect to bad debts and leakages, the Commission encourages Eda Ranu to use its best endeavours to fix the leakages and pursue all available means to strengthen and improve its debt collection activities. The Commission considers that these are management issues and are within the control and influence of the management.

In consideration of the arguments put forward and based on its own assessment, the Commission therefore proposes to amend the current price path to reflect Eda Ranu's current situation where there has been underspend of capital in relation to the PSSUP.

4. OPTIONS ON PRICE ADJUSTMENT

Having proposed that the Commission will adjust the current price path, the Commission will now consider the available options to reflect Eda Ranu's under-expenditure and current state of the project whilst ensuring that consumers are charged a fair and reasonable rates as well as ensuring that Eda continues to provide the required services, and proceeds with the PSSUP.

From the information provided in Eda Ranu's submission, the Commission has identified five (5) options to adjust the current price path and these options are discussed below.

4.1 Option A: CPI - 29%

From the information provided on the actual capital expenditure ("capex") incurred, the Commission notes that these capital expenditures were insignificant compared to those which Eda Ranu had initially committed and which the Commission factored into the current price path during its price control review in 2004.

Hence, under this option the Commission considers only the capital expenditure in isolation from the operating & maintenance expenditure. The Commission makes an allowance for the actual capex (2004 - June 2007) and the revised forward capex for the remainder of the regulatory period into the price path replacing those initially projected. This analysis allowed the Commission to develop a Base Revenue requirement for Eda Ranu as if it was undertaking this analysis at the beginning of the current regulatory period with the availability of the latest capex data. For clarity, what the Commission is doing is recalculating the revenue path as if the current data on capex were available in 2004, using the same methodology (and other assumptions) made at that time.

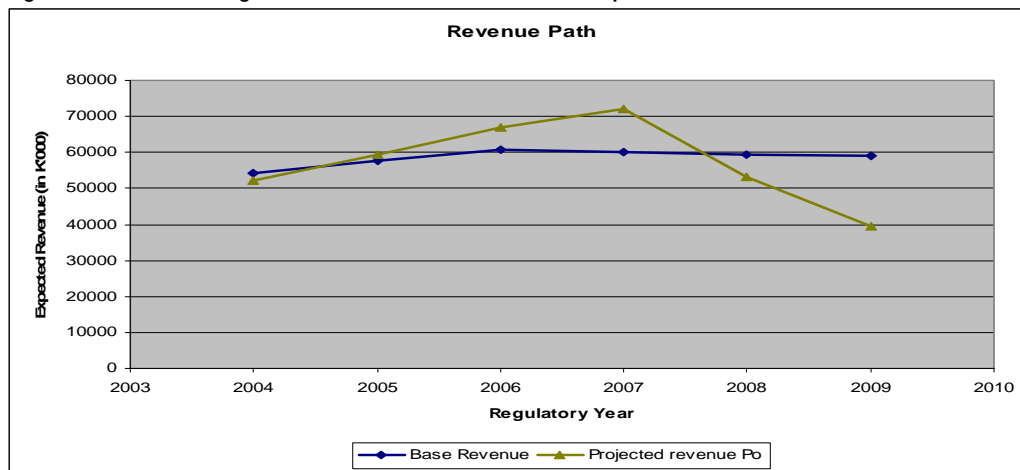
The Commission worked out a net present value (NPV) of this Base Revenue path or stream of cash flows. Then the Projected Revenue path could be defined as the actual revenues for 2004 to 2007 (including budgeted expenditure in the latter part of 2007), with a CPI-X adjustment for the final two year's revenues, where the X Factor in the 2008 and 2009 years would be calculated by ensuring the NPV of the Projected Revenue² path equalled the NPV of the Base Revenue path.

After allowing for this amendment, the price path for Eda Ranu in the remainder of the regulatory period will be CPI-29% such that tariff adjustments will be based on growth in CPI minus 29%. Based on this adjustment, the trend in the Base Revenue for Eda Ranu and its Projected

² This is called the "Projected Revenue Po" line in the following Figures.

Revenue for the remainder of the regulatory period are depicted in Figure 4.1 below.

Figure 4.1 Revenue growth for Eda Ranu - Actual Capex



The decline of the Eda Ranu's base revenue and downward sliding of the projected revenue takes into consideration reduced capital expenditure. Theoretically, this would be the preferred option as it strictly takes into consideration the actual capital expenditures that Eda Ranu has invested and is projecting to invest in its water and sewerage network over the whole of the current regulatory period. This analysis also assumes that Eda Ranu's actual and forecast costs are economically efficient costs.

This analysis does not factor in any further increase in unspent capital expenditures and increase in savings made by Eda Ranu. In this sense the analysis is conservative on the low side of profitability, and Eda Ranu can improved profitability by careful management of its continuing expenditures.

In considering this option, the Commission does not propose to allow Eda Ranu to adopt the price path of CPI-29% for reasons including the following:

- Such huge savings which should have been made by Eda Ranu as a result of underspent of capex is unavailable at the moment because there is some evidence of overspend in operating & maintenance expenditures for 2005 and 2006, and the Commission is not satisfied that this option is financially feasible³.
- Eda Ranu is still in the process of securing the loan and an adjustment of this extent could seriously impact the loan-negotiation process.
- There is some evidence that Eda Rau has retained surplus cash which can be used to off-set some of the loan once the PSSUP project

³ The analysis required to ascertain efficient expenditures and to determine the reasonableness of Eda Ranu's operating & maintenance expenditures is not possible in the time frame allowed for this Review.

proceeds, and hence returning all of these over-recovered costs to consumers may not be necessary.

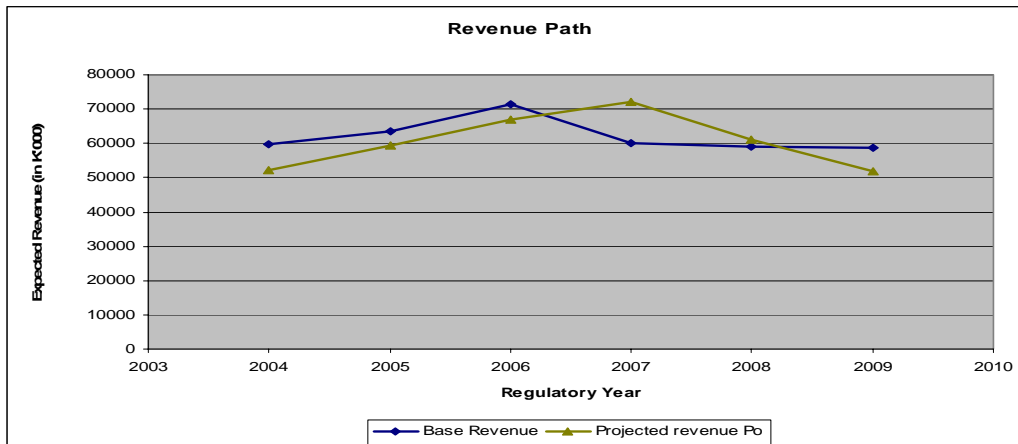
- A price increase followed by a price reduction and followed by a potential price increase (in 2010 and the following years once the PSSUP is underway), does not provide stability of prices and is counter to good regulatory practice in minimising social impact of pricing decisions.
- This approach would likely place significant financial strain on Eda Ranu, particularly when (rather than if) it proceeds to implement the PSSUP.

4.2 Option B: CPI - 18%

The second option is basically derived by allowing the adjustment to the capex as mentioned in Option A above and also using the actual operating and maintenance expenses (“opex”) for the first two years of the regulatory period (including year 2004). In considering this option, the Commission realises that Eda Ranu has overspent in terms of its operating and maintenance expenses but the Commission opts not to test the expenses and whether they are prudent in terms of cost efficiencies. Rather, the Commission assumes that these costs are prudent and allowing the actual operating and maintenance expenses to be fitted into the price path.

After allowing for these adjustments and using the same NPV process described in Option A, the Commission derived a price path of CPI-18%. This option appears to be a sensible and practical option as both the actual capital and operating expenditure for the first two years have been factored into the price path. The impact of this option on the revenue path is shown in Figure 4.2 below.

Figure 4.2 Revenue growth for Eda Ranu - Actual Capex and Opex



The trend in the revenue growth of Eda Ranu for the remainder of the regulatory period will slightly decline as it reflects the underspent of capital expenditure (from the delayed PSSUP project) and overspent of operating expenses (which may or may not reflect economic efficiency).

In considering this option, the Commission does not propose to allow Eda Ranu to adopt the price path of CPI-18% for reasons including the following:

- Eda Ranu is still in the process of securing the loan and an adjustment of this extent could seriously impact the loan-negotiation process.
- There is some evidence that Eda Ranu has retained surplus cash which can be used to off-set some of the loan once the PSSUP project proceeds, and hence returning all of these over-recovered costs to consumers may not be necessary.
- A price increase (in 2005 and 2006) followed by a price reduction and followed by a potential price increase (in 2010 and the following years once the PSSUP is underway), does not provide stability of prices and is counter to good regulatory practice in minimising social impact of pricing decisions.
- This approach would likely place significant financial strain on Eda Ranu, particularly when (rather than if) it proceeds to implement the PSSUP.

4.3 Option C: CPI - 8%

In considering this option, the Commission takes into account the adjustments made in Options A and B above. In Option B, the Commission assumes that the operating and maintenance expenses are efficient without testing whether they are prudent or economically efficient.

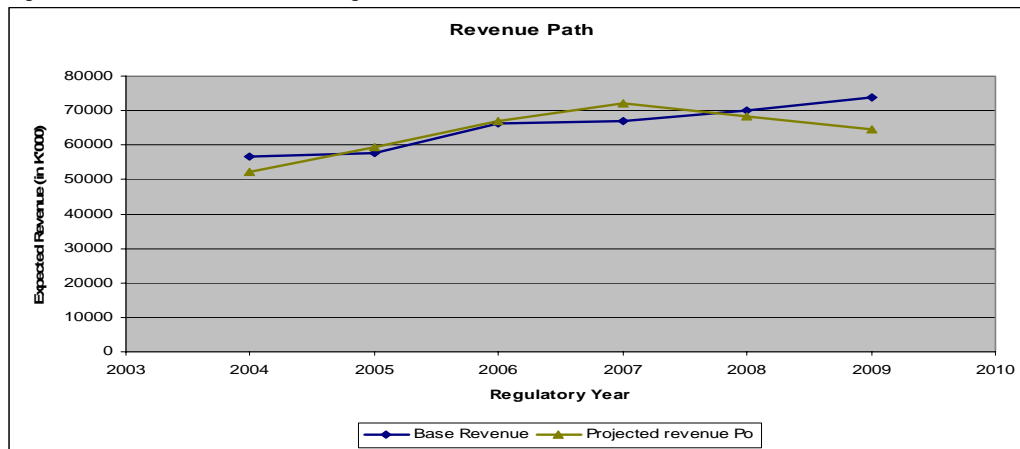
In Option C, the Commission notes that there had been significant increases in some of the expense items over the first two years of the regulatory period. These expense items do not appear to directly relate to Eda Ranu's economically efficient costs of providing the services, and in particular are not trending in a uniform way or exhibit spikes which are difficult to understand. Therefore in this Option C, the Commission has superficially tested these operating and maintenance expense items (without recourse to detailed review and discussion with Eda Ranu to test the veracity and reasonableness of these expenditures) and has used either the historical average by expense item or best estimate for year 2006 and use these cost figures as the base to forecast the operating and maintenance expenses for the remainder of the current regulatory period.

In doing so, the Commission derived a price path of CPI-8% using the same NPV process described in Option A. This means that the annual adjustments on the water and sewerage tariffs for the remainder of the regulatory period will be adjusted by CPI-8%. The graph depicting the revenue growth is shown in Figure 4.3 below.

In essence, what the Commission is doing here is assuming that the operating & maintenance expenditure in 2005 to June 2007 (while significantly higher than originally forecast in 2004), are legitimate and should form the basis of the forecast operating & maintenance expenditure

in the last part of 2007 through to the end of 2009. As a result the Base Revenue line in Figure 4.3 below is higher than the Base Revenue line in Figure 4.3 above.

Figure 4.3 Eda Ranu revenue growth



The Commission considers this option could be an appropriate price path going forward, however, the Commission notes that Eda Ranu is not sufficiently recovering revenues from the areas which it has recovery problems such as the settlements, villages and leakages thorough the system. Again, the Commission wants to ensure that Eda Ranu maintains itself financially to continue to provide the services and also be commercially viable to meet the requirement of securing the PSSUP loan.

As such, the Commission does not propose to allow Eda Ranu to adopt the price path of CPI-8% for reasons including the following:

- Eda Ranu is still in the process of securing the loan and an adjustment of this extent could seriously impact the loan-negotiation process.
- There is some evidence that Eda Ranu has retained surplus cash which can be used to off-set some of the loan once the PSSUP project proceeds, and hence returning all of these over-recovered costs to consumers may not be necessary.
- A price increase (in 2005 and 2006) followed by a price reduction and followed by a potential price increase (in 2010 and the following years once the PSSUP is underway), does not provide stability of prices and is counter to good regulatory practice in minimising social impact of pricing decisions. The Commission notes the price changes for the Option C would be lower than in Options A or B.
- This approach would likely place some financial strain on Eda Ranu, particularly when (rather than if) it proceeds to implement the PSSUP.

4.4 Option D: CPI - 2.5%

In developing the current price path, the Commission employed a building block approach to determine Eda Ranu's revenue requirement which comprised of the following aspect⁴;

- A return on capital invested in the network;
- A return of capital invested in the network through an allowance for depreciation; and
- The efficiency operating costs of the business.

These aspects of the building block approach have been taken into consideration of the discussions of the above options.

In the current price determination (made in 2004), the Commission made a very generous allowance for Eda Ranu to recover specific capital cost associated with the PSSUP whilst allowing Eda Ranu to improve its operating costs of the business. The Commission expected the capital identified in the Final Report of August 2004 to be invested in the network, however, over the period Eda Ranu has underspent the expected capital expenditures and over spent the expected operating & maintenance costs.

So while the Commission would have expected that Eda Ranu to return a profit over each year of the regulatory period as an adjustment for the over-recovery of capital which it did not spend, the actual position has been that Eda Ranu's costs have risen to the extent that expenditures have almost absorbed this over recovery.

The Commission has cited a number of items such as significant increases in salary levels which are not directly related to the PSSUP thus further increasing Eda Ranu's cost of operations. The Commission has sought information from Eda Ranu on the cost drivers of this increase and the information provided was not sufficient to clearly substantiate the reasons for this increase. Indeed during the limited period for this review, and given the scope of the reference provided by the Minister of Treasury, such analysis is not possible. This analysis is more appropriately undertaken during the more detailed regulatory reset process scheduled for 2009, prior to the next regulatory period.

The Commission is concerned that any changes in operational & maintenance expenses as discussed above in Option C as well as in Option D above should come after a regulatory reset. The Commission understands that forecasts of costs are likely to vary from actual expenditure, however, it would expect that Eda Ranu would have been able to more accurately budget (and forecast) its costs at least within the 18 months window between when the Commission was undertaking its previous decision in 2004 and the actual expenditures in the 2005 year.

⁴ Note that the analysis occurs on a pre-tax basis and uses a pre-tax WACC.

In arriving at this option, the Commission has been mindful of a number of matters, particularly the extent of cost increases over the regulatory period. The Commission is of the view that it cannot support a continuation of the current price path given the underspending in terms of capital expenditure. However, at the same time the Commission is reluctant to support the operating & maintenance cost increases associated with Eda Ranu's actual operations from 2005 to June 2007.

As such, the Commission has decided for this draft determination to adjust the Eda Ranu prices by CPI-2.5% over the next two years, for reasons including the following:

- While Eda Ranu is still in the process of securing the loan, an adjustment of this extent should not seriously impact the loan-negotiation process, because the revenue reductions are small and to some extent balance with the continued potential over-recovery of revenue due to the slow ramp-up of the PSSUP project (against the originally forecast capex). Also the detailed regulatory reset in 2009, prior to the start of the next regulatory period, will be allow the Commission the opportunity to fine tune the revenue (and price) path to accommodate the economically efficient costs which arise from the PSSUP project and other capex undertaken by Eda Ranu.
- There is the opportunity for Eda Ranu to retain further surplus cash under this scenario, as the PSSUP project is unlikely to ramp-up immediately. This additional surplus cash can be used to off-set some of the loan once the PSSUP project proceeds and hence returning all of these over-recovered costs to consumers may not be necessary.
- A price increase (in 2005 and 2006) followed by a lower price reduction (2.5% in real terms) and followed by a potential price increase (in 2010 and the following years once the PSSUP is underway), while not stable provides less volatility in prices than In Options, A, B or C. The Commission believes that this level of price change is a reasonable balance between the financial needs of the Eda Ranu and the consumer benefit of not paying excessive prices for the utility services provided.
- There are opportunities for Eda Ranu to offset the price pressure leading to reduced revenues (and hence profitability) from a CPI-2.5% price path, by slightly increasing the percentage of recoverable water deliveries from the current 40%. This approach provides some incentives to improve its losses from delivered water without placing undue pressure of the finalisation of the project finance for the PSSUP project.
- This approach is unlikely to place financial strain on Eda Ranu, particularly when (rather than if) it proceeds to implement the PSSUP.

While noting that this Option D will have an impact to reduce Eda Ranu's prices by approximately 7.5% in real terms, the Commission suggests that Eda Ranu employ strategies to ensure that it is able to retain both its profitability and revenue. This would include its ability to improve its collection of outstanding debts, improvement to leakages and illegal connections particularly from the non-revenue sector.

Having considered the above issues, the Commission proposes in its draft determination for Eda Ranu to apply a price path of CPI-2.5% for the remainder of the regulatory period.

4.5 Option E: CPI + 0%

The Commission is cautious that while Eda Ranu has not implemented the Port Moresby Sewerage Upgrade Project, it has to be financially supported in terms of its tariffs to secure the loan for the Project. As such, there is the option of leaving the current tariffs for both water and sewerage services in place without amendment for the next two years. This means that whatever the tariffs are for 2007 will be the same for 2008 and 2009.

The effective price reduction would be 5% in real terms (given the prior decision by the Commission set the price path at CPI+5%). There is some support for this approach for the following reasons:

- A price increase (in 2005 and 2006 and 2007) followed by no price changes before 2010 would be supportive of price stability for consumers, when compared to Options, A, B, C or D.
- There would be continued over-recovery of revenue from this price path as there are likely to be further delays in the ramp-up of the capex for the PSSUP project, and this could be retained in a separate account and be used to off-set draw-down of the loan once the expenditures for the PSSUP project ramps-up.

The Commission would have expected that Eda Ranu would be able to return a reasonable profit over each year of the regulatory period as there should have been an allowance for the over recovery of capital which it did not spend. However, the actual position has been that Eda Ranu's costs have risen in line with the expected surplus and in the example of the 2005 year Eda Ranu has actually made less profit than expected despite increased revenues allowed under the Commission's 2004 decision relating to capital costs which Eda Ranu did not incur. This causes the Commission concern as it suggests a level of inefficiency in Eda Ranu's operations which has been masked by the inclusion of the PSSUP in the capital program.

The Commission is further concerned that these operating cost increases should come so soon after a regulatory reset. The Commission understands that the forecasting of costs are likely to vary from actual expenditure, however, it would expect that Eda Ranu would have been able to more

accurately forecast its costs within the 18 month window between when the Commission was undertaking its previous decision and the 2005 year. At the same time the Commission notes that Eda Ranu has been able to collect a significant amount of additional revenue which was not expected in its original decision.

Of primary concern to the Commission is the impact that the capital program is having on the Eda Ranu's incentive to control costs. Figure 4.4 sets out the difference between the impact of a zero percent X factor under the Commission's original decision (in 2004) versus those now expected (where there is less the capital expenditure on the sewerage program).

Figure 4.4 Building Block Returns under the Commission's original 2004 decision versus those now expected

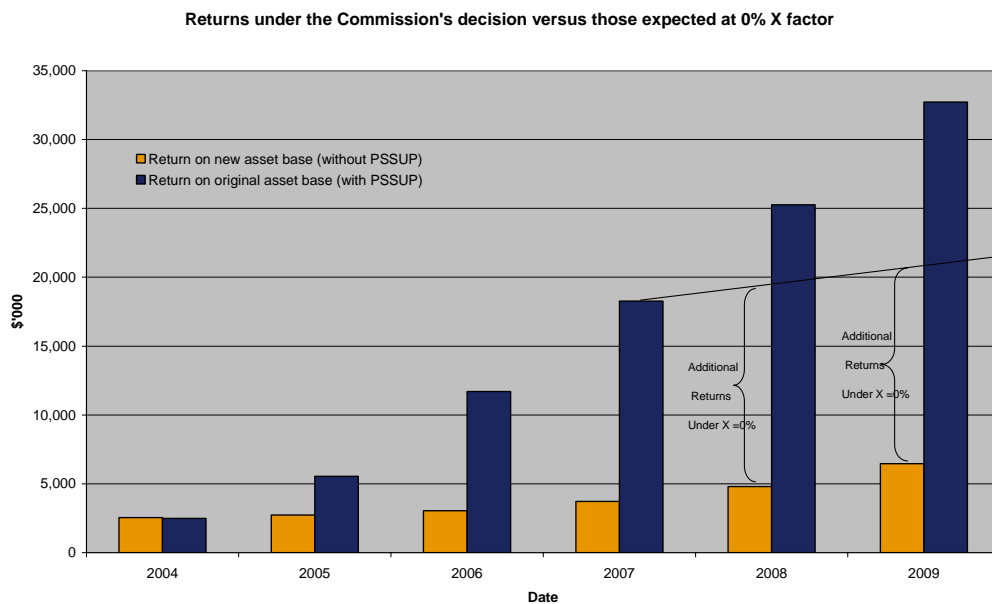


Figure 4.4 demonstrates the difference in the rate of return expected if the Commission held all things equal in its original 2004 model (the blue columns), and removed the allowance for the PSSUP (the amber columns). The difference in the columns is the sum of the return of and return on capital associated with the PSSUP.

Now given the rates for 2007 have been set and the blue column is the return allowed by the Commission (on inaccurate Eda Ranu forecasts), the black line is the CPI+0% outcome extended forward from the end of 2007. Thus the difference between the black line and the amber columns is the effective free cash flow which is allowed by Option E (were this to be adopted) and which is not needed by Eda Ranu in 2008 and 2009.

The Commission notes that should Eda Ranu be able to set prices on the basis of a zero percent X factor (a CPI+0% formula) it would be able to extract significant excess returns from its current customer base in line with the additional returns generated in the 2005, 2006 and 2007 years where its claim for capital expenditure did not come to pass. These excess returns

will continue to be generated where the X Factor is held at zero percent despite no corresponding capital costs.

The impact of an X factor which is set a zero would result in a significant level of additional returns to Eda Ranu. That is a zero percent X factor would result in the inclusion of returns on the a capital expenditure program which has not been incurred by Eda Ranu and at the same time allow Eda Ranu to take advantage of the step changes in prices outlined in the Commission previous decision. This would continue to mask the problems outlined regarding increases in operating cost which have eroded Eda Ranu's profit margins.

As such this option does not encourage economic efficiency nor does it provide discipline on the regulated entity to manage its business in a manner which is a reasonable balance between its financial concerns and the benefits to consumers from efficient service delivery. For the reasons including those listed below, the Commission will not propose to allow Eda Eda Ranu to adopt this price path for the remainder of the current regulatory period:

- From a financial point of view Eda Ranu does not need excessive surplus cash and its existence could be an encouragement to waste money on unnecessary projects, or to spend in an inefficient manner (reference the opex in 2005 which has risen significantly from forecasts in 2004).
- Eda Ranu appears to have potentially wasted much of the free cash flows provided in the first two years of the current regulatory period and the Commission has concern that this could continue into the future.
- There is no price pressure on Eda Ranu, and hence a lower incentive for additional efficiency improvements, such as through a further reduction of 'losses', both in receivables, collections, further meter roll-out and in repairing leakages.
- There is limited additional pressure to undertake and complete the PSSUP in the short-term, where there is an obvious consumer need.
- Consumers should not have to pay for services they do not yet receive, nor should they be required to pre-fund assets when the regulated entity has the financial ability to fund these itself.

5. SUMMARY OF DRAFT DETERMINATIONS

This section outlines the Commission's draft determination in light of Eda Ranu's inability to incur substantial PSSUP capital expenditure during the first half of the current regulatory period, but the likelihood of the PSSUP being partly implemented during the remainder of the current regulatory period. The proposed adjusted price path for the remainder of the current regulatory period, is a CPI-2.5% price path.

5.1 Likelihood of implementation within the regulatory period

The Commission understands that the PSSUP will not be substantially implemented until the loan is secured. The Commission also understands that the Government is supportive of this project. However the terms of the loan are subject to agreement between the State, Eda Ranu and its stakeholders and these are yet to be finalised. It is obvious that failure to reach that agreement at an early stage will most probably result in a further delay in the implementation of the PSSUP.

Nonetheless, the Commission believes there is significant potential for partial implementation of the PSSUP project during the current regulatory period.

As such the Commission prefers an approach which continues to recognise that the project will proceed. Severe options such as Options A and B would likely prove onerous to the regulated entity. However, the Commission indicates now that if the PSSUP project is not substantially complete by 2009, it would very likely take a different view over the severity of complete removal of this asset from the RAB and hence the forward price path for the regulatory period commencing 2010.

5.2 Adjusted Price Path

Given the situation regarding the underspend of the capital expenditure program outlined in Chapter 3 the Commission has little choice but to amend the price path for Eda Ranu. This is due to the regulatory mechanism employed by the Commission and Eda Ranu's response to the over recovery of revenue under this mechanism. Embedded in the Commission's original decision to include the capital investment of K245 million for a new sewer and treatment plant was the recognition that Eda Ranu and not the Commission, better understood the needs of consumers. There has been not only a failure by Eda Ranu to undertake the capital works program but also there have been increased costs across the business which appear to have limited justification. The Commission is concerned that the increased costs of Eda Ranu has been a direct result of the

allowances made in the regulatory price path by the Commission for the PSSUP project and that this underspent capital expenditure has possibly been unreasonably diverted to less efficient spending programs.

This project appears likely to be approved for delivery within the short-term and is likely to progress within this regulatory period. As such the Commission will not remove all of the capital expenditure from the regulatory asset base in this regulatory period (as would occur under Option A, B and C). However, it will remove a “real” percentage of the previously allowed revenue path as it is clear the regulatory settings were possibly too generous to Eda Ranu, to the detriment of consumers.

Under the Commission approach to regulation which is based on providing Eda Ranu the incentive to invest and at the same time reduce costs efficiently, the Commission would have preferred not to take this action which it notes is necessarily fairly heavy handed. Had the Commission seen evidence that Eda Ranu was able to use the underspend to its advantage by making appropriate provision for this project (setting the funds aside and controlling its other operational & maintenance expenditures) the Commission would have been in a position to consider making a continuing allowance for this recovery of future investment in this regulatory period.

The Commission decision to alter the price path mid way through the regulatory period is an unusual step for price control regulation⁵ and has not been taken lightly by the Commission. As such the Commission is imposing a series of additional measures to ensure that Eda Ranu puts in place reasonable management process to address the Commission’s concerns. If these measures are adopted by Eda Ranu it is unlikely to foresee a repeat of this circumstance in subsequent regulatory decisions.

The Commission will reduce Eda Ranu’s tariffs such that they be adjusted annually over the last two years of the regulatory period based on CPI-2.5% in line with the considerations outlined in Option D. The resulting reduction in Eda Ranu’s revenue and ultimately profit levels will need to be actively managed by the Management of Eda Ranu through two policy measures:

- A reduction of costs; and
- An increase in the revenue collected by Eda Ranu, but within the price path.

Cost reduction

First, the Commission has decided to place an additional cap on Eda Ranu’s operating costs over the final two years of the regulatory period. That is while Eda Ranu will continue to incur costs, the Commission will place a freeze on all costs for the next price review. The Commission will be monitoring Eda Ranu’s performance over the remaining years of the

⁵ The only other instance of an early opening of a regulatory price control arrangement was in the UK under Littlechild, early in the mid 1980’s, where the data provided to the regulator at the time of the reset was significantly falwed.

regulatory price path and will only consider nominal cost changes at the time of the next regulatory reset decision where Eda Ranu is able to demonstrate that there has been a clear external cost driver which has resulted in a real price change, but where Eda Ranu management has been unable to influence the outcome to reduce the cost increases.

At the time that Eda Ranu presents its case for change in the prices to the Commission (during early 2009 or as otherwise scheduled) it must include the following in its delivery of cost data:

- Clearly defined cost drivers by opex and capex item;
- Evidence of cost increases and measures taken to reduce the impact of these costs increases - including open and competitive tendering processes, analysis of competing cost options and proof of selection of the minimum cost/benefit outcome, and clear examination of competing technical solutions;
- Evidence of productivity increases over the existing regulatory period and proposed productivity measures for the forthcoming regulatory period; and
- Rationale for all wages increases including payments to Board Members and executive staff which are over and above the percentage change in the average national wage, starting with a benchmark at the beginning of 2005.

Increasing revenue collection

The second area the Commission recommends to Eda Ranu is to place considerable interest in increasing its collection of revenue from the 60% of consumers currently not paying for water or sewerage. While recognising the need for a Universal Service Obligation (USO), the Commission has concerns whereby Eda Ranu continues to charge the cost of water and sewerage services supplied to the non-revenue sector to the 40% of the population who are in a position to be invoice and are able to pay.

The price cap regulation which the Commission has imposed should provide Eda Ranu with the appropriate incentive to collect revenues from the group of customers receiving services who currently do not pay (or at least to reduce the percentage of customers who do not pay for services over time), however, the Commission has seen not evidence that of improvement in the collection of revenue from this category of customers.

The Commission estimates that the 2.5% per annum reductions in prices will reduce Eda Ranu's revenue by approximately K2million. At the same time an increase in collections of approximately 5% in the number of people paying would be sufficient for Eda Ranu to continue to collect this revenue removed by the Commission's draft determination. This would re-establish the revenue path and profitability which Eda Ranu was provided in the Commission's original 2004 decision. The Commission considers that this an appropriate approach as it provides a further incentive on Eda Ranu to continue to decrease the level of the non-financial embedded USO.

Should Eda Ranu undertake both programs successfully the Commission estimates that Eda Ranu will be able to increase its revenue and profit levels.

In addition, the Commission believes that even where Option D is followed, Eda Ranu will be able to generate free cash flows in excess of the regulated return allowed in the Commission's original 2004 decision. As such the Commission, at the next detailed regulatory reset in 2009, will expect to see additional cash collections either in the cash accounts of Eda Ranu or to have had these cash flows applied to the efficient delivery of the PSSUP project and/or the reduction in the draw-down of the concessional loan for the PSSUP project. The use of this additional cash flow will need to be demonstrated as prudent and efficient to the Commission during the next regulatory reset.

The Commission seeks further comments on the draft determinations as outlined above.

5.3 Draft Variation to Price Control Formula used in Prices Order

The Commission has developed a draft variation to its previous price control formula used to determine annual Prices Order for Water and Sewerage services tariffs. This variation is based on the outcomes of this draft determination. The draft variation to its previous price control formula is provided at Appendix D. The Commission seeks feedback on the variation in the price control formula, prior to making its final determination.

The Commission seeks feedback and comments on the draft variation to its previous price control formula.

6. APPENDICES

Appendix A: Minister's Application



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3rd July 2007

Mr. Thomas Abe
The Commissioner
Independent Consumer and Competition Commission
P.O.Box 6394
BOROKO
National Capital District

Dear Mr. Abe,

SUB: MINISTERIAL REQUEST TO REVIEW CURRENT PRICING ARRANGEMENT FOR EDA RANU

I am writing to seek a review, pursuant to section 25A(2) of the *Prices Regulation Act*, of the price direction applicable to Eda Ranu.

I note that section 25A (3) envisages that a request for review of a pricing direction include reasons for seeking a review and a proposed maximum price. I provide below the reasons for seeking such a review.

During the pricing review on water and sewerage services provided by Eda Ranu in 2004, in accordance with the section 25A (6) of the *Price Regulation Act*, a price path was set which allowed Eda Ranu to earn certain maximum average revenues during the period 2005 to 2009. The increment in the tariff rate recommended by the commission during the review was factored into a five year price direction which began on 1st of January 2005. The final price path allows Eda Ranu to recover the efficient operating costs, to meet the costs of capital and the costs for depreciation. The tariff increase was granted in anticipation that the capital and operational costs would be incurred commencing from 2005 and recovered through the regulated price path for Eda Ranu, which, in turn, would be obliged to furnish the service envisaged by the capital expenditure incorporated into the price path calculations.

Notwithstanding the tariff increase granted, I have noted that the service has not been rendered to customers as intended during the last two and half years. During the period since 1st January 2005, Eda Ranu has taken the money it generated in form of increased tariff rates without undertaking the capital works and expenditure on the sewerage system upgrade project which was factored into its price path.

As to suggesting a proposed maximum price, I note that the provision of sewerage services is not the subject of a specific price, but, rather, the price direction stipulates a maximum average price path for the provision of both water and sewerage services. Hence, I am unable to suggest a maximum price. Furthermore, the amount of adjustment applicable to the basis for seeking the review is a matter most appropriately quantified by your Commission and, therefore, I do not wish to attempt to quantify it. In summary, I seek a downward adjustment of the maximum average annual revenues to reflect the failure of Eda Ranu to undertake the capital works and expenditure, more particularly the sewerage system upgrade project, which have been factored into its price path, the subject of the relevant price direction.

Thus, pursuant to the section 25A (2) of the *Price Regulation Act*, I hereby request the ICCC to review the current price direction for Eda Ranu, taking account of its failure to provide services in accordance with the capital expenditure envisaged in its price path.

Yours sincerely



RABBIE L. NAMALIU, CSM KCMG MP
Minister for Treasury

Appendix B: Section 25(A) of Prices Regulations Act (Amended)

When making an order under Subsection (1), the Commission shall have regard to

- (a) the need to protect consumers and users of the declared goods or services from misuse of market power in terms of prices, pricing policies (including policies relating to the level of structure of prices) and the standard of the declared goods or services; and
- (b) the cost of making, producing or supplying the declared goods or services; and
- (c) the desirability of encouraging greater efficiency in relation to making, producing or supplying the declared goods or services; and
- (d) the need to ensure an appropriate rate of return on any investment in relation to the declared goods or services; and
- (e) the borrowing, capital and cash flow requirements of persons making, producing or supplying the declared goods or services; and
- (f) considerations of demand management and least-cost planning; and
- (g) existing standards of quality, reliability and safety of the declared goods or services, and the desirability of encouraging improvements in those standards; and
- (h) the effect any proposed order on general prices inflation over the medium term; and
- (i) the economic and social impact of any proposed order; and
- (j) any other matters the Commission considers relevant.

Appendix C: Respondents to Issues Paper

1. Eda Ranu
2. Independent Public Business Corporation
3. National Research Institute
4. PNG Waterboard

Appendix D: Draft Variation of Prices Order

In its *“Water and Sewerage Review - Final Report”* dated 25 November 2004, the Commission imposed a maximum average revenue (“MAR”) form of price control on Eda Ranu. The form of the MAR previously set is described in the following paragraphs.

Prior MAR for 2005 to 2009

The MAR for 2005 to 2009 was set using the following MAR constraint:

Previous Adjustment Formula

$$\begin{aligned}\Delta\text{MAR}_{t+1} &= (\Delta\text{CPI}_t + 0.11) \text{ for } t+1 = 2005; \\ \Delta\text{MAR}_{t+1} &= (\Delta\text{CPI}_t + 0.10) \text{ for } t+1 = 2006; \\ \Delta\text{MAR}_{t+1} &= (\Delta\text{CPI}_t + 0.05) \text{ for } t+1 = 2007, 2008 \text{ or } 2009;\end{aligned}$$

where:

ΔMAR_{t+1} = the change in maximum average revenue calculated as the percentage increase in total average revenue in the year $t+1$ as a proportion of the total average revenue in year t ; and

ΔCPI_t = the percentage increase in the consumer price index excluding betelnut, alcoholic beverages and tobacco (“CPI”) calculated over the four quarters to June in year t , over the CPI calculated over the four quarters to June in year $t-1$.

Tariffs for 2005 to 2007

Tariffs for the regulated services of Eda Ranu have been set under this MAR and have been notified and published in the National Gazette. In a notice dated 19th December 2006, the Commission notified the tariffs which have applied for 2007 and published these in the National Gazette dated 21st December 2006.

MAR Review

Following an application by the Minister for Treasury under Section 25A(2) of the PR Act, the Commission has reviewed Eda Ranu’s existing pricing arrangement with a particular focus on the capital expenditure requirements which Eda Ranu committed to undertake between the period of the current price path, being from 2005 to 2009. Following this review, including publication of an Issues Paper and now a Draft Report, and consideration of submissions and comments from various stakeholders, the Commission proposes the following adjustment to the previous MAR adjustment formula.

MAR for 2008 & 2009

For the purposes of section 21(2)(a), (b), (c), (d) and (g) of the PR Act, the maximum prices at which Water and Sewerage services may be supplied by Eda Ranu are subject to a new maximum average revenue cap for the remainder of the current regulatory period. This remaining period is from 1 January 2008 to 31 December 2009. The form of the new MAR to apply during this period is described in the following paragraphs.

New MAR for 2008 and 2009

The MAR for 2008 & 2009 will be set using the following constraint:

New Adjustment Formula

$$\Delta \text{MAR}_{t+1} = (\Delta \text{CPI}_t - 0.025) \text{ for } t+1 = 2008 \text{ or } 2009;$$

where:

ΔP_{t+1} and ΔCPI_t are defined as above.

Notification of New Tariffs for 2008 and 2009

The tariffs which have been adjusted in accordance with this New Adjustment Formula will be notified by the Commission. The tariffs for 2008 shall be based on adjustments to the tariffs notified previously for 2007.