SA Water

6 November 2018

Adam Wilson
Chief Executive Officer
Essential Services Commission of South Australia
GPO Box 2605
Adelaide SA 5001

Dear Adam

Re: Submission on Guidance Papers for the SA Water Regulatory Determination 2020

SA Water wishes to make a submission to ESCOSA in response to the release of the Guidance Papers for the 2020 Regulatory Determination process.

SA Water welcomes the release of the Guidance Papers and the direction they provide for the 2020 regulatory determination. SA Water is supportive of the enhanced determination process, particularly the important role customers will play in working with SA Water to develop its proposal, Our Plan 2020, to be submitted to ESCOSA in October 2019.

The Guidance Papers will play a critical role in providing direction for SA Water and the customer representatives, the Customer Negotiation Committee, in negotiating SA Water's regulatory proposal. If that process is to be successful in an open and transparent manner, it is important that the Guidance Papers provide accurate and full information and not create unrealistic expectations for the Customer Negotiation Committee or for customers.

In reviewing the Guidance Papers, SA Water has identified that the indicative revenue forecast range, on page 17 of Guidance Paper 2, does not accurately reflect the likely range of revenue outcomes for the regulatory period 2020 – 2024 and may therefore only serve to distort expectations. The stated range of a revenue reduction of 9 to 13 percent is unrealistic due to a number of reasons, as discussed further below.

Most particularly, SA Water is concerned that quoting a revenue projection at this stage in the process prejudges the outcome of ESCOSA's determination and represents an outcome which may not be in the best long-term interests of customers. Moreover, the publication of such an unrealistic revenue projection undermines the ability to reach a fair agreement with the Customer Negotiation Committee, before the negotiation process has even commenced.

The identified issues with the revenue forecast include:

1. The expenditure allowance used for the revenue projection is prior to SA Water developing its 10 year corporate business plan, or reaching agreement with the Customer Negotiation Committee, and does not factor in expenditure required to maintain existing customer service levels. Based on the level of expenditure in ESCOSA's revenue calculation, customer service levels would likely fall in the next regulatory period. This does not align with the levels of service customers have told us they are seeking for the coming regulatory period.

2. The proposed methodology for the regulatory rate of return in the Guidance Papers, which is the most volatile of the regulatory building blocks, has the following issues:

    - It does not factor in the movements in the market rate between now and April 2020, when the rate will be set. Based upon the methodology used, this could be significant. For example, the market rate assumed by ESCOSA is below the 1 year, 2 year and 5 year average. This indicates there is a risk of a higher market rate by April 2020 with a higher revenue allowance. In fact, using this methodology, the volatility in the market rate between 2012 and 2017 could result in a revenue variation of up to 25 percent.

    - It prejudges the methodology to be adopted for the rate of return and prevents genuine negotiation between SA Water and the Customer Negotiation Committee around this very important element. It also does not address price stability which is an important factor for customers.

    - The Guidance Paper only references the revenue change in 2020 and not for the remainder of the regulatory period or for the medium term, i.e. beyond 2024. Using ESCOSA's proposed rate of return methodology, assuming the long-term average of the market parameters and all other things equal, would result in an <u>increase</u> in revenue estimated to be approximately 8 percent for water and 11 percent for sewer from 2024. This future consequence for customers has not been made transparent in the Guidance Paper and does not align with ESCOSA's primary objective to protect the long-term interests of customers with respect to price, quality and reliability.

    - The current rate of return methodology has a misalignment between the inflation allowance in the calculation and the actual rate of inflation. This misalignment creates a risk of over or under recovery of revenue based upon whether the actual rate is above or below the Reserve Bank of Australia's (RBA) long-term forecast. Based upon the methodology proposed and current rates, this is artificially under recovering revenue for 2020 and, as the methodology is volatile, creates a risk of a significant revenue, and therefore price, increase in 2024.

3. No financial viability test has been factored into the revenue assessment. The revenue range quoted is likely to impact on SA Water's financial viability which would limit the ability to invest to meet customer service expectations.

4. The Guidance Paper is not clear on what the impact would be for customers. The way revenue is collected through customer prices is a matter for government policy. The percentage change therefore represents a change in overall revenue, not individual customer prices, potentially leaving customers disappointed at being misled by unrealistic predictions.

Even taking ESCOSA's assumptions from the Guidance Paper for all elements of the determination, including the rate of return and expenditure assumptions, it is not clear how ESCOSA has derived a revenue reduction of up to 13 percent. Furthermore, as noted above, ESCOSA's assumed scenario ignores issues previously raised by SA Water about the current rate of return methodology and ignores any additional expenditure that might be required during the next determination period.

A more realistic range of possible revenue outcomes from a fair and transparent determination process are demonstrated by the following scenarios:

- Scenario 1 – addressing the issues with the current rate of return methodology by using the long-term average for equity in the rate of return and updating inflation adjustment to be closer to actual inflation (50 percent actual and 50 percent RBA long term rate), with all other elements remaining as per ESCOSA's assumptions, would lead to a revenue reduction for water of around 3 percent and a reduction of around 2 percent for sewer.

- Scenario 2 – Using the rate of return methodology as per scenario 1 and updating the expenditure assumptions based upon the potential need to invest to meet customer service expectations, regulatory obligations and external environmental factors, with all other elements remaining as per ESCOSA's assumptions, would lead to a revenue increase for water of around 3 percent and an increase of around 4 percent for sewer.

As can be seen from the above analysis, equally plausible scenarios result in revenue projections as variable as a reduction of around 3 percent to an increase of 4 percent. As SA Water is yet to finalise its business planning process, it is not possible to make prudent assumptions about the likely level of expenditure required between 2020 and 2024. Similarly, the fact that the most volatile element of the regulatory building blocks, the rate of return, is highly variable only serves to further highlight the premature nature of releasing revenue path projections at this time.

In closing, based on these concerns, SA Water is seeking that ESCOSA issue further guidance to ensure a genuine regulatory process and so that the Customer Negotiation Committee and other stakeholders are appropriately informed to allow for a balanced and unbiased negotiation.

Yours sincerely

Roch Cheroux
Chief Executive