

# SA WATER PRICE DETERMINATION 1 JULY 2016 – 30 JUNE 2020

*Final Framework and Approach*

November 2014



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The Essential Services Commission of South Australia is the independent economic regulator of the water, electricity, gas, ports and rail industries in South Australia. The Commission's primary objective is the *protection of the long-term interests of South Australian consumers with respect to the price, quality and reliability of essential services*. For more information, please visit [www.escosa.sa.gov.au](http://www.escosa.sa.gov.au).

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## GLOSSARY OF TERMS

<b>ABS</b>	Australian Bureau of Statistics
<b>ADP</b>	Adelaide Desalination Project
<b>AER</b>	Australian Energy Regulator
<b><math>\beta</math></b>	Equity Beta
<b>CAPM</b>	Capital Asset Pricing Model
<b>Capex</b>	Capital Expenditure
<b>CGB</b>	Commonwealth Government Bond
<b>Commission</b>	Essential Services Commission of South Australia
<b>CPI</b>	Consumer Price Index
<b>CSO</b>	Community Service Obligation
<b>D</b>	Value of Debt
<b>DRP</b>	Debt Risk Premium
<b>E</b>	Value of Equity
<b>ESC Act</b>	Essential Services Commission Act 2002 (SA)
<b>ESCOSA</b>	Essential Services Commission of South Australia
<b>FTE</b>	Full Time Equivalent
<b>FVC</b>	Fair Value Curve
<b><math>\gamma</math> or Gamma</b>	The value of a dollar of a firm's dividend imputation credits
<b>GSL</b>	Guaranteed Service Level
<b>Guidance Paper</b>	Review of SA Water's Prices: 2013/14 – 2015/16 Guidance Paper
<b><math>i_{\text{exp}}</math></b>	Expected Inflation
<b>Inquiry</b>	Inquiry into Drinking Water and Sewerage Retail Services Pricing Reform
<b><math>k_d</math></b>	Cost of Debt
<b><math>k_e</math></b>	Cost of Equity
<b>IPART</b>	Independent Pricing & Regulatory Tribunal, NSW
<b>LRMC</b>	Long Run Marginal Cost

<b>MRP</b>	Market Risk Premium
<b>NWI</b>	National Water Initiative
<b>Opex</b>	Operating Expenditure
<b>RAB</b>	Regulatory Asset Base
<b>RBP 2016</b>	SA Water's Regulatory Business Proposal for the 1 July 2016 to 30 June 2020 period.
<b><math>r_f</math></b>	Risk-free Rate
<b>SA Water</b>	South Australian Water Corporation
<b>SA Water PD 2013</b>	Price determination that applies to SA Water during the regulatory period 1 July 2013 to 30 June 2016
<b>SA Water PD 2016</b>	Price determination that applies to SA Water during the regulatory period 1 July 2016 to 30 June 2020
<b>SA Water PD 2020</b>	Price determination that will apply to SA Water for the regulatory period commencing 1 July 2020
<b>SRMC</b>	Short Run Marginal Cost
<b>V</b>	Value of the Firm ( $V = E + D$ )
<b>WACC</b>	Weighted Average Cost of Capital
<b>Water Industry Act</b>	Water Industry Act 2012 (SA)



# 1. BACKGROUND AND PURPOSE

## 1.1 *Legislative framework and Commission's role*

The Essential Services Commission of South Australia (**Commission**), established under the *Essential Services Commission Act 2002 (ESC Act)*, is the independent economic regulator of essential services in South Australia. In undertaking its regulatory functions, the Commission's primary objective is the ***protection of the long-term interests of South Australian consumers with respect to the price, quality and reliability of essential services.***<sup>1</sup>

The regulatory functions of the Commission are set out in section 5 of the ESC Act:

### *5—Functions*

*The Commission has the following functions:*

- (a) to regulate prices and perform licensing and other functions under relevant industry regulation Acts;*
- (b) to monitor and enforce compliance with and promote improvement in standards and conditions of service and supply under relevant industry regulation Acts;*
- (c) to make, monitor the operation of, and review from time to time, codes and rules relating to the conduct or operations of a regulated industry or regulated entities;*
- (d) to provide and require consumer consultation processes in regulated industries and to assist consumers and others with information and other services;*
- (e) to advise the Minister on matters relating to the economic regulation of regulated industries, including reliability issues and service standards;*
- (f) to advise the Minister on any matter referred by the Minister;*
- (g) to administer this Act;*
- (h) to perform functions assigned to the Commission under this or any other Act;*
- (i) in appropriate cases, to prosecute offences against this Act or a relevant industry regulation Act.*

Since 1 July 2012, the South Australian water industry has been a regulated industry under the *Water Industry Act 2012 (Water Industry Act)*. The Commission can therefore use its broad regulatory powers and functions under the ESC Act within the South Australian water industry.

Pursuant to section 35(1) of the Water Industry Act, the Commission may make a price determination under the ESC Act regulating prices, conditions relating to prices and price-fixing factors for water and sewerage retail services in South Australia.

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<sup>1</sup> ESC Act 2002, section 6(a)

There are several points to note about the scope of the price determination powers and process.

First, in authorising the making of a price determination, the Water Industry Act limits the determination to those services falling within the definition of "retail services"; any services outside the scope of that definition may not be the subject of a price determination.

Section 4(1) of the Water Industry Act defines a retail service as follows:

***retail service*** means a service constituted by—

- (a) *the sale and supply of water to a person for use (and not for resale other than in prescribed circumstances (if any)) where the water is to be conveyed by a reticulated system; or*
- (b) *the sale and supply of sewerage services for the removal of sewage, (even if the service is not actually used) but does not include any service, or any service of a class, excluded from the ambit of this definition by the regulations;*

Any operations or services falling outside the scope of that definition are not subject to price regulation; for example, the provision of network services on a stand-alone basis is not price regulated.

Second, the Water Industry Act (section 5(2)) removes irrigation water service providers from the scope of a price determination:

(2) *This Act does not apply to or in relation to—*

- (a) *an irrigation trust, or any services provided or infrastructure held by an irrigation trust, under the Irrigation Act 2009;*
- (b) *the Renmark Irrigation Trust, or any services provided or infrastructure held by the Renmark Irrigation Trust, under the Renmark Irrigation Trust Act 2009;*
- (c) *any other person providing irrigation services designated by the Minister by notice in the Gazette,*

*except to the extent prescribed by the regulations.*

Third, section 35(4) of the Water Industry Act provides the Treasurer with a power to issue a statutory instrument, known as a 'pricing order':

(4) *The Treasurer may, for the purposes of subsection (3), issue an order (a pricing order) that —*

- (a) *sets out any policies or other matters that the Commission must have regard to when making a determination contemplated by this section;*
- (b) *specifies various parameters, principles or factors that the Commission must adopt or apply in making a determination contemplated by this section;*
- (c) *relates to any other matter that the Treasurer considers to be appropriate in the circumstances.*



Section 35(3) of the Water Industry Act requires the Commission to comply with the terms of any pricing order issued by the Treasurer under that Act.

## *1.2 First Regulatory Period – 2013/14 to 2015/16*

In May 2013, the Commission made its First Price Determination in respect of the water and sewerage retail services provided by the South Australian Water Corporation (**SA Water**). The *SA Water's Water and Sewerage Revenues 2013/14 - 2015/16 Final Determination (SA Water PD 2013)* sets the maximum average revenues that SA Water can earn during the period 1 July 2013 to 30 June 2016.

SA Water then sets prices for water and sewerage retail services consistent with the revenue allowances.

## *1.3 Purpose of this document*

Prior to 30 June 2016, the Commission will make a new determination (**SA Water PD 2016**) for SA Water, covering the period commencing 1 July 2016 to 30 June 2020. The purpose of this Framework and Approach paper is to set out the proposed principles and approach that will guide that determination. It applies only to SA Water, not to other retailers licensed under the Water Industry Act.

The Commission will settle key principles and matters of process for the SA Water PD 2016 in time to provide SA Water with reasonable certainty as it develops its Regulatory Business Proposal (**RBP 2016**). The Commission stresses, however, that it does not intend to provide detailed instructions to SA Water on all of the matters that must be addressed in RBP 2016. SA Water should argue the merits of its proposals, based on its business plans, and having regard to the views of its customers, supported by clear, reasoned arguments and evidence.

There are, however, certain areas where the Commission has sought to identify the minimum information requirements that it expects SA Water to present as part of RBP 2016. For example, within the expenditure sections of this paper, the granularity of data and supporting written information that should be provided have been specified.

In any industry certain conditions and factors change as new information becomes available. It is, therefore, not possible to settle all matters, nor is it possible to say with certainty that the Commission's approach to some matters will not, or should not, change.

For example, the Commission may change its approach on the basis of consultation feedback and/or consideration of any other new information in response to SA Water's RBP 2016.

This paper should be interpreted as reflecting the proposed framework and approach at this point in time, based on information currently available.

## 1.4 Inquiry into reform of SA Water's Prices

The Commission is currently conducting an Inquiry into reform of SA Water's drinking water and sewerage prices (**Inquiry**).<sup>2</sup> A draft report was released on 16 July 2014. The draft report focuses on the following areas for reform:

- ▲ SA Water's drinking water tariff structure to promote greater cost reflectivity
- ▲ possible changes to the current property-based approach to sewerage pricing
- ▲ location-based pricing as an alternative to the current statewide pricing approach
- ▲ treating end-users as customers (rather than land-owners)
- ▲ increasing the number of individual customers that are metered and introducing smart water meters.

Following public consultation on the draft report, a final report will be submitted to the Treasurer and Minister for Water and the River Murray by 31 December 2014.

The State Government will consider the reform options examined by the Commission, determine if any reforms should be implemented and, if so, the timeframe for implementation. The Commission cannot pre-empt which, if any, reforms the Government will undertake during the period of the SA Water PD 2016. Consequently, this Framework and Approach paper assumes that the current pricing arrangements will apply, subject to the requirements of the September and November 2014 Pricing Orders, discussed below.

## 1.5 September 2014 Pricing Order

In September 2014, a Pricing Order was issued under the Water Industry Act, setting out the matters that the Commission must comply with in making the SA Water PD 2016. The Pricing Order (reproduced at Appendix 1), requires the SA Water PD 2016 to:

- ▲ be of a 4 year period, commencing 1 July 2016
- ▲ utilise a revenue cap form of control
- ▲ adopt separate revenue cap controls for drinking water and sewerage services, but not apply revenue caps based on customer class or location
- ▲ include a mechanism to adjust for any over or under recovery of revenue due to variations between actual and forecast water consumption or sewerage connections
- ▲ include a mechanism that allows for the pass through to customers of efficient and material costs associated with events beyond SA Water's control
- ▲ adopt Regulated Asset Base (**RAB**) values as at 1 July 2013 of \$7.77bn (drinking water) and \$3.58bn (sewerage) in December 2012 dollars

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<sup>2</sup> All Inquiry publications are available on the Commission's website at <http://www.escosa.sa.gov.au/projects/189/inquiry-into-drinking-water-and-sewerage-retail-services-pricing-reform.aspx>.

- ▲ allow SA Water to recover certain non-commercial costs specified by direction under section 6 of the *Public Corporations Act 1993*. (Such a direction was made on 23 October 2014 (reproduced at Appendix 3).

The Pricing Order also sets out the following procedural matters:

- ▲ the determination must be based on a “building blocks” approach and must set out all assumptions, methods and values assigned to the building block components
- ▲ the draft determination must identify any areas where a forecast cost is likely to change materially between draft and final determination, including the cause and likely magnitude of the variation
- ▲ the Commission must, by 31 December 2013, provide the Treasurer with a separate report, setting out its proposed approach to the calculation of the rate of return on the RAB, which should be consistent with Principle 1 of the NWI Principles of the Recovery of Capital Expenditure.

At the same time as releasing this final Framework and Approach paper, the Commission has released a draft report on its proposed approach to calculating SA Water’s rate of return.<sup>3</sup> That draft report also discusses the Commission’s proposed approach to calculating tax expenses. As those matters are discussed in detail in the draft report, the Commission has not repeated its proposal in this Framework and Approach paper.

## 1.6 November 2014 Pricing Order

On 18 November 2014, a further Pricing Order was issued under the WIA (reproduced at Appendix 2), revising the date by which the report setting out the Commission’s proposed approach to the calculation of the rate of return on the RAB is required, from 31 December 2014 to 31 March 2015. This additional time will allow the Commission to publicly consult on its proposed approach.

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<sup>3</sup> Essential Services Commission of South Australia, *SA Water Regulatory Rate of Return: 2016 - 2020, Draft Report to the Treasurer*, November 2014; available at <http://www.escosa.sa.gov.au/library/20141121-SAWaterRateofReturn-DraftReport.pdf>

## 2. PROCESS FOR THE SA WATER PRICE DETERMINATION 2016

### 2.1 *Price Determination Process*

The process for making the SA Water PD 2016 will involve the following steps:

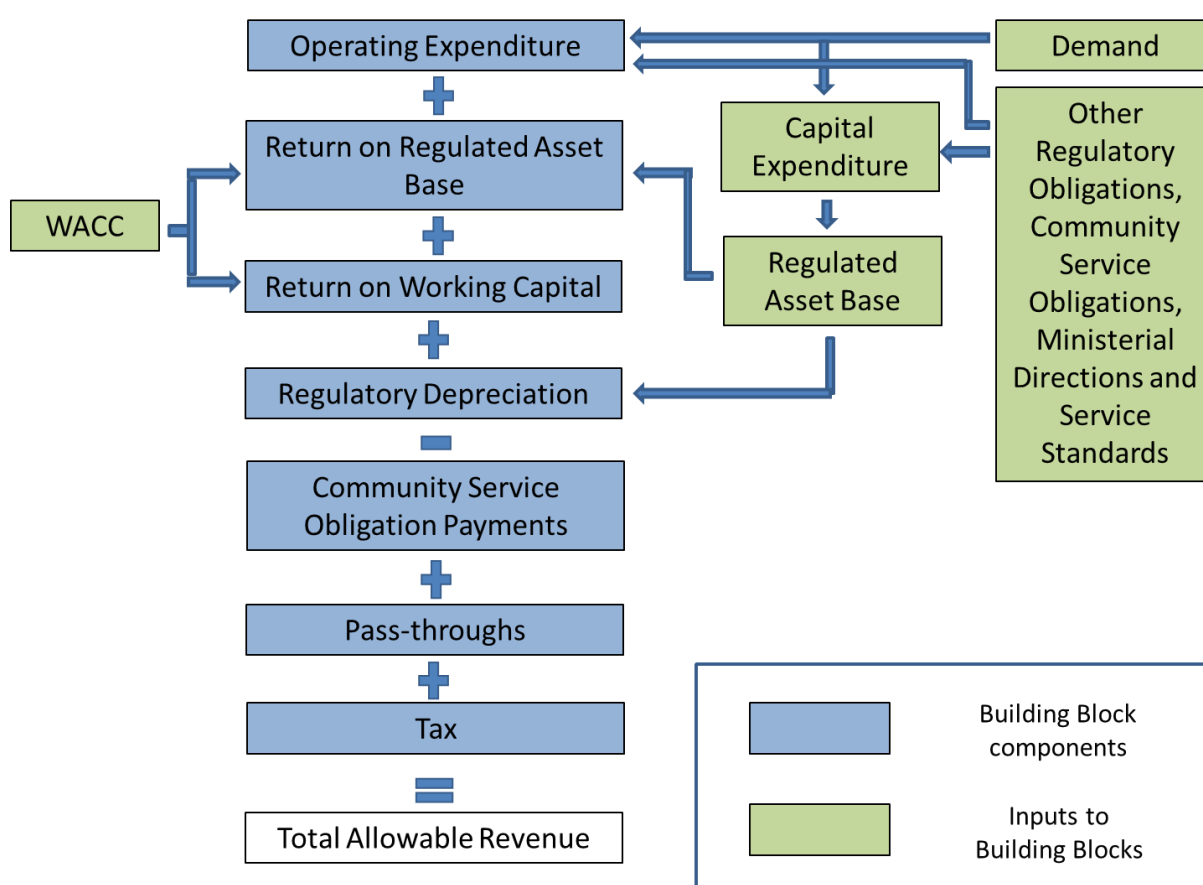
1. The service standards and performance targets to be met by SA Water during the period of the SA Water PD 2016, which will impact on SA Water's expenditure during that period, will be set (see Chapter 4).
2. SA Water's regulated retail services will be classified as either "direct control" services (which, under the terms of the September 2014 Pricing Order, are the sale and supply of drinking water and sewerage services and are subject to revenue caps), or "excluded services" (services provided to individual or distinct groups of customers, which will be subject to a lighter-handed form of control) (see Chapter 5).
3. The manner in which the revenue caps will apply will be determined, as will the forms of regulation to apply to excluded services (e.g. pricing principles and/or price monitoring) (see Chapter 6).
4. The cost components, or "building blocks", that are used to determine total allowable revenue for direct control services will be determined. In particular, the Commission will:
  - a. determine prudent and efficient capital and operating expenditures for the SA Water PD 2016 (see Chapter 7). Operating expenditure is directly recoverable through allowed revenues and capital expenditure is added to SA Water's RAB, which is itself an input into the revenue building blocks
  - b. apply the 1 July 2013 RAB values for drinking water and sewerage assets, as set in the September 2014 Pricing Order, and "roll forward" those values to incorporate efficient capital expenditure incurred by SA Water, regulatory depreciation, inflation, and asset disposals during the period of the SA Water PD 2013. The resulting RAB values will then be set for the SA Water PD 2016 using a similar roll forward process, based on forecast costs (see Chapter 8)
  - c. determine the allowance for working capital (see Chapter 8)
  - d. set the regulatory rate of return, which is applied to the value of the RAB and the amount of working capital to determine the return on assets and working capital components
  - e. make an allowance for tax expense
  - f. take into account the payments from the Government for Community Service Obligations (**CSO**) that the Government requires SA Water to perform under section 6 of the *Public Corporations Act 1993*. (SA Water incurs costs in performing CSOs; CSO payments are deducted from total allowed revenues, to ensure there is no double-recovery of those amounts)
  - g. make allowances for cost pass-through events that have occurred during the period of SA Water PD 2013; these events are those that were unforeseen at the time of making the SA Water PD 2013 but which meet the criteria established by the Commission in that determination and which have led to cost changes that

may be considered for a pass-through to revenues in the SA Water PD 2016 (see Chapter 9).

5. The combined building blocks of revenue will be used to determine revenue caps that will apply to drinking water and sewerage services for the SA Water PD 2016 (see Chapter 10).

The building block approach described above sets allowed revenues to reflect only the prudent and efficient costs incurred in providing the direct control services to an agreed set of service standards (and in meeting any other obligations that the Government directs SA Water to provide) in a rigorous and transparent manner. Figure 2-1 shows how total revenue allowances are derived from these cost building blocks.

**Figure 2-1: The Building Blocks of the Total Revenue Allowance**



## 2.2 Prudent and efficient

The SA Water PD 2016 will ensure that SA Water's allowed revenue recovers efficient costs only. It is not in the long-term interests of consumers for allowed revenues to exceed efficient costs, as SA Water's revenues and prices will be higher than they ought to be, nor should revenue be set below efficient costs as it may compromise SA Water's ability to provide essential services to consumers.

The Commission will assess expenditure proposals using the ‘prudent’ and ‘efficient’ tests, as implemented for the SA Water PD 2013:

- ▲ The ‘prudence’ principle tests whether the benefits of the expenditure outweigh the costs (i.e. should the project be done at all?)
- ▲ The ‘efficiency’ principle tests whether the proposed expenditure is the least-cost solution to achieve the intended outcome.

These concepts are commonly used by regulators in assessing the expenditure proposals of regulated entities.

The Commission will scrutinise the prudence and efficiency of the following proposed classes of expenditures:

- ▲ capital expenditures on both a project/program basis and a ‘whole of system’ basis, over a long-term planning horizon
- ▲ operating expenditures by examining whether they are both prudent (benefits exceed costs) and efficient (represent the least-cost means of achieving the benefits).

In testing the prudence of capital expenditures, consideration will be given to the benefits of, and need for, the proposed project/program. In testing the efficiency of capital expenditures, consideration will be given to the following factors:

- ▲ the proposed timing and delivery of the project/program
- ▲ the alternative options considered in developing the project/program
- ▲ the forecast costs of the planned project/program
- ▲ any further relevant considerations.

The efficiency of operating expenditure will be tested by examining the efficiency of base year expenditure (the current level of costs), and movements in recurring expenditure relative to a base year, taking account of both the opportunities for further efficiency that may exist (e.g. through the implementation of new technologies), and any new business costs that SA Water is likely to face (e.g. from additional environmental obligations). Further, the Commission may benchmark SA Water’s current and proposed costs against other water utilities.

The Commission will invite all members of the community to comment on the prudence and efficiency of proposed expenditures and take account of these views in its assessment.

The Commission may seek external expert advice to assist it in assessing the prudence and efficiency of SA Water’s expenditure proposals.

## *2.3 Other regulatory obligations*

Under the Water Industry Act and the ESC Act, the Commission’s role is independent economic regulation. Environmental and health obligations are set for SA Water by other regulators.

Prior to making the SA Water PD 2016, the Commission will liaise with other regulators and agencies, to ensure coordination and identify regulatory impacts as early as possible.

However, it is important that any cost impacts on SA Water that arise from environmental and health regulatory obligations are:

- ▲ based on obligations that are clearly stated in legislative instruments (e.g. environmental operating licences)
- ▲ determined to be efficient before being passed on to customers.

SA Water will need to demonstrate that any cost impacts reflect only the most efficient ways to meet regulatory obligations.

Further, SA Water must state explicitly in RBP 2016 any expenditures that it is required to incur in order to meet service standards set by other regulators. SA Water should also clearly state where expenditure is needed to meet customer service standards set by the Commission.

In assessing SA Water's RBP 2016, the Commission will consult closely with other regulators to seek their views on the consistency of SA Water's expenditure proposals with regulatory requirements. The Commission will publish all correspondence with other regulators to ensure that the public is aware of other regulators' views and to facilitate public consultation on the expenditure proposals.

## 2.4 Customer consultation

SA Water must undertake consumer consultation in the development of RBP 2016. The RBP should include information on how customers have been consulted and evidence of customers' responses to SA Water's proposals.

The manner in which SA Water chooses to consult will be for it to determine – but it must be genuine and effective. The Commission will assess all RBP 2016 proposals on the basis of whether or not the demonstrated benefits to customers exceed the costs. SA Water should, therefore, seek to demonstrate the net benefits to customers associated with its proposals.

While SA Water may consult on any aspects of RBP 2016 as it sees appropriate, at a minimum, it should consult on significant expenditure proposals that rely on customer benefits for justification and on customer service standards. This is consistent with the requirements imposed under other regulatory regimes. For example, the Essential Services Commission of Victoria requires each regulated water business to set out how it used the results of surveys on customers' preferences in cost–benefit analysis of major projects.<sup>4</sup>

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<sup>4</sup> Essential Services Commission of Victoria, *2013 Water Price Review: Guidance on Water Plans*, October 2011, p. 110.

### 3. PROCESS

The Commission published a Draft Framework and Approach paper for public consultation in November 2013. Three submissions were received in response to the public consultation, two from SA Water and one from Business SA<sup>5</sup>. A summary of the issues raised in these submissions, and the Commission's responses, is provided at Appendix 5.

As noted earlier, since the publication of the Draft Framework and Approach, two Pricing Orders have been issued providing direction and guidance on the SA Water PD 2016 across a number of areas.

Further, on 23 October 2014, a direction was given to SA Water pursuant to section 6 of the *Public Corporations Act 1993*. The direction requires SA Water to provide certain non-commercial services during the SA Water PD 2016. It also provides details of associated CSO funding arrangements for those services. A copy of the Direction is provided at Appendix 3.

The submissions and the new information have been taken into account in developing this Final Framework and Approach paper.

An indicative timetable for the SA Water PD 2016 is listed below:

**Table 3-1: Indicative<sup>6</sup> Timetable for the SA Water PD 2016**

Date	Activity
November 2013	Released Draft Framework and Approach paper for public consultation
February 2014	Submissions to Draft Framework and Approach paper due
August 2014	SA Water provided a further submission on Service Standard framework
September 2014	Pricing Order published
November 2014	Further Pricing Order Published
November 2014	Release Final Framework and Approach paper
November 2014	Release draft report on SA Water's regulatory rate of return
December 2014	Issue RBP 2016 Templates to SA Water

<sup>5</sup> Copies of the submission received are available at: <http://www.escosa.sa.gov.au/projects/206/economic-regulation-of-sa-water-from-1-july-2016-draft-framework-and-approach.aspx>

<sup>6</sup> All dates are indicative at this time.



<b>Date</b>	<b>Activity</b>
March 2015	Provide to Treasurer a final report on SA Water's regulatory rate of return
August 2015	Receive SA Water's RBP 2016, including proposed Service Standards targets
September/ October 2015	Release RBP 2016 for public consultation
January/ February 2016	Release Draft SA Water PD 2016, including Commission's draft Service Standards targets for public consultation
May 2016	Publish Final SA Water PD 2016, including final Service Standards targets
1 July 2016	Implement Final SA Water PD 2016 and Service Standards

## 4. SERVICE STANDARDS

This chapter provides an overview of the service standards and service incentive framework for the SA Water PD 2016. This chapter refers to the framework only, with the actual service standards and targets to be proposed by SA Water in its RBP 2016.

At the same time as releasing the draft Framework and Approach paper, the Commission released a companion paper setting out the draft Service Standard Framework.<sup>7</sup> Three submissions were received in response to the public consultation on the framework, two from SA Water and one from Business SA.<sup>8</sup> A summary of the issues raised in these submissions, and the Commission's response, is provided as Appendix 5. The Commission has taken account of those submissions in developing the service standards and service incentive framework and approach outlined in this Chapter.

In the SA Water PD 2013, the Commission took the approach of setting service standards which reflected SA Water's underlying historical service performance outcomes. As noted in the Statement of Reasons:

*That position was developed through the public process of providing regulatory advice to the Treasurer during 2011 and 2012, was agreed by stakeholders generally and, in particular, was endorsed by SA Water as an appropriate regulatory approach.<sup>9</sup>*

Those service standards are available on the Commission's website.<sup>10</sup>

The targets for those standards were set in early 2013-14 to reflect the Commission's best understanding of SA Water's underlying historical performance.<sup>11,12</sup>

SA Water's RBP 2016 must propose a set of service standards and targets, determined in consultation with its customers. This will foster a relationship between SA Water and its customers that mirrors what might be expected to occur in a market environment. SA Water's RBP 2016 should reflect the prudent and efficient costs required to deliver the proposed service standards and targets.

The Commission will determine the final service standards and targets, to be developed as part of the price determination process. In doing so, it will consult on, and conduct its own scrutiny of, the service standards and targets proposed by SA Water.

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<sup>7</sup> The SA Water Service Standards: Draft Framework and Approach paper is available on the Commission's website at <http://www.escosa.sa.gov.au/projects/206/economic-regulation-of-sa-water-from-1-july-2016-draft-framework-and-approach.aspx#stage-list=0>.

<sup>8</sup> Copies of the submission received are available at: <http://www.escosa.sa.gov.au/projects/206/economic-regulation-of-sa-water-from-1-july-2016-draft-framework-and-approach.aspx>

<sup>9</sup> *Op. cit.*, p. 22.

<sup>10</sup> Refer <http://www.escosa.sa.gov.au/water-overview/codes-guidelines/service-standards.aspx>.

<sup>11</sup> *Op. cit.*, p. 25.

<sup>12</sup> Essential Services Commission of South Australia, SA Water Service Standards 2013/14 – 2015/16, Final Decision, October 2013; available at [http://www.escosa.sa.gov.au/library/130926-SAWaterServiceStandards\\_2013-2016-FinalDecision.pdf](http://www.escosa.sa.gov.au/library/130926-SAWaterServiceStandards_2013-2016-FinalDecision.pdf).

## 4.1 Consumer engagement

Regulatory service standards are drivers of the prudent and efficient levels of both capital and operating expenditure (**capex** and **opex**) that will be allowed in the price determination.

There is an inherent trade-off between prices and service level. Higher service levels may provide extra benefits to customers, but will also raise costs and prices. Coupled with price regulation, service standard regulation seeks to determine efficient service levels, given the absence of a competitive market. An assessment of customers' needs, expectations, and willingness to pay for services form an important input in determining service standards. Customers need to be given the opportunity to assess whether their preference would be for a lower/higher level of service in return for a stated reduction/increase in bills.

The Commission's service standard framework places a clear onus on SA Water to genuinely engage with customers in developing RBP 2016.

SA Water has developed a customer engagement program for that purpose.<sup>13</sup> The Commission has worked with SA Water as it undertakes its program, to ensure reasonable confidence in the results.

As an initial part of that program, SA Water has undertaken scenario-testing of service standards with its customers.

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<sup>13</sup> All reports and findings from SA Water's customer engagement program will be made publicly available on its website. Refer <http://yoursay.sawater.com.au>.

**Box 4-1: Summary of the first three stages of SA Water's customer engagement program**

**Stage 1 – Focus groups**

SA Water commenced its customer engagement program in November 2013 by holding a series of focus groups with metropolitan Adelaide and regional South Australian customers that had recent contact experience with SA Water. Feedback was also sought from SA Water's residential and business customer advisory groups.<sup>14</sup> Customer interest centred around six main themes: the role of SA Water, water recycling, water quality, water for growth, customer experience and education and service delivery and investment.<sup>15</sup>

**Stage 2 – Internal business planning**

The findings from the Stage 1 focus groups were used to inform internal business planning workshops within SA Water. These workshops developed service and investment options to be discussed with customers in Stage 3.

**Stage 3 – Customer engagement workshops and online survey**

SA Water held workshops with customers from across metropolitan Adelaide and regional South Australia. Unlike Stage 1, customers were recruited from across SA Water's entire customer base, not just customers with recent contact experience.

The workshops centred around testing customers' preferred service and investment options in the six themes identified in Stage 1. In respect of service standards, this included testing:

- ▲ customers' satisfaction with current service levels;
- ▲ willingness to pay for increased levels of service; and
- ▲ willingness to accept reduced levels of service.

The workshops were complemented by a public online survey that tested similar scenarios.<sup>16</sup>

Overall, the majority of customers were generally satisfied with the current service levels that SA Water provides, with many workshop participants choosing to change nothing about the current service levels provided.

Following completion of the first three stages of its consumer engagement program, SA Water made a further submission to the draft framework and approach, noting that it did not receive any information from its customers that would require changes to the customer consultation and service standard setting process set out in the draft framework and approach.

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<sup>14</sup> SA Water has established two Customer Advisory Groups, one focusing specifically on residential customers and the other on business customers. The role of both Customer Advisory Groups is to make sure SA Water decisions are aligned with customer expectations. Further details are available at <http://www.sawater.com.au/SAWater/AboutUs/CustomerSupport/Customer+Council.htm>.

<sup>15</sup> SA Water, *Customer Engagement Program, Stage 1 Report, Understanding customer values, needs and expectations*, March 2014, available <http://yoursay.sawater.com.au/wp-content/uploads/2014/05/Customer-Engagement-Program-Stage-1-Report.pdf>.

<sup>16</sup> SA Water, *Customer Engagement Program*, <http://www.yoursay.sawater.com.au>

## 4.2 Service standards and targets

The term *service standard* refers to the element of service quality that customers value.

The purpose of setting regulatory service standards (with associated targets) is:

1. To ensure that customers receive the quality of service that they value.
2. To inform the prudent and efficient level of expenditure (capex and opex) for price determination purposes.
3. Then to perform a consumer protection role through enforcement of standards, noting that the Commission's standards are distinct from health, environmental and technical standards set by other regulatory bodies (such as the Environment Protection Authority or the Technical Regulator).

The Water Industry Act provides the Commission with the power to set regulatory service standards as part of a cohesive and legally binding framework.

SA Water has not identified any new or additional service standards through consultation with its customers to date. Accordingly, the current set of service standards (set out in Table 4-1) will apply to SA Water for the PD 2016. Nevertheless, the Commission is open to considering any other specific standards (including variations to existing standards) that might be identified through customer consultation occurring as part of the SA Water PD 2016 process.

As with the current service standards, once the standards are in place, SA Water will be required to demonstrate that it has used its best endeavours to meet them on an annual basis.<sup>17</sup>

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<sup>17</sup> The Commission's definition of best endeavours in the regulatory context is "to act in good faith and use all reasonable efforts, skill and resources to achieve an outcome in the circumstances". Further discussion on this matter is included in the Commission's *Water Regulatory Information Requirements Water Industry Guideline No. 2 (WG2/01), Explanatory Memorandum*, p. 17; available at [http://www.escosa.sa.gov.au/library/121220-WaterIndustryGuidelineNo2\\_WG2\\_01-ExplanatoryMemorandum.pdf](http://www.escosa.sa.gov.au/library/121220-WaterIndustryGuidelineNo2_WG2_01-ExplanatoryMemorandum.pdf).

**Table 4-1: SA Water's service standard measures for 2016-2020**

<b>Retail customer service</b>
Timeliness of response to telephone calls
Timeliness of response to complaints
Timeliness of response to water quality complaints
Timeliness of connection
Timeliness of processing trade waste applications
<b>Retail water</b>
Timeliness of attendance at water breaks, bursts & leaks
Timeliness of water service restoration
<b>Retail sewerage</b>
Timeliness of sewerage service restoration
Timeliness of sewerage overflow attendance
Timeliness of sewerage overflow clean up

SA Water must propose a target for each of the above regulatory service standards, based on previous performance outcomes and the evidence collected through its customer engagement (and any other relevant information). Any historical performance-based targets should be set using averages for the period 2012-13 to 2015-16.

The Commission will have regard to a number of factors in determining the final targets, such as the evidence-based targets proposed by SA Water, levels of historical performance, customer satisfaction with existing performance levels and interstate comparisons.

### *4.3 Performance monitoring and public reporting*

A key benefit of the regulatory framework established by the Commission is transparency on levels of customer service. This includes the Commission's monitoring and routine public reporting of retailers' performance against those standards.<sup>18</sup>

During the period of the SA Water PD 2016, the Commission will monitor and report on SA Water's performance against the service standards.

In addition to the service standards, the Commission will monitor other performance indicators to assess SA Water's overall performance. These indicators will include:

- ▲ customer service measures
- ▲ unplanned water supply interruptions
- ▲ sewerage mains breaks and chokes.

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<sup>18</sup> The Commission's first *Annual Performance Report* for SA Water is available at <http://www.escosa.sa.gov.au/water-overview/reporting-and-compliance/annual-performance-reports.aspx>.

Additional service standards may be introduced for future price determinations, where monitoring of indicators over time identifies areas of persistent poor performance or some other regulatory driver is identified.

Monitoring the level of customer complaints, and the extent to which complaints are resolved prior to being handled by the Energy and Water Ombudsman SA (**EWOSA**), will also form part of the Commission's performance monitoring.

#### *4.4 Service Incentive Scheme*

Regulatory service standard regimes in the energy and water sectors often include financial incentive schemes to encourage service providers to meet service targets. The Commission received no comment on this aspect in the submissions received.

Prior to introducing such a scheme, there would need to be evidence to demonstrate that its adoption would result in net benefits to consumers. Given the early stage of the development of the water regulatory regime in South Australia, such evidence is not yet available. The Commission is, therefore, not presently proposing to implement such a scheme for the SA Water PD 2016.

#### *4.5 Guaranteed Service Level Scheme*

It may simply be uneconomic to seek to ensure that all customers receive the average service level targets set. To account for such situations, in some sectors, regulated utilities are required to make Guaranteed Service Level (**GSL**) payments, with affected customers receiving payments where defined levels of service are not met.

GSL payments are intended to be payment made in recognition of the inconvenience experienced by customers receiving poor performance and not as a form of compensation. By their nature, however, they also provide a financial incentive for the regulated business to minimise the payments required to be made under the scheme. That is, there is a trade-off between making the payments or undertaking capital and/or operational expenditure to address any underlying performance or reliability issue.

The Commission will not require SA Water to propose a GSL scheme in its RBP 2016. However, the Commission would consider introducing a GSL scheme if any areas of service where a GSL scheme could be appropriate are identified through the Commission's consultation on the SA Water PD 2016. Noting that GSL schemes generally require at least part funding from all customers (from the regulated revenue), the Commission would not introduce a GSL scheme in the absence of a clear customer need, and willingness to pay for, such a scheme. If customer support is identified, the implementation costs would need to be determined by SA Water and assessed by the Commission through the PD 2016.

## 5. CLASSIFICATION OF SERVICES

In its Statement of Approach<sup>19</sup> for the SA Water PD 2013, the Commission classified SA Water's services into three broad categories<sup>20</sup>:

- ▲ direct control services
- ▲ excluded services
- ▲ non-regulated services.

In its RBP 2013,<sup>21</sup> SA Water proposed which of its services should be allocated to each of these categories. Following community consultation on the allocations of these services, the Commission determined the allocations for the SA Water PD 2013, as set out in Table 5-1.

**Table 5-1: Service Classes and Allocations – SA Water PD 2013**

DIRECT CONTROL SERVICES	EXCLUDED SERVICES	NON-REGULATED SERVICES
<ul style="list-style-type: none"> <li>▲ Sale and supply of drinking water</li> <li>▲ Sale and supply of sewerage services</li> </ul>	<ul style="list-style-type: none"> <li>▲ Standard and non-standard connection services (includes developer charges)</li> <li>▲ Miscellaneous minor services</li> <li>▲ Annual sewerage and recycled water audit services</li> <li>▲ Easement extinguishment services</li> <li>▲ Network Analysis services</li> </ul>	<ul style="list-style-type: none"> <li>▲ Laboratory services that are not retail services</li> <li>▲ Project management services that are not retail services</li> <li>▲ Water transportation services provided to third parties</li> <li>▲ Operation and maintenance of the River Murray lock system</li> <li>▲ Soil and sand testing services</li> <li>▲ Emergency functional services</li> <li>▲ Metropolitan floodwaters drainage administration</li> </ul>

For the SA Water PD 2016, the Commission proposes to maintain these three categories of services, noting that the September 2014 Pricing Order defines the sale and supply of drinking water and sewerage services as direct control services (subject to revenue caps). However, the Commission may, based on performance observed over the period of the SA Water PD 2013, and community feedback, introduce other retail services into the direct control category. It is also open to SA Water to make such a proposal in RBP 2016.

<sup>19</sup> Essential Services Commission of SA, *Statement of Approach*, July 2012, p. 21.

<sup>20</sup> Essential Services Commission of SA, *SA Water's Water and Sewerage Revenues 2013/14 – 2015/16 Final Determination Statement of Reasons*, May 2013, page 17.

<sup>21</sup> SA Water, *Regulatory Business Proposal 2013*, October 2012, p. 48.



For example, SA Water's compliance with the relevant pricing principles for excluded services throughout the period of the SA Water PD 2013 will be reviewed and, if new information or arguments come to light, the Commission may apply direct controls to some services.

The allocation of services between the direct control and excluded services categories will have regard to the extent to which competition exists for those services, and the extent to which the services are consumed by all, or a broad class, of customers, versus by some customers only.

In general, excluded services are those provided to a subset of specific customers. The costs of such services should be recovered through specific charges to those customers, rather than being costs borne by all customers through tariffs.

Direct control services are all regulated services that are not excluded services. They currently comprise the sale and supply of drinking water and sewerage retail services.

### *5.1 Non-regulated services*

Some services provided by SA Water are not retail services (as defined under section 4 of the Water Industry Act). As the Commission has no regulatory powers over those services, they are classed as non-regulated services.

## 6. FORMS OF REGULATION

### 6.1 *Introduction*

The September 2014 Pricing Order requires the use of separate revenue cap controls for drinking water and sewerage retail services. As part of the revenue-setting exercise, the Commission will consider whether or not any currently excluded services should be subject to direct control, based on experiences during the SA Water PD 2013.

The Commission intends to continue with a pricing principles and a price monitoring approach for excluded services.

### 6.2 *Direct control services*

The building block approach will be used to determine total revenue caps for direct control services that reflect prudent and efficient costs. SA Water will then set prices for direct control services consistent with the revenue allowances.

Under a revenue cap approach, SA Water will be guaranteed to earn the revenue determined under the SA Water PD 2016. If demand for SA Water's direct control services is lower than expected (translating into lower than forecast revenues) SA Water can increase prices in the future to recover forgone revenue. If demand is higher than expected, prices would be reduced in the future. A revenue cap approach can lead to prices increasing or decreasing to adjust for changes in demand. The frequency of such price adjustments is a matter that would require consideration by the Commission (as discussed further below).

The current average revenue cap approach adopted in the SA Water PD 2013 is fundamentally different. It allows SA Water to earn more or less revenue than expected during the course of the regulatory period.<sup>22</sup> The average revenue controls limit revenues per unit, not revenues in total. If SA Water sells more units (e.g. kL of water) it can collect more revenue, and vice versa if it sells fewer units. Average revenues allocate the risk of demand variability to SA Water, whereas revenue caps allocate that risk to consumers (SA Water is protected from the risk of demand being higher or lower than expected).

Under a revenue cap approach, prices can adjust each year to account for demand variations or an adjustment can occur at a later time (e.g. at the end of the four year period), to account for the net effect of demand changes over multiple years. Annual adjustments may lead to small adjustments to prices (depending on the revenue outcomes from the preceding year) whereas an end of regulatory period adjustment may lead to a larger price change, if demand is consistently higher or lower than forecast. Some form of annual or longer-term adjustment mechanism is required to ensure that the revenue amounts are achieved. A mechanism of this type is also required by clause 3.5 of the September 2014 Pricing Order.

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<sup>22</sup> The September 2012 Pricing Order required the inclusion of a revenue adjustment mechanism to provide at least partial protection to SA Water from that risk. The Commission implemented a mechanism that allows 30% of the difference in forecast revenue resulting from higher or lower demand to be adjusted for in the following regulatory period (SA Water PD 2016).

It should be noted, however, that the total amount of revenue that SA Water will be allowed to recover in respect of the PD 2016 period (in present value terms) will not be impacted by the frequency of price adjustments. SA Water should propose a revenue adjustment mechanism as part of RBP 2016.

### 6.3 Excluded services and Recycled Water

At this time, for the SA Water PD 2016, the Commission proposes to retain the form of regulation for excluded services that it adopted in the SA Water PD 2013, continuing with a pricing principles and price monitoring approach. This is summarised in Table 6-1.

**Table 6-1: Forms of Price Regulation for Excluded Services and Recycled Water**

SERVICE	PRICING PRINCIPLES	PRICE MONITORING
<b>Excluded Services</b>	<p>Commission's Excluded Service Pricing Principles 1-4</p> <p>NWI Pricing Principles (where relevant)</p> <p>These principles relate to cost recovery and transparency.<sup>23</sup></p>	<p>Maintain and submit to the Commission annually:</p> <ul style="list-style-type: none"> <li>• Pricing Schedule</li> <li>• Pricing Policy Statement</li> <li>• Regulated Accounts</li> </ul>
<b>Recycled Water</b>	<p>National Water Initiative (NWI) Pricing Principles 1-9 of Recycled Water and Stormwater Use.</p> <p>These principles relate to cost recovery and transparency.<sup>24</sup></p>	<p>Maintain and submit to the Commission annually:</p> <ul style="list-style-type: none"> <li>• Pricing Schedule</li> <li>• Pricing Policy Statement</li> <li>• Hypothetical Bill</li> <li>• Regulated Accounts</li> </ul>

However, the Commission reserves the right to change its approach for some services if new information or arguments come to light that would suggest an alternative approach is warranted.

Further information on the NWI Pricing Principles is contained in Appendix 4.

<sup>23</sup> Essential Services Commission of SA, *SA Water's Water and Sewerage Revenues 2013/14 - 2015/16 Final Determination Part A - Statement of Reasons*, May 2013, p. 186; available at [http://www.escosa.sa.gov.au/library/130527-SAWater\\_Water\\_SewerageRevenues\\_2013-16-FinalDetermination-StatementOfReasons\\_0.pdf](http://www.escosa.sa.gov.au/library/130527-SAWater_Water_SewerageRevenues_2013-16-FinalDetermination-StatementOfReasons_0.pdf)

<sup>24</sup> National Water Commission, *National Water Initiative Pricing Principles*, April 2010, p. 16; available at <http://www.environment.gov.au/water/publications/action/pubs/nwi-pricing-principles.pdf>

The Commission has developed a proposed dispute resolution framework for excluded services. This proposed framework is contained in *Water Industry Rule No.1 – Excluded Retail Services*,<sup>25</sup> which was finalised in December 2013.

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<sup>25</sup> Essential Services Commission of SA, *Water Industry Rule No. 1 - Excluded Retail Services*, December 2013, available at: <http://www.escosa.sa.gov.au/projects/201/water-industry-rule-no-1-excluded-retail-services.aspx>.

## 7. EXPENDITURE

### 7.1 Introduction

In the SA Water PD 2013, the Commission determined the prudent and efficient<sup>26</sup> level of costs to be incurred by SA Water for the provision of direct control services, and in meeting non-commercial obligations specified by the Government. Allowing only prudent and efficient costs is consistent with the Commission's statutory objectives, as well as the requirements of the NWI Pricing Principles.<sup>27</sup> Expenditure information that SA Water will be required to provide in RBP 2016 will be broadly consistent with that required in the Guidance Paper for the SA Water PD 2013.<sup>28</sup>

RBP 2016 should include only prudent and efficient capital and operating expenditures. The Commission will examine proposed expenditures, including through benchmarking SA Water against water industry peers. All members of the community will be given the opportunity to present their views on SA Water's proposed expenditures.

#### 7.1.1 General information requirements

SA Water must provide both spreadsheet-based financial information and supporting written commentary. Historic actual cost data will be required to provide context to forecast data. The commentary must demonstrate that SA Water's proposed expenditures are both prudent and efficient. Further information requirements include:

- ▲ a description of the process for developing and seeking approval of new projects and associated expenditures
- ▲ a demonstration of the links between proposed expenditures and demand forecasts
- ▲ evidence that asset management plans are in place and have been followed
- ▲ the impacts of any new regulatory obligations on expenditures
- ▲ information on SA Water's consultations with external bodies during its development of expenditures (e.g. occupational health and safety and water quality issues)
- ▲ information on the level of consumer consultation that has taken place (see section 2.4 for further information)
- ▲ any relevant cost benchmarking information (e.g. provision of benchmarking studies undertaken)
- ▲ details of any emerging issues with asset populations (e.g. if the accuracy of a particular type of meter is deteriorating faster than expected, this may support the case for early replacement)

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<sup>26</sup> A discussion of the 'prudent & efficient' tests is provided at section 7.1.10.

<sup>27</sup> NWI Pricing Principles are available at:  
<http://www.environment.gov.au/water/publications/action/pubs/nwi-pricing-principles.pdf>

<sup>28</sup> Essential Services Commission of SA, *Review of SA Water's Prices: 2013/14 – 2015/16 Guidance Paper*, February 2012.

- ▲ details of any issues which may materially affect expenditures that could possibly arise during the period of the SA Water PD 2016
- ▲ details of any capital/operating expenditure linkages within the forecasts (e.g. capital expenditures that are proposed to reduce operating expenditures or any ongoing operating expenditure incurred to defer capital projects)
- ▲ any further supporting information that SA Water wishes to present in support of its expenditure proposals.

The Commission will also take into account the directions issued to SA Water under the Public Corporations Act in October 2014, requiring it to perform certain non-commercial services, and the associated CSO funding arrangements for those services.

Accordingly, RBP 2016 should:

- ▲ identify all directions that require SA Water to incur non-commercial costs
- ▲ provide rigorous and robust estimates of those non-commercial costs required to meet each direction.

### *7.1.2 Reporting period*

The reporting period will cover the period from 2012/13 to 2019/20. RBP 2016 should contain both historic and proposed capital and operating expenditure information for these periods.

### *7.1.3 Risk Allocation and Estimation for Capital Works*

Capital expenditure information for each year should comprise a list of specific named and costed projects, grouped by investment strategy and program. All project cost estimates should be mid-point estimates based on an equal chance of under-spending or over-spending. Estimates should be based on an appropriate split of risk between SA Water and third party contractors.

SA Water should be able to demonstrate, in its project cost estimating, that it has actioned the business practices improvements that formed the basis of the catch-up efficiency targets set for the SA Water PD 2013 period.

### *7.1.4 Expenditure templates*

The Commission will issue a series of expenditure templates by December 2014. The templates will capture both capital and operating expenditure information. The Commission will work with SA Water to refine the templates to ensure that they align closely with SA Water's reporting systems and formats. This will minimise requirements for data mapping/allocations, and increase the ease and transparency of the process.

### 7.1.5 Customer consultation

SA Water must consult with its customers on proposed expenditures that rely on customer benefits to justify them prior to submitting RBP 2016. RBP 2016 must clearly demonstrate how customer inputs, including views from customers about their willingness to pay, have been taken into account in the development of expenditure proposals, particularly those projects/activities that are discretionary.

### 7.1.6 Efficiency improvement targets

The Commission believes that there will always be opportunities for efficiency improvements across the broad range of activities that SA Water undertakes in providing retail services to the South Australian community.

SA Water should, therefore, propose specific annual ongoing and catch-up efficiency improvement targets for both capital and operating expenditures. RBP 2016 should clearly identify any projects/programs of work that will help to achieve these targets. Further, supporting information should be provided on productivity assumptions, procurement initiatives, and the application of new techniques/technology, including details of how these have been applied in developing the proposed capital and operating expenditures. SA Water should consider efficiency improvement targets separately for capital and operating expenditures.

### 7.1.7 Cost escalation assumptions

The Commission believes that regulated entities have considerable ability, through their management, remuneration, contracting, procurement and other policies, to manage input costs. Therefore, entities should not be protected from the risk of input costs escalating in real terms, unless a convincing case is provided to demonstrate that real cost increases are unavoidable.

The Commission uses the Consumer Price Index (**CPI**)<sup>29</sup> published by the Australian Bureau of Statistics (**ABS**) as a benchmark for scrutinising forecast costs. It recognises that SA Water's inputs are different to the basket of goods and services used to determine the CPI. However, the CPI has advantages of transparency, independent calculation, and difficulty to manipulate.

The Commission intends to adopt a CPI-based approach to cost escalators in the SA Water PD 2016, unless it can be demonstrated that circumstances beyond the reasonable control of SA Water exist, which justify either an above-CPI or below-CPI cost change. For example, the Commission allowed electricity cost escalation above CPI in the SA Water PD 2013.

If SA Water believes that such circumstances will exist in any specific cost category, it will need to provide strong supporting evidence in RBP 2016.

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<sup>29</sup> Weighted average of the eight Australian capital cities.

### 7.1.8 Capitalisation of certain expenditures

As the Commission's primary objective is to protect the long-term interests of consumers, it sets a revenue path that reflects efficient costs over a regulatory period. Where there are efficient costs that provide benefits outside that period, the Commission will consider whether those costs are more appropriately recovered in future periods. This approach matches the timing of cost recognition with the benefits received, is consistent with the approaches taken by other economic regulators and is as specified in section 4.4.2(c) of Water Industry Guideline No.2.<sup>30</sup>

In the SA Water PD 2013, the Commission chose to treat a limited number of expenditure items as capex for regulatory purposes, even though they may be treated as opex for accounting purposes.

These items comprised the marginal cost of running the Adelaide Desalination Plant for warranty proving purposes in 2013 and 2014, and the cost of replacing reverse osmosis membranes used in the desalination process.

The Commission intends to continue to apply this matching principle in the SA Water PD 2016.

RBP 2016 should be prepared in line with established accounting rules, other than for those items (as stated above) where the Commission specified a different treatment in the SA Water PD 2013. This should be separately identified in RBP 2016.

SA Water should also highlight any other material areas of opex where, consistent with the above stated primary objective of protecting the long-term interest of consumers, it may be considered appropriate to recover costs over a longer period.

### 7.1.9 Project cost breakdowns

Project cost breakdowns should be provided at an investment strategy level for actual and forecast years. This should include, at a minimum, costs split by direct labour, contract labour, materials, and other costs. It is not sufficient to simply allocate all costs to a single category on the basis that works are provided under a single 'service delivery' contract. Where systems do not hold this information, an indicative view should be provided, with a suitable explanation on how the cost allocation has been determined.

#### 7.1.10 Price base

All actual capital and operating expenditures (up to and including 2014/15) should be presented in nominal (money of the day) prices.

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<sup>30</sup> Essential Services Commission of SA, *Water Regulatory Information Requirements for Major Retailers*, October 2013, available at: <http://www.escosa.sa.gov.au/library/130926-WaterRegulatoryRequirements-MajorRetailers-GuidelineNo2-WG2-2.pdf>



Forecast capital and operating expenditures (from 2015/16 onwards) should be reported at real dollar prices (i.e. without forecast inflation). The price base should be March 2015 CPI, as published by the Australian Bureau of Statistics (All Groups, weighted average of 8 capital cities).

## 7.2 *Capital expenditure*

This section outlines the capital expenditure information that the Commission will require from SA Water. RBP 2016 must include only prudent and efficient capital expenditures.

### 7.2.1 *Longer-term investment*

As the Commission requires longer-term information to properly assess the prudent and efficient levels of capital expenditure for the PD 2016 period, SA Water should provide an indicative view of capital expenditure forecasts beyond 2019/20, with a supporting narrative detailing the rationale behind those forecasts.

### 7.2.2 *Reporting requirements*

The Commission will provide SA Water with templates to capture information on capital expenditures. All individual projects above a \$4 million capital expenditure materiality threshold must be specified within each investment strategy. SA Water should provide a narrative definition/description of each 'investment strategy'.

Total investment on projects less than \$4 million will initially be captured at an 'investment program' level within each investment strategy.

For each project/program, gross capital expenditure should be reported, with capital contributions separately identified in order to derive net capital expenditure. The sources of contributions (e.g. customers or the Commonwealth Government), should be identified.

For each named project, costs should be split by asset class (further information on the nine asset classes is provided in section 8.3).

At an Investment Strategy level, a cost split by asset class is also required for each year.

A schedule of asset disposals, and gifted assets, should be provided.

Aligned with the information provided during the SA Water PD 2013, the capital expenditure templates will request information on all major projects (>\$4m) planned for the following price control period (i.e. for the 2020/21-2023/24 period). The Commission will issue updated spreadsheet templates by December 2014.

While the above information provides a guide, further detail of the minimum information requirements will be refined through the RBP template development process.

The Commission notes that additional regional reporting requirements may arise from the *Inquiry into Reform Options for SA Water's Drinking Water and Sewerage Prices* in respect of statewide pricing practices.

### 7.2.3 Project/program information

For each project above \$11 million (gross capital expenditure) with any spend in the SA Water PD 2016 period, the following information is required:

- ▲ Narrative description of the project covering its scope, drivers, costs, and the phasing of spend
- ▲ Copies of all relevant project authorisation papers. Depending on the maturity of the project, this may comprise (but is not limited to) the following –
  - project development funds submission
  - project brief
  - external consultants reports
  - detailed feasibility studies
  - project authorisation papers (SA Water Board/Public Works Committee/Cabinet)
  - re-submissions
  - post-investment appraisal papers.

A full listing of projects between \$4 million and \$11 million should also be provided, detailing planned phasing of spend and supported by a short descriptive narrative. A sample of these projects will be subject to further examination.

For projects below \$4 million, only summary information by investment program will initially be required. Depending on the materiality of planned investment on projects less than \$4m within each investment strategy, it may prove necessary to examine a sample of these projects in more detail.

Similarly, for each investment program totalling greater than \$11 million within the SA Water PD 2016 period, a narrative description of the program covering scope, drivers, costs, phasing of spend, and any further relevant supporting documentation will be required.

### 7.2.4 Service classifications

In setting drinking water and sewerage revenue allowances, the Commission will incorporate prudent and efficient capital expenditures that relate only to direct control services. SA Water should identify in RBP 2016 any projects that may be partially or entirely related to excluded or non-regulated services (e.g. certain elements of recycling projects may be considered to fall outside direct control services).

### 7.2.5 Capital expenditure by asset class

SA Water should provide details of actual and planned capital expenditure by asset classes.

Asset classes were developed in conjunction with SA Water during the PD 2013 process. The Commission does not intend to change these asset classes for PD 2016, although it remains open to considering any proposals in this area (see section 8.4 for further information).

## 7.3 Operating expenditure

As part of the expenditure review process, the Commission will consider the level of operating expenditure that it would expect a prudent and efficient water utility to incur over the period of the SA Water PD 2016.

The Commission will examine all operating expenditure relevant to SA Water's direct control business, both direct costs and overheads. RBP 2016 must show where expenditure is linked to service standards set by the Commission (refer to chapter 4), CSOs and other regulatory obligations. RBP 2016 must include only prudent and efficient operating expenditures.

The Commission is also likely to benchmark SA Water's current and proposed operating expenditure relative to other water utilities as one input into its assessment.

### 7.3.1 Reporting requirements

The following operating expenditure reporting requirements should be addressed in RBP 2016:

- ▲ Gross operating expenditure and contributions (subsidies)
- ▲ Splits of operating expenditure by:
  - category (water or sewerage)
  - service type (direct control services, excluded services and unregulated services)
  - resource type (direct labour, contract labour, materials and other)
  - business unit (at an appropriate granularity).
- ▲ Historic and proposed operating expenditure figures, sufficiently disaggregated to allow detailed examination of individual costs
- ▲ Information based on internal reporting categories (i.e. aligned with how the business is managed/reported internally, to a level of 15-20 lines of disaggregation). Alignment to SA Water internal reporting/accounting systems will afford the ability to drill down into detail where necessary and reduce the burden of information provision.
- ▲ The methodology and rationale adopted in developing proposed operating expenditure

- ▲ Where operating expenditure has been allocated (i.e. between projects, categories, service or area), the basis of any allocations and a demonstration that they are appropriate
- ▲ Discussion on the drivers and justifications of expenditure, activities to be carried out and outcomes to be achieved. A supporting commentary should address year on year changes/trends in operating expenditure, for both historic and proposed operating expenditure. Variances must be fully explained.
- ▲ Detailed project information from business cases or board papers to support any change in operating expenditure. This includes cost increases, cost savings or deferment of costs.
- ▲ A detail breakdown of labour cost forecasts and a reconciliation of full time equivalent (FTE) staff
- ▲ An explanation of the relationship between the level of its operating expenditure and the quality and quantity of customer service
- ▲ An explanation of any changes to operating expenditure resulting from the current or proposed capital program and any significant changes in the levels of operating expenditure likely to eventuate during the PD 2016 relative to the PD 2013.

This list is not exhaustive and SA Water should not limit RBP 2016 in this regard.

While the above information provides a guide, further detail of the minimum information requirements will be refined through the RBP 2016 template development process.

The Commission notes that additional regional reporting requirements may arise from the *Inquiry into Reform Options for SA Water's Drinking Water and Sewerage Prices* in respect of statewide pricing practices.

### 7.3.2 Base Year

The Commission proposes to take a base year approach to assessing SA Water's forecast operating expenditure. The base year will be 2014/15 and RBP 2016 should be based on actual operating expenditure incurred in 2014/15 where available and clearly identify any forecast expenditure for 2014/15 where actual data is not available. When available, the base year information will be updated for 2014/15 full-year actual operating expenditure.

### 7.3.3 Superannuation

In the SA Water PD 2013, the Commission advised SA Water that, prior to its RBP 2016, it should seek a further review of the superannuation liabilities arising from the (now closed) SA Water Pension and Lump Sum defined benefit scheme which, based on a 2012 actuarial report, was in deficit.

Therefore, SA Water should seek a further review of the scheme, in time to be submitted as part of RBP 2016. Consideration will then be given as to how any ongoing deficit should be addressed in the SA Water PD 2016.

#### 7.3.4 SA Water's water portfolio mix

RBP 2016 must demonstrate that the proposed 'portfolio mix' of water sources (i.e. the ADP, River Murray, reservoirs and other sources) represents the optimised cost to meet demand forecasts. RBP 2016 should include:

- ▲ evidence to support the estimated volumes to be drawn from each water source. This may include, for example, estimated inflow information for the River Murray over the proposed period
- ▲ a schedule separately identifying the operating, maintenance & administrative costs related to the ADP, with supporting commentary covering:
  - how operating, maintenance and administrative costs related to ADP have been optimised
  - any assumptions that have been made on ADP usage versus other infrastructure over the period of the SA Water PD 2016. Explanations of the manner in which the forecast costs reflect compensatory savings in other cost areas should also be included.

## 8. REGULATED ASSET BASE AND WORKING CAPITAL

### 8.1 Introduction

The water industry is highly capital intensive and substantial infrastructure is required to provide drinking water and sewerage services to customers. The value of that infrastructure - the value of the Regulated Asset Base (**RAB**) - the regulatory value of assets associated with the provision of direct control drinking water and sewerage services - is a critical driver of the maximum revenue allowances to be set.

In the September 2014 Pricing Order, the Treasurer set the value of the RAB, as at 1 July 2013, as follows:

**Table 8-1: Values of the Regulated Asset Base as at 1 July 2013  
(\$Dec12)**

DIRECT CONTROL SERVICE	RAB VALUE (\$'000)
Drinking Water	7,767,081
Sewerage	3,584,534
<b>Total</b>	<b>11,351,615</b>

The Commission's revenue allowances will provide SA Water with the opportunity to earn a reasonable rate of return on the RAB and to recover the costs of providing regulated assets over the period of their useful lives (otherwise known as regulatory, or allowable, depreciation).

The outcomes of the current pricing reform options inquiry may influence the manner in which revenue allowances and prices are set. For example, if the current statewide pricing policy was no longer to apply, SA Water's RAB may need to be "disaggregated" across regions.

However, in principle, the Commission will determine two key elements of the RAB for the purposes of the SA Water PD 2016, subject to the September 2014 Pricing Order:

1. the RAB values to apply at the commencement of the SA Water PD 2016 (as at 1 July 2016)
2. how those values will be updated or "rolled forward" over the period of the SA Water PD 2016.

### 8.2 RAB values at commencement of the SA Water PD 2016

The Commission will use the same asset roll forward methodology used in the SA Water PD 2013 to roll forward the RAB values from 1 July 2013 to 1 July 2016.

The roll forward methodology is consistent with Principle 5 of the NWI Pricing Principles, which states that the RAB should be updated each year in accordance with the following formula:

$$RAB_t = (RAB_{t-1} + \text{Prudent and Efficient Capital Expenditure}_t - \text{Depreciation}_t - \text{Disposal}_t \text{ (discarded assets)}). \text{ (Where } t = \text{the year under consideration).}$$

### 8.2.1 Ex-post Review of Capital Expenditure

The Commission will review SA Water's actual capital expenditure during the period of PD 2013, to ensure that RAB values at the commencement of PD 2016 incorporate only prudent and efficient capital expenditures.

Ex-post reviews of capital expenditure are commonplace in other Australian jurisdictions, and in the UK, and provide an additional level of comfort to consumers that they are funding only prudent and efficient investments.<sup>31</sup>

Such review may be particularly relevant to Government-owned enterprises, where the incentives towards profit maximisation may be weaker than for privately-owned entities, and where there is the potential for non-commercial objectives to be given higher priority.

#### 8.2.1.1 Mechanics of an ex-post Review

The ex-post review will comprise a detailed examination of a sample of projects/programs of work and, through this, of the systems and processes in place at SA Water.

SA Water operates in a dynamic environment and it is very likely that it will have been necessary to undertake projects/programs not anticipated at the time of preparing the RBP 2013. Equally, it is likely that opportunities will have arisen to be able to defer projects/programs that were included in RBP 2013.

The Commission recognises that care must be taken in carrying out such a review, to ensure that investments are reviewed only in the context of the information that was available to SA Water at the time when the decision to invest was made.

Aligned with regulatory practice in other jurisdictions, the ex-post review will cover the full three year period of the SA Water PD 2013, accepting that the final year (2015/16) will include forecast rather than actual capital expenditure. An adjustment will be made for any difference between assumed and actual net capital expenditure for 2015/16 when the opening RAB is calculated for the following regulatory period (**SA Water PD 2020**).

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<sup>31</sup> For example, refer to IPART's *Final Report on Hunter Water Corporation's prices from 1 July 2013 to 30 June 2017*, available at [http://www.ipart.nsw.gov.au/Home/Industries/Water/Reviews/Metro\\_Pricing/Review\\_of\\_prices\\_for\\_Hunter\\_Water\\_Corporation\\_from\\_1\\_July\\_2013/11\\_Jun\\_2013\\_-\\_Final\\_Report/Final\\_Report\\_-\\_Hunter\\_Water\\_Corporations\\_water\\_sewerage\\_stormwater\\_drainage\\_and\\_other\\_services\\_-\\_1\\_July\\_2013\\_to\\_30\\_June\\_2017](http://www.ipart.nsw.gov.au/Home/Industries/Water/Reviews/Metro_Pricing/Review_of_prices_for_Hunter_Water_Corporation_from_1_July_2013/11_Jun_2013_-_Final_Report/Final_Report_-_Hunter_Water_Corporations_water_sewerage_stormwater_drainage_and_other_services_-_1_July_2013_to_30_June_2017).

To facilitate the review, RBP 2016 should provide justification for any new capital projects/activities or material increases in existing capital projects/activities during the period of PD 2013, relative to those that were allowed by the Commission in setting the SA Water PD 2013.

### 8.3 Asset classes

The Commission proposes at this stage to use the same asset classes as in the SA Water PD 2013. RAB values by asset class at the commencement of the PD 2013 are summarised in Table 8-2 and Table 8-3.

**Table 8-2: RAB Values by Drinking Water Asset Class as at 1 July 2013 (\$Dec12)**

WATER ASSET CLASS	RAB VALUE \$'000
Pipes	4,211,232
Non-Pipes	1,724,809
ADP	1,437,593
Corporate Depreciable	90,408
Corporate Non-depreciable	303,039
<b>Total Water RAB</b>	<b>7,767,081</b>

**Table 8-3: RAB Values by Sewerage Asset Class as at 1 July 2013 (\$Dec12)**

SEWERAGE ASSET CLASS	RAB VALUE \$'000
Sewer Pipes	2,240,498
Sewer Non-Pipes	1,151,089
Sewer Corporate Depreciable	91,875
Sewer Corporate Non-depreciable	101,073
<b>Total Sewerage RAB</b>	<b>3,584,534</b>



The Commission will consider any proposals to change asset classes. If changes are proposed to asset classes, the rationale and the full consequential adjustments to RAB values (and economic lives) as at 1 July 2016 should be provided.

The economic lives of depreciable assets used in the SA Water PD 2013, which were based on information provided by SA Water, are provided in Table 8-4.

**Table 8-4: Economic Lives of Depreciable Assets by Asset Class**

ASSET CLASS	ECONOMIC LIVES (YEARS)	
	AVERAGE REMAINING LIFE OF EXISTING ASSETS (as at 1 July 2013)	AVERAGE ECONOMIC LIFE OF NEW ASSETS
Water Pipes	60.79	102.91
Water Non-Pipes	32.44	64.08
Water ADP	55.54	56.67
Water Corporate Depreciable	6.80	14.73
Sewer Pipes	65.32	107.24
Sewer Non-Pipes	28.31	46.79
Sewer Corporate Depreciable	6.80	14.73

The Commission will consider any proposals to change the calculation of depreciation, including asset classes and the economic lives of the various asset classes and the methodology or assumptions used. Should a change to the method of calculating depreciation relative to that used in the SA Water PD 2013 be proposed, the proposal should include a full justification of the changes and an analysis of the impacts resulting from those changes.

#### **8.4 Updating RAB values**

SA Water PD 2016 will specify the manner in which the RAB values will be rolled forward during each year of the PD 2016, subject to the requirements of the September 2014 Pricing Order. The Commission expects that methodology to be consistent with the roll-forward methodology used in the SA Water PD 2013, but it will have regard to best regulatory practice at the time of making the PD 2016.

In accordance with NWI pricing principles, the Commission will allow prudent and efficient asset additions (capital expenditures) and deduct the value of asset disposals in determining RAB values during the period of the SA Water PD 2016.

## 8.5 Return on RAB Values

The Commission will allow SA Water to earn a return on RAB values. The return will be calculated by multiplying each mid-year RAB value by the regulatory rate of return.

As discussed in Chapter 1, the Commission has released a separate draft report on its proposed approach to calculating SA Water's regulatory rate of return.<sup>32</sup>

## 8.6 Return on working capital allowance

As SA Water generally incurs costs of providing regulated services in advance of receiving payment for those services, the Commission may make a revenue allowance to reflect working capital financing costs. The inclusion of a working capital allowance is a matter that is frequently considered by economic regulators.

Maintaining sufficient working capital is an important requirement for any business. SA Water should be responsible in managing its cash flows to meet its commitments in a prudent and efficient manner. Nevertheless, the funding of a business's working capital requirements are an economic cost of doing business and there is an argument for its inclusion in a regulated entity's revenue building blocks.

Approaches to determining the return on working capital allowances for regulated utilities vary across regulators in Australia. The Commission will be reviewing those practices to determine the most appropriate model to use in the case of SA Water. In particular, the Commission notes that the AER and the NSW Independent Pricing and Regulatory Tribunal (**IPART**), have differing views on the return on working capital allowances; the AER does not make a provision for a return on working capital, whereas IPART does.

In previous determinations for the energy industry, and also in the SA Water PD 2013, the Commission did include allowances for the return on working capital but considered the issue in respect of capital expenditures and operating expenditures separately.<sup>33</sup>

In determining SA Water's revenues, the Commission takes into account the prudent and efficient costs that SA Water incurs in delivering its services to customers. In doing so, the Commission develops financial models that seek to reflect SA Water's cash flow receipts and disbursements. The matter of working capital is important because the determination of SA Water's revenues is dependent on the accurate modelling of all of the relevant cash flows. Although such models may be complex, they are not perfect representations of reality. Assumptions are required across a range of important factors, including the size and,

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<sup>32</sup> Essential Services Commission of South Australia, *SA Water Regulatory Rate of Return: 2016 - 2020, Draft Report to the Treasurer*, November 2014; available at <http://www.escosa.sa.gov.au/library/20141121-SAWaterRateofReturn-DraftReport.pdf>

<sup>33</sup> Refer to the Commission's review of ETSA Utilities' 2005-2010 electricity distribution prices available at <http://www.escosa.sa.gov.au/projects/35/electricity-distribution-price-review-2005-10.aspx> and its review of Envestra's 2006-2011 gas distribution access arrangement available at <http://www.escosa.sa.gov.au/projects/104/2006-11-gas-distribution-access-arrangement.aspx>.

importantly, the timing of SA Water's cash flows. As such, there may need to be an explicit recognition of working capital arising from the specific methodology employed in the modelling of SA Water's cash flows (as well as any of the underpinning assumptions).

Accordingly, there may be a need to provide for a return on working capital to ensure that SA Water is neither under-compensated nor over-compensated when arriving at its revenue requirement.

In conclusion, the Commission will review whether it is necessary to compensate SA Water by providing an allowance for any return on working capital and, if so, how to provide for it within the revenue building blocks and the financial modelling of its cash flows.

To that end, the Commission will release a report outlining its position on the above matters in early 2015 and will finalise its positions on providing a working capital allowance and its approach to the modelling of SA Water's revenues during the SA Water PD 2016 process.

## 9. PASS-THROUGHS

### 9.1 Introduction

In competitive markets, firms may incur unexpected costs due to events outside of their control. Unlike price-regulated firms, those firms have the option to raise prices at any time. However, not all unexpected costs can be passed on through higher prices in competitive markets. The discipline of competitive markets ensures that only unexpected costs that are uncontrollable, unavoidable, and raise short-run marginal costs are passed on.

Having regard to the fact that a price-regulated firm generally cannot raise prices in the same way that unregulated firms can, “pass-through” mechanisms have been adopted by regulators in Australia, and other countries. Under these mechanisms, a regulator may adjust prices or revenue caps during a price determination period to account for unexpected cost impacts (whether upwards or downwards) that meet certain criteria.

The September 2014 Pricing Order requires the inclusion of a pass-through mechanism in the SA Water PD 2016.

Where pass-through mechanisms are permitted, regulators recognise that not all unexpected cost changes are passed through in competitive markets, and that pass-throughs create price uncertainty for consumers. It is also important that regulated entities have strong incentives to manage costs. Furthermore, the consideration of cost pass-throughs can involve significant costs.

For these reasons, only limited events will trigger consideration of whether or not a pass-through should be permitted. Consistent with the requirements of the September 2014 Pricing Order, those events must be demonstrated to have material cost implications (positive or negative), and could not be controlled by SA Water acting prudently and efficiently or substantially mitigated through prudent management.

### 9.2 SA Water PD 2013

Pass-throughs were not considered under the SA Water PD 2013. Instead, pass through events that occurred during that time period will, if the Commission determines, result in a revenue pass-through in the period of the SA Water PD 2016.

SA Water should include in its RBP 2016 any pass-through events that it considers occurred during the period of the SA Water PD 2013, and a proposal as to how those costs are to be recovered during the period of the PD 2016.

### 9.3 SA Water PD 2016

The Commission currently expects pass-through events will be specified at the time of making the price determination. SA Water may propose in RBP 2016 any pass-through events that it seeks to be included in that regime.

The Commission will assess SA Water's proposal using the following criteria:

- ▲ the financial impact must be material
- ▲ the event could not have otherwise been controlled by SA Water (acting prudently and efficiently)
- ▲ the event leads to cost impacts that could not have been substantially mitigated through prudent management.

## 10. REVENUE CAPS, PRICES AND/OR PRICING PRINCIPLES

### 10.1 Introduction

Previous chapters have indicated how the Commission, at this stage, intends to determine each of the revenue building blocks in the SA Water PD 2016. These building blocks will be added together to determine the total revenue allowance for each direct control service. The prices of direct control services will then be set by SA Water consistent with the revenue allowances.

### 10.2 SA Water PD 2016

The September 2014 Pricing Order requires the adoption of a revenue cap form of regulation for drinking water and sewerage services. The Commission will consider the merits of applying direct controls to other services, based on public consultation and experience during the period of the SA Water PD 2013.

The Commission proposes to continue with a pricing principles and a price monitoring approach for excluded services.

To assist the Commission in assessing the reasonableness of RBP 2016, revenue and pricing proposals must also be accompanied by the following supporting information:

- ▲ the relationship between the proposed revenues and key cost drivers
- ▲ underlying cost justifications, including cost estimates and validity of those estimates
- ▲ revenue model(s) used, including details of inputs, assumptions and outputs
- ▲ an overview of the consumer consultation that has taken place in developing the proposed revenues
- ▲ details of any implementation and transitional issues.

Where SA Water draws upon supporting information, such as modelling and customer consultation, in support of proposed revenues, the findings should be summarised in the proposal, and the detailed information (e.g. methodology and assumptions) must be included as appendices to the proposal.

As prices cannot be set as part of the Commission's determination, the impacts of SA Water's prices on specific customer groups (e.g. residential and business groups) will not be known until SA Water determines its prices each year.

SA Water is encouraged to include indicative price information in RBP 2016 where possible, and identify potential customer impacts from those indicative prices. In addition, information about SA Water's pricing strategy for the PD 2016 period would provide valuable context to RBP 2016.

# APPENDIX 1: 2 SEPTEMBER 2014 PRICING ORDER

## WATER INDUSTRY ACT 2012 (SECTION 35)

### PRICING ORDER

FOR THE REGULATORY PERIOD 1 JULY 2016 – 30 JUNE 2020

#### PREAMBLE

This pricing order has been prepared in order to provide information that would assist SA Water to prepare its Regulatory Business Proposal and the Essential Services Commission of South Australia (ESCOSA) to prepare its Final Framework and Approach in July 2014 and its Draft Determination for SA Water's drinking water and sewerage services for the second regulatory period.

A further pricing order may be issued to vary this pricing order prior to ESCOSA issuing its Final Determination. These variations may be required in response to matters raised by ESCOSA in its Draft Determination or its Final Inquiry Report on water pricing reform once the South Australian Government has considered these matters and developed an appropriate response.

Pursuant to section 35(4) of the *Water Industry Act 2012 (the Act)*, the Treasurer hereby issues the following pricing order (**this Order**):

#### 1. INTERPRETATION

1.1 Where a term used in this Order is defined in the Act, it has the meaning given in the Act.

1.2 In this Order, unless the contrary intention appears:

*determination* means a determination of the Commission under section 35 of the Act and Part 3 of the *Essential Services Commission Act 2002 (the ESC Act)* made in respect of retail services;

*drinking water retail service* means a retail service constituted by the sale and supply of water of a quality fit for human consumption;

*Initial Pricing Order* means the order issued by the Treasurer pursuant to section 35(4) of the Act dated 24 September 2012;

*NWI Pricing Principles* means the National Water Initiative Pricing Principles 2010 agreed by Australian governments as the basis for setting water prices / charges in their jurisdictions, as amended or replaced from time to time;

*NWI Principles for the Recovery of Capital Expenditure* means the Principles for the recovery of capital expenditure which form part of the NWI Pricing Principles, as amended or replaced from time to time;

*NWI Principles for Urban Water Tariffs* means the Principles for urban water tariffs which form part of the NWI Pricing Principles, as amended or replaced from time to time;

*second regulatory period* means the four year period commencing 1 July 2016;



*sewerage retail service* means the sale and supply of sewerage services for the removal of sewage.

## **2. APPLICATION**

- 2.1 This Order is to take effect from the date that it is signed.
- 2.2 This Order is to apply to a determination for the second regulatory period in respect of drinking water retail services and sewerage retail services provided by SA Water, and as such applies in conjunction with the Initial Pricing Order.
- 2.3 Clause 3 of the Initial Pricing Order is varied to include a new subclause 3.3 as follows:

“3.3 In the case of a determination to which any further order made pursuant to section 35(4) of the Act applies, clause 3.1 applies subject to that further order.”
- 2.4 For the avoidance of doubt, the Commission must ensure that any draft of a determination to which this Order will apply and which is provided to any person in accordance with section 26(1) of the ESC Act is prepared consistently with, and complies with, all applicable requirements of the Initial Pricing Order and this Order.

## **3. SA WATER DRINKING WATER AND SEWERAGE RETAIL SERVICES**

The Commission must adopt or apply the following parameters, principles or factors when making a determination to which this Order applies:

- 3.1 The second regulatory period must be adopted as part of the determination.
- 3.2 The determination must only determine the total revenue which may be derived from the provision of drinking water retail services and sewerage retail services.
- 3.3 The determination must apply a separate total revenue control for drinking water retail services and sewerage retail services respectively.
- 3.4 The determination must not establish, or require the establishment of, a revenue control for a drinking water retail service or a sewerage retail service based on customer class or location.
- 3.5 The determination must include a mechanism which allows for the adjustment of the total revenue which may be derived where the Commission determines there to be a relevant and material variation between forecast and actual rates of water consumption or sewerage connections. The adjustment mechanism must operate on the basis of efficient costs associated with variations in demand, and so as to promote a stable price path for retail services.
- 3.6 The determination must include a mechanism which allows for the adjustment of the total revenue which may be derived where the Commission determines appropriate as a result of the occurrence of an event beyond the control of SA Water which has or will have a material impact on the cost of provision of a drinking water retail service or a sewerage retail service during the regulatory period. The adjustment mechanism must operate on the basis of efficient costs attributable to the event, and so as to promote a stable price path for retail services.
- 3.7 The determination must adopt or apply the NWI Principles for the Recovery of Capital Expenditure, subject to the following:

- 3.7.1 the determination must adopt or apply the value of \$7.77 billion as the regulated asset base (**RAB**) as at 1 July 2013 (in December 2012 dollars) in relation to assets used by SA Water in the provision of drinking water retail services;
  - 3.7.2 the determination must adopt or apply the value of \$3.58 billion as the RAB as at 1 July 2013 (in December 2012 dollars) in relation to assets used by SA Water in the provision of sewerage retail services;
  - 3.7.3 the determination must allow SA Water to recover the efficient cost of assets acquired (or to be acquired) after 1 July 2013 which are required to support activities that SA Water is required to provide in accordance with a direction under section 6 of the *Public Corporations Act 1993*;
  - 3.7.4 for the avoidance of doubt, the Commission must only adopt or apply Principle 6 of the NWI Principles for the Recovery of Capital Expenditure in relation to contributed assets that SA Water acquires after 1 July 2013.
- 3.8 The determination must adopt or apply Principle 1 of the NWI Principles for Urban Water Tariffs, subject to the following:
- 3.8.1 in relation to costs relating to externalities (including water planning and management), the determination must only allow SA Water to recover such costs as are attributable to and payable by SA Water in accordance with the law, including a direction under section 6 of the *Public Corporations Act 1993*;
  - 3.8.2 the determination must allow SA Water to recover such costs (less any relevant contributions to such costs that it receives) that are attributable to activities that SA Water is required to provide in accordance with a direction under section 6 of the *Public Corporations Act 1993*, and are either:
    - (i) specified in the relevant direction, or if not so specified,
    - (ii) determined by the Commission to be efficient.

#### **4. PREPARATION AND PRESENTATION**

- 4.1 The determination must be prepared and presented consistently with "*the Regulated Asset Base (RAB), or building blocks approach*" as described in the NWI Principles for the Recovery of Capital Expenditure (subject to clause 3.7 above).
- 4.2 In particular, the determination must identify the assumptions on which it is based, including the method of calculation of, and monetary value assigned to, each of the following parameters for the purposes of the determination:
  - 4.2.1 the RAB, where the values set out in clauses 3.7.1 or 3.7.2 (as appropriate) are to be rolled forward consistently with Principle 5 of the NWI Principles for the Recovery of Capital Expenditure;
  - 4.2.2 the rate of return on the RAB (which should be consistent with Principle 1 of the NWI Principles for the Recovery of Capital Expenditure);

- 4.2.3 any allowance for working capital (i.e. any allowance considered appropriate to adjust for the lead or lag in cash flow as a result of incurring costs in providing services and receiving payment for those services);
  - 4.2.4 the rate of return of capital (depreciation), including its method of calculation, and any adopted classifications of, or remaining life attributable to, the regulatory assets on which it is based;
  - 4.2.5 operating expenditure (which should include efficient operational, maintenance and administrative costs);
  - 4.2.6 the costs of externalities, consistent with clause 3.8.1; and
  - 4.2.7 any allowance for tax paid (which should be identified separately from the rate of return on the RAB where the weighted average cost of capital (WACC) is calculated on a post-tax basis).
- 4.3 Where the Commission anticipates a likely material variation in either the method of calculation of, or monetary value assigned to, any of the parameters identified in clause 4.2 as between any draft of a determination to which this Order will apply in accordance with clause 2.4, and the relevant final determination, then the draft of the determination must identify, in relation to any such anticipated likely material variation:
- 4.3.1 the relevant parameter;
  - 4.3.2 the likely cause or causes;
  - 4.3.3 where the anticipated variation is to the monetary value assigned to a parameter, the likely magnitude and direction.
- 4.4 The Commission must prepare and provide to the Treasurer, on or before 31 December 2014, a separate report setting out the Commission's proposed approach to the calculation of the rate of return on the RAB (which should be consistent with Principle 1 of the NWI Principles for the Recovery of Capital Expenditure).

## 5. VARIATION

This Order may be varied by a subsequent pricing order issued under section 35 of the Act.

  
 Jay Weatherill  
**PREMIER**  
**A/TREASURER**

✓ 15 / 2014

## APPENDIX 2: 18 NOVEMBER 2014 PRICING ORDER

**WATER INDUSTRY ACT 2012 (SECTION 35)**  
**PRICING ORDER**  
**FOR THE VARIATION OF A PREVIOUS PRICING ORDER**

Pursuant to section 35(4) of the *Water Industry Act 2012* (**the Act**), the Treasurer hereby issues the following pricing order (**this Order**):

**1. INTERPRETATION**

- 1.1 In this Order, *September Pricing Order* means the order issued by the Treasurer pursuant to section 35(4) of the Act dated 2 September 2014.

**2. APPLICATION**

- 2.1 This Order is to take effect from the date that it is signed.
- 2.2 This Order applies so as to vary the September Pricing Order.
- 2.3 Clause 4.4 of the September Pricing Order is varied to delete the words "31 December 2014" and substitute in their place "31 March 2015".

**3. VARIATION**

- 3.1 This Order may be varied by a subsequent pricing order issued under section 35 of the Act.

  
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**TOM KOUTSANTONIS M.P.**  
Treasurer

Date: 18<sup>th</sup> November 2014



## APPENDIX 3: MINISTERIAL DIRECTION TO SA WATER

### DIRECTION TO THE SOUTH AUSTRALIAN WATER CORPORATION

#### PURSUANT TO SECTION 6 OF THE PUBLIC CORPORATIONS ACT 1993

##### BACKGROUND:

1. Pursuant to section 6 of the *Public Corporations Act 1993*, and sections 6 and 7(2)(f) of the *South Australian Water Corporation Act 1994*, the South Australian Water Corporation (SA Water) is subject to control and direction by its Minister, and has the functions conferred on it by its Minister.
2. The *South Australian Water Corporation Act 1994* is committed to the Minister for Water and the River Murray (the Minister) by way of *Gazetted* notice dated 21 October 2011 (p. 4289).
3. The *Water Industry Act 2012* provides for the regulation of prices for water and sewerage retail services by declaring the water industry to constitute a regulated industry for the purposes of the *Essential Services Commission Act 2002*, and providing for the Essential Services Commission of South Australia (the Commission) to make a determination under the *Essential Services Commission Act 2002* regulating prices, conditions relating to prices, and price-fixing factors for such retail services.
4. In making such a determination, the Commission must comply with the requirements of any pricing order issued by the Treasurer under section 35 of the *Water Industry Act 2012*.
5. The Treasurer has, on 2 September 2014, issued such a pricing order (the Third Pricing Order) which applies to, amongst other things, a determination in respect of drinking water and sewerage retail services provided by SA Water for the four year period commencing 1 July 2016 (the second regulatory period).
6. As part of the Third Pricing Order, the Treasurer has required that any determination of the Commission in respect of such services allow SA Water to recover:
  - (a) the efficient cost of assets to be acquired over the course of the second regulatory period which are required to support activities that SA Water is required to provide in accordance with a direction under section 6 of the *Public Corporations Act 1993*;
  - (b) the costs of externalities (including water planning and management) as are attributable to and payable by SA Water in accordance with the law, including a direction under section 6 of the *Public Corporations Act 1993*;
  - (c) such costs (less any relevant contributions to such costs that it receives) that are attributable to activities that SA Water is required to provide in accordance with a direction under section 6 of the *Public Corporations Act 1993*, and are either:
    - (i) specified in the relevant direction, or if not so specified,

(ii) determined by the Commission to be efficient.

7. The Minister considers it appropriate, in the interests of transparency, to direct SA Water, over the course of the second regulatory period, to:
- (a) provide certain services, in addition to the services it is required to provide pursuant to section 7 of the *South Australian Water Corporation Act 1994*, and the Charter for SA Water;
  - (b) purchase renewable energy certificates or carbon offsets for the purpose of operating the Adelaide Desalination Plant;
  - (c) maintain state-wide pricing in respect of the drinking water and sewerage retail services it provides to customers;
  - (d) continue to contribute to water planning and management charges; and
  - (e) continue to annually reimburse the Minister in respect of fees paid to the Valuer-General for copies of the valuation roll,
- the costs of which may be recovered by SA Water in accordance with the terms of the Third Pricing Order.
8. The Minister intends that, from 1 July 2016, this Direction will revoke and replace the previous Direction made to SA Water pursuant to section 6 of the *Public Corporations Act 1993* on 9 May 2013 and published in the Gazette on 31 October 2013.
9. This Direction may be revoked and replaced by a subsequent direction pursuant to section 6 of the *Public Corporations Act 1993*.

**DIRECTION:**

I, Ian Hunter, Minister for Water and the River Murray, direct SA Water to purchase or provide the following services, facilities and contributions from 1 July 2016 and until further notice, subject to and in accordance with the following provisions:

**A. Emergency Management Services**

Emergency engineering functional services as required for compliance with the State Emergency Management Plan prepared by the State Emergency Management Committee under the *Emergency Management Act 2004*, up to the following cost in each financial year of the second regulatory period:

2016-17	2017-18	2018-19	2019-20
\$559 000	\$573 000	\$587 000	\$602 000

The South Australian Government will make the following contributions to SA Water in relation to such costs in each financial year of the second regulatory period:

2016-17	2017-18	2018-19	2019-20
\$559 000	\$573 000	\$587 000	\$602 000

**B. Government Radio Network Services**

Services required for SA Water's ongoing connection to and participation in the South Australian Government Radio Network, up to the following cost in each financial year of the second regulatory period:

2016-17	2017-18	2018-19	2019-20
\$560 000	\$574 000	\$588 000	\$603 000

The South Australian Government will make the following contributions to SA Water in relation to such costs in each financial year of the second regulatory period:

2016-17	2017-18	2018-19	2019-20
\$560 000	\$574 000	\$588 000	\$603 000

**C. Save the River Murray Levy Administration Services**

Administration of the Save the River Murray Levy in accordance with section 93 of the *Water Industry Act 2012*, up to the following cost in each financial year of the second regulatory period:

2016-17	2017-18	2018-19	2019-20
\$60 000	\$60 000	\$60 000	\$60 000

The South Australian Government will make the following contributions to SA Water in relation to such costs in each financial year of the second regulatory period:

2016-17	2017-18	2018-19	2019-20
\$60 000	\$60 000	\$60 000	\$60 000

**D. Fluoridation Services**

Services required for:

- (i) the continuation of the fluoride dosing program in metropolitan Adelaide and the existing country fluoride dosing installations;
- (ii) the construction and operation of any new fluoride dosing installations;

as recommended or agreed by or on behalf of the Chief Executive, Department for Health and Ageing, from time to time.

**E. Purchase of renewable energy or carbon offsets for the Adelaide Desalination Plant**

SA Water must purchase applicable renewable energy certificates (RECs) for the purposes of the operation and maintenance of the Adelaide Desalination Plant and associated infrastructure, or otherwise fully offset the carbon impact of that operation and maintenance, sufficient to maintain South Australia's commitment at clause 17 of the *Implementation Plan for Augmentation of the Desalination Plant (100 gigalitres per annum)*, *National Partnership Agreement on Water for the Future*.

**F. State-wide Pricing Facility**

SA Water must, in fixing standard terms and conditions governing the provision of services pursuant to section 36 of the *Water Industry Act 2012*, set such standard terms and conditions relating to the prices of, or tariffs for, the provision of the drinking water and sewerage retail services it provides on the basis of state-wide pricing i.e. the tariffs or tariff components for such services must be the same, or result in a similar outcome, for any customer in the class of customers to which the terms and conditions are expressed to apply, irrespective of the customer's location.

The South Australian Government will make the following contributions to SA Water in each financial year of the second regulatory period in order to support the lowest levels of state-wide standard terms and conditions relating to price as possible:

(i) in relation to SA Water's drinking water retail services:

2016-17	2017-18	2018-19	2019-20
\$67 416 173	\$67 416 173	\$67 416 173	\$67 416 173

(ii) in relation to SA Water's sewerage retail services:

2016-17	2017-18	2018-19	2019-20
\$40 162 827	\$40 162 827	\$40 162 827	\$40 162 827

**G. Water Planning and Management Charges Contribution**

SA Water must make the following contributions to the Department for the Environment, Water and Natural Resources in each financial year of the second regulatory period in order to support water planning and management activities.

2016-17	2017-18	2018-19	2019-20
\$17 995 000	\$18 445 000	\$18 906 000	\$19 379 000

**H. Annual reimbursement of fees paid for valuation roll**

SA Water must make the following contributions to the Minister in each financial year of the second regulatory period in order to reimburse the Minister for fees paid to the



Valuer-General pursuant to section 21(a) of the *Valuation of Land Act 1971* for a copy of the valuation roll or any addition, correction or amendment to the roll.

2016-17	2017-18	2018-19	2019-20
\$4 961 000	\$5 085 000	\$5 212 000	\$5 342 000



The Hon Ian Hunter MLC  
MINISTER FOR WATER AND THE RIVER MURRAY

23 October 2014

## APPENDIX 4: PRICING PRINCIPLES

Table A.1 sets out the NWI pricing principles for recycled water and stormwater use with which SA Water must comply with under the SA Water PD 2013. Table A.2 sets out the pricing principles that currently apply to excluded services, which are largely based on the NWI pricing principles.

**Table A.1: NWI pricing principles for recycled water and stormwater use<sup>34</sup>**

PRICING PRINCIPLES
<p><u>Principle 1: Flexible regulation</u></p> <p>Light handed and flexible regulation (including use of pricing principles) is preferable, as it is generally more cost-efficient than formal regulation. However, formal regulation (e.g. establishing maximum prices and revenue caps to address problems arising from market power) should be employed where it will improve economic efficiency.</p>
<p><u>Principle 2: Cost allocation</u></p> <p>When allocating costs, a beneficiary pays approach — typically including direct user pay contributions — should be the starting point, with specific cost share across beneficiaries based on the scheme’s drivers (and other characteristics of the recycled water/stormwater reuse scheme). Prices to contain a water usage (i.e. volumetric) charge</p>
<p><u>Principle 3: Water usage charge</u></p> <p>Prices to contain a water usage (i.e. volumetric) charge.</p>
<p><u>Principle 4: Substitutes</u></p> <p>Regard to the price of substitutes (potable water and raw water) may be necessary when setting the upper bound of a price band.</p>
<p><u>Principle 5: Differential pricing</u></p> <p>Pricing structures should be able to reflect differentiation in the quality or reliability of water supply.</p>
<p><u>Principle 6: Integrated water resource planning</u></p> <p>Where appropriate, pricing should reflect the role of recycled water as part of an integrated water resource planning system.</p>

<sup>34</sup> NWC, *National Water Initiative Pricing Principles*, April 2010, page 16; available at <http://www.environment.gov.au/water/publications/action/pubs/nwi-pricing-principles.pdf>

## PRICING PRINCIPLES

### Principle 7: Cost recovery

Prices should recover efficient, full direct costs — with system-wide incremental costs (adjusted for avoided costs and externalities) as the lower limit, and the lesser of stand-alone costs and willingness to pay as the upper limit. Any full cost recovery gap should be recovered with reference to all beneficiaries of the avoided costs and externalities. Subsidies and Community Service Obligation payments should be reviewed periodically and, where appropriate, reduced over time.

#### *Notes:*

*Direct costs include any joint/common costs that a scheme imposes, as well as separable capital, operating and administrative costs. This definition of direct costs does not include externalities and avoided costs.*

### Principle 8: Transparency

Prices should be transparent, understandable to users and published to assist efficient choices.

### Principle 9: Gradual approach

Prices should be appropriate for adopting a strategy of 'gradualism' to allow consumer education and time for the community to adapt.

**Table A.2: Pricing principles for excluded services**

PRICING PRINCIPLES
<p><u>Setting Developer Charges (Principles for Urban Water Tariffs: NWI Pricing Principle 8)</u></p> <p>Developer charges should reflect the investment in both new and existing assets required to serve a new development<sup>i</sup> and have regard to the manner in which ongoing water usage and service availability charges are set.</p> <p><i>Notes:</i></p> <p><i>i. Where there are benefits beyond the boundary of the development, the developer charge should have regard to the share of capacity required to serve the development.</i></p>
<p><u>Capping Developer Charges (Principles for Urban Water Tariffs: NWI Pricing Principle 9)</u></p> <p>Developer charges should not exceed the costs of serving new developments which includes investment in both new and existing assets required to serve a new development.</p>
<p><u>Revenue from Developer Charges (Principles for Urban Water Tariffs: NWI Pricing Principle 10)</u></p> <p>To avoid over-recovery, revenue from developer charges should be offset against the total revenue allowance either by excluding or deducting the contributed assets from the RAB or by offsetting the revenue recovered using other mechanisms.</p>
<p><u>Cost Recovery for New Capital Expenditure (Principles for Recovery of Capital Expenditure: NWI Pricing Principle 1)</u></p> <p>For new or replacement assets, charges will be set to achieve full cost recovery of capital expenditures (net of transparent deductions/offsets for contributed assets and developer charges and transparent community service obligations) through either:</p> <ul style="list-style-type: none"> <li>a) a return of capital (depreciation of the RAB) and return on capital (generally calculated as rate of return on the depreciated RAB); or</li> <li>b) renewals annuity and a return on capital (calculated as a rate of return on an undepreciated asset base (ORC)).</li> </ul>

## PRICING PRINCIPLES

### Differential Water Charges (Principles for Urban Water Tariffs: NWI Pricing Principle 7)

Water charges should be differentiated by the cost of servicing different customers (for example, on the basis of location and service standards) where there are benefits in doing so and where it can be shown that these benefits outweigh the costs of identifying differences and the equity advantages of alternatives.

*Notes:*

*Differential pricing may be achieved by upfront contributions, including developer charges.*

### Commission's Additional Pricing Principles

1. Principle 1: Where a service is provided for the sole benefit of the recipient, the beneficiary should pay the full efficient cost of the service, and other consumers should not be required to contribute to the cost of the service.
2. Principle 2: Where a service is provided to a distinct group of customers (e.g. trade waste audits are provided to trade waste customers only), prices to a customer should reflect the incremental cost of supplying the service to the customer, and a reasonable allocation of the fixed costs of providing the service, where relevant.
3. Principle 3: Prices should reflect the efficient cost of the particular service provided, although in circumstances where the cost of implementing differentiated prices to different customers is likely to outweigh the benefits, non-differentiated prices can be implemented.
4. Principle 4: SA Water must be able to provide transparent information to customers on how the costs for these services have been calculated, or are to be applied, and must be able to support its position in the event of a dispute.

## APPENDIX 5: SUMMARY OF SUBMISSIONS

Description of Issue	Commission Response
<b>Business SA</b>	
1. Stresses the importance that small business customers are appropriately categorised in assessing customer impacts for the price determination.	The September 2014 Pricing Order requires the Commission to set revenue caps for SA Water. Individual prices will continue to be set annually by SA Water. The bill impacts experienced by different types of customers, such as small businesses, during the period of the SA Water PD 2016 cannot be determined until SA Water sets its prices each year.
2. States that any financial impact analysis should consider the ability of customers to shift to alternative sources of potable water.	<p>Under the September 2014 Pricing Order, the Commission sets revenue caps, with SA Water responsible for setting end-user prices consistent with the maximum revenue allowances set by the Commission. The Pricing Order also requires the application of the NWI Pricing Principles for alternative sources of water such as recycled water and stormwater.</p> <p>In accordance with the NWI pricing principles, prices for water and sewerage services should be cost-reflective. Cost-reflective pricing for drinking water will facilitate customers' choices when pursuing viable alternatives. The Commission's Inquiry into SA Water's drinking water and sewerage services provides further detail on this issue, including a number of recommendations for pricing reform.</p> <p>The presence of a suitable third party access regime for SA Water's infrastructure also plays a critical role for some customers to move to</p>

	Description of Issue	Commission Response
		cheaper alternative sources of water. In 2013 the South Australian Government prepared a Third Party Access bill for consultation. <sup>35</sup> The Commission provided a submission on that bill. <sup>36</sup>
3.	Supports a four year regulatory period as striking a balance between limiting administrative efficiencies and providing some long term certainty for SA Water.	The September 2014 Pricing Order requires a four year regulatory period.
4.	Supports SA Water consulting with customers on proposed expenditures that rely on customer benefits, prior to submitting RBP 2016. Seeks appropriately segregated data on customer group impacts, to allow it to provide input into the process.	<p>The Commission notes that SA Water has commenced its customer engagement program, as part of developing its RBP 2016 submission. The Commission would encourage all stakeholders, including Business SA, to participate in this program.</p> <p>Price impacts on different customer groups cannot be determined until SA Water sets its prices, following the Commission's revenue determination.</p>
5.	Supports the use of benchmarking SA Water against other water utilities.	The Commission encourages SA Water to provide benchmarking information in support of its RBP 2016 submission. Additionally, as part of determining efficiency improvement targets, the Commission may consider benchmarking SA Water against water industry peers, as it did in setting the SA Water PD 2013.
6.	Supports the use of an optimised mix of supply sources to minimise costs. Is keen to see detailed information on long-term growth plans for recycled water and stormwater re-use, to reduce reliance on the River Murray and the desalination plant.	SA Water should ensure that its water supply mix is being optimised to minimise costs, and the Commission expects RBP 2016 to contain detailed evidence of such optimisation, taking into account any regulatory requirements, and any proposed customer service standard

<sup>35</sup> Refer to [http://www.treasury.sa.gov.au/data/assets/pdf\\_file/0004/2488/water-industry-amendment-bill-2013-consultation-draft.pdf](http://www.treasury.sa.gov.au/data/assets/pdf_file/0004/2488/water-industry-amendment-bill-2013-consultation-draft.pdf).

<sup>36</sup> Refer to <http://www.treasury.sa.gov.au/economy/water-pricing/water-and-sewerage-infrastructure>.

	Description of Issue	Commission Response
		<p>changes.</p> <p>The Commission will also expect to see evidence of SA Water’s long-term water supply plans covering all potential sources of water, which should reflect all legislative requirements, security of supply standards, and be based on prudent and efficient expenditure only.</p>
7.	Does not support the provision of a working capital allowance to SA Water.	<p>The Commission is not proposing that a particular quantum for working capital be set but, rather, to ensure that SA Water is not economically disadvantaged by any methodological issues arising from the application of the “building block” methodology and associated financial modelling techniques employed in determining its revenues. The Commission will consider providing for a return on any working capital to the extent that is not reflected, or not implicitly recognised, in any of the other building block components that make up SA Water’s total revenue requirement.</p>
8.	Is supportive of limited pass-throughs, both for cost increases and windfall saving events.	<p>The Commission will carefully scrutinise any pass-through requests identified by SA Water, and is also mindful of the possibility of negative pass-throughs to address unforeseen events that were outside of SA Water’s control that may have led to windfall savings.</p>
9.	Supports ESCOSA having full autonomy with respect to water demand forecasts.	<p>The September 2014 Pricing Order requires the use of revenue caps, which will provide SA Water with a guaranteed revenue stream during the period of PD 2016 irrespective of the level of water demand. If actual demand is lower than forecast, prices can increase to recover the foregone revenue and if actual demand is higher than forecast, prices can decrease. The risk of actual demand being more or less than was forecast will therefore rest with consumers.</p>



	Description of Issue	Commission Response
10.	Supports the continuation of smart metering being on a voluntary basis, such that no additional costs are incurred by businesses.	As stated in the Draft Report on the Inquiry into Drinking Water and Sewerage Services Pricing Reform, the Commission supports customers having the option to install smart water meters at their own cost rather than being mandated. <sup>37</sup>
11.	With respect to any move away from property value-based sewerage charging, is keen to ensure that customers impacted are appropriately informed of how these changes will impact them.	The Draft Report on the Inquiry into Drinking Water and Sewerage Services Pricing Reform recommends the removal of property based sewerage charges and contains detailed analysis of the impacts to customers of that proposal. <sup>38</sup>
12.	States that the current level of reliability standards seems appropriate. Highlights the importance of a reliable water supply to business, and questions whether reliability standards for business could be maintained were households to indicate that they were willing to trade lower reliability standards for lower prices.	SA Water is required to engage with its customers and undertake scenario-testing of the service standard targets it proposes, to ensure that customers are given the opportunity to at least consider whether they would prefer to accept higher/lower levels of service in exchange for higher/lower bills.
13.	Supports a Guaranteed Service Level (GSL) in principle, but is keen to ensure that the benefits of such a scheme outweigh the costs.	The Commission will not require SA Water to include a GSL scheme in RBP 2016. However, the Commission will reconsider this position if strong customer support for the adoption of a GSL scheme is identified through the Commission's consultation on the price determination.

#### SA Water (4 February 2014)

1.	Seeks finalisation of a number of building blocks to be used to set	Under the terms of the September 2014 Pricing Order, the Commission
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<sup>37</sup> Further information on the Pricing Inquiry is available at: <http://www.escosa.sa.gov.au/projects/189/inquiry-into-drinking-water-and-sewerage-retail-services-pricing-reform.aspx>

<sup>38</sup> Further information on the Pricing Inquiry is available at: <http://www.escosa.sa.gov.au/projects/189/inquiry-into-drinking-water-and-sewerage-retail-services-pricing-reform.aspx>

	Description of Issue	Commission Response
	<p>prices:</p> <ul style="list-style-type: none"> <li>• Working capital allowance</li> <li>• Weighted Average Cost of capital</li> <li>• Tax Allowance</li> </ul>	<p>must prepare and provide to the Treasurer, on or before 31 December 2014, a separate report setting out the Commission's proposed approach to the calculation of the rate of return on the RAB.</p> <p>In addition, the Commission will review its position on at least two aspects of the components of the revenue building blocks methodology to be used in SA Water's revenue determination; in particular, the allowance for tax and the return on working capital. The Commission is expecting to release a Draft Paper outlining its positions on the above matters (separate to its report on the rate of return) by early 2015.</p>
2.	Seeks clarification of capitalisation policy.	<p>Consistent with its primary objective to protect the long term interests of consumers, in the SA Water PD 2013, the Commission chose to treat a limited number of expenditure items as capex for <u>regulatory purposes</u>, even though they may be treated as opex for <u>accounting purposes</u>. These items comprised the marginal cost of running the Adelaide Desalination Plant for warranty proving purposes in 2013 and 2014, and the cost of replacing reverse osmosis membranes used in the desalination process. The Commission confirms that it intends to continue to apply this capitalisation policy in the SA Water PD 2016.</p>
3.	Seeks clarity on the possible introduction of Guaranteed Service Levels (GSLs).	<p>The Commission will not require SA Water to include a GSL scheme in RBP 2016. However, the Commission will reconsider this position if strong customer support for the adoption of a GSL scheme is identified through the Commission's consultation on the price determination.</p>
4.	Seeks clarity on an ex-post review of capital expenditure.	<p>The Commission confirms that, in making the SA Water PD 2016, it will carry out a review of SA Water's actual capital expenditure during the</p>

	Description of Issue	Commission Response
		period of SA Water PD 2013, to ensure that only prudent and efficient capital expenditure is incorporated into the RAB going forward.
5.	Seeks clarity on the level of Community Service Obligations to offset customer prices.	The Minister for Water and the River Murray has issued a direction to SA Water under section 6 of the <i>Public Corporations Act 1993</i> , setting out all non-commercial services that are to be provided by SA Water during the period of PD 2016, and setting out the CSO funding that will be provided to SA Water by the Government. This is attached as Appendix 3.
6.	Seeks clarity on the allowance for pass-through events from the first determination.	This issue will be addressed as part of the PD 2016 setting process, following submission of RBP 2016. The SA Water PD 2013 gives SA Water the ability to propose cost pass-throughs from the period of PD 2013.
7.	Seeks clarity on risk allocation and estimation for capital works.	All project cost estimates should be mid-point estimates, based on an equal chance of under-spending or over-spending. Estimates should be based on an appropriate split of risk between SA Water and third party contractors.
8.	Seeks clarification on the revenue adjustment mechanism for changes in demand.	<p>Under the terms of the September 2014 Pricing Order, the Commission will determine the revenue allowances that SA Water may earn in respect of each of its direct control services. In effect, SA Water will have separate annual revenue caps imposed on its drinking water and sewerage retail services.</p> <p>While the Pricing Order requires an adjustment to revenues for any over- or under-recovery (of revenues collected), the Commission has yet to determine the specific details of the adjustment process. This</p>

	Description of Issue	Commission Response
		matter will be the subject of further review during the Revenue Determination.
9.	Seeks clarification on the allowance for real cost increases.	Clarification of this issue has been provided in section 7.1.7 of the final Framework and Approach paper.
10.	Seeks clarification on consulting with customers based on the current pricing policy and structure, rather than based on implementing all recommendations of the Inquiry into Drinking Water and Sewerage Services Pricing Reform Draft report.	<p>The Commission agrees that, for the purpose of commencing customer consultation, the current pricing policy and structure should be used, rather than basing it on the Inquiry recommendations which may, or may not, be adopted by the Government.</p> <p>However, in the instance that the Government's adoption of the Inquiry recommendations leads to a material change in the pricing policy and structure, then the Commission expects that SA Water will undertake further customer engagement.</p>
11.	Supports a four year regulatory period and seeks confirmation of this.	The September 2014 Pricing Order requires a four year regulatory period.
<b>SA Water (5 February 2014)</b>		
1.	<p>Supports the proposed approach requiring SA Water to consult with its customers on service standard metrics and incentive schemes ahead of the regulatory process to allow customers to drive SA Water's expenditure proposals.</p> <p>Further supports the recommendation that the targets for the service standards should be set following customer consultation to ensure SA Water's expenditure is aligned with the levels of service our customers want and expect.</p>	The Commission will work with SA Water as it undertakes its consumer engagement program to ensure that it can have reasonable confidence in the results of that process.

Description of Issue	Commission Response
<b>SA Water (8 August 2014)</b>	
<p>1. Supports the service standard framework set out by ESCOSA in its Draft Framework. Whilst the levels of service customers value and are willing to pay for are still subject to more detailed analysis, SA Water did not received any information from customers that would prompt changes to the Draft Framework proposed by ESCOSA.</p>	<p>The set of service standards to apply to SA Water for the period of PD 2016 will be the same as the current service standards applicable to SA Water. However, the Commission is open to considering any other specific standards (including variations to existing standards) that might be identified through customer consultation occurring as part of the PD 2016 process.</p>
<p>2. SA Water does not support any increase in costs associated with the reporting framework for the forthcoming regulatory period, specifically:</p> <ul style="list-style-type: none"> <li>a. Increases in service standard metrics;</li> <li>b. Increases in reportable data items;</li> <li>c. Increases in reporting frequencies; or</li> <li>d. Increases in the quality of interim quarterly data.</li> </ul> <p>Seeks the opportunity to further discuss any possible efficiencies to the current reporting regime that would minimise the costs of regulatory reporting in order to assist SA Water in operating as efficiently as possible.</p>	<p>This is an objective supported by the Commission in principle, with the Commission seeking to ensure positive net benefits from regulation. The detailed reporting requirements will be discussed with SA Water as part of the PD 2016 process.</p>



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