30 January 2020

Adam Wilson
Chief Executive Officer
Essential Services Commission of South Australia
GPO Box 2605
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Dear Adam

Submission on Guidance Paper 9: Annual updates of the regulatory rate of return

SA Water wishes to make a submission to ESCOSA in response to the release of the *Guidance Paper 9: Annual updates of the regulatory rate of return* (Guidance Paper), as part of the 2020 Regulatory Determination process.

SA Water supports the principles, noted in the Guidance Paper, of price stability for customers and providing financial viability for the utility to ensure it is positioned to maintain service levels for customers. In reviewing the Guidance Paper we have considered these principles and have the following comments in relation annual adjustments for the rate of return.

The use of annual adjustments does not address the key issue with the current rate of return methodology, which is misalignment of the inflation adjustment, as raised in our response to Guidance Papers 6 and 7 in August 2019. The approach proposed for the annual adjustment repeats the use of a 1 year Reserve Bank of Australia (RBA) forecast and 9 years of the RBA target rate midpoint which maintains the current misalignment between the inflation adjustment and the inflation embedded within the point in time RBA bond rate.

If an annual adjustment is to be applied, an alternative approach could be to adjust the rate of return to correct for the discrepancy between the forecast and actual cost of debt (as adopted by other regulators), and also between the forecast and actual inflation for the preceding year.

Annual adjustments to the rate of return risks price uncertainty for customers. Currently, SA Water takes the approach that price adjustments are passed on to customers in full at the start of the regulatory period with subsequent annual price movements aligned to CPI. This provides the price certainty we believe customers value. The adoption of annual adjustments would require a price adjustment in addition to CPI, thereby precluding a commitment to a price path for the regulatory period. The worked examples in the Guidance Paper show the rate of return adjustment in one direction, but in practice they could increase and decrease in different years within the four-year regulatory period. Analysis of interest rate movements in the last regulatory period reflect this. Further, given the short-term averaging period used to determine the risk-free rate, this volatility would be reflected in prices and the intended outcome to avoid step changes in price would not be achieved.

As noted in the worked example within the Guidance Paper, in order to avoid 'price shocks' from a scenario of annual adjustments and an increasing rate of return, SA Water could apply to ESCOSA to defer the additional revenue to the next regulatory period. Although this may address a price shock within a regulatory period, it has the potential to exacerbate potential price shock across regulatory periods. If the rate of return is trending up, revenue would be higher in the next regulatory period and adding the recovery of deferred revenue would only add to the potential price increase.

Additionally, this approach would be less transparent to customers who would experience annual price changes (potentially both up and down within the regulatory period) which do not directly reflect the cost of providing the service to the customers.

Based upon the points noted above, we would need more information to be able to establish that the benefits of annual adjustments to the rate of return out-weigh the potential impacts on price stability and financial viability. We would welcome the opportunity to work with ESCOSA to further consider these points.

Yours sincerely,

David Ryan
Chief Executive