



SA Water Regulatory Determination 2020

DRAFT Framework and Approach

November 2017

Request for submissions

The Essential Services Commission (**Commission**) invites written submissions from members of the community on this paper. Written comments should be provided by **25 January 2018**.

It is the Commission's policy to make all submissions publicly available via its website (www.escosa.sa.gov.au), except where a submission either wholly or partly contains confidential or commercially sensitive information provided on a confidential basis and appropriate prior notice has been given.

The Commission may also exercise its discretion not to publish any submission based on length or content (for example containing material that is defamatory, offensive or in breach of any law).

Responses to this paper should be directed to: **SA Water Regulatory Determination 2020: Draft Framework and Approach**

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Table of contents

- Request for submissions 2
- Glossary of terms ii
- 1 Executive summary..... 1
- 2 Objectives for the SA Water Regulatory Determination 2020 4
 - 2.1 What are we looking to achieve for SA Water Regulatory Determination 2020? 4
 - 2.2 Areas of focus for SAW RD20 5
 - 2.3 Questions for stakeholders 8
- 3 The proposed framework..... 9
 - 3.1 Methodology for SAW RD20 10
 - 3.2 Regulation of SA Water’s other retail services..... 14
 - 3.3 Questions for stakeholders 15
- 4 The proposed review process 16
- 5 Next steps 17
- .Appendix 1: Legal framework for the economic regulation of SA Water..... 18
- Appendix 2: Roles and responsibilities of participants in water regulation..... 23

Glossary of terms

CAPM	Capital Asset Pricing Model
Commission	Essential Services Commission, established under the Essential Services Commission Act 2002
ESC Act	Essential Services Commission Act 2002
Minister	Minister for the Water and River Murray (Change for specific Industry)
RBP	Regulatory Business Proposal
SA Water	SA Water Corporation
SAW RD16	SA Water Regulatory Determination 2016
SAW RD20	SA Water Regulatory Determination 2020
Treasurer	Treasurer for the South Australian Government

1 Executive summary

The Essential Services Commission (**Commission**) is consulting on its proposed Framework and Approach for the SA Water Regulatory Determination to apply from 1 July 2020 to 30 June 2024 (**SAW RD20**).

To promote the long-term interests of SA Water's customers, the proposed framework and approach for SA Water Regulatory Determination 2020 (**SAW RD20**) is aimed at delivering the following outcomes:

- ▶ SA Water should understand what customers value and develop proposals for services and prices that respond to those needs
- ▶ SA Water should incur only efficient expenditure, taking a long-term approach to its decision-making to ensure that the essential services it provides are sustainable, and
- ▶ customers should receive the benefits of that improved efficiency through the prices they pay.

We are seeking input from a wide range of stakeholders on the draft proposals set out in this paper, which will assist us to continue to improve the way in which we apply economic regulation to SA Water.

The proposed framework and approach for SAW RD20 is aimed at challenging SA Water to deliver affordable, reliable and appropriate quality water and sewerage services to South Australians – not just for the SAWRD20 period but also into the future. SA Water has responded well to our regulatory approach since our first determination in 2013, delivering significant efficiencies and price reductions to customers and the proposed approach aims to build on those achievements.

Promoting a long-term approach

We propose to work closely with SA Water as it prepares its Regulatory Business Proposal (**RBP**) for SAWRD20 to ensure that its plans meet consumers' long-term interests. We will carefully scrutinise and verify all information and proposals put by SA Water, before making a decision on its RBP. We expect the RBP to be credible, evidence-based and verifiable.

We will ask SA Water to include information in its RBP about its long-term plans for customer services, expenditure (including efficiency gains) and revenue recovery for drinking water and sewerage services. Those plans should inform its customers of the indicative direction of prices in the long term and provide the Commission with a basis to assess its RBP, and future RBPs, against those long-term projections.

The proposed regulatory approach extends well beyond the SAW RD20 review. During the next regulatory period, we will be monitoring and evaluating SA Water's performance, to ensure that consumers receive the outcomes that it is committing to under its RBP. We want SA Water to be transparent in reporting its performance to customers and respond effectively to consumers' needs. We recognise that the environment in which SA Water operates is changing and that it needs to be adaptable to those changing circumstances. It is therefore important for SA Water's commitments to be outcome focussed, to provide it with the flexibility to change its priorities as necessary, without compromising the price, quality and reliability of essential services that it provides.

The proposed regulatory framework

The framework for economic regulation that has been applied to SA Water has delivered positive outcomes to consumers. In particular, SA Water's annual regulated revenues are now \$110m lower compared to 2012-13, prior to our first regulatory determination. SA Water has achieved significant operational efficiencies during that period and has a more customer-focussed business.

We want to retain much of the existing regulatory framework that has served customers well, while also looking to improve aspects that could deliver even better customer outcomes. The core elements of the framework that we propose to retain are:

- ▶ Setting separate revenue caps for SA Water’s drinking water and sewerage services, to apply for four years.
- ▶ Determining those revenue caps using a cost-based approach. We will scrutinise SA Water’s proposed expenditure closely, to ensure its revenues recover only prudent and efficient forecast expenditure.
- ▶ Regulating SA Water’s other retail services (including the sale of recycled water and connection services) using a pricing principles approach.

We want to enhance some elements of the regulatory framework, to provide even stronger incentives to SA Water to provide the services that customers value at efficient prices. In addition to pursuing a long-term approach, we want to improve the framework in the following areas:

- ▶ Providing greater oversight of SA Water’s customer engagement process, providing it with principles that it should follow as it engages with customers to understand their price/service preferences. We will give SA Water the opportunity to propose service standards to apply during the next regulatory period, informed by its customer engagement process.
- ▶ Issuing various technical papers during the process of SA Water preparing its RBP, to provide guidance to SA Water and stakeholders on detailed methodological issues, such as the basis for estimating the regulatory rate of return.
- ▶ Ensuring that SA Water consults with stakeholders on its RBP before submitting it to us, to demonstrate the credibility of its proposals. If we are satisfied that the proposals best promote the long-term interests of SA Water’s customers, we will make a determination that approves those proposals.
- ▶ Involving other regulators of SA Water more regularly in the process, to ensure that SA Water’s RBP and the determination are consistent with the environmental, health, technical and social obligations that SA Water must meet.
- ▶ Improving the reporting frameworks that apply to SA Water, to give it greater accountability for reporting its performance.

Proposed principles for assessing SA Water’s proposals

In assessing SA Water’s proposed RBP, we intend to apply the following principles:

- ▶ Our primary objective is to protect the long-term interests of consumers, with respect to the price, quality and reliability of essential services. In the context of regulating SA Water, this means that we aim to:
 - Set service standards that are valued by customers, having regard to the costs and benefits of delivering them.
 - Provide SA Water with appropriate incentives to meet those service standards at the lowest sustainable cost to customers.
- ▶ SA Water should have an effective relationship with its customers, where it informs and listens to customers about the issues that matter to them, engaging with them at the right times.
- ▶ SA Water should develop its RBP based on a robust engagement process, which clearly tests customers’ priorities and preferences for the price/service offerings it can provide.

- ▶ SA Water should be pursuing current and future cost efficiencies, which may involve changing its priorities from time to time to meet changing market circumstances and customer expectations. It should actively manage cost pressures through sound financial management, with a focus on continuous improvement in its operations.
- ▶ We want to take a long-term approach, encouraging SA Water to engage with its customers on the long-term implications of its proposals.

The review process

Following consultation on this paper, we will finalise the framework and approach by April 2018.

We will work with SA Water as it develops its RBP, which is due to be submitted to us and published by September 2019. To assist SA Water and provide all stakeholders with more detailed information about the methodologies for the SAW RD20 review, we plan to release various technical papers prior to receiving the RBP.

We expect SA Water to have consulted widely on its proposals, including with consumer representatives, prior to submitting it. We will test the robustness of that consultation process and issue a Draft Regulatory Determination by February 2020 on whether or not the RBP meets the long-term interests of customers. If it does not, we will identify areas where SA Water should change its proposals, consulting publicly on those matters.

If required, SA Water will submit a revised RBP responding to any changes identified in the Draft Regulatory Determination, by April 2020. We will then issue a Final Regulatory Determination authorising SA Water's RBP, by May 2020.

What are we seeking feedback on?

- ▶ Are the proposed guiding principles for the SA Water Regulatory Determination 2020 appropriate? Are there other factors that we need to take into account?
- ▶ Does the proposed approach allow customers, customer advocates and other stakeholders appropriate and reasonable opportunities to have their say on the service/price mix that SA Water should offer from 1 July 2020?
- ▶ Is the proposed level of oversight of SA Water's customer engagement process sufficient? Is the proposed framework and approach for economic regulation of SA Water from 1 July 2020 likely to best promote consumers' long-term interests?
- ▶ Does the proposed framework achieve the right balance of protecting consumers' interests, while minimising the cost of regulation?

2 Objectives for the SA Water Regulatory Determination 2020

SA Water is a State-owned monopoly provider of water and sewerage services to over 1.6 million South Australians. Since 2012, the Essential Services Commission has been responsible for independent economic regulation of SA Water, and all other South Australian licensed water and sewerage retailers, under the Water Industry Act 2012.

As a monopoly business, SA Water does not have the benefit of competition to drive its performance. Economic regulation can help focus SA Water to deliver the services that customers value at efficient prices, through the obligations and incentives imposed under licence conditions and related regulatory requirements.

In applying economic regulation to SA Water, we must follow our primary objective under the Essential Services Commission Act 2002, which is to protect the long-term interests of consumers with respect to the price, quality and reliability of essential services. The concept of *long-term* interests is important, as opposed to short-term interests. Ensuring that SA Water operates with a long-term focus, through sensible financial and operational management, will best promote consumers' long-term interests.

We also have other legislative requirements and objectives that guide us. Those objectives generally focus on the principles of economic efficiency which, when applied to SA Water, means that we encourage it to maximise the potential of its resources and seek continuous improvement in areas of service that its customers value. A summary of the legal framework that applies to our regulatory responsibilities with respect to SA Water is contained in Appendix 1.

Our regulatory function exists within a broader policy and regulatory system that applies to the water industry. There are other regulators and agencies that are responsible for environmental, health, social and technical regulation of SA Water. Appendix 2 describes those organisations and their roles. We will work closely with those other regulators, to ensure that our approach is coordinated with theirs.

2.1 What are we looking to achieve for SA Water Regulatory Determination 2020?

To promote our primary objective, the proposed framework and approach for SA Water Regulatory Determination 2020 (**SAW RD20**) is aimed at delivering the following outcomes:

- ▶ SA Water should understand what customers value and develop proposals for services and prices that respond to those needs
- ▶ SA Water should incur only efficient expenditure, taking a long-term approach to its decision-making to ensure that the essential services it provides are sustainable, and
- ▶ customers should receive the benefits of that improved efficiency, through the prices they pay.

These objectives are aimed at promoting a high performing water utility, that is continuously looking to understand and respond to the requirements of its customers, while becoming more efficient over time. The proposed regulatory approach is intended to challenge SA Water to deliver continuous improvement, for the benefit of its customers.

We appreciate that SA Water's objectives are strongly aligned with ours – it too is seeking to promote its customers' long-term interests through the services it delivers and prices it charges. Starting with a common objective provides for a less adversarial and more constructive relationship between us. By acknowledging that common objective, we can work closely with SA Water to focus on how to best meet that objective, as it prepares its plans for the provision of water and sewerage services.

Those plans will be documented in a Regulatory Business Proposal (**RBP**), which will set out the customer service levels and revenues that SA Water intends to recover from its drinking water and sewerage customers over the four years from 1 July 2020. SA Water will be developing its RBP over the coming 18 months and will be submitting it for our approval in September 2019.

In assessing SA Water's proposed RBP, we intend to apply the following principles:

- ▶ Our primary objective is to protect the long-term interests of consumers, with respect to the price, quality and reliability of essential services. In the context of regulating SA Water, this means that we aim to:
 - Set service standards that are valued by customers, having regard to the costs and benefits of delivering them.
 - Provide SA Water with appropriate incentives to meet those service standards at the lowest sustainable cost to customers
- ▶ SA Water should have an effective relationship with its customers, where it informs and listens to customers about the issues that matter to them, engaging with them at the right times.
- ▶ SA Water should develop its RBP based on a robust engagement process, which clearly tests customers' priorities and preferences for the price/service offerings it can provide.
- ▶ SA Water should be pursuing future cost efficiencies, which may involve changing its priorities from time to time to meet changing market circumstances and customer expectations. It should actively manage cost pressures through sound financial management, with a focus on continuous improvement in its operations.
- ▶ We want to take a long-term approach, encouraging SA Water to engage with its customers on the long-term implications of its proposals.

Each of these principles is discussed in more detail in subsequent sections of this paper.

The outcomes that we are promoting must also complement the environmental, health, technical and social outcomes that SA Water must deliver under other regulatory frameworks. We will work with those other regulators to ensure that we coordinate our approach with theirs.

2.2 Areas of focus for SAW RD20

While the previous two SA Water Regulatory Determinations resulted in good customer outcomes, we want to promote further improvements to provide even stronger incentives for SA Water to deliver services valued by customers at the lowest sustainable cost. Areas where we think improvements can be made include:

- ▶ Having a long-term perspective
- ▶ Providing consumers and other stakeholders with an even greater opportunity to be involved in the regulatory process
- ▶ Greater coordination with other regulators

2.2.1 A long-term approach to economic regulation of SA Water

The proposed regulatory approach is aimed at driving SA Water to deliver good customer outcomes in the long term. While SA Water has delivered good outcomes to its customers since the Commission's

first regulatory determination in 2013, including recovery of regulated revenues that are now \$110 million lower each year than was collected in 2012, customers should expect to see further gains.

The previous determinations focussed on services and revenues over a four-year period and we think that a longer-term perspective will benefit SA Water's customers. While we propose to continue setting maximum revenues and service standards for four years, we will encourage SA Water to think about its long-term strategy for customer service and revenues and engage with customers on those long-term plans.

SA Water should be challenging itself to become more efficient over time, by actively managing cost pressures through sound financial management and focussing on continuous improvement in its operations. We want SA Water to develop long-term plans on how it can deliver those further gains to customers, through the services it provides and the prices that customers pay. The RBP should be clear about those long-term plans, which should include plans for asset management and financing plans. That information reflects that fact that SA Water operates assets that have long lives and its business decisions should also have a long-term focus. It should also inform its customers of the direction of prices in the long term (acknowledging that long-term forecasts will be indicative only) and provide the Commission with a basis to assess its next RBP, and future RBPs, against SA Water's long-term projections.

We expect SA Water to be ambitious in its efficiency targets, to provide itself a real challenge for the future. Where we are not satisfied that the efficiency targets are challenging enough, or there is generally insufficient evidence in the RBP to support its targets, the regulatory determination may require SA Water to amend its efficiency proposals. While SA Water is yet to prepare its forecast costs of providing drinking water and sewerage services for the next regulatory period, one of its major cost components, the cost of debt, is expected to fall under our approach of using a ten-year trailing average cost of debt. All else being equal, this would place downward pressure on customers' prices.

Encouraging SA Water to take a long-term approach would not lessen our expectation of SA Water's ability to manage its performance in the short term, including in the way that it responds to the immediate requirements of its customers. We expect it to effectively manage its resources in the short term, to ensure that it is meeting all regulatory obligations in an efficient manner.

A long-term focus will help draw a link between the long-term plans of SA Water and the service levels that customers can expect to receive in the future. For example, if SA Water were to underinvest in its infrastructure, it may be some time before that underinvestment becomes apparent through a decline in service levels experienced by customers. Obtaining information about long-term asset management and investment plans will inform our view of the potential for SA Water to deliver efficient, sustainable services into the future.

The proposed regulatory approach also extends well beyond the SAW RD20 review. During the next regulatory period, we will be monitoring and evaluating SA Water's performance, to see if consumers are receiving the outcomes that SA Water is committing to under its RBP. We want SA Water to be transparent with its customers about its performance and respond effectively to consumers' needs. We recognise that the environment in which SA Water operates is changing and that it needs to be adaptable to those changing circumstances. It is therefore important for SA Water's commitments to be outcome focussed, to provide it with the flexibility to change its priorities as necessary, without compromising the price, quality and reliability of services that it provides.

2.2.2 Providing consumers and other stakeholders with an even greater opportunity to be involved in the regulatory process

In order to promote the long-term interests of customers, we need to understand customers' priorities and views about SA Water's services. We will be encouraging SA Water to engage closely with its customers in preparing its RBP and we want it to consult with other stakeholders before finalising the

RBP for our approval. That consultation should include an opportunity for customers and stakeholders to comment on SA Water's proposals, to ensure that it has responded to customers' priorities appropriately.

While SA Water has achieved most service standards that we have set to date, we want to make sure that those standards reflect what customers value in the future and promote service improvement where the benefits to customers exceed the costs. For example, customers' expectations about the way in which SA Water manages water mains bursts may have changed in light of recent performance and we want to make sure that SA Water meets its customers' expectations, while acting efficiently.

We also want to provide SA Water with incentives to become more efficient over time, without compromising service levels to customers and its ability to meet its regulatory obligations.

To achieve those aims, we expect SA Water to engage with its customers on its service levels and opportunities for change. That should include areas where customers may value service improvements. It should also include areas of service that are not highly valued by customers. In both cases, SA Water should be transparent with customers about the cost implications of any service level changes (increases or decreases). It should also identify opportunities for reprioritising its expenditure, to address any upward cost pressures that may arise where customers express a preference for increased service levels. We expect evidence of customers' views and SA Water's expenditure plans to meet customer expectations, to be clearly documented in its RBP.

We will test the robustness of SA Water's consultation and the more that SA Water can demonstrate that it has consulted widely and taken stakeholders' views into account, the more we will view its proposals as credible.

We propose the following guiding principles for SA Water to consider when engaging with its customers to determine their priorities and preferences:

- ▶ The purpose of the engagement and how the results will be used should be made clear to customers. This includes being clear about the level of influence participants can have on the final decision to be made.
- ▶ A representative sample of the population that will be affected by the decision should be given the opportunity to have their views heard. This includes choosing the appropriate methods to allow different types of customers to meaningfully participate in the process.
- ▶ The engagement should be conducted at the right time in the decision making process to allow customer views to be genuinely considered. This includes allowing customers the opportunity to validate if their views have been accurately represented.
- ▶ Any engagement process should be proportionate to the significance and impact of the investment decision being considered. This includes ensuring that the cost of undertaking the engagement does not outweigh the benefits to be achieved through the investment decisions.
- ▶ The results of the engagement process should be communicated clearly and transparently to participants and the wider customer base. This includes reporting back on how the promises made through the engagement process have been, or will be, delivered.

We will oversee and provide further guidance to SA Water on its customer engagement process as it is implemented.

The SAW RD20 regulatory process will also be open to extensive consultation, starting with this draft Framework and Approach paper. The determination will rely on a diverse range of evidence and we want to make sure that the consultation approach to SAW RD20 provides opportunities to gather that evidence from stakeholders. There will be various opportunities to hear from our stakeholders during

the review process. We will consult on various technical papers that will be prepared as we work with SA Water over the course of its RBP preparations. We will also consult on a draft regulatory determination prior to releasing a final regulatory determination.

The Commission’s Consumer Advisory Committee will play an important role in participating in SA Water’s stakeholder engagement process and advising us of the quality of that process. We will also be seeking the views of other stakeholders that were involved in that process.

The consultation process that we will use will not simply rely on requesting written submissions to our consultation papers. We will discuss key issues with stakeholders directly and will make ourselves available to meet with interested parties during consultation phases.

2.2.3 Coordinating with other regulators

SA Water is subject to other regulatory obligations, including environmental, health and social obligations. It is important that the regulatory approach is complementary to those other types of regulation. In particular, SA Water’s customers pay for the cost of meeting all of those other regulatory obligations and we want to ensure that we coordinate our approach with other regulators, acknowledging that economic regulation is part of a broader system.

To achieve that objective we will include other regulators during the development of the framework and approach and during the process of SA Water preparing its RBP. Through that process all regulators will clearly identify the regulatory obligations which will apply to SA Water and ensure that those obligations do not impose unreasonable compliance costs and provide sufficient certainty to SA Water to allow it to develop its RBP. We will ask other regulators for their views about the extent to which SA Water’s RBP is consistent with the regulatory frameworks that they administer and take those views into account in the draft regulatory determination. We will also look at opportunities to coordinate the regular and ongoing monitoring and reporting of programs and outcomes delivered by SA Water during the SAW RD20 period.

2.3 Questions for stakeholders

- Have we identified the right areas for improvement?
- Are there other areas for improvement that we should consider?
- Are the proposed guiding principles for the SA Water Regulatory Determination 2020 right or are there other factors that we need to take into account?

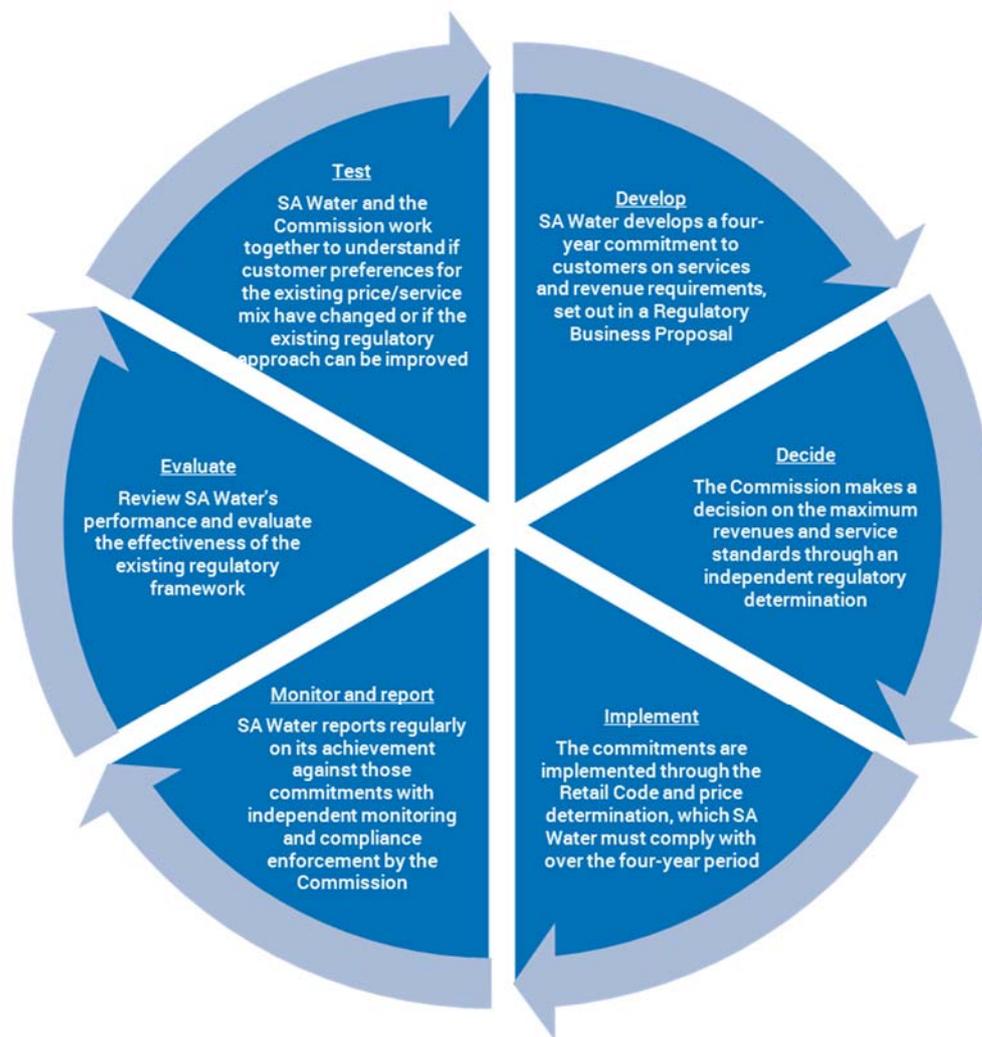
3 The proposed framework

The framework for economic regulation that has applied to SA Water has delivered positive outcomes to consumers. SA Water has achieved significant operational efficiencies during that period, which have been passed on to consumers through lower prices.

We want to retain much of the existing regulatory framework that has served customers well, while also looking to improve those aspects that could deliver even better customer outcomes. The core elements of the proposed framework are described in Figure 3.1 below. The elements in blue are those that form part of the SAW RD20 process and include testing consumers' preferences, SA Water developing its RBP and the Commission making its regulatory determination.

Following that process, the Commission will implement its determination and SA Water will commence the delivery of its commitments to customers. We will implement a monitoring, reporting and enforcement framework during the four-year regulatory period, to evaluate SA Water's performance and ensure that consumers receive the outcomes that SA Water is committing to under its RBP. That evaluation process will help inform the following regulatory determination, where we will ask SA Water to see if consumers' preferences have changed since the previous determination and prepare a new RBP.

Figure 3.1: The key elements of the Commission's framework for economic regulation of SA Water



3.1 Methodology for SAW RD20

We are also proposing to maintain the same general methodology for SAW RD20, although there are some aspects of that methodology that we would like to improve, as discussed in the preceding chapter.

The proposed methodology involves:

- ▶ Setting binding standards for those aspects of customer service that are valued by customers. The service standards will be different to those currently implemented if evidence indicates that there are better, more meaningful aspects of service that should be addressed. We propose to give SA Water the opportunity to propose service standards, informed by its customer engagement process. If we think that those standards are appropriate, we will adopt them as binding standards under the Water Retail Code.
- ▶ Reviewing SA Water's proposed costs for providing drinking water and sewerage services to ensure that they reflect prudent and efficient expenditure. We intend to undertake a rigorous review of SA Water's proposed capital and operating expenditure, to ensure that revenues recover efficient costs. The manner in which the cost review will be undertaken is discussed in section 3.1.3 below.
- ▶ Setting SA Water's maximum drinking water and sewerage revenues (not prices). The SA Water Regulatory Determination 2016 set four-year maximum revenue caps for drinking water and sewerage prices, with SA Water retaining responsibility for setting the prices to recover those revenues. We propose to continue that approach, to drive SA Water's accountability to its customers and recognising the economic, social and environmental objectives that underpin price structures.
- ▶ Regulating SA Water's other retail services (including the sale of recycled water and connection services) using a pricing principles approach.

3.1.1 The methodology for setting service standards

We propose to require SA Water to develop a draft set of service commitments to its customers as part of its RBP. The draft standards should relate to the aspects of service valued by its customers.

We are open to a set of service standards that are quite different to the current service standards. We intend to work closely with SA Water to provide appropriate guidance as it develops its draft proposals. We will be looking for evidence that the draft service standards have been informed by, and respond to, the issues raised through SA Water's customer engagement processes. Further, as meeting the proposed services standards will impact certain aspects of SA Water's proposed capital and operating expenditure plans, we will also be looking for evidence that the service/cost trade-off has been considered through these discussions.

We will still make an independent determination of the final service standards when we consider the entire RBP. This will include details of how we will hold SA Water to account for delivering those service standards.

3.1.2 The methodology for setting regulated revenues

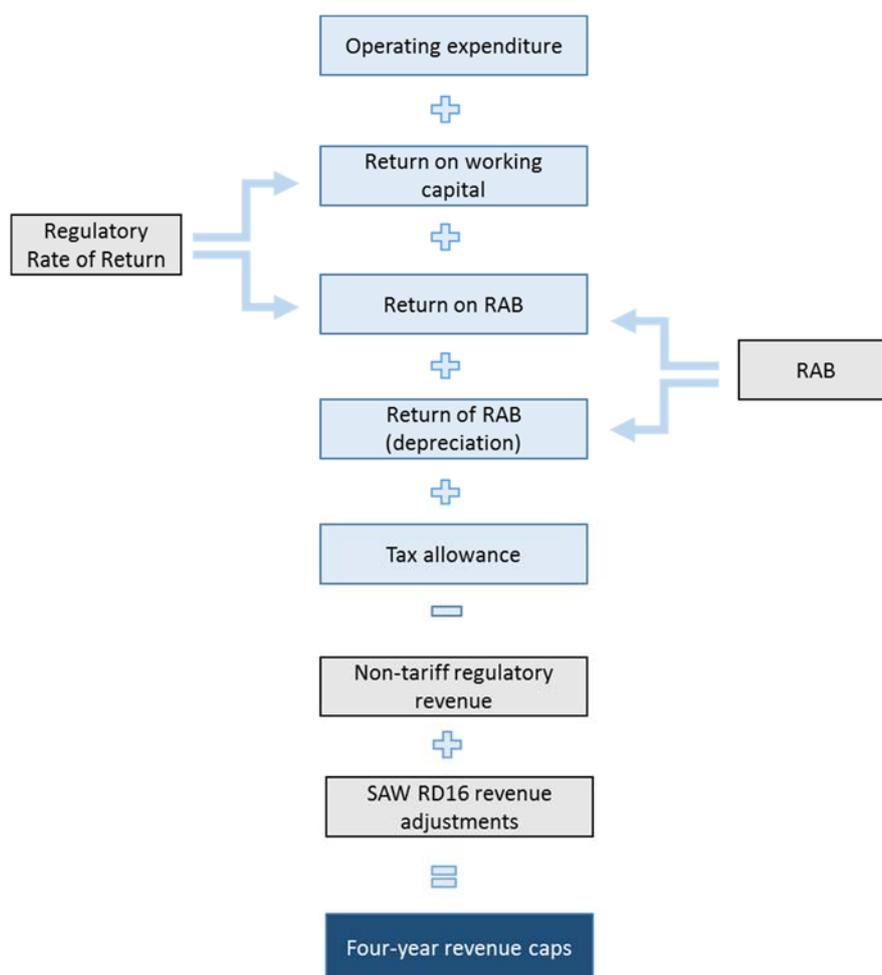
We propose to continue using a cost-based "building blocks" methodology for determining regulated drinking water and sewerage revenues. The cost components that will comprise regulated revenues are:

- ▶ operating expenditure
- ▶ return on regulated asset base (a product of the regulatory rate of return and regulated asset base)

- ▶ return on working capital (a product of the regulatory rate of return and working capital base)
- ▶ return of capital (depreciation), and
- ▶ tax allowance.

In addition to determining those cost components, we must determine forecasts of drinking water demand and sewerage connections that can impact SA Water’s costs. We must also determine any revenue that funds regulated expenditure that is not sourced from drinking water or sewerage tariffs (which is deducted from the cost building blocks) and any adjustments that need to be made as a consequence of SA Water Regulatory Determination 2016 (**SAW RD16**) (eg. demand variation adjustments¹). Figure 3.2 shows how the total revenue cap is derived from these cost building blocks.

Figure 3.2: Building block methodology



There are four key cost components that drive most of SA Water’s regulated revenues: capital expenditure, operating expenditure, the regulatory rate of return and the regulated asset base. The following sections discuss the proposed methodology for estimating those inputs.

¹ The demand variation adjustment mechanism allows an equal sharing between SA Water and its customers of the revenue impacts from any material differences between forecast and actual drinking water and sewerage demand during the SAW RD16 period, subject to a one percent materiality threshold.

3.1.3 The methodology for reviewing forecast capital and operating expenditure

The maximum revenue caps will reflect the prudent and efficient costs of providing drinking water and sewerage services, having regard to:

- ▶ The effectiveness of SA Water's long-term plans for the management and financing of its operations
- ▶ The extent to which SA Water's costs are driven by competitive forces, for example through competitive procurement and market testing.

Capital and operating expenditure are prudent if the benefits of the expenditure outweigh the costs. The expenditure is efficient if it is the lowest sustainable cost of achieving the intended outcome.

We will apply a rigorous approach to reviewing SA Water's proposed costs for the next determination period, focusing our effort on the issues that present the greatest risk to customers of inefficient practices leading to higher prices.

In previous determinations, we have reviewed SA Water's governance systems and processes for controlling costs. We have also closely examined SA Water's expenditure programs/projects at a detailed level.

We will continue to ensure that SA Water has robust systems and processes in place to deliver prudent and efficient expenditure. For example, we will review SA Water's processes to ensure that there is clear alignment between its proposed expenditure and the outcomes that the expenditure is intended to drive.

Where we see evidence of robust systems and processes in a particular business area, there is less risk of inefficient expenditure for any program or project in that area. We may therefore spend less time reviewing those projects or programs. However, where there is insufficient evidence to support the existence of strong processes for cost control in a business area, we may put greater emphasis on reviewing the detailed cost forecasts of that area.

We think this approach represents the best use of our regulatory effort at this point in time.

To provide it with more detailed guidance, we will be issuing a technical paper and expenditure template to SA Water as it commences the development of its expenditure forecasts. This will ensure that the expenditure information is presented in a manner that can be easily assessed. The Commission is likely to engage a technical advisor to assist with its review of SA Water's forecast expenditure.

3.1.4 The methodology for setting the regulatory rate of return

A key input into a cost-based approach to setting maximum revenues is the regulatory rate of return. We propose to adopt the same principles that applied to SAW RD16, although we will review the input methodologies to determine if any improvements can be made.

The principles that we plan to apply are set out in the box below.

Proposed Principles for setting SA Water's regulatory rate of return

General principle: The rate of return should reflect the prudent and efficient financing strategy of an incumbent large water utility which minimises expected costs in the long term, on a risk-adjusted basis.

Supporting principle 1: The rate of return should reflect a long-term obligation on the utility to provide reliable and secure water and sewerage services to consumers. It should not solely reflect the new entrant cost of capital.

Supporting principle 2: The rate of return should provide an incentive for SA Water to incur prudent and efficient investment in regulated assets and financing costs.

Supporting principle 3: The approach to setting the regulatory rate of return should be based on consistent principles over time and should be predictable. It should change only to reflect material changes in evidence or regulatory practice.

Supporting principle 4: The assumed prudent financing strategy should not depend on the ownership of the regulated business (i.e. the approach is indifferent to whether the entity is in Government or private ownership).

The reasons for arriving at those principles are described in our advice to the Treasurer on SA Water's regulatory rate of return to apply from 1 July 2016.²

We will, however, review areas where the methodologies for calculating the inputs into the regulatory rate of return can be improved, where it further promotes our objectives.

For example, we will review the alternatives to the capital asset pricing model (CAPM) approach for determining the cost of equity. We will release a separate consultation paper on that issue following the completion of the Commission's research, in early 2018.

3.1.5 The methodology for calculating the regulated asset base

In SAW RD16, the value of the regulated asset base at 1 July 2016 was set by rolling forward the value that applied at 1 July 2013, by updating it for actual capital expenditure incurred, asset disposals and regulatory depreciation during the three-year period. Actual capital expenditure incurred was adjusted in areas where we concluded that capital expenditure was not prudent and efficient (following an ex-post review of capital expenditure). Those inefficient costs were not reflected in the capital expenditure that was rolled into the regulated asset base.

We propose to use the same roll forward approach in SAW RD20, with the exception of the ex-post review of capital expenditure. We plan to conduct that review only if SA Water's total capital expenditure incurred during the current regulatory period (incorporating forecast costs where actual cost data is not available) is greater than the total capital expenditure incorporated into SAW RD16. If it is, we will conduct an ex-post review of capital expenditure, focussing on those areas of capital expenditure that have materially impacted the excess expenditure. This approach will continue to protect consumers against possible inefficient capital expenditure, but will focus more on aggregate outcomes than individual projects and will provide SA Water with greater flexibility to manage its overall capital expenditure.

² The advice is available on the Commission's website at <http://www.escosa.sa.gov.au/ArticleDocuments/424/20150331-SAWaterRegulatoryRateReturn2016-2020-Rep.pdf.aspx?Embed=Y>.

3.2 Regulation of SA Water's other retail services

We regulate SA Water's other retail services, which include the sale of recycled water and provision of new connections. Those services have been regulated through a combination of pricing principles and binding service standards and we propose to continue that approach under SAW RD20.

These other retail services, which are listed in the box below, are regulated separately from drinking water and sewerage services because they are provided by SA Water to individual customers or a distinct class of customers and the costs of the services should be recovered directly from those beneficiaries.

SA Water's retail services current regulated under a pricing principles approach

- ▶ sale of recycled water
- ▶ standard and non-standard connection services (including developer services)
- ▶ trade waste services
- ▶ non-domestic hauled waste services
- ▶ easement extinguishment and encumbrance services
- ▶ hydrant and fire plug services
- ▶ meter services
- ▶ network analysis and audit services

We have not seen any evidence to suggest that it is appropriate to set revenue caps or price caps for these retail services, based on complaints data and submissions from previous reviews. However, we remain open to new evidence and submissions on this matter.

We propose that the costs of providing a recycled water scheme be part of the costs of providing sewerage retail services, where SA Water can demonstrate that the scheme:

- ▶ is a prudent and efficient means of addressing environmental (sewage discharge) obligations and
- ▶ forms part of a least cost mix of diversified water sources needed to achieve required security of supply, or
- ▶ is driven by the need to trial new technologies, with the aim of achieving more efficient ways to deliver a secure supply of water.

In the above cases, any revenues derived directly from the provision of recycled water must be used to offset the costs of providing those schemes.

We currently adopt pricing principles for the sale of recycled water and other excluded services based on the National Water Initiative Pricing Principles.³

We will explore opportunities for the principles to be strengthened to promote contestability of the services where possible.

³ The pricing principles are set out in sections 3 and 4 of SA Water's water and sewerage retail services price determination 2016-2020, available at: <http://www.escosa.sa.gov.au/ArticleDocuments/334/20160606-Water-SAWaterRegulatoryDetermination2016FinalReport-RevenueDetermination.pdf.aspx?Embed=Y>.

3.3 Questions for stakeholders

Is the proposed framework and approach for economic regulation of SA Water from 1 July 2020 likely to best promote consumers' long-term interests, while minimising the cost of regulation?

Should we continue with the approach of setting revenue caps for drinking water and sewerage services, with a pricing principles approach for other retail services?

4 The proposed review process

The proposed process for SAW RD20 is set out in Table 4.1. As discussed previously, in addition to the consultation processes described below, it is likely that we will consult on various technical matters during the process of SA Water preparing its RBP. Those matters will become evident as we work with SA Water during that process.

Table 4.1: Proposed SAW RD20 process

Date	Milestone
Nov 2017	Commission issues draft Framework and Approach (this document)
Nov 2017-Jan 2018	Commission consults on draft Framework and Approach
Apr 2018	Commission releases final Framework and Approach
Apr 2018	Commission issues draft methodology for rate of return
Apr-May 2018	Consultation on draft methodology for rate of return
Jul 2018	Commission finalises methodology for rate of return
Sep 2019	SA Water submits draft regulatory business proposal
Oct – Dec 2019	Consultation on draft regulatory business proposal
Feb 2020	Commission issues draft regulatory determination
Feb – Mar 2020	Consultation on draft regulatory determination
May 2020	Commission issues final regulatory determination

We will consult a wide range of stakeholders and work with the State Government and other regulators to ensure that the regulatory frameworks are clear, well in advance of SA Water submitting its RBP. The State Government has an important role in setting certain requirements for SA Water, including the community service obligations that SA Water must provide. We will work with the State Government to make sure that the proposed approach is consistent with those policy requirements.

5 Next steps

We invite written submissions to the proposed framework and approach for SAW RD20. Submissions may respond directly to the questions that we have raised in this paper, although we welcome comments on any aspects of the framework and approach, including matters that stakeholders think are important but are not reflected in our proposals. We will take those submissions into account when finalising the framework and approach.

The process for providing written submissions is set out on the inside of the front cover of this paper.

We will also consult directly with key stakeholders during the consultation period, providing opportunities for all interested parties to ask questions about the proposed framework and approach for SAW RD20 process.

Appendix 1: Legal framework for the economic regulation of SA Water

The regulatory functions of the Essential Services Commission (**Commission**) are set out in Section 5 of the Essential Services Commission Act 2002 (**ESC Act**). Functions relevant to the economic regulation of SA Water include:

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.*

In performing these functions, the following objectives (including the Commission's primary objective when undertaking any function) inform and guide the Commission. They are set out in Section 6 of the ESC Act.

6 – Objectives

In performing the Commission's functions, the Commission must –

- (a) have as its primary objective protection of the long term interests of South Australian consumers with respect to the price, quality and reliability of essential services; and*
- (b) at the same time, have regard to the need to –*
 - (i) promote competitive and fair market conduct; and*
 - (ii) prevent misuse of monopoly or market power; and*
 - (iii) facilitate entry into relevant markets; and*
 - (iv) promote economic efficiency; and*
 - (v) ensure consumers benefit from competition and efficiency; and*
 - (vi) facilitate maintenance of the financial viability of regulated industries and the incentive for long term investment; and*
 - (vii) promote consistency in regulation with other jurisdictions.*

With regard to the Commission's principal statutory objective, three elements of service delivery are captured – price, quality and reliability – and these are to be interpreted in a context of economic efficiency. That is particularly so in light of the fact that Sections 6(b)(iv) and (v) of the ESC Act expressly refer to efficiency considerations.

Price determination powers

Under the ESC Act

Part 3 of the ESC Act sets out a legislative scheme governing the exercise of the Commission's price determination powers and functions.

Sections 25(1) and 25(2) have the combined effect of empowering the Commission to make price determinations where authorised to do so by a relevant industry regulation Act, which, in this case, is the Water Industry Act 2012 (**WI Act**).

Section 25(3) provides that a price determination may regulate prices, conditions relating to prices, or price fixing factors in any manner the Commission considers appropriate. Examples include:

- (a) fixing a price or the rate of increase, or decrease, in a price
- (b) fixing a maximum price, or maximum rate of increase, or minimum rate of decrease, in a maximum price
- (c) fixing an average price for specified goods or services, or an average rate of increase or decrease in an average price
- (d) specifying pricing policies or principles
- (e) specifying an amount determined by reference to a general price index, the cost of production, a rate of return on assets employed, or any other specified factor
- (f) specifying an amount determined by reference to quantity, location, period or other specified factor relevant to the supply of goods or services
- (g) fixing a maximum average revenue, or maximum rate of increase, or minimum rate of decrease in maximum average revenue, in relation to specified goods or services, or
- (h) monitoring the price levels of specified goods and services.

These examples are not exhaustive and the Commission may make a price determination to operate in a manner it considers appropriate, subject to any specific requirements of an industry regulation Act. In the case of the WI Act, certain requirements do exist, as discussed below.

As well as the general factors set out in Section 6 of the ESC Act, Section 25(4) specifies additional factors to which the Commission must have regard when exercising its price determination function. They include:

- (a) the particular circumstances of the regulated industry and the goods and services for which the determination is being made
- (b) the costs of making, producing or supplying the goods or services
- (c) the costs of complying with the laws or regulatory requirements
- (d) the return on assets in the regulated industry
- (e) any relevant interstate and international benchmarks for prices, costs and return on assets on comparable industries
- (f) the financial implications of the determination
- (g) any factors specified by a relevant industry regulation Act, or by regulation under the Act, and

(h) any other factors that the Commission considers relevant.

Two further statutory imperatives arise under Section 25(5) of the ESC Act in relation to price determinations. They are:

- (a) wherever possible, the costs of regulation do not exceed the benefits, and
- (b) the decision takes into account and clearly articulates any trade off between costs and service standards.

Finally, Section 25(6) provides that Subsections 25(3), 25(4) and 25(5) have effect in relation to a regulated industry, subject to the provisions of the relevant industry regulation Act for that industry (in this case, the WI Act).

Under the WI Act

Section 17 of the WI Act declares that the water industry is a regulated industry for the purposes of the ESC Act. Accordingly, the Commission has a general power to regulate prices in the water and sewerage industries.

Specifically, in terms of the price regulation function, the WI Act provides that:

7 – Functions and powers of Commission

(1) *The Commission has (in addition to the Commission's functions and powers under the Essential Services Commission Act 2002) –*

- (a) *the licensing, price regulation and other functions and powers conferred by this Act...*

The provisions of the WI Act that confer pricing powers on the Commission are set out in Section 35. Consistent with the general discretionary powers under Part 3 of the ESC Act, the price determination power set out in Section 35 of the WI Act is discretionary:

35 – Price regulation

(1) *Subject to this section, the Commission may make a determination under the Essential Services Commission Act 2002 regulating prices, conditions relating to prices, and price fixing factors for retail services.*

A 'retail service' is defined in Section 4 of the WI Act to include 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.

Accordingly, any operations or services falling outside the scope of the above definition are not subject to price regulation by the Commission – for example, the provision of network services on a stand alone basis. In addition, Section 5(2) of the WI Act states that services provided, or infrastructure held, by irrigation trusts (as defined in the Irrigation Act 2009), the Renmark Irrigation Trust or persons providing irrigation services designated by the Minister, are not subject to the provisions of the WI Act.

Pricing Orders

The price regulation provisions of the WI Act also include a framework for the Treasurer to issue Pricing Orders. Section 35(4) provides that the Treasurer may issue a Pricing Order that:

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

Pursuant to Section 35(3) of the WI Act, the Commission must comply with the requirements of a Pricing Order when making a determination.

Industry licences, codes and rules

The Commission has additional powers to issue licences to entities providing water and sewerage retail services and make industry codes or rules that apply to the conduct or operations of such entities, once licensed.

Under the ESC Act

Part 4 of the ESC Act provides the Commission with broad powers to make, vary and amend industry codes or rules. Industry codes prescribe the rules of conduct and procedures that must be followed by regulated entities providing essential services. The use of industry codes allows for a high degree of regulatory flexibility while maintaining appropriate scrutiny, accountability and transparency in the process of their development. Industry codes can cover any number of areas within a regulated industry, from consumer protection to technical matters.

Section 28(3) requires the Commission to consult with the relevant industry Minister, representative bodies and participants in the regulated industry prior to making, varying or revoking a code or rule.

Section 28(8) requires that any codes or rules be periodically reviewed by the Commission to ensure they continue to be relevant and effective.

Under the WI Act

The WI Act requires the Commission to issue SA Water with a non-transferable perpetual licence, which it did on 1 January 2013. Section 25(1) requires it to make a licence subject to various conditions. While some conditions must be imposed as stand alone licence conditions, others must be prescribed in industry codes and rules made by the Commission under the ESC Act.⁴

In issuing licences under Section 25(1) of the WI Act, Section 25(2) requires the Commission to have regard to the scale and nature of the operations of the water industry entity – with the scale and nature being determined by it after consultation with the entity or a person or body nominated by the entity.

In addition, Section 25(5) requires the Commission, in making an industry code under Section 25(1), to include provisions to assist customers who may be suffering specified types of hardship relevant to the supply of any services (such provisions to comply with any direction of the Minister). This provision operates in conjunction with Section 37(1) of the WI Act which requires the Minister to develop and publish a customer hardship policy in respect of residential customers of water industry entities. In summary, the Minister's hardship policy must set out:

- ▶ the processes water industry entities must have in place to identify residential customers experiencing payment difficulties due to hardship, and

⁴ The Code has been made by the Commission pursuant to the requirements of Section 25(1).

- ▶ the range of processes or programs that a water industry entity should use to assist hardship customers.

The Minister published the applicable hardship policy in February 2013. Section 37(3) requires a water industry entity to adopt the Minister's hardship policy and Section 37(4) makes compliance with the policy a condition of a licence issued to a water industry entity by the Commission.

Appendix 2: Roles and responsibilities of participants in water regulation

The Commission undertakes its role as an economic regulator within a broader legislative and policy framework. A summary of the key entities involved in the regulation of SA Water is provided in the table below.

Entities involved in the regulation of the water industry

Entity	Overview of role within the water industry	Relevant legislation
Consumer and Business Services	Responsible for administration of the Australian Consumer Law, covering consumer protection and fair trading, in South Australia Regulates the relationship between landlords and tenants for the payment of rates and charges for water and sewerage services Regulates the professional conduct of plumbers	Competition and Consumer Act 2012 Residential Tenancies Act 1995 Plumbers, Gasfitters and Electricians Act 1995
Department for Communities and Social Inclusion	Develops customer hardship and concession policies Administers the Consumer Advocacy and Research Fund	Water Industry Act 2012
Department of Environment, Water and Natural Resources	Regulates state water resources and other natural resource management matters	Natural Resources Management Act 2003
Energy and Water Ombudsman SA	Handles complaints from customers of water retailers that have joined the scheme	Water Industry Act 2012
Environment Protection Authority	Regulates the environmental impact of water businesses	Environment Protection Act 1993
Essential Services Commission	Regulates behavioural standards for the sale and supply of water and sewerage retail services Establishes average customer service and reliability service standards for water and sewerage retail services and assesses the prudent and efficient costs for delivery of water and sewerage retail services Regulator for the third party access regime (to commence 1 July 2016)	Essential Services Commission Act 2002 Water Industry Act 2012
Minister for Water and the River Murray	Administers the Water Industry Act Directs SA Water's Board in performing its functions	Water Industry Act 2012 South Australian Water Corporation Act 1994 Public Corporations Act 1993
Ombudsman South Australia	Investigates complaints about South Australian Government and local Government agencies	Ombudsman Act 1972
SA Health	Regulates public health requirements for providing drinking water supplies	Safe Drinking Water Act 2011
Technical Regulator	Regulates safety and technical matters	Water Industry Act 2012
Treasurer of South Australia	Sets licence fees for water industry entities Issues Pricing Orders	Water Industry Act 2012



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