

1 Overview

This Draft Regulatory Determination proposes reductions to the total revenue that SA Water may recover during the four-year period commencing 1 July 2020, of 18 percent (\$547 million) and 13 percent (\$164 million) for drinking water and sewerage retail services respectively, as compared to the amounts determined for the current four-year period (2016-2020).

On the Commission's analysis, the revenue outcomes proposed would, if implemented, provide SA Water with sufficient revenue to fund efficient operations, finance prudent investments on a long-term basis and meet the health, safety, environmental and customer service standards that will apply to SA Water over the coming four years.

The Draft Determination is consistent with the expectation that SA Water should deliver drinking water and sewerage retail services at the quality and reliability levels that customers value for the lowest sustainable long-term cost to them. It passes through to customers the benefits of the lower financing costs that SA Water currently faces, while keeping capital and operating expenditure broadly in line with the amounts incurred in the current regulatory period.

Draft drinking water and sewerage retail service revenues, compared to 2016-20 revenues and SA Water's proposal for 2020-24 (Present value, \$Dec18 in millions)

	2016-20 Regulatory Determination	SA Water 2020-24 Proposal	2020-24 Draft Determination
Drinking water	3,035	3,047	2,488
Sewerage	1,269	1,323	1,105

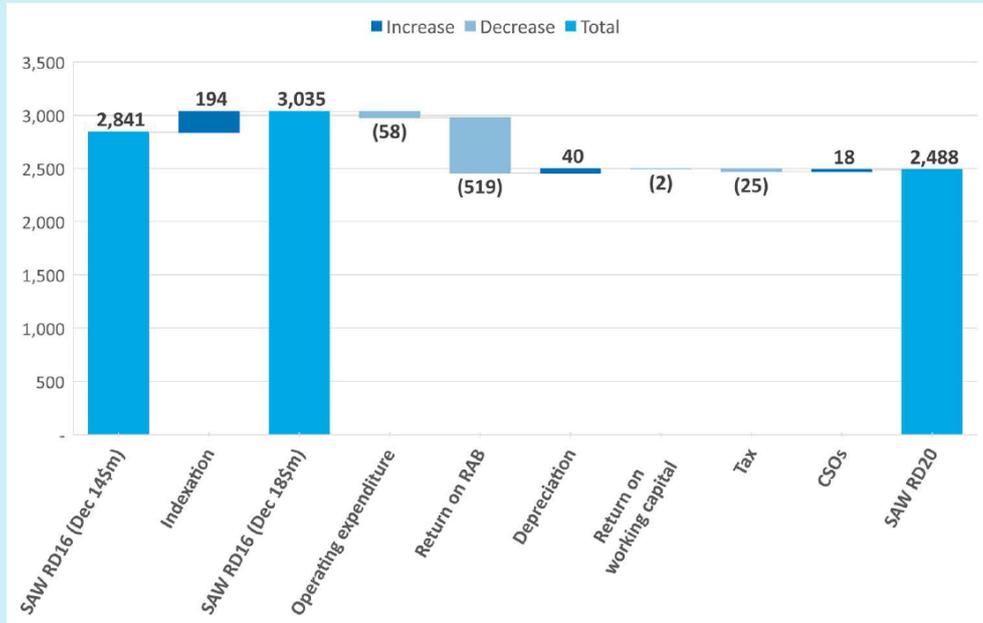
A key driver of the proposed revenue reductions is the current economic environment, in which debt and equity financing costs have fallen significantly over the past four years. Based on the most recent financial market information, the regulatory rate of return (post-tax, real) is expected to be 2.71 percent in 2020-21 as compared to 4.53 percent which applied in 2016-17. Given current uncertainty on the transition from the current low inflation environment, the Commission proposes to adopt a glide path to the long-term inflation target band (rather than the current one-year transition). It also proposes to update the rate of return prior to each year of the regulatory period, to reflect prevailing market conditions.

The Commission has reviewed the levels of capital and operating expenditure required for SA Water to run its operations efficiently over the next four years, allowing an increase of \$190 million in capital expenditure and a decrease of \$115 million in operating expenditure, as compared to current levels. Both stakeholder submissions and the Commission's own review have highlighted that some of SA Water's expenditure proposals – noting that in total SA Water is seeking an additional \$456 million in capital expenditure and \$121 million in operating expenditure over current levels – have not been justified by SA Water and are not consistent with customers' main priority that SA Water's prices are kept as low as possible while at least maintaining current levels of service.

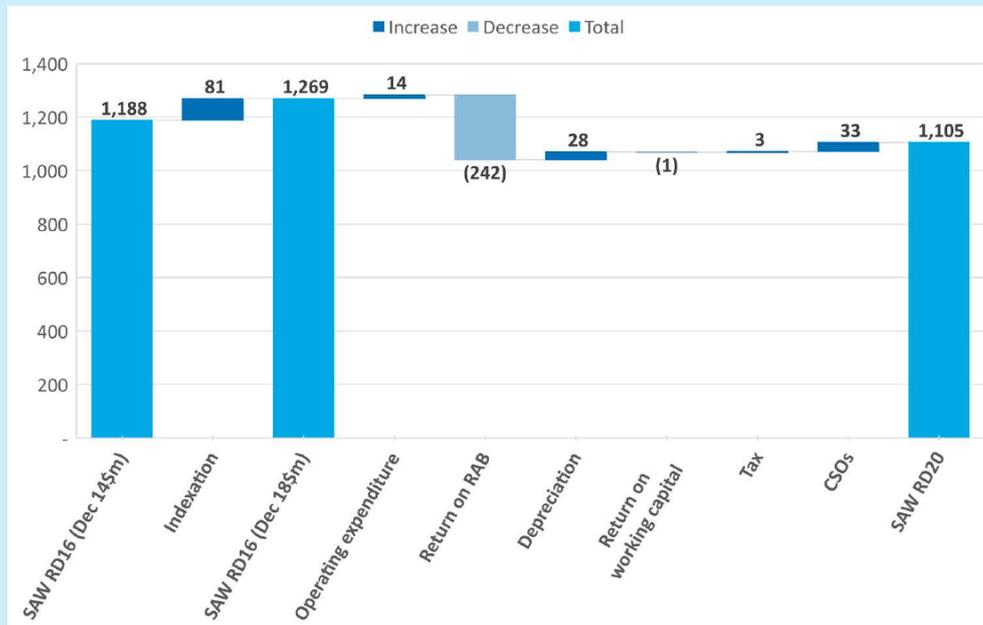
Importantly, the revenue reduction proposed in this Draft Determination is indicative, based on evidence and information available at this time, and may change for the Final Determination in light of submissions, new evidence and updated market information. The Commission notes that the South Australian Government is considering the recommendations of an independent Inquiry into SA Water's drinking water regulated asset base and prices: this Draft Determination does not take into account any outcomes that might arise from that Inquiry.

As can be seen in the following figures, the proposed reduction in drinking water revenues is greater than the reduction in sewerage revenues, mainly due to greater reductions in operating expenditure for drinking water services as compared to sewerage services.

Change in draft drinking water retail service revenues compared to 2016-2020 Determination
(Present value, \$Dec18 in millions)



Change in draft sewerage retail service revenues compared to 2016-2020 Determination
(Present value, \$Dec18 in millions)



The Draft Determination has been conducted in accordance with statutory requirements and has involved extensive customer and stakeholder engagement. Feedback has highlighted that SA Water is generally performing well in service delivery (albeit there are areas for focus and improvement) and has improved its customer engagement practices. The Commission acknowledges SA Water's work in those areas over the past four years and has also indicated opportunities for future improvement by SA Water, particularly in relation to more transparent reporting on capital project outcomes and its longer-term asset management planning.

Submissions on this Draft Determination are welcomed by 15 April 2020. All submissions will be considered before a Final Determination is made in May 2020.

1.1 Proposed outcomes of this Draft Determination

Pursuant to the provisions of the *Water Industry Act 2012* (**WI Act**) and the *Essential Services Commission Act 2002* (**ESC Act**), the Essential Services Commission (**Commission**) has made a Draft Determination in relation to the maximum revenue that the SA Water Corporation (**SA Water**) can recover from the provision of drinking water and sewerage retail services from 1 July 2020 to 30 June 2024.

Submissions on this Draft Determination are welcomed by 15 April 2020. All submissions will be considered before a Final Determination is made in May 2020.

The Draft Determination proposes a reduction in SA Water's drinking water and sewerage retail service revenues of 18 percent (\$547 million) and 13 percent (\$164 million) respectively over the next four years, compared to the previous four years. Those revenues are approximately 18 percent and 16 percent below those proposed by SA Water in its Regulatory Business Proposal (**RBP**) for the four-year period from 1 July 2020. Table 1.1 summarises the proposed revenue caps, relative to those proposed in SA Water's RBP and SA Water Regulatory Determination 2016 (**SAW RD16**).

Table 1.1: Draft drinking water and sewerage retail service revenues, compared to 2016-20 revenues and SA Water's proposal for 2020-24 (Present value, \$Dec18 in millions)

	2016-20 Regulatory Determination	SA Water 2020-24 Proposal	2020-24 Draft Determination
Drinking water	3,035	3,047	2,488
Sewerage	1,269	1,323	1,105

The proposed revenue reductions may change as a result of further or new evidence or information arising from consultation on this Draft Determination. SA Water's maximum revenues may also change under the Commission's proposal to update the regulatory rate of return each year during the 2020-24 regulatory period, to reflect changes in prevailing market conditions.

1.2 The Commission sets maximum revenues, SA Water sets prices

Consistent with the legislative framework, the Commission has proposed draft revenue caps for drinking water and sewerage retail services, not prices; SA Water's prices will continue to be set by SA Water in accordance with the South Australian Government pricing policies.

The Commission notes that the South Australian Government is considering the recommendations of an independent Inquiry into SA Water's drinking water regulated asset base (**RAB**) and prices: this Draft Determination does not take into account any outcomes that might arise from that Inquiry.

1.3 Drivers of the proposed revenue reduction

The proposed revenue reduction is driven primarily by lower financing costs (the regulated rate of return). SA Water's regulated rate of return on assets was 4.53 percent (post-tax, real) in 2016-17 and is expected to fall to 2.71 percent (post-tax, real) in 2020-21. This reflects the current economic environment, where debt and equity financing costs have fallen significantly.

SA Water proposed a rate of return methodology that resulted in a 4.17 percent (post-tax, real) proposed return in 2020-21. The Draft Determination does not accept SA Water's proposed methodology, as it is subject to conceptual and measurement errors, including a focus on short-term measures. Estimating the real rate of return requires an estimate of long-term inflation expectations (10 years, to align with assumed 10-year bond term). The Commission proposes a 10-year average inflation expectation, calculated using the Reserve Bank of Australia's (RBA) inflation forecasts for two years, a linear glide path to the International Monetary Fund's (IMF) medium-term (five year) projection of consumer price inflation in Australia, and the mid-point of the RBA's inflation targeting band thereafter. This approach is a departure from the approach used in SAW RD16, which used RBA's one-year inflation forecast and the mid-point of the RBA's inflation target band thereafter. The proposed change reflects the current uncertainty about the speed in which inflation might return sustainably within the RBA's 2 to 3 percent target inflation range.

The Draft Determination also proposes to update the rate of return prior to each year of the regulatory period, to reflect prevailing market conditions.

In keeping with customers' clear messages throughout the review process about the need for prices to be kept as low as possible, stakeholders have consistently asked the Commission to carefully review SA Water's proposed capital and operating expenditure, to ensure that they are prudent and efficient.

Having considered SA Water's regulatory obligations over the next four years (including health, safety, environmental and customer service standards), the Commission has, on an overall basis, provided for an increase of \$190 million in capital expenditure and a decrease of \$115 million in operating expenditure, as compared to current levels (15 percent and 6 percent respectively).

There is a proposed reduction in operating expenditure for drinking water services and an increase for sewerage services. This is driven in part by the forecast reduction in electricity costs, which has a proportionately larger impact on drinking water retail service costs as electricity usage is more intensive for this service. In addition, the Draft Determination includes an increase in operating expenditure to support initiatives to improve the performance of the sewerage network, which further contributes to the different operating expenditure amounts for drinking water and sewerage services.

Those outcomes are, however, materially below the capital and operating expenditure amounts sought by SA Water in its RBP, by 15 percent and 12 percent respectively. Based on the evidence presented and available at this stage, the Commission is not satisfied that SA Water's proposed cost increases are justified. Stakeholders highlighted several projects that they thought required further scrutiny:

- ▶ They were not convinced that the extensive water quality improvement programs (proposing to move above current regulatory requirements) were necessary.
- ▶ They wanted to better understand SA Water's obligation to provide drinking water to remote communities, given the high costs of the solutions proposed.
- ▶ They were concerned that they had not been given the chance to understand and consider the ambitious Zero Cost Energy Future initiative and wanted the Commission to ensure that customers would be adequately shielded from any risks of the benefits of this program not being realised.

- ▶ They also asked the Commission to consider whether or not SA Water had set itself a sufficiently challenging operating expenditure efficiency target, noting that SA Water did not identify any major areas for improvement other than the efficiencies expected through the ZCEF initiative and smaller efficiencies from information technology (IT) initiatives.

The capital and operating expenditure outcomes reflect the Commission's views on prudent and efficient expenditure. The most material differences between the Draft Determination outcomes and those proposed by SA Water in its RBP include:

- ▶ removing certain capital projects to meet projected increased customer demand, where that increased demand is highly uncertain (\$56 million capital expenditure reduction proposed)
- ▶ rebalancing the proposed metropolitan water quality improvement program to span across two regulatory periods, rather than one period (\$41 million capital expenditure reduction proposed)
- ▶ removing projects to upgrade regional properties from non-drinking water to drinking water, on the basis that the South Australian Government is reviewing its policy of regional water supply which is likely to impact those projects (\$38 million capital expenditure reduction proposed)
- ▶ removing the proposed regional water quality improvement programs (proposing to move above current regulatory requirements) until further community consultation has occurred to better define the needs, scope and efficient costs of meeting the proposed outcomes (\$25 million capital expenditure reduction proposed)
- ▶ an expectation that operating expenditure efficiencies can be achieved, particularly in procurement, network operations and IT-led savings (\$81 million operating expenditure reduction proposed)
- ▶ a better understanding of the 'normal' efficient base year operating expenditure to remove one-off or irregular cost pressures (\$82 million operating expenditure reduction proposed), and
- ▶ an expectation that SA Water should manage anticipated new operating cost pressures by reprioritising existing budgets to absorb such costs (\$78 million operating expenditure reduction proposed).

The Draft Determination does not include a revenue allowance for SA Water's investments in solar and battery storage under its ZCEF initiative because it is not a retail service under the WI Act. SA Water announced the initiative as a means of delivering low and stable prices to its customers. However, information provided by SA Water demonstrates that the primary benefit of this initiative is to earn revenue by producing and selling electricity into the National Electricity Market, rather than offsetting SA Water's electricity purchases as a retail operating cost. This does not meet the definition of a retail service under the WI Act and so cannot be funded by SA Water's customers through the revenue caps set for drinking water and sewerage retail services. SA Water is free to pursue the initiative as a commercial venture, but its costs would not be recoverable from the revenue caps for drinking water and sewerage services.

1.4 Proposed changes to service standards and other consumer protections

The Draft Determination proposes 33 service standards that SA Water will be required to meet in SAW RD20. The current separate reliability standards for metropolitan Adelaide and regional areas will be maintained, so that SA Water maintains an appropriate focus on each and service performance remains transparent for customers around the State. New service standards are also proposed to address identified gaps in customer service and reliability that are important to customers.

The performance targets proposed for the standards will maintain SA Water's focus on service delivery in each area, with no diminution in service levels (as compared to current average levels of performance) and increases only where SA Water has demonstrated customer support and willingness to pay for particular improvements.

The proposed service standards include new standards that set targets for:

- ▶ customer satisfaction
- ▶ resolution of customer complaints on first contact
- ▶ timeliness of complaint resolution
- ▶ escalation of customer complaints to the Energy and Water Ombudsman SA (EWOSA), and
- ▶ frequency of water interruptions.

The Commission proposes to monitor and publicly report on underlying drinking water and sewerage network performance, working with other regulators (described below) to ensure that the networks are being operated and maintained in a way that promotes safe and reliable services in the long term.

The Draft Determination also proposes changes to certain obligations that it imposes on SA Water, including facilitating greater choice of communication channels between SA Water and customers and clearer information on customers' bills.

1.5 Extensive stakeholder engagement has informed the Draft Determination

The Draft Determination has benefited from far greater levels of community and stakeholder engagement than has been the case in the past, including stronger engagement with other regulators of SA Water (the Environment Protection Authority (EPA), SA Health, Office of the Technical Regulator, the Department for Environment and Water (DEW) and the Department of Human Services).

SA Water developed its RBP through multiple phases of stakeholder engagement. Its initial proposals were subject to a new process of customer challenge, through a Negotiation Forum involving SA Water, a Customer Negotiation Committee (CNC) and an Independent Probity Advisor. The Commission acknowledges the robustness of the work undertaken by the CNC and Independent Probity Advisor and is grateful for their contributions to this process. It will look to embed and build on that work in future regulatory periods.

The Commission thanks those parties, and all other stakeholders, that have provided valuable input into the determination process. All submissions and views have been considered in making this draft determination.

The Commission acknowledges that SA Water's engagement practices in developing the RBP represent an important and material improvement on past practices in this area. As explained below, the Commission will also explore ways to assist in both embedding and improving those practices over time, noting that there is always the capacity for improvement in both business and regulatory systems.

In that context, stakeholders have generally expressed a degree of concern in relation to the level of transparency and detail provided by SA Water at times throughout the process, including the content of its RBP. In the Commission's view, the process to date demonstrates that there is significant scope for SA Water to be more open and transparent with stakeholders on regulatory matters, and to genuinely take on board customer views and preferences at multiple stages of its business planning and delivery processes.

Stakeholders have generally supported the new determination process to date, although areas for improvement have already been identified, including that:

- ▶ the customer challenge process should occur over a longer period of time
- ▶ SA Water could consult earlier and more extensively with the community on the development of its new initiatives
- ▶ there may be opportunities to better integrate SA Water's plans with the plans of other industry participants, and
- ▶ greater transparency about SA Water's plans, including its long-term plans, would allow for more effective community engagement.

The Commission will commence a full review of the new process later in 2020 and will consider issues raised to date and any other issues that are raised by stakeholders, in considering the process for the next SA Water Regulatory Determination in 2024. It will also monitor and publicly report on the outcomes of this regulatory determination to ensure that SA Water is held to account in the delivery of its commitments to customers, as well as monitoring and seeking public transparency on SA Water's longer-term operational, capital and business planning.