

21 April 2020

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**Dear Nathan,**

Business SA welcomes the draft decision of ESCOSA for SA Water's 2020-24 Regulatory Determination which will see water revenues decrease by 18% and sewerage revenues by 13% on July 1, a significant driver being the declining cost of capital. Consumers should realise the benefits of these externally driven changes and we expect revenue reductions to be proportionately translated to price reductions in the new financial year. Importantly, SA Water is still being approved to recover \$3.6 billion from consumers over the next four years and we acknowledge ESCOSA's undertaking that this is sufficient to fund efficient operations, finance prudent investments and meet health/safety/environmental and customer service standards. Business SA agrees such factors cannot be compromised.

Further, while outside ESCOSA's remit, we acknowledge the State Government's Independent Water Price Inquiry findings are still to be implemented. Again, consumers should benefit from downward adjustments to the value of SA Water's assets, acknowledging around two-thirds of SA Water's revenues are proportionately linked to asset values.

Now more than ever before during the COVID-19 crisis, every cost of doing business in South Australia is under the spotlight, with the cost of utilities being no exception. Consequently, it is important that SA Water are only approved to spend the necessary amount to maintain a safe and reliable water supply. Further to that point, Business SA acknowledges SA Water for proactively considering other more immediate options to support businesses materially impacted by COVID-19. This reflects that many cannot wait until July 1 for price reductions to flow through via this regulatory determination process.

Business SA makes the following comments on key aspects of ESCOSA's draft decision. We also refer to **Attachment A**, an expert review of ESCOSA's decision undertaken by Isle Utilities to inform an SME consumer perspective, acknowledging funding support through the State Government's Consumer Advocacy and Research Fund (CARF).

1. Business SA supports ESCOSA's approach to assessing SA Water's operating expenditure, particularly IT expenditure. This was a particular concern in our earlier submission, supported by Isle Utilities' findings of shortcomings in the benchmarking approach which lead to SA Water being compared against utilities with a much greater need for IT infrastructure, particularly in the electricity sector where smart meters are more prevalent.

We agree that savings from IT investments need to be more transparent to consumers, including a mechanism which provides more accountability to realise savings from IT investments.



We also welcome the forecast \$35.1 million reduction in energy costs being passed back to consumers.

2. In our previous submission, we questioned whether the regional and remote water quality improvement projects were the optimum use of money to achieve the desired outcome, and in the case of the regional projects, the extent to which consumers were making the case for improvement themselves .

While we welcome a halt to these projects before they are more adequately substantiated, and other Government policy reviews take place, we recognise that remote towns in particular, and some regional areas, have more material concerns about water quality than exist in metropolitan Adelaide.

We maintain the view that the \$126m Metropolitan Water Quality Improvement project requires more substantive justification, and while we accept that spreading it out over two periods tempers the cost impact, if it remains inadequately justified, we are unconvinced it should proceed in its current form regardless of the allocated timeframe.

Considering the broader picture and referring back to comments made in our previous submission, no major systemic water quality issues in metropolitan Adelaide have been communicated to SA Water's Business Customer Working Group in recent years. Of course, Business SA recognises that SA Water always has water quality issues to manage in metropolitan Adelaide, but we have never been under the impression that a \$126m capital upgrade was required to address them. Consequently, we were surprised that the largest single new capital project in SA Water's 2020-24 business proposal pertained to metropolitan water quality improvements. While we do not dispute that surveyed consumers may prefer if metropolitan water tasted better, we did not believe this was an issue that required material redress by SA Water. We understand that consumers more broadly may desire something better tasting, but our argument remains whether such a significant investment all SA Water customers pay for is necessary when for the most part, Adelaide's water quality today is markedly improved compared with decades past.

Furthermore, we would expect that fixing some long-standing water quality issues in regional and remote South Australia should take precedence over metropolitan Adelaide.

3. Business SA highlights the concerns of Isle Utilities that ESCOSA's 7% reduction in SA Water's IT Capital Expenditure is not relative to its 40% reduction in SA Water's IT operating expenditure. Further, that additional IT benchmarking requested should be a relatively straight forward exercise which can be expedited.

We support ESCOSA's broader approach to better align IT investment and savings but we are concerned that if savings from existing IT investments have not been adequately justified that a higher burden of proof should be required to ensure this scenario does not repeat for future period IT Capital Expenditure.

4. Business SA supports ESCOSA's approach to adjusting the risk-free rate, cost of debt and long-term inflationary expectations to effectively adjust SA Water's weighted average cost of capital (WACC) on an annual basis. This should allay any concerns SA Water has through being exposed to a WACC which leaves them with unrecoverable costs over a four-year period should any component move in a direction which leaves SA Water exposed. While this will potentially provide more volatile price outcomes, we recognise it should give SA Water more assurity as a corporation that it can adequately finance itself when facing volatile financial markets.

Further, Business SA acknowledges ESCOSA's undertaking that in the event there were temporary insufficient cash flows resulting from the application of the Commission's real rate of return methodology, it would consider adopting an adjustment to revenues during 2020-24 (to be NPV neutral between regulatory periods) rather than change the real rate of return methodology. We welcome ESCOSA's acknowledgement of Isle Utilities' concerns that any near-term price increase to support financial viability should be 'paid back' to consumers in the long-term.

5. ESCOSA's decision that spending associated with \$389m Zero Cost Energy Future Project does not fit within the definition of a retail service under the Water Industry Act 2012 provides clarity around the extent to which costs associated with this project should be directly recoverable from SA Water consumers. While Business SA had raised concerns about this project, it was primarily on the basis of process and whether a project of this magnitude should proceed in between regulatory determinations and as such, without consumers or others having the opportunity to stress test assumptions as would be the case with electricity or gas network investments under the Australian Energy Regulator regulatory investment test (RIT) process. Ensuring that any decision associated with material solar investments is one which sits with SA Water as a Corporation to make enables prudent projects to proceed, but without the risk of projected outcomes being unrealised resting entirely with consumers.

As ESCOSA states, SA Water is free to pursue the initiative as a commercial venture, but its costs are not recoverable from the revenue caps for drinking water and sewerage services.

6. Business SA supports ESCOSA's approach to SA Water's labour costs which strikes a reasonable balance in limiting wage rises to CPI but removing an additional productivity adjustment. Accordingly, any above CPI wages rises pay for themselves in productivity gains. However, we recognise that the impacts of COVID-19 have not yet been materially factored into SA Water's determination and that decisions on wage rises may need to consider outcomes from the upcoming Fair Work Commission's review of minimum wage changes which flow through to awards.

In conclusion, Business SA thanks ESCOSA for its consultative approach with consumers throughout the SA Water revenue determination process and for being able to respond to any queries along the way in a timely manner.

We would also like to acknowledge SA Water for being able to provide responses to our questions and for their proactive engagement, even on the more contested aspects of their proposal.

Ultimately, serving the best long-term interests of consumers, including South Australian businesses, is also in the best long-term interests of SA Water and Business SA looks forward to continuing to provide constructive feedback to ensure quality, reliable and efficiently priced water is the trademark of South Australia.

For any inquires related to this submission, please contact me on (08) 8300 0009 or [andrewm@business-sa.com](mailto:andrewm@business-sa.com).

Yours sincerely,

Andrew McKenna  
Director, Policy and Advocacy



# Business SA - Independent Review of ESCOSA's 2020-24 Draft Determination

## Draft Review

<b>Client:</b>	<b>Business SA</b>
<b>Author:</b>	<b>Isle Utilities Ltd</b> <b>Paul Harris (Isle)</b> <b>Rohan Harris (Oakley Greenwood)</b>
<b>Reviewer:</b>	<b>Paul Harris</b>
<b>Date:</b>	<b>April 2020</b>



## 1. Introduction

In their (Draft Determination), the Essential Services Commission of South Australia (ESCOSA) has proposed an 18 percent (\$547 million) revenue reduction in SA Water's drinking water revenue and a 13 percent (\$164 million) cut in its sewerage revenue over the four-year period starting 1 July, while requiring the utility to at least maintain its current levels of customer service.

ESCOSA also found that some of SA Water's expenditure proposals are neither justified nor consistent with customers' clearly expressed main priority, which is that prices should be kept as low as possible while maintaining current levels of service.

Highlights of the Draft Determination include:

- SA Water had proposed to recover an extra \$121 million in operating expenditure (OPEX) over the next four-year period – the Draft Determination has resulted in a decrease of \$115 million;
- SA Water had proposed to recover an extra \$456 million in capital expenditure (CAPEX) over the next four-year period – the Draft Determination will instead allow \$190 million; and
- The Draft Determination passes through to customers the benefits of lower financing costs that SA Water currently faces. As a result, ESCOSA has proposed lowering SA Water's allowed regulatory Rate of Return to 2.71 percent in 2020-21 from 4.53 percent in 2016-17.

This review is relatively narrow and small in scope with the focus on OPEX, CAPEX and Rate of Return as follows:

- Discuss the major drivers of the change / ESCOSA decision in these areas impacting customers;
- Provide thoughts on these from a reasonableness viewpoint; and
- Discuss other possible areas of consideration.

This review by Isle was conducted during the advent of the COVID-19 pandemic in late March – early April 2020. For the avoidance of doubt, Isle has not been asked to undertake a detailed review of further customer impacts in light of changing market conditions due to COVID-19.

## 2. Key Findings

### 2.1 OPEX

***SA Water had proposed to recover an extra \$121 million in operating expenditure (OPEX) over the next four-year period – the Draft Determination has resulted in a decrease of \$115 million.***

Material differences in the SA Water proposal and ESCOSA Draft Determination are as follows<sup>1</sup>:

- 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);
- An expectation that operating expenditure efficiencies can be achieved, particularly in procurement, network operations and IT-led savings (\$81 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).

Isle has briefly reviewed ESCOSA’s operating expenditure (OPEX) decisions in relation to six (6) expenditure drivers: efficient base year operating expenditure, meeting external obligations, sustaining services, improving services, growth and IT.

Table 1 below summarises our key findings.

**Table 1 - Key Findings**

Major Expenditure Driver relating to the ESCOSA Decision	Isle Thoughts on Reasonableness of ESCOSA Decision
<b>Efficient base year operating expenditure</b>	<ul style="list-style-type: none"> <li>• Labour operating expenditure was reduced by \$3.3.m to reflect staff vacancies, an adjustment for leave provisions and workers compensation, and a low level of labour costs that should have been transferred to capital projects. Resourcing levels change with changing business models and environments, so prolonged vacancies are not always necessarily an indication that certain roles are not needed (e.g. drought management roles). Furthermore, in our original report, Isle agreed with SA Water’s contention that they were efficient from a non-IT OPEX perspective - <i>Isle thinks this outcome is unreasonable and that SA Water may be justified in challenging ESCOSA’s Draft Decision.</i></li> <li>• Allwater contract operating expenditure was reduced by \$3.0m to reflect the recent adoption of a ‘gain and pain share’ mechanism. Isle’s contract management experience and knowledge suggests that pain:gain principles are effective in reducing costs - <i>Isle thinks ESCOSA’s Draft Decision is reasonable.</i></li> <li>• Electricity operating expenditure was reduced by \$20.1m to reflect a reduced volume and price of energy, for the network and other variable charges component of SA Water’s electricity operating costs. Isle understands that, given the volatility of historical energy prices, ESCOSA has reviewed forecast energy prices and incorporated this into their determination - <i>Isle thinks ESCOSA’s Draft Decision is reasonable.</i></li> <li>• An operating expenditure reduction of \$6.9m to reflect an efficiency target of 1.5% per annum, that was applied in the SAW RD16 Final Decision and that SA Water has historically met or exceeded - <i>Isle thinks ESCOSA’s Draft Decision is reasonable.</i></li> </ul>
<b>Meeting external obligations</b>	<ul style="list-style-type: none"> <li>• An operating expenditure reduction of \$1.2m per annum for the Mount Bold Reservoir Dam Safety Upgrade to reflect inconsistent information between the relevant business case, and SA Water’s ‘Our Plan’ and other supporting documentation - <i>Isle thinks ESCOSA’s Draft Decision is reasonable.</i></li> </ul>

<sup>1</sup> Extracted directly from ESCOSA document ‘20200304-Water-SAWRD20-DraftDecision-StatementOfReasons’

	<ul style="list-style-type: none"> <li>• A further operating expenditure reduction of \$1.2m per annum for the Mount Bold Reservoir Dam Safety Upgrade to reflect that no evidence has been provided to support additional 'non-electricity costs' - <i>Isle thinks ESCOSA's Draft Decision is reasonable.</i></li> </ul>
<b>Sustaining services</b>	<ul style="list-style-type: none"> <li>• An operating expenditure reduction of \$2.0m for the Adelaide Desalination Plant Contract to reflect termination of the AGL electricity contract and a much reduced need to purchase a certain number of Green Power RECs to support this contractual agreement. Based on the information presented in ESCOSA's draft determination, Isle is not convinced that the future number of RECs required and associated market prices have been sufficiently modelled for ESCOSA to make this decision - <i>Isle thinks this outcome is unreasonable and that SA Water may be justified in challenging ESCOSA's Draft Decision.</i></li> <li>• A reduction of \$4.1m for Asset Investment Operating Costs to reflect that this expenditure was not supported by detailed business cases or alternative justifications for reprioritising existing budgets to absorb such costs, and was therefore difficult for ESCOSA to review with confidence - <i>Isle thinks ESCOSA's Draft Decision is reasonable.</i></li> <li>• An operating expenditure reduction of \$2.1m for labour costs to reflect ESCOSA's view that SA Water is an efficient business and has previously demonstrated that it is capable of managing its total labour costs within the CPI envelope, with any above CPI wage rises paying for themselves in productivity gains - <i>Isle thinks ESCOSA's Draft Decision is reasonable.</i></li> </ul>
<b>Improving services</b>	<ul style="list-style-type: none"> <li>• A reduction of \$1.5m for Asset Investment Operating Costs that relates to 100% of the capital expenditure being disallowed by ESCOSA for the Regional Water Quality Improvement Program - <i>Isle thinks ESCOSA's Draft Decision is overly harsh for regional customers and warrants further challenge by Business SA (refer further notes in Section 2.2).</i></li> </ul>
<b>Growth</b>	<ul style="list-style-type: none"> <li>• Operating expenditure for two growth projects: (1) Upper Spencer Gulf Capacity Upgrade (\$1.6m), and (2) the Kangaroo Island Desalination Plant (\$0.8m) has been removed to reflect that SA Water has not yet completed final contract negotiations with the proposed major customers for the additional water, which will directly affect the viability of these projects. ESCOSA has treated these as 'contingent projects' until sufficient evidence is provided to show these projects are both prudent and efficient - <i>Isle thinks ESCOSA's Draft Decision is reasonable.</i></li> </ul>
<b>IT</b>	<ul style="list-style-type: none"> <li>• A reduction of \$2.7m per annum (40%) in IT operating expenditure to reflect a downward adjustment to SA Water's proposed budget to sustain services to customers due to ESCOSA's prudence and efficiency concerns. In Isle's original report, we questioned the accuracy and validity of the IT Benchmarking undertaken by SA Water, particularly as it related to operating expenditure. Furthermore, ESCOSA determined that elements of SA Water's IT investment should be 'operating expenditure neutral', and has therefore embedded an equivalent amount of IT-led business savings into the draft determination to 'claw back' some of the approved IT operating expenditure - <i>Isle thinks ESCOSA's Draft Decision is reasonable.</i></li> </ul>



## 2.2 CAPEX

**SA Water had proposed to recover an extra \$456 million in capital expenditure (CAPEX) over the next four-year period – the Draft Determination will instead allow \$190 million.**

Material differences in the SA Water proposal and ESCOSA Draft Determination are as follows<sup>2</sup>:

- 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); and
- 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).

Isle has briefly reviewed ESCOSA’s capital expenditure (CAPEX) decisions in relation to five (5) expenditure drivers: meeting external obligations, sustaining services, improving services, growth and IT.

Table 2 below summarises our key findings.

**Table 2 - Key Findings**

Major Expenditure Driver relating to the ESCOSA Decision	Isle Thoughts on Reasonableness of ESCOSA Decision
<b>Meeting external obligations</b>	<ul style="list-style-type: none"> <li>• SA Water’s proposed \$86.9m capital expenditure for the Mount Bold Reservoir Dam Safety Upgrade was granted by ESCOSA, which in their view reflected a prudent and efficient project. SA Water evidence showed the project will address the risks of failure posed by flood conditions and earthquakes, in line with the requirements of the ANCOLD guidelines - <i>Isle thinks ESCOSA’s Draft Decision is reasonable.</i></li> <li>• SA Water’s proposed \$78.1m capital expenditure for the Eyre Peninsula Desalination Plant was granted by ESCOSA which in their view reflected a prudent and efficient project. This project was supported by SA Water modelling evidence that showed the potential for damage to the area, and also used options analysis to determine the desalination plant as the lowest cost supply option - <i>Isle thinks ESCOSA’s Draft Decision is reasonable.</i></li> </ul>
<b>Sustaining services</b>	<ul style="list-style-type: none"> <li>• Capital expenditure for the Reticulated Mains Network Management Program was reduced by \$37.2m (26%) to reflect: (1) that the improved level of water network reliability is not supported by customer willingness-to-pay surveys, and (2) the proposed level of mains replacement capital expenditure is too high. In Isle’s original report, we shared the concern of SA Water’s Customer Working Group with respect to the reasonableness of the specific questions being asked in aspects of the broader customer willingness-to-pay surveys. Without knowing the details of the specific questions asked for this particular program, we can only assume ESCOSA had similar concerns. We also understand ESCOSA reviewed in detail the modelling outputs from SA Water’s Pipeline Asset and Risk Management System (PARMS) models and adjusted the cost down appropriately - <i>Isle thinks ESCOSA’s Draft Decision is reasonable.</i></li> </ul>

<sup>2</sup> Extracted directly from ESCOSA document ‘20200304-Water-SAWRD20-DraftDecision-StatementOfReasons’



	<ul style="list-style-type: none"> <li>• Capital expenditure for the Wastewater Network Mains Renewal Program was reduced by \$22.5m (33%) to reflect: (1) that proposed performance targets appear to be based on improving service, rather than maintaining service, and (2) the program exhibits a lack of support through customer willingness-to-pay surveys. In Isle’s original report, we observed that areas of SA Water’s proposed capital expenditure were not supported with evidence showing spending is required to either sustain compliance, rectify an area of non-compliance, or satisfy customer willingness to pay outcomes - <i>Isle thinks ESCOSA’s Draft Decision is reasonable.</i></li> <li>• Capital expenditure for the Storage Tanks Renewal Reliability Program was reduced by \$5.8m (29%) to reflect previous program underspend and an overstated level of risk related to these assets - <i>Isle thinks ESCOSA’s Draft Decision is reasonable.</i></li> </ul>
<p><b>Improving services</b></p>	<ul style="list-style-type: none"> <li>• Capital expenditure for the Metropolitan Water Quality Improvements Program was reduced by \$41.4m (34%) to reflect: (1) that the exact outputs (impact on the technical level of services, the various water aesthetics parameters), and exact expected outcomes (impact on customer perception of water quality) are not specified, nor are related to a service standard proposed for inclusion in the relevant Code, and (2) that 66% of the program will be rolled out over SAW RD20, with the remaining 34% rolled out in the first two (2) years of SAW RD24, which is essentially ESCOSA granting the full program over the next six (6) year period. The program has stated outcomes that are not supported through mandatory compliance requirements, but we understand the program is strongly supported by the results of customer willingness-to-pay research. Furthermore, water capital expenditure benchmarking analysis conducted by Isle in our original report highlighted SA Water’s above median spend relative to an Australian peer group - <i>Isle thinks ESCOSA’s Draft Decision is overly favourable to SA Water and warrants further challenge by Business SA.</i></li> <li>• Capital expenditure for Upgrades to Non-Potable Water Supplies was reduced by \$37.7m (100%) to reflect: (1) that SA Water is not legally obligated to upgrade supplies identified as ‘non-potable’, and (2) that the SA Government is currently reviewing its policy of regional water supply - <i>Isle thinks ESCOSA’s Draft Decision is reasonable.</i></li> <li>• Capital expenditure for the Regional Water Quality Improvement Program was reduced by \$24.8m (100%) to reflect: (1) that SA Water has not established a long-term program for regional water aesthetic upgrades (previously identified and requested at SAW RD16), and (2) that there is no clear line of sight between its proposed infrastructure projects and the improvements customers should expect. Like the aforementioned Metropolitan Water Quality Improvements Program, the Regional Water Quality Improvement Program lacks specification of outputs, but the supporting customer willingness-to-pay research indicates that the majority of customers would accept these project costs. However, the ESCOSA decision is in contrast to that pertaining to the Metropolitan Water Quality Improvements Program and has only allowed expenditure for development of the long-term program and progression of the program based on a ‘contingent project’ list – <i>Isle thinks ESCOSA’s Draft Decision is overly harsh for regional customers and warrants further challenge by Business SA.</i></li> </ul>
<p><b>Growth</b></p>	<ul style="list-style-type: none"> <li>• Capital expenditure for two growth projects: (1) Upper Spencer Gulf Capacity Upgrade (\$22.8m), and (2) the Kangaroo Island Desalination Plant (\$22.8m) has been removed to reflect that SA Water has not yet completed final contract negotiations with the proposed major customers for the additional water, which will directly affect the viability of these projects. ESCOSA has treated these as ‘contingent projects’ until sufficient evidence is provided to show these projects are both prudent and efficient - <i>Isle thinks ESCOSA’s Draft Decision is reasonable.</i></li> </ul>

<p><b>IT</b></p>	<ul style="list-style-type: none"> <li>Capital expenditure for IT Projects was reduced by \$9.6m (7%) to reflect Cardno’s feedback, mainly on the IT Risk Management Program, particularly: (1) the documentation of project expected and outturn benefits was lacking, and (2) the program did not sufficiently consider alternative options to identify the most cost effective option. In Isle’s original report, we questioned the accuracy and validity of the IT Benchmarking undertaken by SA Water, particularly as it related to capital expenditure. Given these challenges associated with SA Water’s provided information, Isle believes the proposed IT capital expenditure reduction of 7% is relatively small compared to ESCOSA’s recommended 40% reduction in IT operating expenditure. Consistent with Isle’s commentary in the original report, ESCOSA has recommended to undertake, ahead of SAW RD24, its own independent benchmarking of IT capital expenditure costs, using suitable comparator businesses with underlying cost structures similar to SA Water. Isle is of the view that this benchmarking should be reasonably straight forward to conduct, and should be delivered as soon as practically possible - <i>Isle thinks ESCOSA’s Draft Decision is overly favourable to SA Water and warrants further challenge by Business SA.</i></li> </ul>
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## 2.3 Rate of Return

***The Draft Determination passes through to customers the benefits of lower financing costs that SA Water currently faces. As a result, ESCOSA has proposed lowering SA Water's allowed regulatory Rate of Return to 2.71 percent in 2020-21 from 4.53 percent in 2016-17.***

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). ESCOSA 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.

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

**Table 3** below summarises our key findings.

**Table 3 - Key Findings**

Driver of ESCOSA Decision	Isle Thoughts on Reasonableness of ESCOSA Decision
<b>Rate of return</b>	<ul style="list-style-type: none"> <li>• ESCOSA accepted SA Water's proposal to calculate the cost of equity based on a 60-day average of the yield on 10-year Commonwealth Government Securities (CGS). In its original report, Isle considered SA Water's approach to averaging the risk-free rate over 60 days instead of 20 days to be reasonable, given the guidance provided by ESCOSA, as well as regulatory precedence (in particular the Australian Energy Regulator) - <i>Isle thinks ESCOSA's Draft Decision is reasonable.</i></li> <li>• The Draft Determination did not accept SA Water's proposed methodology regarding the regulatory treatment of inflation, as it is subject to conceptual and measurement errors, including a focus on short-term measures. ESCOSA noted in its Draft Decision Isle's original response which was that the use of a single year RBA forecast of inflation – which is <u>in effect</u> what SA Water was proposing to adopt to inform its inflation estimate – was unreasonable, given the short-term nature of this forecast in the context of long-term investments and funding requirements. Moreover, Isle originally noted that previous research undertaken by the AER as part of their "<i>Regulatory treatment of inflation</i>" review, indicated that the two pieces of evidentiary information presented by SA Water as support of market expectations (i.e. the bond breakeven approach and the inflation swap approach) were prone to error - <i>Isle thinks ESCOSA's Draft Decision is reasonable.</i></li> <li>• Notwithstanding the above, ESCOSA proposes to use the RBA's 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 existing practice, which used RBA's one-year inflation forecast and the mid-point of the RBA's inflation target band thereafter. ESCOSA notes that 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 - <i>Isle thinks ESCOSA's Draft Decision is reasonable.</i></li> </ul>

	<ul style="list-style-type: none"> <li>• ESCOSA is proposing to adopt a mechanism that would adjust the revenue caps each financial year to account for changes in specified parameters (namely the risk-free rate, the cost of debt and long-term inflation expectations) of the regulatory rate of return, thus allowing it to be updated to reflect prevailing market conditions - <i>Despite the fact that this approach increases price volatility and uncertainty, Isle thinks that on balance, ESCOSA's Draft Decision is reasonable in the current environment.</i></li> <li>• ESCOSA states that any concern about the financial implications of the real rate of return methodology needs to be considered in the context of whether or not the Draft Determination provides sufficient cash flow to finance prudent and efficient investments in drinking water and sewerage infrastructure. To the extent that there were temporary insufficient cash flows resulting from the application of ESCOSA's real rate of return methodology, ESCOSA would consider adopting an adjustment to revenues in SAW RD20 (which would be net present value (NPV)-neutral between regulatory periods), rather than changing the real rate of return methodology. ESCOSA also agreed with Isle Utilities' original position that '... any near-term price increase to support financial viability should be 'paid back' to customers in the long term' - <i>Isle thinks ESCOSA's Draft Decision is reasonable.</i></li> <li>• ESCOSA's draft decision was for an equity beta of 0.65, which was slightly below SA Water's 0.7. ESCOSA noted that a range from 0.6 to 0.7 was presented in Guidance Paper 5. They also noted that the adoption of the annual update methodology would be expected to reduce SA Water's firm-level risk relative to the risks faced under the approach used in SAW RD16. There is, therefore, a prima facie case for lowering equity beta below 0.7 - <i>Isle thinks that, given the adoption of an annual update, ESCOSA's Draft Decision is reasonable.</i></li> </ul>
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