

1 Overview

This SA Water Final Regulatory Determination 2020 (**Final Determination**) establishes reductions to the total revenue that SA Water may recover during the four-year period commencing 1 July 2020, of 16 percent (\$494 million) and 4 percent (\$54 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 will 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 Final 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 allowing for a 28 percent increase in capital expenditure and two percent increase in operating expenditure, compared to those incorporated into the current regulatory determination.

Final drinking water and sewerage retail service revenues, compared to 2016-2020 revenues and SA Water's proposal for 2020-2024 (Present value, \$Dec18 in millions)

	2016-2020 Regulatory Determination	SA Water 2020-2024 Regulatory Business Proposal	2020-2024 Final Determination
Drinking water	3,035	3,047	2,541
Sewerage	1,269	1,323	1,215

The determination process has included:

- ▶ reviewing, amending and enhancing consumer protections contained in industry codes and rules
- ▶ reviewing and resetting the customer service and network reliability service standards with associated performance targets
- ▶ making three separate price determinations for drinking water retail services, sewerage retail services and other ('excluded') retail services, and
- ▶ reviewing the performance monitoring and reporting framework, noting that further consultation will occur on those matters during 2020.

A key driver of the revenue reductions is the significant falls in the market-based debt and equity financing costs 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 2.96 percent in 2020-21 as compared to 4.53 percent in 2016-17. Estimating the real rate of return requires an estimate of long-term inflation expectations. Given current uncertainty about the path of recovery in inflation, and noting potential impacts in that regard arising from the COVID-19 pandemic event (**COVID-19**), the Commission has adopted a glide path to the mid-point of the Reserve Bank of Australia's two to three percent inflation target band by 2026-27 (rather than the one-year transition used in prior regulatory determinations).

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 in real terms (accounting for the effects of inflation) of \$362 million in capital expenditure and an increase of

\$33 million in operating expenditure, as compared to the current determination. Both stakeholders' submissions and the Commission's own review have highlighted that some of SA Water's expenditure proposals - noting that in total SA Water sought an additional \$471 million in capital expenditure and \$121 million in operating expenditure over the amounts included in the current determination - 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.

The Final Determination meets the requirements of the May 2020 Pricing Order under the *Water Industry Act 2012*, which reduced the regulatory value of SA Water's drinking water assets from \$7.77 billion to \$7.25 billion (as at 1 July 2013, in December 2012 dollars).

It also allows for specified increases in SA Water's forecast capital and operating expenditure (net of Government contributions) to reflect directions issued to SA Water by the Minister for Environment and Water under the *Public Corporations Act 1993*.

The Final Determination incorporates expectations of efficiency gains that should be made by SA Water where it is not at the frontier of efficiency compared to other peer water utilities (catch-up efficiencies) and ongoing efficiency improvements that are achievable as the frontier of efficiency continues to improve (continuous efficiencies). The capital expenditure amounts incorporated into this Final Determination include an expectation that SA Water can achieve compounding catch-up efficiency of 1.5 percent per annum across the four-year period commencing 1 July 2020 and an additional compounding continuing efficiency target of 0.5 percent per annum. Operating expenditure included in the Final Determination incorporates a compounding continuing efficiency target of 0.5 percent per annum.

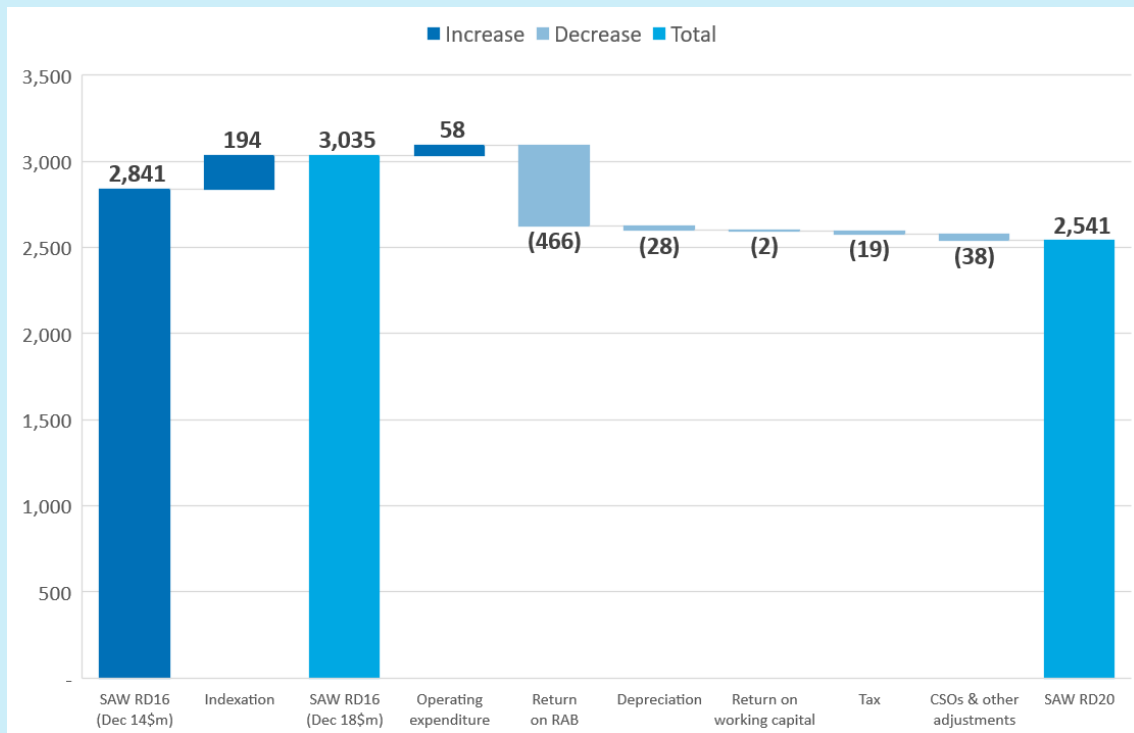
To avoid any double counting of efficiencies, the efficiency target has not been applied to the sample of projects and programs that were reviewed by the Commission, which already incorporate efficiency expectations. They have also not been applied to labour costs, which already have a productivity expectation incorporated in them, nor to the expenditure that SA Water must incur pursuant to directions from the Minister for Environment and Water under section 6 of the *Public Corporations Act 1993*.

Importantly, the expenditure benchmarks set by the Commission do not dictate the actual amount of expenditure that SA Water must incur or how SA Water should direct its expenditure - noting that SA Water cannot recover from customers any revenue in excess of the caps established by this determination. Rather, SA Water is responsible for managing its daily network operations and maintaining supply reliability and services to customers: it must decide appropriate expenditures to meet its obligations and to maintain the long-term integrity of the network. The incentive regulatory regime is intended to encourage SA Water to adopt innovative practices which allow it to spend below the benchmark levels whilst maintaining service levels.

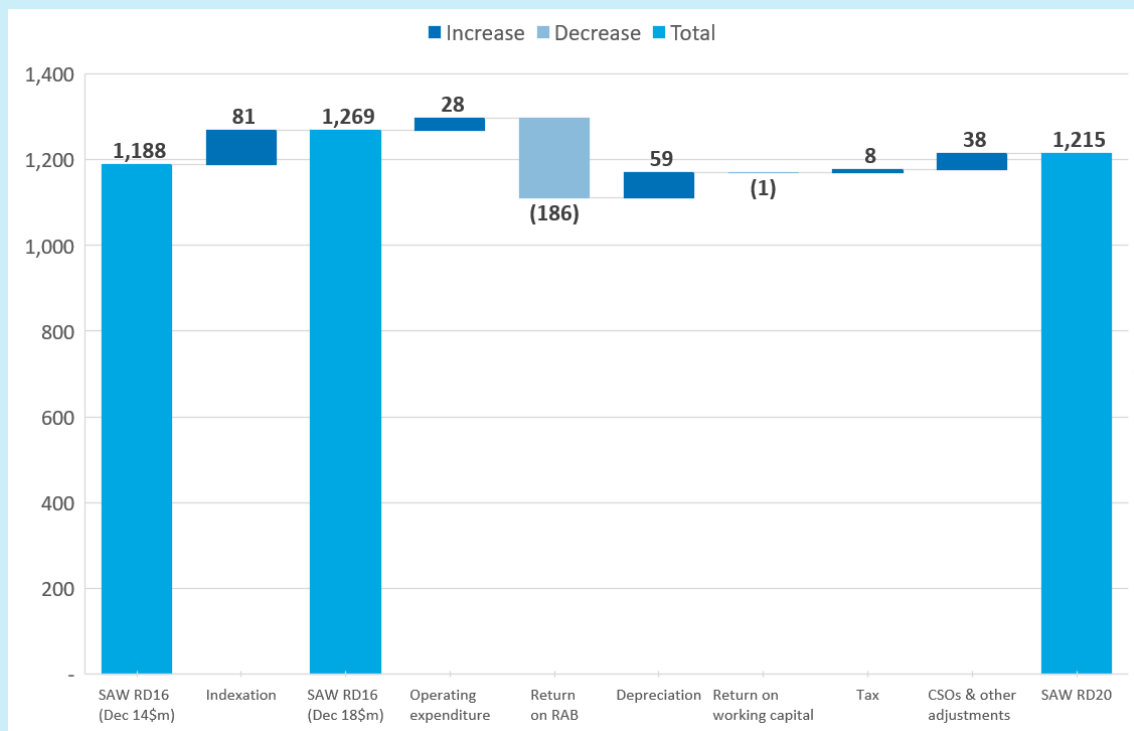
This Final Determination has been made during the period of COVID-19, at a time when there is uncertainty about the extent to which COVID-19 and the related containment measures will impact SA Water's expenditure requirements during the SAW RD20 period. Should SA Water's expenditure materially increase due to COVID-19, the Final Determination provides a cost pass-through mechanism, which may allow revenue caps in the 2024-2028 period to increase to accommodate that change.

The drinking water revenue reductions are greater than the sewerage revenue reductions due to the reduction in the value of drinking water assets through the Pricing Order, impacts of the directions under section 6 of the *Public Corporations Act 1993* and revenue reductions that arise from the current determination (such as the demand variation adjustment mechanism, which impacts drinking water revenues). The reductions in the drinking water and sewerage revenue caps are illustrated in the following figures.

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



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



SA Water Regulatory Determination 2020 (**SAW RD20**) 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 but has also indicated opportunities for future improvement by SA Water. This is particularly in relation to more transparent reporting on the outcomes of SA Water's capital project expenditures and its longer-term asset management planning. In each case, stakeholders and the Commission have identified through the review process that SA Water can and should be delivering stronger performance and accountability. Further consultation will occur in the second half of 2020 to finalise a robust and cost-effective monitoring and reporting regime for those matters, noting that the relevant information should be based on the type of information that should already be collected by SA Water's management.

The Commission has fulfilled its statutory role established under the *Water Industry Act 2012* and the *Essential Services Commission Act 2002*, in which it is required to have regard to all relevant statutory factors and objectives (including the terms of Ministerial Pricing Orders and directions), to consider all relevant evidence available to it and, thereafter, make a regulatory determination which it considers best meets those statutory factors and objectives in light of the evidence.

That decision-making process involves issues of discretion, judgement and degree (to the extent permitted under the statutory framework). This Final Determination therefore sets out the Commission's considered position as to the most reasonable form and quantum of regulation and revenue control to be applied during the 2020-2024 regulatory period that best protects South Australian consumers' long-term interests with respect to the price, quality and reliability of the water and sewerage retail services provided by SA Water.

1.1 Outcomes of SA Water Regulatory Determination 2020

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 Regulatory Determination in relation to the maximum revenue that the South Australian Water Corporation (**SA Water**) can recover from the provision of drinking water and sewerage retail services from 1 July 2020 to 30 June 2024.

In present value terms, this Final Determination will lead to a reduction in SA Water's drinking water and sewerage retail service revenues of approximately 16 percent (\$494 million) and four percent (\$54 million) respectively over the next four years, compared to the previous four years. Those revenues are approximately 17 percent and eight 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 revenue caps, relative to those proposed in SA Water's RBP and SA Water Regulatory Determination 2016 (**SAW RD16**).

Table 1.1: Final drinking water and sewerage retail service revenues, compared to 2016-2020 revenues and SA Water's proposal for 2020-2024 (Present value, \$Dec18 in millions)

	2016-2020 Regulatory Determination	SA Water 2020-2024 Proposal	2020-2024 Final Determination
Drinking water	3,035	3,047	2,541
Sewerage	1,269	1,323	1,215

1.2 The Commission sets maximum revenues, SA Water sets prices

Consistent with the legislative framework, the Commission has determined 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 Final Determination will fix those revenue caps for the four-year period from 1 July 2020.

The SA Water Draft Regulatory Determination 2020 (**Draft Determination**) had proposed revenue caps that could vary each year, based on annual updates to the regulated rate of return and to recover the costs of any approved new 'contingent' capital projects. The Treasurer for the South Australian Government (**Treasurer**) issued a Pricing Order under the WI Act in May 2020, which does not permit revenues to vary during the regulatory period and, as a result, the Final Determination does not include the annual updates mechanism and the contingent projects mechanism has been amended to become an intra-period project review mechanism, with any revenues referable to projects under that mechanism recovered in the subsequent regulatory period.

1.3 Drivers of the revenue reduction

The revenue reduction from this Final Determination is driven primarily by lower market-based debt and equity financing costs (through 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 has fallen to 2.96 percent (post-tax, real) in 2020-21.

SA Water proposed changes to the rate of return methodology outlined by the Commission in the Guidance Papers prepared as a part of this determination process. Those papers explained the methodology utilised previously by the Commission and noted various methodology changes proposed for this determination to address matters raised by stakeholders and changes in market conditions.

The Commission has not accepted 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 the assumed 10-year bond term). The Commission has adopted a 10-year average inflation expectation, calculated using the Reserve Bank of Australia's (**RBA**) trimmed mean Consumer Price Index (**CPI**) inflation forecasts for two years and a linear glide path to the mid-point of the RBA's inflation targeting band by 2026-27, remaining at 2.5 percent thereafter. This medium-term glide path 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 from years two to 10. The change reflects the current uncertainty about the speed in which inflation might return sustainably within the RBA's two to three percent target inflation range. The impact of the change is that it results in a higher real rate of return than that which would have resulted from the SAW RD16 approach.

In keeping with customers' and stakeholders' clear messages throughout the determination process about the need for prices to be kept as low as possible, the Commission has carefully reviewed SA Water's proposed capital and operating expenditure, to ensure that those are kept at prudent and efficient levels.

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 (that is, considering drinking water and sewerage revenues on a combined basis), provided for an increase of \$362 million in capital expenditure (28 percent) and an increase of \$33 million in operating expenditure (1.7 percent), as compared to expenditure in the current regulatory period.

Looking at the two separately, there is a slightly higher increase in operating expenditure for sewerage services (2.7 percent) than for drinking water services (1.4 percent). 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 Final 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 six percent and four percent respectively. Based on the evidence available, presented by SA Water, in stakeholder submissions and through the Commission's own review, 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 were concerned that they had not been given the chance to understand and consider the ambitious Zero Cost Energy Future (**ZCEF**) 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 assessment of prudent and efficient expenditure levels having regard to the evidence available to it through the review process. In doing so, the Commission has established revenues which are commensurate with the levels of service, reliability and quality that SA Water is expected to provide.

The most material differences between the Final Determination and the expenditures 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 (\$33 million capital expenditure reduction proposed)
- ▶ removing the proposed regional water quality improvement programs (proposing to move above current regulatory requirements) until further analysis, including further community consultation, has occurred to better define the needs, scope, location 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 network operations and IT-led savings (\$34 million operating expenditure reduction proposed)
- ▶ a better understanding of the 'normal' efficient base year operating expenditure to remove one-off or irregular cost pressures (\$53 million operating expenditure reduction), and
- ▶ an expectation that SA Water should manage anticipated new operating cost pressures by reprioritising existing budgets to absorb such costs (\$51 million operating expenditure reduction).

The Final Determination does not include a revenue allowance for SA Water's investments in solar and battery storage under its ZCEF initiative. 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.

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. By treating it as an unregulated activity, the Commission has removed all costs of the program and all expected future savings that SA Water expects to receive from it. The electricity expenditure incorporated into the revenue caps are market-based costs and all risks of the program, relative to those market-based costs, will accrue to SA Water and its owner, the South Australian Government.

1.3.1 Changes between the Draft Determination and Final Determination

The drinking revenue caps under this Final Determination are approximately \$53 million above those proposed in the Draft Determination. The sewerage revenue caps are approximately \$110 million more than those proposed in the Draft Determination. The major drivers of those changes are:

- ▶ The real regulatory rate of return has increased between the Draft Determination and Final Determination, mainly due to an increase in the cost of debt and lower long-term inflation expectations.
- ▶ The Minister for Environment and Water has issued new directions under the *Public Corporations Act 1993*, requiring SA Water to undertake certain activities over the coming four years. The directions increase SA Water's forecast capital and operating expenditure (net of Government contributions).
- ▶ The Commission's final decision provides for increased operating expenditure (excluding the impacts of the new directions from the Minister for Environment and Water), compared to the Draft Determination, as a result of incorporating better evidence of SA Water's base level operating expenditure requirements and forecast variations, including electricity purchase costs.
- ▶ Depreciation costs have increased to reflect changes in the weighted average lives of regulated assets, updated to reflect capital expenditure during the current regulatory period. The increase mainly reflects the addition of corporate (short-life) drinking water and sewerage assets and the addition of non-pipe (long-life) drinking water assets.

The Commission has also incorporated the following changes, which have created downward pressure on SA Water's revenues compared to the Draft Determination:

- ▶ In May 2020, the Treasurer issued a Pricing Order under the WI Act, reducing the regulatory value of SA Water's drinking water assets from \$7.77 billion to \$7.25 billion (as at 1 July 2013, in December 2012 dollars).
- ▶ A downward adjustment to drinking water revenues was made to reflect the increased revenue that resulted from actual drinking water demand exceeding forecast demand in the current regulatory period, leading to drinking water revenue exceeding the revenue cap. This adjustment was made in accordance with the demand variation adjustment mechanism under the current determination.
- ▶ There have been changes in revenue from other sources, namely non-tariff revenue (i.e. Community Service Obligations (CSOs)) and other adjustments included in revenue modelling.

1.4 Driving greater public accountability around SA Water's expenditure and service commitments

A clear message that emerged through the review was a desire for increased public transparency and accountability by SA Water in relation to its expenditure and the extent to which that expenditure delivers the outcomes promised. While SA Water currently reports on its achievement (or otherwise) of service standards over time, there is currently not a process through which stakeholders can see and understand the extent to which major expenditure and investments by SA Water over time are successful, in terms of both efficiency and effectiveness. Stakeholders commented on the need for a more transparent long-term capital plan to provide the context for SA Water's proposed projects and initiatives for the next regulatory period.

In addition, and acknowledging that the Final Determination is forward-looking, stakeholders are also seeking assurance that, where significant projects do not proceed as originally proposed in the RBP (for example, through re-prioritisation), there is a public and transparent process surrounding those events. Such a process should provide for an explanation (by SA Water) of the reasons for the change, what new work is being done for the money paid by consumers and clearly established indicators of success for the intended (and actual) outcomes of that new work. It should also include provision for stakeholders and the Commission to review and comment on relevant issues - both prior to any work being done and in the planning stages.

The Final Determination therefore anticipates new requirements in this regard, in order to hold SA Water accountable for its expenditure and outcomes over time, which will also be a way of increasing transparency around projects and expenditure when those matters come to be reviewed in future determinations. That transparency will apply to projects and services specified in this Final Determination and any new projects and services delivered by SA Water during the regulatory period. As the particular mechanisms that will be used do not need to form part of the formal revenue controls for SA Water, and noting the wider stakeholder interest in this issue, the Commission will consult further on the specifics of those mechanisms during the second half of calendar year 2020.

The Final Determination also sets 22 service standards that SA Water will be required to meet over the coming four years. 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 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 in service levels only where SA Water has demonstrated customer support and willingness to pay for particular improvements.

The service standards include new standards that set targets for:

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

The Commission will 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 Final Determination also enhances consumer protections set out in the Water Retail Code - Major Retailers, 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 Final Determination

This Final 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 Final 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.