COMPASS SPRINGS

22 January 2021

Mr M Caputo

Acting Director

Consumer Protection and Pricing

Essential Services Commission

Level 1

151 Pirie Street

ADELAIDE SA 5000

Dear Mr Caputo,

ROBUSTO INVESTMENTS PTY LTD (TRADING AS COMPASS SPRINGS)

ESCOSA DRINKING WATER DRAFT REGULATORY DETERMINATION RESPONSE

Please find below our response to the above document, as issued by the Essential Services Commission of South Australia (ESCOSA) on 19 November 2020.

Executive Summary

The sustained financial viability of Robusto Investments Pty Ltd (trading as Compass Springs) "Compass Springs" is vital to the ongoing provision of essential water services to 172 residential and 2 commercial customers in part of the Mount Compass township.

As you are well aware, we are licensed by the Essential Services Commission of South Australia (ESCOSA), and are required to comply with a number of Acts and Codes to maintain our business operations.

The drinking water supply industry is very heavily regulated through those Acts and Codes in terms of pricing, contract forms, customer hardship policies, dispute resolution mechanisms, water quality testing, consumer engagement and infrastructure standards.

Compass Springs historic pricing arrangements were tied to SA Water's charges (rate plus 15% for consumption, same rate for supply). SA Water has over 700,000 connections serving approximately 1.7m consumers. The two businesses are fundamentally different. Alignment of our pricing mechanism with SA Water's charges does not work for a small business such as Compass Springs.

The business (Bizana Pty Ltd / Hillrise Investments Pty Ltd) that constructed the network acquired by Compass Springs was established almost 25 years ago - well before current administrative, compliance, reporting, upgraded standards and regulatory requirements were brought into effect.

The cost of operations and meeting those requirements has risen significantly over time, with no corresponding increase in revenue because our retail pricing has been tied to SA Water's charges. With a small customer base the impacts on the business have been magnified.

The water infrastructure network that Robusto Investments Pty Ltd acquired in 2016 is aged, requires considerable maintenance and will in the not too distant future require further capital expense to keep it operational.

We reiterate our previous advice that our 2017 Price Submission, subsequent correspondence and this Price Determination does not take into account capital expenditure for infrastructure upgrades.

We propose to deal with further capital investment at a later date after consultation with our customers.

Our pricing is required to be in line with the National Water Initiative Pricing Principles (NWIPP) through a Regulatory Determination overseen by ESCOSA.

Whilst being largely a consumer protection agency, one of ESCOSA's charters is to ensure the ongoing financial viability of its licensed providers, such as Compass Springs.

We require price increases to maintain our viability so we can continue to provide an essential service for our customers.

Time For Proposals

Compass Springs made its initial Pricing Submission in March 2017 with subsequent revisions at the request of ESCOSA. We are of the view our submission(s) complied with the NWIPP.

We say that since making the initial 2017 Pricing Submission that:

1. ESCOSA has persistently delayed without reasonable justification dealing with our Pricing Submission; and
2. In the course of doing so ESCOSA has provided no reasonable grounds for their objections / refusal to confirm compliance; and
3. As a result of the delays brought about by ESCOSA's conduct substantial reputational and financial damage has been suffered by Compass Springs.

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The following table highlights the delays we have incurred through ESCOSA's conduct:

Key correspondence	**Date**	**Note**
Pricing Submission lodged by Compass Springs	17 March 2017	
Follow up email from Compass Springs	28 March 2017	1 month delay
Meeting with ESCOSA	3 May 2017	1 month delay
ESCOSA response	23 May 2017	1 month delay
Meeting with ESCOSA	6 June 2017	
Compass Springs response	30 June 2017	
ESCOSA response	19 July 2017	
Compass Springs response	22 August 2017	
Follow up email from Compass Springs	9 September 2017	
ESCOSA response	26 October 2017	3 month delay
Compass Springs response	24 November 2017	
ESCOSA response	December 2017	
Compass Springs response	20 December 2017	
Follow up email from Compass Springs	18 January 2018	
Letter from Compass Springs	13 February 2018	
Meeting with ESCOSA	15 February 2018	2 month delay
Compass Springs obtain fee proposals, confirm scope with ESCOSA, commission engineering assessment (paid for by Compass Springs)	27 April 2018	
Engineering mapping, cost estimate by Wallbridge & Gilbert submitted to ESCOSA	23 July 2018	
ESCOSA provide valuation brief	7 August 2018	
ESCOSA commission BRM Holdich	15 October 2018	1 month delay
BRM Holdich valuation issued	10 January 2019	
Compass Springs Pricing Submission revised	30 January 2019	

Follow up email from Compass Springs	18 February 2018	
Follow up email from Compass Springs	6 March 2018	
Follow up email from Compass Springs	26 March 2018	
ESCOSA response	27 March 2018	2 month delay
Compass Springs Pricing Submission revised	24 April 2019	
Follow up email from Compass Springs	21 May 2019	
Follow up email from Compass Springs	17 June 2019	
ESCOSA response	20 June 2019	2 month delay
Compass Springs brief and engage Ernst Young	June / July 2019	
Ernst Young report submitted	9 September 2019	
Compass Springs Pricing Submission revised	11 September 2019	
Follow up email from Compass Springs	5 November 2019	
Follow up email from Compass Springs	5 December 2019	
ESCOSA response advising intent to move to Price Determination	5 December 2019	3 month delay
Price Determination process announced by ESCOSA	8 January 2020	
Price Determination due to complete	**17 July 2020**	
Follow up email from Compass Springs	1 June 2020	
ESCOSA email proposing alternate methodology and further delay	24 July 2020	6 month delay
Compass Springs letter demanding reversion to Price Determination	5 August 2020	
Compass Springs pre action claim notice	11 August 2020	

ESCOSA response confirming Price determination to recommence	20 August 2020	
Price Determination due to complete	**December 2020**	
ESCOSA advice delaying Price Determination completion	21 October 2020	2 month delay
Price Determination due to complete	**February 2021**	
ESCOSA advice delaying Price Determination completion	24 November 2020	
Price Determination due to complete	**March 2021**	2 month delay

The process that ESCOSA has undertaken in responding to the Pricing Submission has wasted an inordinate amount of time, and has cost Compass Springs a significant amount in consulting and legal fees, as well as lost income it should have received.

We say this could have been avoided. The delays with the process and the failure to process price increases that we say are compliant with the NWIPP have compounded the sustained operating losses since we acquired the business.

ESCOSA moved to a Price Determination process in late 2019, only to subsequently further delay that process by seeking to impose an alternate basis for determination in July 2020.

It was only when ESCOSA was threatened with legal action by Compass Springs that it reverted to the Price Determination process – but with a further delay of another 9 months – now due March 2021.

This saga will be 4 years in duration at completion of the Price Determination process. It has caused very significant frustration and economic challenges for Compass Springs referred to above, together with considerable frustration and uncertainty for our customers.

Key Issues

We have responded to the items listed in section 2.8 below.

<u>Inconsistencies</u>

This will be dealt with in response to the email from Sean McComish of ESCOSA to Compass Springs dated 23 December 2020.

<u>Debt</u>

We have confirmed that purchase of the business assets of Bizana Pty Ltd / Hillrise Investments Pty Ltd was 100% debt financed.

The purchase value was $1.05m.

As advised finance was initially provided in 2016 at a rate of 14% per annum, interest only.

At that time, and since, we made very considerable efforts to secure finance at competitive rates from a wide range of lenders. It has proven impossible to obtain finance for the business without real estate security to supplement the business assets.

Lenders consistently advised they were unwilling to lend to a business located in Mount Compass (viewed as a non-metropolitan location), and because it is deemed a specialised asset with high risk and limited potential to recover capital because the assets of the business are fixed in place – water tanks, bores, underground pipes and wires which have no or very limited resale value.

Whilst interest rates have declined since 2016, the cost of unsecured debt remains comparatively high, with very limited appetite to lend being evident.

During that time the Reserve Bank of Australia (RBA) small business variable overdraft interest rate was listed as follows (% per annum):

Jul-2016	8.35
Jul-2017	8.28
Jul-2018	8.28
Jul-2019	7.74
Jul-2020	6.51

The listed RBA rate excludes line fees and establishment fees which would typically add 2.00% to the figures quoted above for an interest only facility, paid monthly.

By way of example the advertised Commonwealth Bank of Australia rate for a business overdraft on 20 January 2021 is quoted at **from** 7.68% plus a line fee of 1.12 = 8.80% plus an establishment fee. It was higher in previous years.

As noted above we have been unable to secure finance at anything like these rates without real estate security.

ESCOSA's commentary with reference to advice from KPMG (Sections 6.7, 6.8, 6.9) is simply irrelevant to Compass Springs. We are dealing with a real commercial situation – not an academic hypothetical exercise.

If we could obtain finance at better interest rates we would, as it is in our best interests to do so.

We wish to keep all of our expenses as low as possible. The reality is that finance is simply not available on the terms suggested by ESCOSA. Finance for such loans is generally only available on a short term basis (2 – 5 years). We have not found any product in the market offering a 25 – 30 year loan term as ESCOSA have suggested.

Compass Springs entered into an arrangement with Capitoline Property Pty Ltd to finance its business debt. This has been recorded in our annual financial returns at a cost of $100,000 per annum for a facility for $1,050,000. We will provide confidential details on this under separate cover.

In its Statement of Reasons ESCOSA has summarily dismissed $100,000 per annum for finance costs when we have clearly demonstrated the acquisition for $1,050,000 was debt financed and that the costs we have claimed are reasonable and commercial.

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There has been no "double counting" in our calculations – we have not included the interest payment in our operating cost calculations.

Depreciation

In our opinion the Statement of Reasons contains errors of fact in relation to its treatment of depreciation of the regulated asset base.

ESCOSA have adopted the *Depreciated Replacement Cost* ('DRC') of legacy assets as set out in Table 1 of the BRM Holdich report of 10 January 2019. Table 1 identifies three different asset classes and applies a 'Useful life' to each asset class (expressed as a range of years) and then applies an 'Actual remaining lifespan' to each asset class (expressed as a range of years).

Table 1 errs in applying a zero value to certain assets that were identified in the Wallbridge & Gilbert 'Replacement Cost Valuation' report, resulting in the exclusion of these assets from the depreciation calculation.

It is an error of fact to treat assets 'in need of immediate replacement' as having no value (note that all of these assets remain in use nearly two years after the date of the BRM Holdich report) and to do so denies Compass Springs the ability to recover significant legacy capital expenditure, despite that being explicitly provided for in the NWIPP.

The primary difference between ESCOSA and Compass Springs depreciation assessment is in relation to the treatment of purchased assets which have been determined to have a useful life of 0 – 5 years.

The BRM Holdich report of 10 January 2019 takes the current (2018) value of these assets to be zero – that is, they are excluded from the 'Calculated DRC'. We disagree with this treatment.

This is acknowledged in 3.3 of the BRM Holdich report where $407,514 worth of assets have been dismissed from the calculations – and not referenced elsewhere. Those assets cannot and do not have zero value.

As an example, the *Infrastructure condition report* by Wallbridge & Gilbert of 20 December 2018 makes reference to copper-based water infrastructure (*allotment connections*) with a condition score of 1/10 that 'need replacing now' alongside *Water meter assembly* items (which are not copper) with a condition score of 2/10 (with no statement as to immediate replacement) and all of these assets (that is, the entire network of water meters and allotment connections of the 164 dwellings serviced by Compass Springs) are taken by BRM Holdich and by ESCOSA as **having no value** in the regulated asset base. As of now, two years later, all of these assets remain in working order.

It is not a fair nor reasonable approach to take the remaining life of one class of assets to be the maximum possible number of years (when the estimated useful life has originally been expressed as a range of years), while taking the remaining useful life of another class of assets to be the minimum possible number of years (when the useful life has been expressed as a range of years) – particularly when,

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given the benefit of hindsight, the actual useful life of that latter class has been proven to be more than one year.

A more reasonable approach is to acknowledge that, at the date of the BRM Holdich report, this class of assets did in fact (and still does) have a remaining useful life. This simple acknowledgement, which has subsequently been largely proven, would on its own add approximately $22,642 to ESCOSA's own depreciation calculation.

Given this we maintain that the depreciation calculations we submitted based upon independent inspections, costings and fair expectations of remaining life ranges, with a commencing annual rate of $88,300 are correct, fair and reasonable.

Future Investment

As indicated above and previously, our Pricing Submission and this Price Determination do not involve an assessment of future capital expenditure on the network infrastructure.

We will consult our customers on that subject once this Price Determination process is finalised and then deal with ESCOSA on that matter.

We take this opportunity to point out that whilst it is not a responsibility or obligation of Compass Springs to provide fire fighting resources for its customers, it is intended that a separate 150,000 litre water tank be maintained for emergency use for this purpose. Capitoline Property Pty Ltd will fund it as part the subdivision construction works at the end of George Francis Drive and then Compass Springs will take over the operation the asset.

We also wish to include a UV treatment system for the water supply, but that is dependant upon the outcome of this Price Determination process. ESCOSA's current proposal in the Price Determination will not support this enhancement.

Compensation for Losses

Our most recent Pricing Submission sought to recover accrued losses over a period or 5 years to reduce the impact on our customers.

We would prefer to recover those losses from ESCOSA because we believe the Commission has acted unreasonably in deliberately delaying price increases which we proposed which are in line with the NWIPP. No such recourse is available to Compass Springs.

Compass Springs pricing has been in limbo since submitting its Price Submission in March 2017.

ESCOSA has persistently refused to support our application for increases. If a price increase had been implemented when initially sought the current issues would have been avoided.

Compass Springs has been prompt to respond to all ESCOSA requests over the last 4 years.

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Our losses have been calculated on the basis of the differential between the income we anticipated had our Pricing Submission been approved in 2017 (with amendments) compared with the actual income received, divided over a 5 year period.

To suggest as noted in 6.9.5 that we should have sought an interim price increase is disingenuous. We say that it would have been treated in the same fashion as our other application(s) ie. dismissed by ESCOSA without reasonable justification or explanation.

Efficient Costs

We note ESCOSA have summarily applied a 25% discount to our cost allowances for the following categories in section 6.3.4:

- Legal fees
- Public relations and communications
- Debt recovery, mediation, dispute resolution
- Provision for bad and doubtful debts

We dispute the first three of these on the following basis:

Legal costs

Our records show we expended over $8,000 on legal fees in the 2019/20 financial year and this financial year it will be in excess of $20,000.

In this context an allowance of $10,000 being cut to $7,500 is unreasonable.

Public relations and communications

Compass Springs presently has neither the funds or personnel available to dedicate to a thorough consultation and communication program with our customers. We need to implement a price increase to be able to accommodate and/or provide for this.

We made reasonable allowances for engaging an external consultant to oversee two consultation processes in our Pricing Submission in 2017:

- Implementing the price increases sought in our Pricing Submission of 2017 (now the subject of this Price Determination); and
- A consultation program for reviewing our Capital Expenditure plans (not the subject of this Price Determination but it has to occur before any subsequent dealings with ESCOSA and thereafter price changes).

In Sections 2.6 and 3.6.3 ESCOSA complains that we have not engaged sufficiently with our customers and insists that we do more, then when we make a reasonable allowance for engaging an external consultant ($24,000 per annum for each of the above, reducing to $12,000) ESCOSA argue we should reduce the amount of our allowance.

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That allowance is not at all overly generous. To cut it down by 25% will directly impact on our ability to deliver the very service ESCOSA is demanding of us and compromise our ability to engage with our customers.

Debt recovery, mediation, dispute resolution

We reluctantly joined EWOSA as a dispute reconciliation mechanism. That has proven to be costly for our business – as we bear the cost of the service for the consumer as well as significant administration time. The Managing Director has contributed this time to the business without recompense whilst waiting for pricing changes to occur. This time has not been costed in our reports.

EWOSA's charges to Compass Springs in the 2019/20 financial year were approximately $10,000.

EWOSA have revised their charging schedule which has a resulted in a base charge of $10,000 plus dispute resolution costs to be incurred for Compass Springs. If we have the same level of disputes as last year that would mean EWOSA's costs for Compass Springs will be nearly doubled this year.

ESCOSA have summarily reduced our first year budget allowance by 25% to approximately $15,500 in the Pricing Determination.

We fully expect a number of customers will continue to dispute accounts through EWOSA as a result of this Price Determination process, irrespective of the validity of the changes.

As a result of EWOSA's price increases the budget we proposed is already inadequate. To cut that by a further 25% is unreasonable and unrealistic.

Provision for Bad and Doubtful Debts

We will accept a reduced provision for these items.

WACC / Return on Assets

Ernst Young provided advice to Compass Springs in a letter dated 9 September 2019 entitled "Economic advice in respect of Compass Springs drinking water proposal".

A copy of that letter was submitted to ESCOSA at the time. The advice covered a range of topics but was largely focused on determining a reasonable Return on Assets for Compass Springs.

Ernst Young considered that "the return on assets for Compass Springs drinking water business would likely be in the order of **10-12%** post-tax nominal which has been estimated using a top down assessment based upon our experience in undertaking valuation for similar entities."

Our Pricing Submission proposed a 15% pre-tax return on assets, which is consistent with the Ernst Young advice.

Our commentary on debt rates above reaffirms this to be a very reasonable expectation for a business of the scale, risk profile and other characteristics of Compass Springs.

Equity is more expensive than debt and the relativity of this is proportionate (15.0% for a weighted cost of capital versus debt interest rates ranging from 8.0% - 14% - and higher in some instances).

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We dispute the figures put forward in 6.9.3 as unrealistic and unachievable for Compass Springs.

If ESCOSA is able to source debt finance for Compass Springs at the rates noted without real estate security we would welcome that opportunity and would amend our charges accordingly.

We calculate the Return on Assets using the WACC as 15% of $900,000 = $135,000.

As noted above our debt servicing requirements are presently $100,000 per annum.

Non Residential Customers to be excluded from Price Determination

The price cap mechanism proposed by ESCOSA is unworkable for our business.

We appreciate that ESCOSA is providing protection to largely residential customers. In our case that is 98.9% of our customer base.

However, Compass Springs has entered into an emergency supply arrangement with one of our commercial customers that involves potentially large volumes of water to be delivered at short notice if required.

If their requirement is realised (particularly if it is ongoing) we will either not be able to provide them with water as agreed, or will have to regulate supply to our residential customers to stay within the price cap – which we recognise would not be well received – and is not in the best interests of our customers.

The agreement with our commercial customer is a confidential arrangement – we will provide ESCOSA with further information under separate cover.

In the circumstances the risk to the residential customers can be completely avoided by excluding our non-residential customers from the Price Determination.

Summary

We remain of the view that the amended pricing submission(s) we put forward complied with the NWIPP. ESCOSA has repeatedly rejected our submissions but has not provided any meaningful justification for those rejections until this Statement of Reasons was issued.

We dispute many of the claims made by ESCOSA in the Statement of Reasons.

Our pricing submissions offered stepped increases over time with a view to limiting "bill shock" for customers. We only sought to establish an upper level cap to our pricing in accordance with the NWIPP.

We made it clear when doing so that it was not and never was our intention to move to the maximum possible charges under the fee structure that complied with the NWIPP. We say that ESCOSA has misrepresented our position in the Statement of Reasons.

Our stated intention was to demonstrate to our customers that our pricing changes were well under what was theoretically claimable under the NWIPP and that we only sought to increase prices to a point that ensured the ongoing viability of the business.

We also made it very clear that we were not seeking to have increases for capital expenditure included in the current Pricing Submission(s).

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The statement "Robusto's pricing proposals have major limitations. These include material deficiencies of information, and calculations that are inaccurate or difficult to reconcile based on various forms of available information (both public information, as well as information provided by Robusto in its annual regulatory reporting) " is fundamentally incorrect.

In any instance where an error was identified we corrected it and resubmitted. Otherwise our proposals have been rejected out of hand without explanation or justification by ESCOSA.

In addition, we went to the trouble and expense of providing independent consulting advice from recognised experts including Wallbridge & Gilbert and Ernst Young to determine the value of the asset base and appropriate returns on capital.

The ESCOSA response to date has been to summarily dismiss, or dispute, these advices without meaningful explanation or justification.

We remain firmly of the view that our submission(s) complied with the NWIPP. The failure of the Commission to recognise this and the rejection of the Proposals on this basis is a matter about which Robusto reserves all its rights.

With the revisions noted above we submit that the Price Determination cap for residential customers should be calculated as follows, excluding taxation:

Robusto's Pricing Submission	$251,954
Less adjustments (bad and doubtful debts)	($ 9,294)
Depreciation	$ 88,300
Return on capital	$135,000
Amortised losses	$ 97,057
TOTAL	**$563,017**

Yours faithfully,

Stephen Connor
Managing Director