

OFFICIAL



SA Water Regulatory Determination 2024: Guidance paper 3

Assessing the Regulatory Business Plan

July 2022

OFFICIAL

Enquiries concerning this Guidance Paper should be addressed to:

Essential Services Commission
GPO Box 2605
ADELAIDE SA 5001

Telephone: (08) 8463 4444
Freecall: 1800 633 592 (SA and mobiles only)
E-mail: escosa@escosa.sa.gov.au
Web: www.escosa.sa.gov.au

Any queries on SA Water Regulatory Determination 2024 should be directed to:

Julia Oakley, Director, Consumer Protection and Pricing

Related reading

This Guidance Paper should be read in conjunction with the Framework and Approach paper and any other Guidance Papers released by the Commission for SA Water Regulatory Determination 2024. Those papers and other relevant information are available on the Commission's website:

Framework and Approach: <https://www.escosa.sa.gov.au/projects-and-publications/projects/water/sa-water-regulatory-determination-2024-framework-and-approach/sawrd2024>

Guidance Papers: <https://www.escosa.sa.gov.au/industry/water/retail-pricing/sa-water-regulatory-determination-2024/guidance-papers>

Timing for this review and upcoming consultation opportunities

While the Commission remains responsible for making the final regulatory determination, the review process will involve multiple opportunities for stakeholders to be involved prior to that final determination.

Input from a diverse range of stakeholders is important, as it helps the Commission to make better informed and more inclusive decisions. The Commission will therefore draw on the full range of evidence provided by all stakeholders in making the final determination.

Feedback on this paper and any other matters related to SA Water Regulatory Determination 2024 is welcome.

1 Purpose

This Guidance Paper sets out at a high level how the Commission will approach the assessment of SA Water's Regulatory Business Plan for SA Water Regulatory Determination 2024.

The Commission will make a new regulatory determination to apply to the water and sewerage retail services provided by SA Water Corporation (**SA Water**) from 1 July 2024 to 30 June 2028: SA Water Regulatory Determination 2024 (**SAWRD24**). SAWRD24 will set the maximum revenues that SA Water can earn from its customers over that four-year period, and the service standards it must deliver for its customers.

The SAWRD24 Framework and Approach¹ sets out the key timing, process and governance matters, for the regulatory determination process, which challenges SA Water to:

- ▶ provide water and sewerage services at the lowest sustainable price for the quality and reliability levels valued by customers, and
- ▶ have and deliver against sound long-term asset management, operating and financing strategies, which support the provision of those services for present and future customers.

A key element of the regulatory determination process is the development of a Regulatory Business Plan by SA Water, which details its proposed expenditures and service outcomes for the four-year regulatory period. Guidance Paper 1² sets out the Commission's expectations for the matters to be addressed in the Regulatory Business Plan, and Guidance Paper 2³ explains how the Commission expects SA Water to engage with stakeholders in the development of the Regulatory Business Plan.

This Guidance Paper sets out, at a high level, the Commission's approach to assessing the Regulatory Business Plan and the key areas of the Commission's methodology that are expected to be consistent with the approach taken in SAWRD20. The approach set out in this paper should be taken into account by SA Water as it develops the Regulatory Business Plan, and is intended to maximise the transparency of the Commission's work to prepare SAWRD24.

Feedback from stakeholders on any of these matters is welcome.

1.1 Prudent and efficient expenditure

In setting regulated revenues that recover the lowest sustainable costs of providing retail services, the Commission will be assessing whether or not SA Water's proposed expenditure for the 2024-28 regulatory period is **prudent** and **efficient**.

Broadly speaking, expenditure on an activity will be considered **prudent** where there is a clear justification for that activity. Decisions on whether or not expenditure is prudent will be informed by the Commission's consideration of whether the expenditure is driven by:

- ▶ a legislative or regulatory obligation, which SA Water must comply with
- ▶ an expectation that the activity will deliver benefits to customers that outweigh the costs
- ▶ a clear expectation from customers that an outcome should be achieved, and that they are willing to pay for that outcome.

Expenditure is likely to be considered **efficient** where it represents the lowest sustainable (or 'long-term') cost of achieving the intended outcome. The Commission will set revenues to recover efficient costs only, as this will help deliver the lowest sustainable prices to SA Water's customers.

¹ Framework and Approach available: [SAWRD24-FrameworkAndApproach-Final](#)

² Guidance Paper 1 available: [GuidancePaper1-RegulatoryBusinessPlan.pdf](#)

³ Guidance Paper 2 available: [GuidancePaper2-Stakeholder-engagement-for-RBP.pdf](#)

In order to make its decisions about whether SA Water's proposed expenditure for SAWRD24 is prudent and efficient, the Commission's approach is to:

- ▶ establish an efficient base year for operating expenditure, which is normalised to exclude any one-off or abnormal costs/revenues (this was 2018-19 for SAWRD20 and is likely to be 2021-22 for SAWRD24)
- ▶ scrutinise a representative sample of operating and capital expenditure proposals to review the specific expenditure areas as well as SA Water's overall approach, and
- ▶ identify areas for potential efficiency gains.

The Commission's approach to setting maximum revenues provides SA Water with an incentive to find ways to become more efficient over time by incurring operating costs that are below those set under the determination, as it is able to retain the benefits of any cost savings until the commencement of the following regulatory period. From that time, those operating cost savings are delivered to customers through lower prices, as the new revenue determination will use those lower costs as the starting point for setting future expenditure amounts.

For SAWRD20, the Commission asked SA Water to propose a general efficiency target, and after consideration of its proposal, set an efficiency target of two percent per annum for capital expenditure and 0.5 percent per annum for operating expenditure (with exclusions such as labour costs). This was complex, and difficult to understand and measure.

For SAWRD24, the Commission expects SA Water to propose expenditures that are **net** of efficiency and productivity gains. It is also appropriate that the Regulatory Business Plan may include proposed expenditures for initiatives that will deliver future efficiency savings.

For clarity, the Regulatory Business Plan should include information about the efficiency and productivity gains included in SA Water's proposed revenue requirement: these should be explained, quantified and split by capital and operating expenditure.

In assessing the Regulatory Business Plan, the Commission will form a view on areas where SA Water's efficiency may be below relevant benchmarks or to reflect continuous improvement in systems and processes, with reference to the efficiencies that SA Water has historically been able to achieve. This view will be reflected in the revenue caps in the draft Determination.

Compared to the SAWRD20 approach, the Commission considers that the planned approach to efficiency for SAWRD24, setting "outcome" rather than "input" targets, will provide SA Water with greater flexibility to run its business while achieving the outcomes required, and can also accommodate the inclusion of any efficiency or savings requirements imposed on SA Water by the Government.

1.2 Updated revenue requirement model

As set out in the SAWRD24 Framework and Approach, SA Water is required to provide its Regulatory Business Plan to the Commission in June 2023, with the draft Regulatory Determination planned for publication in November 2023.

Given that the Regulatory Business Plan and draft Regulatory Determination are both substantial documents, wide-ranging and intensive analysis must be undertaken in a relatively short timeframe. In order to mitigate these time pressures, and maximise the quality of analysis, the Commission is bringing forward as much preliminary analysis as possible. For example, external advice is being sought in 2022 on the demand adjustment mechanism that was a requirement of both SAWRD16 and SAWRD20 to identify areas for improvement that can be incorporated in SAWRD24.

During 2021 and 2022, collaborative work by SA Water and the Commission has led to agreement on a long-term revenue requirement model to be used for SAWRD24. Similar but separate models were used by SA Water and the Commission for SAWRD20 to model key inputs such as financial parameters (inflation, weighted average cost of capital, tax), information about the regulated asset base (value and

life expectancy), and proposed operating expenditure, and to calculate key outputs such as the revenue caps for drinking water and sewerage retail services. The new shared revenue requirement model has been streamlined and enhanced, and undergone independent review, and its use will contribute to more effective and efficient information exchange and analysis when the draft Regulatory Determination is being prepared.

The revenue requirement model supports a modelling timeframe of approximately 50 years, which enables the long-term revenue requirement (economic cost) for SA Water's drinking water and sewerage retail services to be estimated over this period. The benefits of this estimation process include the ability to better understand the long-term impact of major expenditure decisions made now. This supports and informs long-term strategic and asset planning.

Establishing an agreed model well in advance of the draft Regulatory Determination process enables early modelling of the baseline revenue requirement for SAWRD24. This can be done through a process such as:

- ▶ **Step 1:** Forecasting the long-term revenue requirement based on SAWRD20 rolled forward without any allowance for demand growth or changes to services. This establishes the revenue requirement to maintain current service levels and operations, based on SA Water's forecast renewal capital expenditure (and associated asset lives), operating costs, and existing assumptions regarding the statewide pricing approach and the rate of return on assets.
- ▶ **Step 2:** Updating the revenue requirement calculated in Step 1 to allow for demand growth, with no change to services or the assumptions regarding statewide pricing and rate of return. Demand growth will mainly impact operating costs, renewal asset expenditure, and customer numbers.
- ▶ **Step 3:** Updating the revenue requirement calculated in Step 2 to allow for changes in external factors since SAWRD20 that impact the weighted average cost of capital (**WACC**).

This three-step process should result in an estimate of the baseline revenue requirement (economic cost) for SA Water to maintain and operate its asset base on a "business as usual" basis, prior to consideration of proposed expenditures for service enhancement, new or revised external obligations, and efficiency savings. Historically, this modelling has not commenced until the Regulatory Business Plan was received.

Early estimates of revenue requirements will support and inform the preparation of the Regulatory Business Plan and the draft Regulatory Determination through:

- ▶ supporting early identification of any potential revenue requirement increases or decreases based on movements in key inputs since 2020
- ▶ providing a starting point for the consideration of potential additional expenditures proposed by SA Water in the Regulatory Business Plan
- ▶ informing early discussion about the potential robustness of SA Water's long-term plans in an environment with continuing input cost pressures
- ▶ enabling early assessment of affordability for customers in an inflationary environment with increased cost of living pressures, and
- ▶ supporting early understanding of the cost of potential new or revised external obligations, including those imposed by regulators and the Government.

The Commission proposes to work with SA Water on this modelling process during the period July – December 2022, and considers that the bringing forward of this analysis should inform both the development of SA Water's Regulatory Business Plan, and the preparation of the draft Regulatory Determination, through early clarity about the "business as usual" revenue requirements and the potential pricing impacts of additional proposed expenditures. This will enable a sharp focus on affordability and sustainability, in the long-term interests of consumers.

1.3 Primary focus areas

The Commission expects SA Water's Regulatory Business Plan to provide robust explanation and analysis in relation to all proposed expenditures; the list below identifies areas of particular importance:

- ▶ **External context:** The external environment, including State Government policy and directions and changes in regulatory obligations, may materially affect expenditures. This may include environmental, social, or governance obligations imposed by the Government. External context also includes demand and supply conditions, as well as external cost pressures such as COVID-19 outcomes, and international supply chain impacts, and what measures SA Water will take to mitigate these.
- ▶ **Integration with long-term strategy:** The Regulatory Business Plan should make sense as a coherent subset of SA Water's long-term strategy and plans. It should be clear how expenditures proposed for 2024-28 fit with long-term strategies and plans, and why they must occur in this period.
- ▶ **Valid reasons for expenditure:** Each major proposed expenditure should meet the prudent and efficient expenditure criteria, have a clear driver and expected outcome, and clear links to either delivery of core services to the required standards, or to improvement, growth, renewal, or enhancement of core services.
- ▶ **SAWRD20 outcomes:** SA Water should explain how its actual expenditure during 2020-24 was prudent and efficient, including how proposed expenditures may have been reprioritised or deferred. This review informs additions to SA Water's regulated asset base for SAWRD24, and also may help to identify any systemic issues that may require further analysis as part of the SAWRD24 process.
- ▶ **Stakeholder engagement:** what stakeholder engagement activities have occurred and how have they informed proposed expenditures.

This Guidance Paper expands on the Commission's high-level expectations in each of these areas.

2 External context

In the Regulatory Business Plan, SA Water needs to explain how it identifies major changes in its external operating environment as early as possible, and explain the impact of any such changes for 2024-28 and longer term, the associated costs, and risk mitigation strategies.

In order to assess the Regulatory Business Plan, the Commission needs to develop a strong understanding of any current or expected major changes to SA Water's external environment. This includes changes to:

- ▶ Government policy, including through the SA Water Charter, or through any Pricing Orders or Ministerial Directions that will apply for the regulatory period
- ▶ minimum regulatory obligations that will mean major cost impacts for SA Water to comply, and
- ▶ changes to the efficient cost of financing new and existing regulated assets.

While the Commission will take steps to inform itself about major changes in SA Water's external operating environment, it is important that the Regulatory Business Plan identifies what SA Water considers to be major changes, and clearly explains how SA Water plans to respond and how the associated costs are prudent and efficient.

Other relevant factors in the external environment the Commission needs to understand include unforeseen or unpredictable changes, such as international supply chain-related impacts or extreme weather conditions, and significant emerging economic issues such as an unexpected increase in new housing developments, or supply chain and materials cost pressures and delays.

The Regulatory Business Plan needs to explain what action SA Water is taking to identify major changes in the external environment as early as possible, what the expected impacts are for both the regulatory period 2024-28 and the longer term, and how it plans to mitigate the associated risks and potential cost impacts.

2.1 Treatment of cost pressures

The Commission expects SA Water to manage its key cost inputs to ensure that only prudent and efficient expenditures are passed through to its customers. Key cost inputs include plant, electrical equipment, pipes, concrete and aggregate, basic chemicals, construction, electricity costs, and labour costs. Several of these areas are discussed briefly below, as well as COVID-19 related costs.

2.1.1 Material costs

In analysing the Regulatory Business Plan, the Commission will consider the evidence for key material cost input pressures, the steps that SA Water has taken or will take to mitigate these cost pressures (for example, long-term contracting arrangements, substitution of key materials), and the flow on impact to proposed expenditures for the 2024-28 regulatory period. The Commission expects SA Water to form a view on the short, medium and long-term trends in material costs and adjust its work program and procurement approaches accordingly to minimise costs.

2.1.2 Electricity costs

Electricity costs amounted to approximately 13 per cent of total efficient operating expenditure for SAWRD20, and 11% for SAWRD16.⁴

SA Water's zero cost energy future initiative (**ZCEF**), is intended to reduce electricity operating expenses, through seven key initiatives including the installation of solar panels and battery storage at SA Water sites. SA Water has installed 367,000 solar panels at 33 sites and 34 megawatt hours of battery storage.⁵ As part of SAWRD20, both the costs and expected future savings of this initiative were excluded from the regulated asset base and the revenue caps, on the basis that the majority of the program's benefits come from exporting energy to the national electricity market, rather than avoiding electricity purchase costs.⁶

For SAWRD24, the Commission will continue to exclude the assets and potential electricity expense savings associated with ZCEF from the revenue cap, regulated asset base, and proposed expenditures. As the electricity expense allowed as part of SAWRD24 will need to be based on market pricing, the Commission will only allow energy costs that are prudent and efficient and would reflect a well-managed approach to electricity purchasing and management in the absence of the ZCEF assets. This approach ensures customers still benefit from an efficient approach to managing electricity expenses while not exposing them to any market risks SA Water faces as an electricity generator in the National Energy Market.

2.1.3 Labour costs

Labour costs amounted to approximately 26 percent of total efficient operating expenditure for SAWRD20.⁷ The key drivers of SA Water's labour costs are the price of labour (wages and associated costs) and the number of people employed (or hours worked). The expectation set out in SAWRD20⁸

⁴ Page 121-122 of Final Determination: Statement of Reasons published June 2020 available here: <https://www.escosa.sa.gov.au/ArticleDocuments/21489/20200611-Water-SAWRD20-FinalDetermination-StatementOfReasons.pdf.aspx?Embed=Y>

⁵ Based on information on SA Water website published 20 October 2021: <https://www.sawater.com.au/about-us/our-vision-and-strategy/annual-report/proactive-environmental-leadership>

⁶ Section 4.3.1.2 of Final Determination: Statement of Reasons (pp48-49).

⁷ Page 121 Final Determination: Statement of Reasons

⁸ Page 122 of Final Determination: Statement of Reasons

was that SA Water should be able to adjust these elements to ensure that increases in total labour costs do not exceed CPI.

The Commission will look for evidence that SA Water is effective in achieving labour productivity gains, and take this into consideration when determining whether CPI remains an appropriate upper limit for overall labour cost growth for SAWRD24.

2.1.4 COVID-19 related costs

SAWRD20 did not include any adjustment to SA Water's expenditure requirements on the basis of COVID-19 impacts, given the lack of evidence at that time to support quantification of the impacts.⁹ At the time, the Commission noted that if there were to be any material increases in expenditure during the 2020-24 regulatory period relating to COVID-19, these could be addressed through the cost pass-through mechanism included in the Regulatory Determination.¹⁰

If, as appears likely at this stage, the ultimate impacts of COVID-19 on SA Water's operating expenses are immaterial, then no allowance for these impacts will be required in SAWRD24. SA Water will need to provide evidence of any proposed expenditures relating to COVID-19 for 2024-28 in the Regulatory Business Plan.

2.2 Treatment of proposed expenditures to address climate change risks

The Commission's primary objective, as set out in section 6 of the *Essential Service Commission Act 2002*, is to protect the long-term interests of South Australian consumers with respect to the price, quality and reliability of essential services. As an economic regulator, it is not the Commission's role to determine what initiatives or investments SA Water should be pursuing in order to address climate change related risks. Where the South Australian Government provides clear direction to SA Water to undertake such initiatives, through SA Water's charter or Ministerial directions, then these initiatives will be included in the revenue caps, with appropriate scrutiny of whether the proposed expenditures are prudent and efficient.

In the absence of clear direction from the Government regarding climate change related initiatives, the Commission will need to consider any such proposals in the Regulatory Business Plan based on whether the climate change risk to be addressed directly impacts the long-term interests of consumers, for example, through water security impacts from increasing average temperatures, or dam safety with increased flood events. The Commission must also consider whether it is appropriate for consumers to pay for, and share the risk of, such initiatives (as it did in relation to ZCEF).

The international Financial Stability Board's *Final Report – Recommendations of the Task Force on Climate-related Financial Disclosures (TCFD)*¹¹ identifies two major categories of climate-related risk:

- ▶ **Transition risks**, related to the transition to a lower-carbon economy. These include risks related to policy change and litigation, technology, markets, and corporate reputation.
- ▶ **Physical risks**, related to the physical impacts of climate change. These can be related to catastrophic events (acute) or ongoing climate pattern changes (chronic), and can directly impact corporate assets, as well as indirectly impact supply chains and financial performance.

⁹ Page 131-132 of Final Determination: Statement of Reasons

¹⁰ Section 2.10 of Price Determination published 1 July 2020 and available here: <https://www.escosa.sa.gov.au/ArticleDocuments/21489/20200611-Water-SAWRD20-FinalPriceDetermination.pdf.aspx?Embed=Y>

¹¹ In 2017, the Financial Stability Board, an international body of financial regulators, released the final recommendations from its Task Force to provide a global framework for organisations on climate-related financial reporting, available here: <https://assets.bbhub.io/company/sites/60/2021/10/FINAL-2017-TCFD-Report.pdf>

The Task Force also identifies that opportunities for organisations may arise through climate-related activities:

“...for example, through resource efficiency and cost savings, the adoption of low-emission energy sources, the development of new products and services, access to new markets, and building resilience along the supply chain.”¹²

The Commission’s preliminary view is that proposed expenditures relating to transition risks or physical risks will be considered for inclusion within the revenue caps, where SA Water demonstrates a strong link between the risk to be addressed and the long-term interests of consumers, and that it is appropriate for consumers to pay for, and share the risks, and that the proposed expenditures are prudent and efficient. Proposed expenditures to address climate-related opportunities will have a higher bar to meet, as do any service enhancement or opportunistic initiatives.

The Commission will continue to develop and mature its approach to the treatment of climate-related risk expenditures over the coming months.

3 Integration with long-term strategy

The Regulatory Business Plan **must** be a subset of SA Water’s long-term strategies and asset management plans. High quality and robust asset management plans are an essential input to the calculation of the revenue caps.

The Regulatory Business Plan should be a sub-set of SA Water’s long-term plans. It should provide a detailed analysis of the specific program of work required in the regulatory period in order to deliver SA Water’s long-term goals for customers. It should be clear how proposed expenditures:

- ▶ fit within long-term plans and strategies
- ▶ are prudent – need to be done and must be done in the regulatory period
- ▶ are efficient – represent the lowest sustainable cost to achieve the outcome.

As decisions made in one four-year regulatory period will necessarily have flow-on impacts to future plans, the Regulatory Business Plan should clearly articulate how the proposed expenditures for the regulatory period have been prioritised consistently to meet required standards, ensure long-term sustainability, balance any potential trade-offs, and deliver customer benefits.

The regulatory determination process also provides an external and independent assessment of SA Water’s capital and operating expenditure plans. This includes assessing whether SA Water’s decision-making systems and processes are consistent with the principles set out in its asset management framework, and whether there is evidence of good governance and continuous improvement.

The Commission expects SA Water’s asset management plans to be long-term – reflecting the life of the assets managed – and updated regularly. Successive versions of the long-term asset management plans should acknowledge and explain material differences between the versions, so that stakeholders and the Commission can reconcile changes over time.

Greater clarity in the Regulatory Business Plan about major changes in the external environment (current or anticipated) and strong links between proposed expenditures for the regulatory period and well-constructed long-term plans and strategies, will ensure there are “no surprises” in the Regulatory Business Plan, and support the Commission’s assessment process.

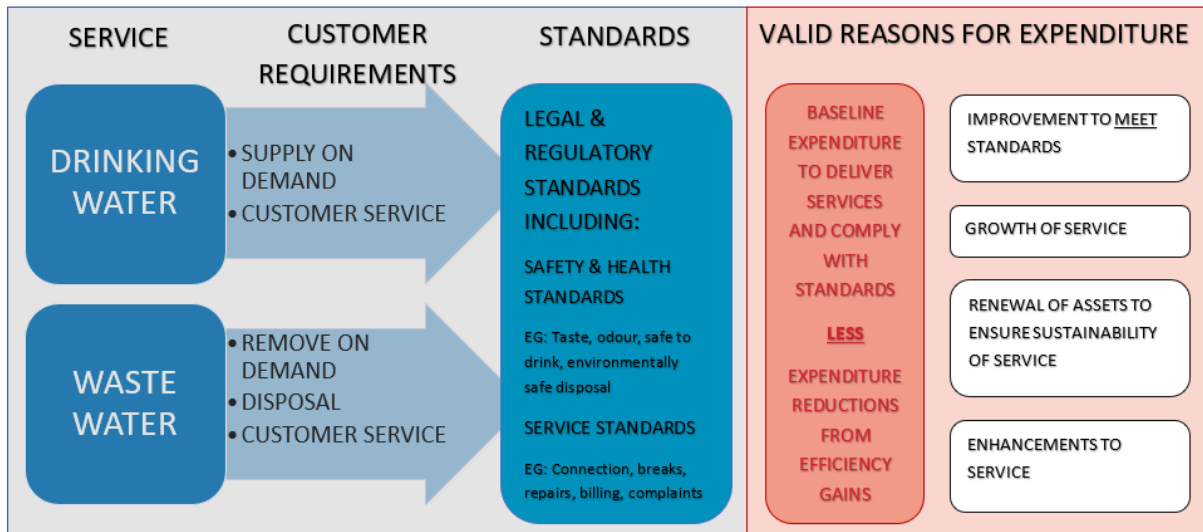
¹² Page 6 of TFCD report

4 Valid reasons for expenditure

The Commission expects to see clear explanations of how SA Water’s proposed expenditures relate to either delivery of core services to the required standards, or to essential renewal, growth, or improvement of core services.

For the purposes of the regulatory determination, the Commission describes SA Water’s core business using the model below:

Figure 1: SA Water simple business model for regulatory determination



During the regulatory determination process, the Commission will review a sample of proposed expenditures across all the areas shown in the model above, with a focus on integration with long-term plans, as set out in section 3, and whether expenditure is prudent and efficient. Consistent with its past approach, the Commission will not assess all projects and programs SA Water intends to undertake in the next regulatory period. The sample of expenditures allows the Commission to assess the effectiveness of SA Water’s internal planning processes to develop a robust forward program of expenditures. For SAWRD20, the sample covered water and sewerage, metropolitan and regional areas, and a range of asset types, and the same sampling approach will be used for SAWRD24, with actual projects and programs for analysis to be selected once the Regulatory Business Plan is received.

Findings from this review are then used to determine expenditure benchmarks which are established at a level that should support SA Water, acting as a prudent and efficient business, to meet known obligations and service standards. The expenditure benchmarks are a key input for the calculation of the two maximum revenue caps: for water retail services and sewerage retail services.

For clarity, the table below maps the operating and capital expenditure categories used for SAWRD20 against the valid reasons for expenditure in the model above. This highlights a change in relation to the treatment of IT related expenditures.

Table 1: Mapping of expenditure categories for SAWRD20 and SAWRD24

SAWRD20 Key Investment Driver	SAWRD24 Valid Reason for Expenditure
External responsibilities	Baseline expenditure to deliver services and comply with standards Improvement to meet standards
Sustaining services	Renewal of assets to ensure sustainability of service
Improving services	Enhancements to service
Enabling growth	Growth of service
IT expenditure	Can map to any of the valid reasons for expenditure, but is not a separate category

In SAWRD20, IT operating and capital expenditure proposals were treated as a separate category.¹³ For SAWRD24, the Commission expects IT expenditure to be categorised under one of the valid reasons for expenditure from the model above, rather than treated as a separate category, as the Commission views IT expenditure as primarily an enabler of service delivery, improvement, and growth. Any proposed IT expenditure should have a clear connection to one of the valid reasons for expenditure, that can be articulated.

The sections below set out at a high-level key considerations for each category of proposed expenditure, and should be read in conjunction with Guidance Paper 1, which summarises what should be in the Regulatory Business Plan for each category.

For **every** category, the Commission expects to see evidence that SA Water has considered a range of options in order to arrive at the most prudent and efficient option, clear links to valid expenditure drivers, and evidence of genuine, robust and diverse stakeholder engagement and support.

4.1 Baseline expenditure for service delivery

Analysis of baseline expenditure for service delivery will be informed by the modelling described in section 1.2 above. In assessing operating and capital expenditure proposals in this category, the Commission will be looking for evidence that:

- ▶ any additional operational expenditure is net of all off-setting efficiencies or savings, as set out in section 1.1, and
- ▶ any reasons for material departures from historical expenditure levels have been well explained to stakeholders, and understood and accepted as reasonably justified.

4.2 All other expenditure

Other than baseline service delivery, all other expenditure proposals must be clearly linked to one of the valid reasons for expenditure in Figure 1.

4.2.1 Improvement to meet changed standards

If there are changes to the safety, health, service or other legally-binding or regulatory standards that SA Water is legally required to meet and which demonstrably have an associated additional cost, then expenditure to achieve compliance with these changed standards may be reasonable and appropriate in principle. The Regulatory Business Plan should articulate any such standards and set out a considered proposal to achieve ongoing compliance. SA Water should not make proposals to exceed required standards, unless this can be achieved at no additional cost to customers.

¹³ Page 113 of Final Determination: Statement of Reasons

As for SAWRD20, the Commission has convened a Regulators Working Group to provide a forum for the economic, environmental, public health, social and technical regulators to share information and emerging trends in their joint regulation of SA Water. Member organisations for SAWRD24 are:

- ▶ Department for Environment and Water
- ▶ Department of Treasury and Finance
- ▶ Environment Protection Authority
- ▶ Office of the Technical Regulator
- ▶ SA Health
- ▶ The Commission.

The Regulators Working Group has begun its work to identify potential changes to regulatory obligations that may impact SA Water's Regulatory Business Plan. The Commission will continue to work with both the Regulators Working Group and SA Water to identify and confirm changes to regulatory outcomes that SA Water will be expected to achieve, at the lowest possible cost.

In assessing operating and capital expenditure proposals in this category, the Commission will be looking for clear explanation of any changes in the standards SA Water is required to meet, and the work required in order to meet the changed standards.

4.2.2 Growth of service

SA Water needs to expand its network to meet increasing demand, either within its current distribution area or as directed by Government or permitted by legislation. Expenditure proposals to meet such requirements need to clearly set out the prudent and efficient costs to meet that demand over time. The Commission expects SA Water to ensure that proposed expenditures of this nature are based on reliable and multiple data sources, and firm commitments from potential major customers.

In assessing operating and capital expenditure proposals in this category, the Commission will be looking for evidence that SA Water's forecasts for growth are based on reliable data sources, including an assessment of the historical accuracy of these forecasts.

4.2.3 Renewal of assets to ensure sustainability of service

The Regulatory Business Plan needs to clearly articulate the expenditures proposed in the regulatory period to renew assets in order to ensure the long-term viability of its services, demonstrating clear and logical prioritisation, strong integration with long-term asset management plans, and efficient use of resources.

While this category of expenditure is clearly linked to baseline service delivery, the emphasis here is on proposals where material amounts of additional capital expenditure are proposed rather than just ongoing maintenance activities.

In assessing operating and capital expenditure proposals in this category, the Commission will be looking for evidence that SA Water's asset management plans are robust, transparent, well-constructed and regularly updated and reconciled. Proposals in this category should be easily understood as a coherent subset of the long-term asset management plan as highlighted in section 3.

4.2.4 Enhancements to service

Any proposed expenditures to enhance services that do not fall into the categories listed above must clearly articulate the costs and benefits to customers, as well as providing evidence of engagement with customers in relation to a proposal, and whether there is stakeholder, legislative, policy or other support for it.

Proposed expenditures in this category are subject to the greatest level of challenge in terms of the requirement for the expenditure, the options considered and the efficient costs.

In assessing operating and capital expenditure proposals in this category, the Commission will be looking for evidence that the benefits to customers outweigh the costs. It is expected that customers want and value these improvements.

5 SAWRD20 outcomes

Understanding whether SA Water's actual expenditure was prudent and efficient will inform SAWRD24

It is to be expected that SA Water's actual expenditure within a regulatory period will differ from the forecasts used to determine the maximum revenue caps. This may be due to unforeseen external factors, management action to improve the business or changes that result from obtaining more information about assets and projects.

Each regulatory determination is, in effect, an *ex-ante* assessment of the prudent and efficient expenditure required to provide retail sewerage and drinking water services, including an assessment of forecast expenditure requirements. An *ex-post* analysis of actual expenditure, and key areas of variation from forecast expenditures, assists with identifying where efficiency improvements have occurred, and also may help to identify problematic business practices or asset management approaches. It is also intended to incentivise prudent and efficient behaviour during the regulatory period as proposed expenditures need to be adjusted and reprioritised.

Therefore, in addition to reviewing SA Water's proposed expenditures in the Regulatory Business Plan for 2024-28, the Commission will also review actual expenditures during the period 2020-24 to assess whether major changes to the forecast expenditures for that period were prudent and efficient. This approach is consistent with SAWRD20, and helps the Commission to determine the efficient base year for operating expenditure for SAWRD24 and to assess any proposed increases in ongoing operational expenditure, as well as any material variations to capital expenditure for baseline service delivery.

As part of an *ex-post* review, SA Water should be able to explain why any major actual expenditures that were not part of the SAWRD20 Regulatory Business Plan were considered to be prudent and efficient decisions during the period. It should also be able to explain the customer benefits of these actual expenditures, and what trade-offs and reprioritisation occurred to accommodate these expenditures within the maximum revenue cap. This protects customers, by ensuring that only prudent and efficient investments are added to the regulated asset base.

SA Water also must highlight any planned expenditures for the 2020-24 period that were deferred and are being proposed again for SAWRD24, and explain why this is the case.

6 Key areas of methodology consistent with SAWRD20

There are a number of areas of the Commission's methodology that underwent rigorous examination and scrutiny as part of SAWRD20, and as a consequence, are not intended to be revisited in such detail for SAWRD24, unless unforeseen circumstance arise which would warrant this.

To make its determination, the Commission does not simply pass through SA Water's proposed or actual costs, as this would provide no incentive for SA Water to operate efficiently. The Commission forecasts SA Water's costs based on a hypothetical efficient business of similar structure to SA Water, that has the obligations of SA Water. In order to do so, the Commission specifically assesses:

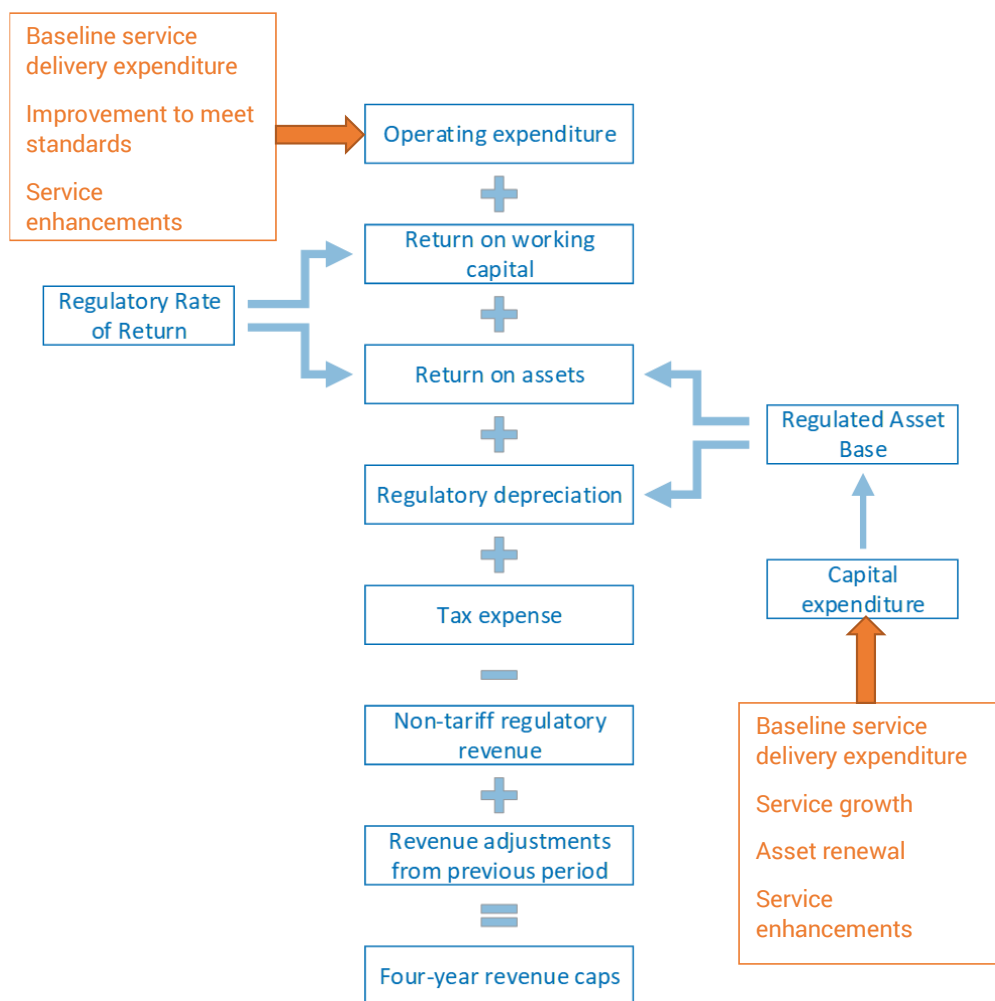
- ▶ the costs to produce or supply the retail services
- ▶ the costs to comply with external legal and regulatory obligations (including the minimum service standards developed by the Commission)

- ▶ the return on assets in the water industry
- ▶ relevant benchmarks for prices, costs, and return on assets in comparable industries, and
- ▶ the financial implications of the determination for SA Water.

The revenue caps for SAWRD20 were determined using the cost building block approach, in accordance with the Pricing Order issued by the Treasurer.¹⁴ This approach was also mandated for SAWRD16. The Commission proposes a continuation of this approach for SAWRD24, subject to any alternative approach that may be required under a Pricing Order issued by the Treasurer for the period 2024-28.

The diagram below summarises the building block model, and highlights where the reasons for expenditure discussed above are most likely to feed into the model:

Figure 2: Building Block Model



The structure outlined in Figure 2 is reflected in the revenue requirement model, discussed in section 1.2 above.

¹⁴ See section 6: [Pricing-Order-for-the-Regulatory-Period-1-July-2020-to-30-June-2024.pdf](#)

6.1 Future Guidance Papers

There are a number of areas where the Commission's methodology was extensively reviewed and interrogated as part of SAWRD20. At this stage, the Commission does not intend to publish Guidance Papers on the areas set out below, but this approach may be revisited if the Commission considers it is warranted as the regulatory determination process progresses, or if required as a consequence of a Ministerial direction or pricing order:

- ▶ **Excluded services and recycled water:** Ongoing compliance and any issues raised will continue to be monitored.
- ▶ **Real rate of return:** The Commission's initial position is that the SAWRD20 approach to the risk-free rate, cost of debt, market risk premium, gearing proportion, and equity beta parameter will be maintained. Long-term inflation expectations is the exception, as an area where the Commission is likely to revisit its approach for SAWRD24 based on its monitoring of current economic developments.
- ▶ **Supply optimisation and the treatment of River Murray licences:** This will not be revisited unless material water security issues emerge.

Areas of the Commission's approach where further work and refinement is planned or in progress include:

- ▶ the demand variation adjustment mechanism, which allows for adjustment to the revenue caps based on material differences between forecast and actual demand during the regulatory period
- ▶ long-term inflation expectations, as noted above
- ▶ the treatment of hedging, supply chain costs and project deferrals, and
- ▶ review of the SAWRD20 intra-period mechanism, including how it should be improved or whether it could be replaced with a different pass-through mechanism.

Further information about these areas will be released as work progresses.

7 Stakeholder Engagement

The Commission is committed to stakeholder engagement, and expects SA Water to invest significant effort in relevant activities when developing the Regulatory Business Plan. The Commission will also conduct its own stakeholder engagement as part of SAWRD24.

7.1 SA Water's stakeholder engagement

Stakeholder input can help the Commission assess whether or not expenditure proposals are prudent and efficient. The Commission's expectations for how SA Water engages with stakeholders in the preparation of its Regulatory Business Plan are set out in Guidance Paper 2.

Essentially, the Commission expects SA Water to demonstrate, with robust evidence in the Regulatory Business Plan, that:

- ▶ it has engaged in a meaningful and substantial way with an appropriately diverse range of stakeholders
- ▶ it has used an appropriately diverse range of channels and methods to engage with stakeholders, and
- ▶ stakeholder views and feedback have been carefully considered and incorporated into project design and prioritisation.

The Commission is likely to engage directly with the stakeholders involved in SA Water's Customer Challenge Group, Peak Bodies Engagement Forum, and other key bodies to obtain their direct feedback on how the content of the Regulatory Business Plan reflects their views, and how the process was managed by SA Water.

7.2 Commission's stakeholder engagement

Once SA Water has submitted its Regulatory Business Plan in July 2023, the Commission will assess the Plan in accordance with the statutory framework. In accordance with its *Charter of Consultation and Regulatory Practice*,¹⁵ the Commission will seek the views of all stakeholders, whether involved in the preparation of the Regulatory Business Plan or not. It is important to the Commission that customers are able to see the efficacy of the regulatory determination process, and that there is a strong focus on their needs.

The Commission intends to allow for an eight-week consultation period on the Regulatory Business Plan, in order to maximise the time available to stakeholders to prepare their responses.

Once it has considered all submissions received, the Commission will prepare its draft Regulatory Determination and release it for consultation no later than November 2023. This will include a detailed Statement of Reasons as well as a draft revenue determination. Stakeholders will have a further eight-week period to review the draft Determination and make their submissions.

After considering all submissions on the draft Determination, the Commission will publish its final Determination by May 2024.

The Commission is committed to engaging with a broad range of stakeholders through diverse channels, and will be available for meetings, workshops and discussions as needed.

The Commission has also commenced holding six-monthly workshops to bring together all key stakeholders and their representative organisations, with the first workshop for SAWRD24 held in December 2021. At minimum, members of the SA Water Customer Challenge Group, Peak Bodies Engagement Forum, and the Commission's Regulators Working Group and Consumer Advisory Committee have been and will be invited.

¹⁵ Available here: <https://www.escosa.sa.gov.au/ArticleDocuments/11387/20191112-Corporate-CharterOfConsultationRegulatoryPractice.pdf.aspx?Embed=Y>



The Essential Services Commission
Level 1, 151 Pirie Street Adelaide SA 5000
GPO Box 2605 Adelaide SA 5001
T 08 8463 4444

E escosa@escosa.sa.gov.au | W www.escosa.sa.gov.au