



SA Water Regulatory Determination 2016

Draft determination: Statement of reasons

February 2016

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Disclaimer

The Commission has considered and reviewed matters raised in the written submissions and undertaken further research as to practices and matters relevant to this review.

The Commission has been assisted by the submissions it has received through this review process. The issues raised by stakeholders through the consultation period have been carefully considered and, where relevant, certain arguments and submissions have been mentioned in the text, either by direct quotation or by reference to themes or arguments, to assist stakeholders to understand the proposed positions that have been reached.

However, a failure to reference an argument or submission does not mean that it has not been taken into account in reaching the final positions. While not all of the positions put in the submissions have been adopted, all submissions have informed the consideration of each of the relevant issues and the competing viewpoints.

The Commission disclaims all responsibility and liability (including, without limitation, liability in negligence) for all expenses, losses, damages, costs or other injury incurred by any person accessing or relying on a published submission as a result of the information contained in that submission being inaccurate or incomplete in any way.

Executive summary

Following a detailed independent review and an opportunity for public submissions, the Essential Services Commission (**Commission**) is consulting on a proposed revised regulatory framework to apply to SA Water for the period 1 July 2016 to 30 June 2020 (**RD16**). Interested parties are invited to make further submissions and provide feedback on the proposals in this draft RD16 by Thursday, 24 March 2016. Their views and feedback will inform the RD16 final determination to be made in June 2016.

RD16 will be the second regulatory determination under the legislative regime established for the water industry in 2012. The first determination (**RD13**) applies for the period 1 July 2013 to 30 June 2016. This proposed new determination will build on the outcomes of that initial determination.

Overall, this draft RD16 seeks to continue to deliver the consumer benefits achieved through RD13, and provides incentives to SA Water to deliver additional financial and management efficiencies over the coming four years and beyond. It proposes:

- ▶ A robust, effective, simplified and customer-focused consumer protection regime, informed by direct feedback from SA Water's customers, to ensure that South Australian consumers have appropriate protections in their dealings with SA Water.
- ▶ Revenue caps over the four-year period for drinking water and sewerage retail services that will deliver, on an annual average basis:
 - a drinking water revenue cap that is, in real terms, one per cent lower than that applying in the RD13 period, and
 - a corresponding sewerage revenue cap that is nine per cent lower.

Compared to the current revenue controls applying under RD13, those caps will deliver a minimum of \$160 million (an average of \$40 million per annum) in savings for SA Water's customers during the RD16 period. The proposed annual average saving of \$40 million, combined with the ongoing \$50 million annual savings arising from RD13, will lead to annual revenue reductions of around \$90 million per annum for SA Water's customers (as compared with revenue outcomes in 2012, prior to the Commission commencing its independent regulatory role).

While, under the regulatory regime, SA Water sets prices for its services, those prices can recover no more than the maximum amounts set by the revenue caps. Nevertheless, if the proposals in this draft RD16 are confirmed in the final determination (in June 2016), there will be overall price reductions for customers.

- ▶ A continuation of a fit-for-purpose pricing principles regime for other retail services provided by SA Water, including recycled water and customer connections, which focuses on driving efficiency.

The available evidence indicates that SA Water has responded to the challenges and incentives provided by the Commission for RD13. SA Water has materially changed its business practices over the past three years. It is actively seeking improvements and efficiencies, has a far stronger customer and service delivery focus and has become more transparent.

In developing this draft RD16, the Commission has reviewed revenue and customer service proposals put forward by SA Water, as well as additional evidence obtained from stakeholder submissions, expert technical advisors, and from SA Water.

The Commission has found SA Water's proposals to be generally prudent and efficient. Nevertheless, it has identified the opportunity for further efficiencies in its proposed expenditure program over the RD16 period – some five per cent in relation to capital expenditure and three per cent in operating expenditure. The revenue reductions proposed in this draft RD16 incorporate those efficiencies.

Background

Under the Water Industry Act 2012, the Commission is the independent economic regulator of the retail water sector in South Australia. Its role includes the regulation of SA Water, the State's major supplier of water and sewerage retail services.

The Commission regulates the customer service and revenue aspects of SA Water's retail operations because SA Water holds a monopoly provider position in the market for those services. In the absence of competition, the potential exists for SA Water to exploit its monopoly position, either by reducing services or earning excessive revenue.

Economic regulation provides a counterbalance to that position, with the Commission able (under statutory powers) to set binding consumer protection obligations and make determinations on revenue and some pricing matters. For example, in the case of drinking water and sewerage retail services, the Commission's regulatory approach aims to provide an incentive for efficient behaviour by encouraging SA Water to incur lower expenditure than that reflected in the maximum revenue caps, while still delivering its regulatory obligations.

The formal mechanisms of economic regulation therefore provide strong incentives for SA Water to deliver services at a level valued by customers, recover no more than prudent and efficient revenues and seek out management and financial efficiencies to reduce its costs over time. However, the regulatory process does not determine the specific projects and programs which SA Water must undertake.

Customers benefit from these regulatory arrangements because they can have confidence that SA Water is meeting its customer service obligations – with strong incentives to deliver cost reductions over time – and with any reductions being passed on to customers through lower prices (as has been the case during RD13 and as is proposed for RD16).

Consumer protections

This draft proposes that, in providing drinking water and sewerage services, SA Water will be required to comply with the consumer protection framework set out in SA Water's retail licence and industry codes and guidelines made by the Commission.

Based on overall high levels of customer satisfaction observed during the period of RD13, and evidence that customers are not willing to pay more for higher levels of service, it is proposed that SA Water be required to use its best endeavours to maintain the same level of service as it achieved over the past two years.

Under this proposal, SA Water's customer service and network reliability performance would be assessed against 17 binding service standard measures. At the same time, the Commission proposes to continue monitoring and publicly reporting on a far broader range of performance measures, to give customers visibility of the nature and quality of the services provided by SA Water.

Drinking water and sewerage retail services

This draft proposes two separate revenue caps (expressed in December 2014 dollars) for each of SA Water's drinking water and sewerage retail services for the four-year RD16 period. They are:

- ▶ drinking water retail services: \$2,888.3 million over the period, and
- ▶ sewerage retail services: \$1,209.3 million over the period.

Those caps have been derived using the standard 'building blocks' regulatory approach, under which the Commission has assessed the costs that would be incurred by a notional 'prudent and efficient' firm in delivering the services SA Water is required to deliver during the period. That assessment has been informed by the proposals put forward by SA Water, as well as by public submissions made on those proposals. The key elements are as follows.

Demand

The demand forecasts, expressed in gegalitres (GL) for drinking water and connection numbers for sewerage retail services, are as follows:

- ▶ drinking water retail services:
 - 2016-17: 190.1 GL
 - 2017-18: 191.4 GL
 - 2018-19: 192.9 GL
 - 2019-20: 194.5 GL
- ▶ sewerage retail services: annual rate of sewerage connections growth of 1.2 per cent.

The Commission has considered the demand forecasts proposed by SA Water and reviewed and assessed the efficacy of the model it used to derive those forecasts. It is satisfied that the model is robust and can be relied on for the purposes of setting demand forecasts for RD16.

Operating expenditure

The building block assumption for operating expenditure in this draft is \$1,792 million (\$Dec14).

SA Water's operating expenditure costs include wages and salaries, pumping and treating water, carrying out maintenance activities, reading meters and sending customer bills and information. Unlike capital expenditure, which is gradually recovered over the life of SA Water's assets, operating expenditure is recovered as it occurs in each year.

In establishing forecasts of efficient operating expenditure, the Commission has considered the operation of the Adelaide Desalination Plant as a part of an overall optimised water supply portfolio. In that context, this draft provides for (but does not require) the operation of that plant over the coming four years in a 'minimum production' mode of no more than eight GL per annum (its maximum capacity is 100 GL per annum).

This position has been reached on the basis that, while there are some uncertainties, the financial difference between running the plant at that minimum capacity and not running it at all appears to be minimal (\$4 million per year if it is run at that level and approximately \$5 million per year in alternative water sourcing costs if it is not run). In addition, there are security of supply and operational flexibility benefits associated with having the plant available for rapid start, although those cannot be quantified at this time based on available evidence.

The Commission has also considered labour costs for RD16. In doing so, it has reached the view that the base rate of increase in the cost of labour – which is an input to the calculation of SA Water’s total labour costs – should be capped by the rate of change in the Australia-wide Consumer Price Index (CPI). SA Water had proposed a base rate of change at half a percentage point above the CPI. However, given current evidence and economic circumstances in this State, the Commission is not persuaded that a higher base rate of change is prudent and efficient.

Finally, the Commission has considered SA Water’s initiative for a self-imposed one per cent per annum operating efficiency target. The Commission welcomes this initiative and proposes to adopt the one per cent target for the first two years of RD16. However, having regard to the continuous business improvement potential identified by SA Water, the Commission has reached the preliminary position that, for the final two years of the period, an operating cost efficiency target of 1.75 per cent per annum is appropriate.

Capital Expenditure

The building block assumption for capital expenditure in this draft is \$1,163.8 million (\$Dec14).

Capital expenditure is expenditure on the purchase or creation of assets that can be utilised in the longer term. SA Water operates in a capital-intensive industry. It owns many long-life assets, such as pipe networks, dams, and water and sewerage treatment plants. Over time, existing assets may be upgraded or replaced, and network growth necessitates the construction or acquisition of new assets.

The Commission has examined a sample of the capital projects and programs proposed by SA Water for the RD16 period. The sample covered a wide range of planned investments, with the review including SA Water’s governance, capital planning, cost allocation and asset management processes.

Overall, the Commission has found that SA Water’s proposals generally reflect the expenditure that would be incurred by a prudent and efficient business. It accepts SA Water’s proposal for a capital expenditure efficiency target equalling \$60 million over the four-year period. Nevertheless, it has formed the preliminary view that there is scope for some capital expenditure reductions. These arise from some of the proposed projects for which an appropriate business case has not been made.

Rate of Return

This draft proposes four separate annual real rates of return to be applied within RD16, consistent with the ‘trailing average’ approach for calculation of the rate of return set out in the Commission’s 2015 position paper on that matter. (That approach has been adopted in this draft.)

The rates of return (on a real, post-tax basis) are as follows:

- ▶ 2016-17: 4.65 per cent
- ▶ 2017-18: 4.47 per cent
- ▶ 2018-19: 4.16 per cent
- ▶ 2019-20: 3.99 per cent

Additional features

The draft proposes that the revenue cap regime incorporate the following two additional features, to provide flexibility and ensure ongoing efficiency within the overall framework.

- ▶ A demand variation adjustment mechanism, to be given effect at the end of RD16, that will provide a regime for ensuring there are no windfall financial gains or losses arising from material variations between the forecast demand for retail services (as assumed in RD16) and the actual demand that eventuates during the period.
- ▶ A pass-through mechanism, enabling the revenue caps to be adjusted (downwards or upwards) during the next regulatory period (commencing 1 July 2020) if there is a significant change in legal obligation or an extraordinary event during RD16 that is not within SA Water's direct control, is unavoidable and has a material impact on the costs of providing retail services.

Other retail services

SA Water provides other 'excluded services' outside of drinking water and sewerage retail operations. They include the provision of both standard and non-standard connection services, trade waste services, recycled water services, hydrant and fire plug services and metering services. In each case, the relevant service is not provided on a mass-market basis (unlike drinking water and sewerage retail services). Therefore, while it is appropriate to regulate them, the form of regulation used is more light-handed.

This draft RD16 provides for a price determination for the provision of excluded services in the form of a set of principles with which SA Water must comply when setting prices.

Under that proposed approach, the Commission would not take a direct role in setting or approving fees and charges for excluded services. Instead, SA Water would be required to demonstrate that its prices complied with the applicable pricing principles (for example, requiring them to reflect efficient costs). The Commission is proposing to continue to act as the independent dispute resolution body when a customer cannot resolve with SA Water a dispute as to whether or not those pricing principles have been properly applied.

Next steps

The review process allows all stakeholders to engage with the Commission and provide submissions on the proposed decisions prior to a final regulatory determination being made in June 2016. All stages are set out below.

Stages in the SA Water RD16 review process

Date	Action
November 2013 to February 2014	Interested parties were able to make submissions to the Commission on the framework and approach to regulating SA Water's revenues and services standards for RD16.
November 2014	The Commission released a Final Framework and Approach paper to provide SA Water with reasonable certainty as it developed RBP16.
September 2015	SA Water submitted RBP16 to the Commission.
September 2015 to October 2015	Interested parties were able to make submissions to the Commission on RBP16 or other issues related to the water and sewerage retail services to be provided by SA Water in the four-year period commencing 1 July 2016.
February 2016	The Commission releases this draft RD16 for public consultation.
February 2016 to March 2016	Interested parties are invited to make submissions to the Commission on this draft RD16.
June 2016	The Commission releases RD16.
June 2016 to July 2016	SA Water commences implementation of RD16, which includes setting new water and sewerage service prices, based on the maximum revenue allowable, as determined by the Commission.
1 July 2016	RD16 comes into effect.



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