ESSENTIAL SERVICES COMMISSION OF SOUTH AUSTRALIA

Water

SA Water Regulatory Determination 2016

Final determination: Executive summary

June 2016

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Executive summary

Following a detailed independent review and stakeholder engagement, the Essential Services Commission (**Commission**) has developed a regulatory framework to apply to SA Water for the period 1 July 2016 to 30 June 2020 (**RD16**). Stakeholder views and feedback have informed this RD16 final determination. The Commission thanks those who have contributed towards this review.

RD16 is 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 new determination builds on the outcomes of that initial determination.

Overall, this 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 establishes:

- A robust, effective, simplified and customer focused consumer protection regime, informed by direct feedback from SA Water's customers, to ensure that South Australian customers 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, 2.5 percent lower than that applying in the RD13 period, and
  - a corresponding sewerage revenue cap that is 10.9 percent lower.

  Compared to the current revenue controls applying under RD13, those caps will deliver an average of $60 million per annum in savings for SA Water's customers during the RD16 period. The annual average saving of $60 million, combined with the ongoing $50 million annual savings arising from RD13, will lead to annual revenue reductions of around $110 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. This determination will, nevertheless, deliver 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 stronger customer and service delivery focus and has become more transparent.

In developing this 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 percent in relation to capital expenditure and one percent in operating expenditure. The revenue reductions determined in this 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 on its network. In the absence of competition, the potential exists for SA Water to exploit its monopoly position in its network, 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

In providing drinking water and sewerage services, SA Water is required to comply with the consumer protection framework set out in SA Water's retail licence and the industry codes, rules and guidelines established 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, SA Water will be required to use its best endeavours to maintain the same level of service as it achieved over the past two years.

SA Water's customer service and network reliability performance will be assessed against 18 binding service standard measures. At the same time, the Commission will continue monitoring and publicly reporting on a wider 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

RD16 establishes 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: $2,841.3 million over the period, and
- sewerage retail services: $1,188.1 million over the period.

Those caps have been derived using the standard 'building blocks' regulatory approach: the Commission has assessed the costs that would be incurred by a notional 'prudent and efficient' firm to deliver the services required of SA Water 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 gigalitres (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 percent.

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 is reliable for the purposes of setting demand forecasts for RD16.

Operating expenditure

The building block assumption for operating expenditure is $1,795.3 million ($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 determination 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, they 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 percent per annum operating efficiency target. The Commission welcomes this initiative and has adopted the one percent target for the first two years of RD16. However, having regard to the continuous business improvement potential identified by SA Water, the Commission has determined that, for the final two years of the period, an operating cost efficiency target of 1.5 percent per annum is appropriate.

Capital expenditure

The building block assumption for capital expenditure in RD16 is $1,200.1 million ($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 proposal generally reflects 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 determined that there is scope for some capital expenditure reductions. These arise from some of the proposed projects either not being considered to be prudent, or having been planned at a cost that is more than the efficient amount.

Rate of return

The regulatory rate of return reflects the cost of financing investments in regulated assets.

This determination sets 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.

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

- 2016-17: 4.53 percent
- 2017-18: 4.33 percent
- 2018-19: 4.01 percent
- 2019-20: 3.81 percent

Additional features

This RD16 establishes a revenue cap regime that incorporates 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 RD16 regulates the price of excluded services through a set of principles with which SA Water must comply when setting prices.

Under that approach, the Commission will not take a direct role in setting or approving fees and charges for excluded services. Instead, SA Water will be required to demonstrate that its prices complied with the applicable pricing principles (for example, requiring them to reflect efficient costs). The Commission will 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.

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