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BusinessSA
South Australia's Chamber of Commerce and Industry

22 January 2015

Mr Con Carellas
Essential Services Commission of South Australia
GPO Box 2605
ADELAIDE SA 5001

Dear Mr Carellas

We write in response to your request for submissions on ESCOSA's Draft Report for SA Water's Regulatory Rate of Return over the period 2016-20.

Executive Summary

SA Water's rate of return is a critical determinant of water prices and it is imperative for ESCOSA to ensure it is set at market reflective levels for the benchmark efficient water utility. Unfortunately, there has not been a recent independent review of the value of SA Water's asset base. As a result, any decision on its rate of return is arbitrary to a point, considering consumers are still 'in the dark' as to the verifiable value of its asset base.

Notwithstanding, Business SA supports ESCOSA's draft decision to adopt a recent market observation approach to the cost of debt to ensure it reflects current commercial realities. In terms of the industry risk applied to the benchmark efficient water utility, beta, Business SA is of the view that the AER's most recent draft determination on NSW electricity utility, Ausgrid should form the upper bound at 0.7.

Although ESCOSA may find it difficult to protect the interests of consumers with respect to both price and stability, businesses should only be charged the lowest possible price which is reflective of the actual costs of an efficient entity delivering water and waste related services. The primary consideration for ESCOSA should always be to deliver consumers the lowest possible price, and if stability in price can be achieved without materially impacting the optimum price level, only then should ESCOSA look to 'iron out' short term fluctuations. If ESCOSA cannot be confident that its attempts to stabilise price have a negligible impact on achieving optimum efficient prices for business, businesses prefer to manage this risk themselves.

Background

Business SA recognises the limited scope of ESCOSA's draft report, but it is worth noting the substantial rise in water prices experienced in South Australia over the past decade. Even after taking into account the plateau in water usage and supply charges from 2012/13 to 2014/15, the tier one non-residential water usage rate has still increased by 879% since 2004/5 and the tier two rate by 537% over the same period. Concurrently, business supply charges have increased by 182%. The vast majority of these increases have occurred since 2008/9 which the State Government/SA Water have both justified on the basis of having to fund the Adelaide Desalination Plant and to a lesser extent, the North South Interconnection System Project.[1]

Furthermore, trade waste charges have increased by over 1000% across the same period and SA Water is still planning to levy 9.5% per annum increases from 2017/18 on the basis of moving towards cost reflectivity.

However, the CPI index for South Australia has only increased by 30.41% since 2004/5[2]. Any business which tried to pass on cost increases of several hundred percent to consumers over the past decade would no longer be in business. So, South Australian businesses have had to absorb the rising costs in water in tandem with every other rising cost of doing business. As a result, this State's economy is barely growing.

While ESCOSA has been primarily tasked to determine a regulatory rate of return to apply to SA Water which is representative of an efficient water retail business, we remind ESCOSA of its legislated objective which is the:

"Protection of the long term interests of South Australian consumers with respect to the price, quality and reliability of essential services"

We provide further comment on specific parameters of ESCOCSA's proposed weighted average cost of capital (WACC) for SA Water over 2016-20 as follows:

Cost of Debt

Business SA supports ESCOSA's proposal to use a recent market observation approach to determining the efficient entity's cost of debt. We acknowledge that in a period of record low interest rates, the recent market observation approach does significantly reduce the efficient entity's cost of debt when compared to a 10 year trailing average approach. Moreover, it is not for ESCOSA as an economic regulator to mitigate SA Water's debt profile risk by averaging out its allowable cost of debt over ten years. It is incumbent upon SA Water or any efficient entity to take appropriate steps, including through the use of derivative instruments, to manage their debt profile and what cannot be managed cost effectively should have already been priced into the hypothetical business purchase through a higher yield.

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[1] South Australian Government Transparency and Regulatory Statements (2004/5 to 2012/13), SA Water 2014/15 Water Prices

[2] Australian Bureau of Statistics, Consumer Price Index Australia, Tables 5 Index Numbers ; All groups CPI ; Adelaide September 2014

While we support ESCOSA's approach of an average four year bond term in so far as it reflects the regulatory period, much will depend on whether or not ESCOSA decides to update the cost of debt on an annual basis.

We support the basis of ESCOSA's decision to adopt the recent market observation approach being based on following the vast majority of regulatory precedent; which should actually provide regulatory certainty to SA Water. Moreover, any adoption of a trailing average approach would not reflect the commercial reality of an efficient entity having to look forward in relation to debt market considerations.

Finally, Business SA considers the specific cost of debt advised by SA Water to be in line with current market parameters.

Equity Beta

We acknowledge ESCOSA's proposed equity beta of 0.80, but note the Australian Energy Regulator (AER) recently determined a beta of 0.70 in its draft determination for the NSW electricity distribution business, Ausgrid, for the period 2015-19. Considering the expected structural change in the electricity distribution market on the back of solar and associated battery storage, any beta for an Australian water utility should be at least equivalent, if not lower than for an Australian electricity distribution business.

ESCOSA acknowledges that the revenue cap to apply to SA Water's revenues from 2016-20 (as opposed to the average revenue cap from 2013-16) will reduce the risk to SA Water of demand being higher or lower than forecast; that is, the risk is being transferred to consumers who face higher or lower prices depending on maximum demand. However, ESCOSA asserts a practical difficulty in measuring the impact of the movement to revenue caps on the systemic risk of equity (beta), and therefore absent any meaningful way of estimating that impact, proposes to keep beta at 0.80, rather than reduce it. Business SA accepts that it may be difficult to measure the specific impact of water demand risk being transferred to consumers, but there is no doubt it acts to reduce the risk to SA Water and it can be aggregated with other evidence such as the AER's draft Ausgrid determination, to justify a lower beta for the benchmark efficient entity.

Aggregate Impact of ESCOSA's decision

By at least adopting ESCOSA's low case estimate, SA Water's revenues would decline by $209 million across three years. Business SA would expect this impact to be even larger if ESCOSA adopted a more appropriate measure of beta.

If ESCOSA adopted its high case estimate and passed on an additional $409 million in revenue to consumers, there would be a considerable adverse impact on business which is already struggling to absorb the exorbitant increases in water and trade waste prices over the past decade. Furthermore, business is already subsidising residences $93 million per annum in water related costs and is quite frankly unwilling to accept additional price hikes.

Predictability and Stability of Prices V's Absolute Cost Reflectivity

From the perspective of business, prices must be cost reflective which should concurrently be efficient as a matter of regulatory principle. In so far as any trade off between volatility and price, business is unwilling to pay more for certainty and no differently to how businesses manage any input cost risk, it will be an individual decision based on the relativity of that cost to each individual business's bottom line.

While businesses prefer not to have volatility in the short term, they are willing to risk volatility to ensure the probability of paying the most efficient price is maximised through using a recent market observation approach. Notwithstanding, ESCOSA should consider adjusting the cost of debt on an annual basis, akin to the AER's approach of annual adjustments to the trailing average cost of debt, although this approach would require flexibility in the revenue cap.

Who we are

As South Australia's peak Chamber of Commerce and Industry, Business SA is South Australia's leading business membership organisation. We represent thousands of businesses through direct membership and affiliated industry associations. These businesses come from all industry sectors, ranging in size from micro-business to multi-national companies. Business SA advocates on behalf of business to propose legislative, regulatory and policy reforms and programs for sustainable economic growth in South Australia.

Should you require any further information or have any questions, please contact Rick Cairney, Director of Policy, Business SA on (08) 8300 0060 or rickc@business-sa.com.

Yours sincerely

Nigel McBride
Chief Executive Officer