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22 January 2015

Dear Commissioners,

RE: SA Water Regulatory Rate of Return 2016-2020 Draft Report to the Treasurer

Thank you for the opportunity to make a submission to this important consultation[1]. As the peak body for the community services sector in South Australia, SACOSS has a long–standing interest in the delivery of essential services. Our research shows that the cost of basic necessities like energy and water impacts greatly and disproportionately on vulnerable and disadvantaged people. Our advocacy is informed by our members; organisations and individuals who witness these impacts in our community.

As you would be aware, SACOSS is also participating in a similar process for the regulation of electricity distribution in South Australia (SA Power Networks) by the Australian Energy Regulator. This also involves discussion of the elements that comprise the Weighted Average Cost of Capital, (WACC). However, while there are many similarities, they each have a very different context: most importantly, public versus private ownership.

Our aim is for SA Water to continue in public ownership and SACOSS intends to be pragmatic about the necessity of the Corporation paying good (but not great) dividends back to Treasury to ensure this continues. However, in order to align the interests of the Corporation's owners with its customers, this must be achieved in a way that restores and preserves affordability for customers and drives innovation and efficiency within the business. This is, of course, a much bigger project than is being addressed in this consultation but it sets out the basis for our responses that follow.

The importance of the WACC in revenue determinations is acknowledged. When multiplied by the Regulatory Asset Base (RAB) it results in a large part of the revenue collected from consumers and this holds true for electricity, gas and water. However, in this particular case, the Draft Report makes it clear[2] that the September 2014 Water Pricing Order provides for a process where the Treasurer may again change the value of the RAB in response to the Commission's final determination. It in effect allows for the Treasurer to neutralise the effect on prices of any changes proposed for the WACC – as was the case in 2012 for the current regulatory period.

This could be interpreted as undermining the goal of independent regulation but we are determined to treat this as an opportunity to further advance the long term interests of the South Australian community in what are, in effect, their dual roles as water users and SA Water's owners. This is an opportunity is to establish a long term approach to how water

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[1] http://escosa.sa.gov.au/projects/218/sa-water-regulatory-rate-of-return-2016-2020-report-to-the-treasurer.aspx
[2] Draft Report to Treasurer, p9

users are exposed to changes in the cost of capital over time. To understand why setting a solid precedent in this is important, it is worth considering the asset values all of the regulated utilities in SA.

The RAB is a fundamental parameter in the revenue determinations of regulated energy and water businesses. Invariably, the majority of revenue allowances approved by regulators are to cover the return *on* and *of* capital. The return *on* capital is found by multiplying the Weighted Average Cost of Capital (WACC) by the RAB. The return *of* capital is determined by approved regulatory depreciation schedules. Combined, this revenue can be considered as representing the principal and interest repayments by consumers for the cost of the infrastructure.

Figure 1, below, consolidates the RABs of South Australia's regulated Utilities and shows that consumers are paying off assets worth over $18 billion. Not surprisingly, consumers are sensitive to changes in interest rates – each % of WACC is worth $180m per annum in interest alone. This money could have many alternate uses in the economy and absent a competitive market to allocate it efficiently the regulatory process seeks to mimic what such a market would do.

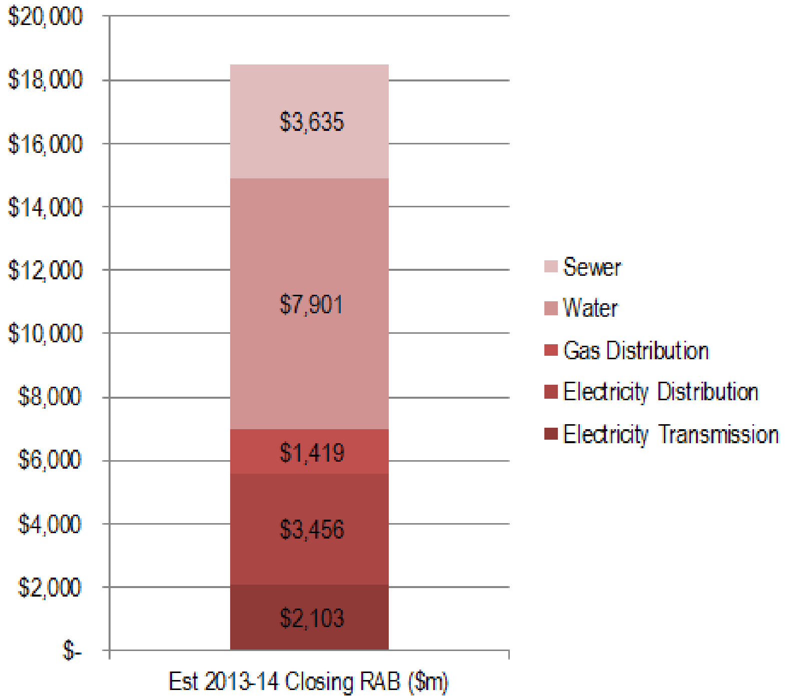


Figure 1: Estimate of the Regulatory Asset Bases of South Australian Utilities at end June 2013 ($m). Source: SACOSS analysis of ESCOSA and AER Regulatory Determinations and Regulatory Information Notice (RIN) data provided by the businesses

Given that these RABs have a tendency to grow over time, the consumer interest is certainly tied to the long-term approach to the pairing of RAB and WACC across these regulated businesses. We understand that the WACC attempts to forecast the efficient cost of capital to be incurred by a prudent and efficient water utility - the benchmark utility - during the period in question (2016-20). We have also been involved in enough of these deliberations to have seen opposing arguments presented by the same proponents at different times depending on the stage of the economic cycle. SACOSS is of the view that the long term interests of consumers is most likely to be served, and most likely to align with the shareholder interest, if SA Water can be allowed to get on with being an efficient, well respected and un-controversial water business that can provide stable, low risk returns to its owners. Our comments on the various parameters aim to reflect this view.

We note from the Draft Report that if the low case being contemplated had been applied in the current Regulatory Period, revenues would have been 6% lower[3]. The high case would have increased revenues by over 12%. Without adjustment to the RAB, and for a given level of consumption, changes in revenue equate to changes in prices.

Our overall position on water prices is that, following the major water security investments of recent years and the cost of capital having return to levels more akin with pre-GFC conditions, there is no case for future prices to rise beyond CPI and an argument that prices should in fact fall.

Our comments on the WACC elements follow:

<u>Risk-free rate</u>

The so-called risk free rate is a key input to how the WACC is built up to reflect the opportunity cost of capital tied up in the business. The overall WACC is very sensitive to the choice of risk free rate since the rest of the formula aims to estimate the premium above the risk free rate that is appropriate for a business of this type.

The central question in this regard is about whether Commonwealth Government Bonds are a suitable proxy, if so which 'term to maturity' should be chosen and over what timeframe should observations be averaged. The Draft Report provides useful comparisons of the possible combinations.

The Commission proposes to continue with CGBs as the proxy but to change the term to maturity from 10 years to 4 years to align with the length of the regulatory period. SACOSS accepts the rationale for this (p14: "…matching debt to future cash flows, which are reset every four or five years, is more relevant to a regulated business than matching debt to asset lives")

<u>Averaging Period.</u>

As we have experienced in recent years, the cost of capital varies substantially over time. To a large extent, the debate is about what balance of forward looking estimates ('point in time' or 'recent market observations') and longer terms historic observations should be reflected in the final determination. The Commission prefers the approach of averaging 20-days of market observations as close as possible to the start of the regulatory period.

Of course, at the current point in the economic cycle the forward looking '20 days' approach delivers a lower risk free rate than the '10 year trailing average': 2.87% vs 4.62%. The appeal of the lower rate is obvious but SACOSS is also conscious that GFC conditions could reappear at some future date and would prefer a solution that reduces volatility for both the owners and customers of SA Water.

Our view is that this is an opportunity is to establish a long term approach to how water users are exposed to changes in the cost of capital over time. On this basis, SACOSS prefers the Commission to consider a hybrid approach that combines the forward looking

[3] Revenue effects from Draft Report Table 7.2 and ESCOSA's 2013-16 Revenue Determination

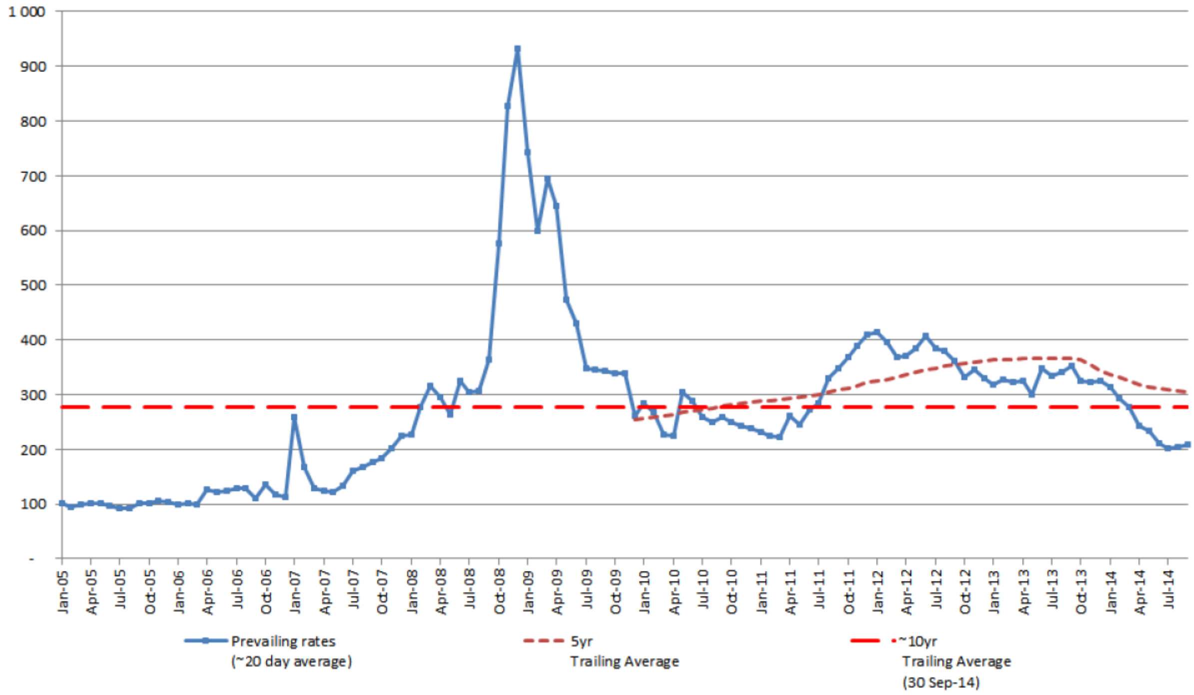
with historic levels that better reflects the turnover of debt and hedges for a prudent and efficient business.

Inflation Forecast

SACOSS is of the view a forward looking approach to the inflation forecast - i.e. using the '20 Days' approach exclusively as opposed to the 10 year trailing average - is appropriate.

Cost of Debt

The importance of selecting an appropriate averaging period for an estimate of an appropriate Debt Risk Premium (DRP) is highlighted in the following chart from the Draft Report that in effect compares the relative volatility of three different averaging periods over the last decade:



As discussed in relation to the Risk-free rate, the more 'point in time' estimate (the 20-day averaging period) delivers the lowest result today but could, under less fortunate timing, deliver very much higher results. SACOSS also accept the efficiency argument of the 'marginal cost of debt' being an important factor but considers that a hybrid approach that dampens volatility is a better match to the long term interests of consumers.

Our preliminary view is that an averaging period better matched to the timing of an efficient debt portfolio would most likely make for a prudent and efficient result.

SACOSS is also of the view that a credit rating of BBB is too low for the benchmark. The benchmark should reflect what is in the consumer interest and it is, in our view, in the consumer interest (and entirely achievable) for the benchmark to be a more creditworthy entity.

Market Risk Premium (MRP)

SACOSS has recently commissioned an independent estimate of WACC for SA Power Networks from the South Australian Centre for Economic Studies (SACES). The SACES preliminary work suggests to SACOSS that the 6% MRP adopted by the Commission in the Draft Report is reasonable although more recent data would suggest a lower value is emerging. However, the preliminary SACES work also suggests that the ‘regulatory precedent’ of 0.8 for the ‘equity beta’ (ß) now represents the high point on a range with a strong evidence base pointing toward 0.5.

On the subject of ‘regulatory precedent’, the Draft Report states:

> *“In its Final Advice to the Treasurer published in February 2012, the Commission expressed the view that regulatory stability was important and departures from accepted regulatory practice should only be made when context, logic or evidence strongly warranted such a decision.”*

In our view, these criteria have been met in relation to ß and we believe that, particularly with the Treasurer able to smooth any transitional effects, now is the time to adopt this updated value.

Imputation Credits

The Commission proposes to continue to adopt a value for the parameter ‘gamma’ (γ) of 0.5. SACOSS notes that this is the same value proposed by the AER in its current Rate of Return Guideline. We understand that SAPN has proposed a value of 0.25 and SACOSS is opposed to this 0.25 value.

We thank you in advance for your consideration of our comments. If you have any questions relating to the above, please contact SACOSS Senior Policy Officer, Jo De Silva on 8305 4211 or via jo@sacoss.org.au.

Yours sincerely,

Ross Womersley
Executive Director