Care. Compassion. Commitment.

Submission to

Regarding: SA Water Regulatory Rate of Return 2016 – 2020, Draft Report to the Treasurer - November 2014

Submission prepared by: Uniting Communities

10 Pitt Street, Adelaide, South Australia.

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Introduction – Uniting Communities

Uniting Communities works with South Australian citizens across metropolitan, regional and remote South Australia through more than 90 community service programs.

Our vision is : A compassionate, respectful and just community in which all people participate and flourish.

We are made up of a team of more than 1500 staff and volunteers who support and engage with more than 20,000 South Australians each year.

Recognising that people of all ages and backgrounds will come across challenges in their life, we offer professional and non-judgemental support for individuals and families.

Uniting Communities offers programs for:

- Older People
- Younger People
- Families & Children
- Housing & Crisis Support
- Mental Health & Well-being
- People with Disabilities
- Carers
- Financial & Legal Services.

Our perspective for this submission is drawn, in particular, from financial counselling and relationship counselling services as well as residential aged care, disability and carer support services and the APY Lands Paper Tracker service. We also have a developed public policy and advocacy interest in utilities policy and regulation due to the impacts on the costs of living for low income people, including people living in poverty.

Uniting Communities thanks ESCOSA for the opportunity to present responses to this draft report and we consider most of the questions asked in the draft report subsequently. However, by way of introduction, we wish to make a couple of contextual comments.

Contextual Comments

1. Cost of water:

We note that water prices in South Australia have increased over recent years at a faster rate than CPI with a couple of quite substantial increases over the last five years, an average of 60% increase, this is shown in figure 1. This price increase has put substantial cost of living pressure on large numbers of households who are already struggling with declining real incomes and rising costs of the basics including housing, essential services and health. An increased burden on households for water and sewerage charges is to be avoided in the best long term interests of consumers.

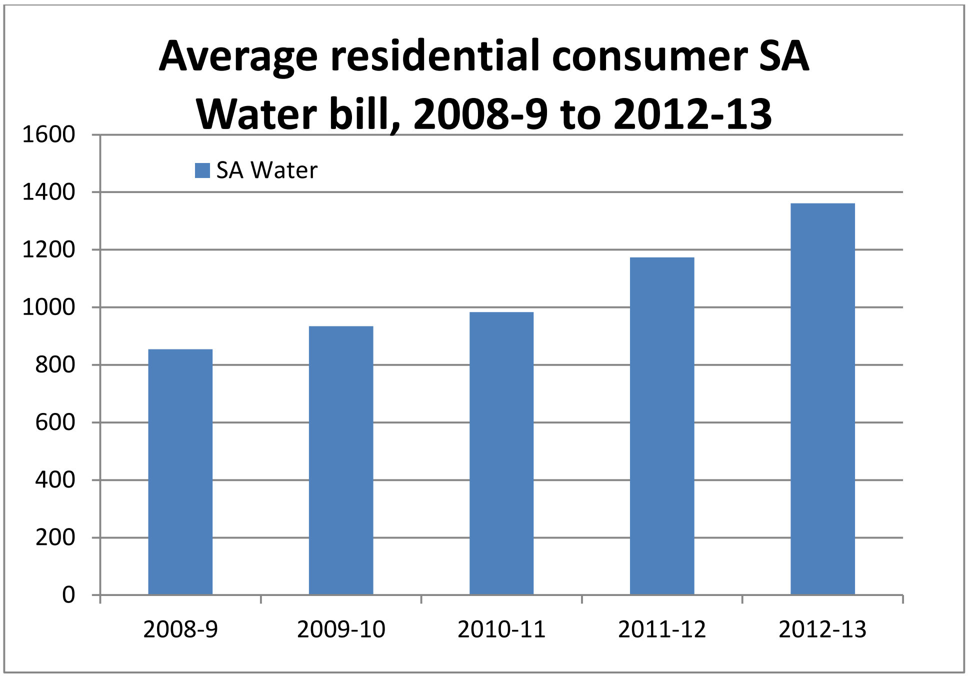
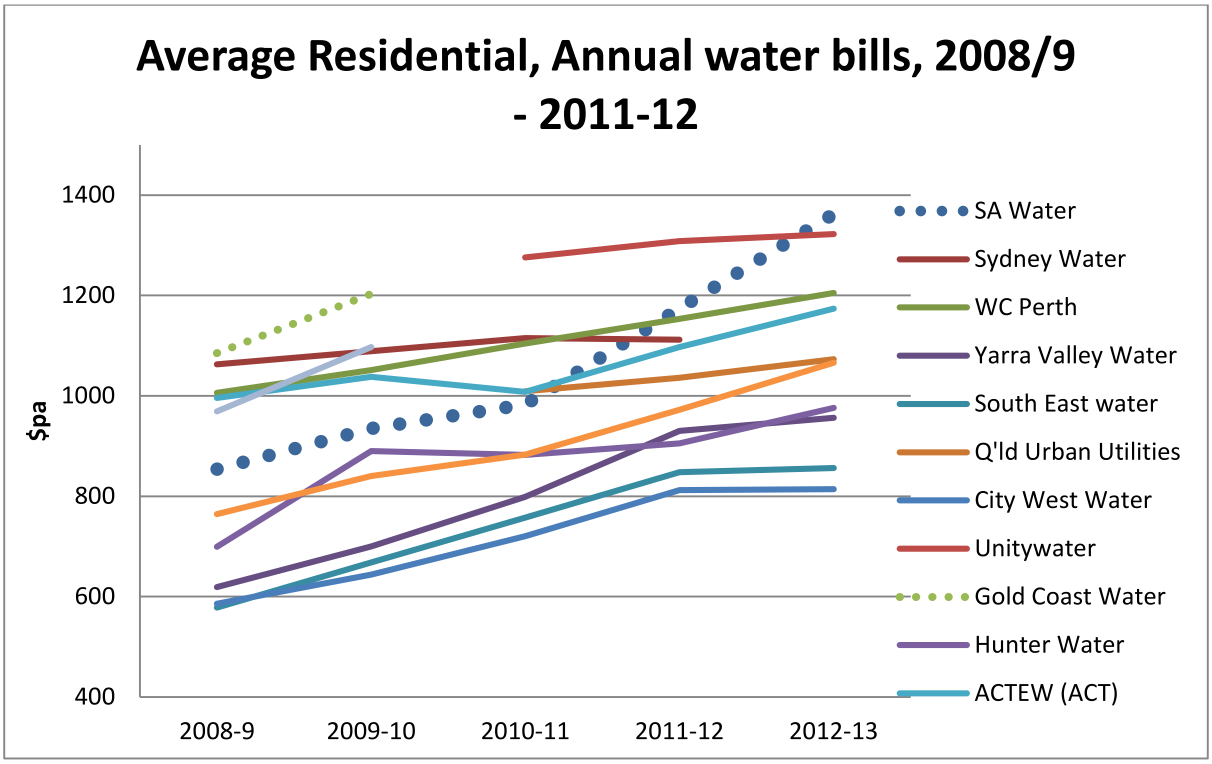


Figure 2 shows that South Australia has the highest water prices for any Australian capital city, and in 2012-13, only Gold Coast water had a higher average, annual household bill; $1417, compared to SA water average bill of $1362. South Australian consumers also experienced the highest rate of increase in water bills over this time.

Figure 2. Average residential Water Bill, various suppliers, 2008-0 to 2011-12



Source: National Water Commission; National Performance report, 2014 – table 5.2

2. Pricing Orders

We are deeply concerned about the operation of the pricing order that is given on page 9 of the discussion paper, section 1.2.

Key concerns being in the following statement: *"the pricing order proposes a process for setting SA Water's revenues that is different to the standard regulatory process. In particular, it puts forward a process for SA Water PD 2016 that will involve;*

- *The commission making a draft price determination ...*
- *The Treasurer considering the need to change the value of SA Water's Regulatory Asset Base through the use of a further pricing order based on the likely final determinations and outcomes to deliver different revenue outcome."*

Uniting Communities is very concerned by this second dot point because we believe that it reduces or even removes the capacity for the regulator to operate truly independently and in the best long term interests of consumers. Quite simply, the Treasurer maintaining control over setting the Regulated Asset Base (RAB) means that there is capacity to adjust prices paid by consumers upwards irrespective of efficient financing arrangements and irrespective of the best long term interests of consumers. We strongly recommend that an independent review of the RAB of SA Water is conducted and run parallel to this process. We do not believe it appropriate for the owner of SA Water, the State Government, to be effectively controlling the price of SA Water by its capacity to adjust the RAB, particularly after the regulator has made a determination on other parameters.

Recommendation 1: That an independent review of the SA Water Regulated Asset Base (RAB) is undertaken as a matter of priority

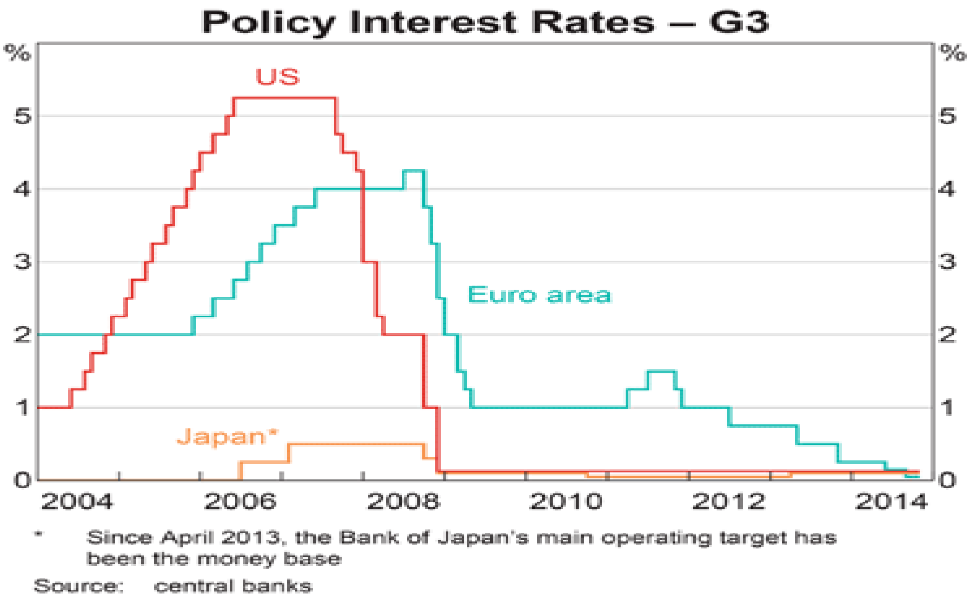
Recommendation 2: That the SA Government refrain from issuing pricing orders in regard to the regulation of SA Water regulated revenue.

3. Unallocated CARF funding

We are also concerned that the CARF (Consumer Advocacy and Research Fund) funding has not been made available in time to support consumer input into this process. It is particularly disappointing that the machinery of government has been unable to move quickly enough to enable effective contribution to this important paper and these substantial pricing issues by consumer based organisations despite this being the very clear intention of Parliament in setting the CARF in legislation. We note that this issue is beyond the powers of ESCOSA but think it is important to note this disappointment as we hurriedly seek to respond to a very important consideration namely the rate of return for SA Water 2016-2020 noting that this will have a quite significant impact on a number of households.

4. Global Interest rates

Figure 3, global interest rates, 2004-14



Source: Reserve Bank of Australia: http://www.rba.gov.au/chart-pack/interest-rates.html#

Figure 3 shows that interest rates globally have come down substantially over recent years, particularly in the post Global Financial Crisis (GFC) period. The figure shows that, globally, we are experiencing a low interest environment and a low capital cost environment. Therefore for a company raising capital on global capital markets, rate of returns can be expected to be significantly lower than previously when the GFC and more turbulent financial factors were at play.

Questions from Draft Position Paper

We now consider the various questions posed by ESCOSA in the draft position paper.

<u>4 year CGB's</u>

The Commission's draft proposal is to use four year CGBs (Commonwealth Government Bond) interpolated from three year and five year CGBs. Uniting Communities believes that this is an appropriate benchmark to be utilising given that the regulatory period is for four years, so a matching with four years CGBs makes sense to us.

<u>Risk Free Rate</u>

In determining risk free rate component of cost of capital, a significant issue is raised in the discussion paper about the most appropriate methodology to determine the risk free rate. Two options are presented: the utilisation of an "on the day" approach, i.e. using a twenty day averaging period to determine the risk free rate as opposed to the use of a long term trailing average, using Reserve Bank data - discussion has been based on the use of 10 year trailing average.

We recognise the Commission's preference for a 20 day trailing average period however we also note that part of the debate is about the question of "best outcomes for consumers" compared to greater certainty and the associated premium that goes with paying for greater certainty. We do not believe that this is the full story. Consumers want the best price and a reasonable degree of certainty and they want 'value,' this being the lowest fair price. Consumers have suffered at the hands of network businesses in water and other utilities over a number of years whereby network businesses are forever, it would appear, arguing for the risk free rate that best suits them. We opine that when global capital markets were uncertain with the GFC impacts and the 'on the day' rate was high, networks wanted 'on the day' based risk free premium. Now that 'on the day' rates are very low, there is much more interest in long term trailing averages.

Indeed, we could argue that the outcome that is in the best long term interests of consumers would be to select the risk free rate associated with the lower of the two approaches at time of a regulatory determination.

We note that the AER in considering energy markets is moving towards a longer term trailing average process and we believe that this is a more appropriate model because it does provide a degree of stability in capital cost movements for businesses, as they are affected by the risk free rate. We believe that it is more efficient for businesses to lock in borrowing for a longer period of time, providing much greater certainty for consumers and businesses over an extended period of time. However, we are not convinced by the notion of a 10 year trailing average being applied and believe that a trailing average more in line with the regulatory period, namely four years, should be applied. It may be more appropriate to simply apply a five year trailing average approach. We therefore strongly support an efficient five year trailing average being used as the basis for calculating the risk free rate, as this is close to the duration of the regulatory period.

Inflation forecast

Uniting Communities accepts the general direction of the inflation forecast proposed by ESCOSA regarding these as being in line with a range of economic forecasts and inflation rate projections, they will need to be adjusted for our proposed 5 year trailing average.

Cost of Debt

We note that the Commission proposes that a BBB credit rating and 60% gearing ratio is applied. We accept the 60% gearing ratio, but are opposed to a BBB credit rating being applied as the basis for financing. The simple reality is that SA Water is able to borrow at much better rates than BBB, frankly, a AAA credit rate for this income guaranteed, low risk business would be more appropriate. In the interest of compromise, we would accept a AA+ credit rating basis for determining costs of debt.

The discussion paper says that, "The combination of the nominal risk free rate of 2.87% and the debt risk premium of 1.67% produces an estimated nominal cost of debt of 4.56%."

We are inclined to the view that a risk free rate of 2.87% is high considering Japanese interest rates are at 0%, European interest rates are about 0.5% and US interest at similar levels (see figure 3), so in fact the nominal risk free rate should indeed be lower than 2.87%.

<u>Cost of Equity</u>
The draft position paper states that the Commission proposes to adopt a market risk premium of 6% and an equity beta (β_e) of 0.8.
We accept the Sharpe-Lintner CAPM being applied as the appropriate model for cost of equity.

The market risk premium of 6% is too high, given current low interest rates (for borrowing) and the very low risk of borrowing for government owned utilities with guaranteed, regulated revenue, we suggest that 5% is more reasonable.

We reject out of hand the notion of an equity beta, β_e of 0.8. We include below some copy from the AER's most recent comprehensive consideration of estimates of beta.

The AER's most recent paper[1] considering estimates for β_e states "During both the 2009 WACC review and now we considered the empirical estimates support a range of 0.4 to 0.7. In the 2009 WACC review, we adopted a point estimate of 0.8 (slightly above the range of empirical estimates). In this issues paper, we propose to lower our point estimate from 0.8 to 0.7 because we now have greater confidence in the reliability of the empirical estimates."

We argue that the AER strayed too high in 2009 with their point estimate of β_e due to heavy influence of GFC uncertainty. The range presented in this most recent consideration of β_e is the best starting point, namely 0.4-0.7. The best subsequent point estimate, if the long term interest of consumers really was paramount, would be at the bottom of this range, 0.4; however as a compromise we regard the midpoint of the range 0.4 – 0.7, namely 0.55 as an acceptable point estimate for equity beta.
We recognise that application of this β_e and a lower market risk premium which would definitely result in a lower cost of equity than the 7.67% proposed in the draft position.

<u>Gamma, γ</u>

We note that the Commission proposes to adopt a gamma of 0.5 however; we don't see the merits in doing this given that SA Water doesn't pay company tax, to the best of our knowledge, and since gamma is a parameter related to tax imputation credits it really

[1] AER: Better Regulation Equity beta issues paper October 2013

doesn't seem to be particularly relevant. There certainly should not be an allowance for taxation payments, paid by consumers, if this full amount is not paid as tax.

We have included below an additional column from Table 7.1 proposed in the draft decision which relates to the various parameters and we have included our perspective of which values should be applied for each of these parameters. We highlight that we are particularly concerned about;

- credit rating of BBB being applied, we argue for AA+
- equity beta of 0.8 being applied, we argue for 0.55
- allowance for γ tax payments, SA Water is State Government owned, so we do not think they pay company tax, nor do they pay franked or un-franked dividends to private shareholders

Chart 1: Summary of Uniting Communities view re Rate of Return Parameters, based on table 7.1

Parameter	SA Water PD '13	Input (Low case)	Input (High case)	**Uniting Communities proposal**
Averaging Period (Risk free rate)	20 days	20 days	10 years	**5 year, RBA trailing average**
Term to maturity	10 years	4 years	4 years	**4 years**
Nominal risk free rate	3.25%	2.87%	4.62%	**2.87%, or lower**
Credit rating	BBB	BBB	BBB	**AA+**
Gearing	60%	60%	60%	**60%**
Debt risk Premium	2.8%	1.69%	3.35%	**1.69% (RBA data**
Equity Beta	0.8	0.8	0.8	**0.55**
Market Risk Premium	6.0%	6.0%	6.0%	**0.5%**
Cost of debt nominal	6.04%	4.56%	7.98%	**(lower than) 4.56%**
Cost of equity nominal	8.05%	7.67%	9.42%	**5.6% (Sharpe Lintner CAPM)**
WACC nominal	6.85%	5.81%	8.56	**4.97**
Inflation forecast	2.24%	1.91%	2.63%	**Between 1.91 and 2.63 due to 5 year trailing average proposed**
WACC post-tax, real	4.5%	3.83%	5.77%	**3.06 (indicative)**
Corporate tax rate	30%	30%	30%	**Not applicable**
Gamma	0.5	0.5	0.5	**Not applicable**

Recommendation 3

We recommend that the rate of return parameters proposed in the right hand column of chart 1, above, be applied to SA Water rate of return considerations.

For any further questions about comments made in this paper please contact Mark Henley
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