

Business SA

Submission - ESCOSA inquiry into reform options for SA Water pricing (Draft Report)

September 2014

BusinessSA
South Australia's Chamber of Commerce and Industry

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Introduction

Business SA, as the peak Chamber of Commerce and Industry in South Australia, represents thousands of businesses across all industry sectors. These member businesses range from micro businesses through to multinational companies. Business SA plays a lead role in advocating on key issues affecting our members and South Australia's economic future.

The Essential Services Commission of South Australia (ESCOSA) is an independent statutory body responsible for, amongst other matters, the economic regulation of water and sewerage services in South Australia including industry licensing, consumer protection and retail pricing.

The *Water Industry Act 2012* establishes the regulatory framework for the water and sewerage industry covering economic regulation, technical regulation, water planning and customer complaint handling and governs all water industry entities providing "retail services" to South Australian customers.

On 24 September 2012, the then Treasurer, Jack Snelling M.P., instructed ESCOSA to undertake an inquiry into options for pricing reform of drinking water and sewerage retail services provided by SA Water in South Australia.

The 'Terms of Reference' for the inquiry asked ESCOSA to consider the following matters:

i) Approaches to drinking water supply charges for SA Water customers, including charges based on the number and size of meters, and transition arrangements for managing the significant impacts on customers;

ii) Approaches to drinking water supply charges for SA Water customers, including services which may improve economic efficiency and/or South Australia's water security, including analysis of the costs and benefits of such approaches for different customer classes, and in particular:

   a) The likely impact of billing a consumer for such services (rather than the owner of land) and the associated elimination of rating on abuttal;

   b) The likely impact of requiring the installation of individual meters for each customer;

   c) The likely impact of requiring the installation of smart meters.

iii) The impact of state-wide pricing requirements on SA Water for drinking water and sewerage retail services in terms of economic efficiency, South Australia's water security, and costs and benefits for different customer classes.

Business SA notes that the 'Terms of Reference' do not explicitly restrict ESCOSA from considering the efficiency of SA Water's revenue.

However, ESCOSA have advised in its draft report that 'The Inquiry is to review efficient pricing structures and associated charging arrangements, not whether SA Water's costs are efficient, nor whether SA Water's revenue is appropriate. The Inquiry therefore assumes that SA Water will recover the same amount of revenue from its customers as it currently earns.'

Business SA's submission focuses on the impacts of proposed water, sewerage and trade waste price reforms on business and the extent to which the inquiry's terms of reference need to be broadened.

Executive Summary

Water is a significant cost for South Australian businesses, particularly large water users in sectors such as agriculture, horticulture, viticulture and associated food and beverage manufacturing. Business has had to absorb extraordinary price rises in recent years, with water usage rates alone tripling on average since 2009. Furthermore, volume load base (VLB) trade waste customers, a large proportion of which are food and beverage manufacturers, have faced significant increases in trade waste charges since the mid 2000's and still face major increases from SA Water with prices set to rise by an average 9.5% per annum from 2017/18.

Business SA welcomes ESCOSA's inquiry into water pricing which aims to provide reform options to ensure all water related charges are cost reflective and that economic efficiency is maximised. Unfortunately however, ESCOSA's report is limited to ensuring SA Water's revenues remain constant which is not in the spirit of ensuring businesses pay a truly cost reflective price for water and associated sewerage and trade waste costs. Businesses do not have the luxury of ensuring their revenues remain constant in competitive markets and the market for water related services should reflect competitive market characteristics, despite the market's existing monopoly structure.

ESCOSA's report acknowledges the existence of a $93 million subsidy from business to residential customers across SA Water's network. Treasurer Koutsantonis recently passed comments in relation to the 2014/15 State Budget that the Government could no longer afford to subsidise the emergency services levy and that all South Australians, including businesses, would have to pay the full cost of service delivery.

In a similar context to the State Government being unable to continue to subsidise the cost of the emergency services levy, South Australian businesses can no longer afford to subsidise residential customers for water and sewerage services. South Australia is already the most expensive State in which to do business when combining all business costs, including utilities and the fact that our economy is barely showing positive growth is testament to the reality of how tough the environment is for business, particularly small business.

Many of South Australia's large water users and trade waste dischargers are significant employers in sectors like food and beverage manufacturing. As South Australia begins a period of structural change in the economy to manage a transition away from auto-manufacturing, it is even more important that all Government policies encourage sustainable sectors of the economy like agriculture, horticulture, viticulture and associated food and beverage manufacturing. The State Government will only enable the economy to diversify post Holden if it creates an environment where other sectors of the economy are incentivised to invest and expand to create new jobs. If the cost of water is artificially inflated and passed back onto businesses, those same businesses will be unable to expand and pick up the slack left by the demise of auto-manufacturing.

South Australia has led the country in water efficiency, pioneered by our irrigated industry sectors like horticulture and viticulture. In more recent times and particularly through the millennium drought, businesses, like urban households, have been forced to adopt a much more rigorous approach to water conservation. This has been largely driven by a pricing structure which has reflected the scarcity of water but also due to a whole of community push to ensure the health of the River Murray and South Australia's water security. Business SA is concerned that ESCOSA's report fails to adequately address the cost of water supply which may lessen the economic incentive for water efficiency. This could have significant consequences during the next drought if SA Water has to substantially draw on Adelaide's de-salination plant which would push up the price of water for all users, including businesses.

Business SA - Key Recommendations to State Government

1. The State Government must amend the 'Terms of Reference' of ESCOSA's inquiry to explicitly include a full, independent and transparent review of SA Water's entire cost and revenue base, including but not limited to its operational expenditure and the value of its regulatory asset base. This review must publish all long run marginal costs for every available water source to SA Water including but not limited to River Murray water, catchment water, de-salinated water, stormwater and recycled water.

2. The State Government must introduce a moratorium on any further increase in SA Water's trade waste costs until it commissions a full, independent and transparent review of trade waste costs which must occur in conjunction with Recommendation 1.

3. The State Government must commission a report on the economic contribution of all industry either directly or indirectly reliant on water allocations from the River Murray including but not limited to agriculture, horticulture, viticulture and associated food and beverage manufacturing. Only with this information and transparency on the marginal cost of running the de-salination plant can the State Government, in consultation with industry, make decisions in the best interest of the State economy when it comes to any trade off in relation to operating the de-salination plant during the next drought.

Direct Impact of Reforms on Business – Industrial and Commercial Customers

ESCOSA's analysis shows that the proposed water price reforms will result in higher water bills for 59% of industrial customers and 55% of commercial customers. While we acknowledge there is significant variance in the impacts on business users, and that large water users with no or low trade waste costs may be better off under the proposed reforms, the reforms as currently proposed represent yet another cost increase for many businesses which are already under considerable pressure. Business SA wants the costs reduced for large water users, but with a more holistic approach to ESCOSA's review, including reviewing SA Water's revenues, the majority of businesses should be able to benefit from water pricing reform.

Business SA undertook a survey of members to help inform our submission and also solicited direct feedback from members, including through a meeting of large water users with ESCOSA representatives in attendance. While we only had 27 responses to our survey, we note the inherent difficulty in businesses responding to these types of reform consultations when for example, meter sizes and sewerage connections are not necessarily known and many small business people do not have the time to contact SA Water for information just to complete a survey. However, the feedback we did receive via the survey was still useful, particularly the qualitative feedback on how the changes will actually impact on businesses, especially large employers in the manufacturing sector.

Although our limited survey data showed 65% of businesses are better off under ESCOSA's proposed reforms, the average amount businesses are better off is approximately 42% against the average amount businesses are worse off, being approximately 119%. This indicates a need for the State Government to carefully consider transitional measures should ESCOSA's proposed reforms be adopted.

From feedback provided to Business SA, there will be some large water users better off under ESCOSA's proposal, particularly in agriculture and some food processing operations. One of our members informed Business SA that "the current cost of water at $3.23/KL is extremely expensive to our business and we have no access to any other water supply. Water used in our business is mainly for livestock (pigs and cattle). We would be very happy with the proposed cost of $0.65/KL."

However, where large users are better off, they are typically less exposed to trade waste costs due the nature of their operations and we note that there are many large food and beverage manufacturers which will be significantly worse off under ESCOSA's proposal, mainly due to the impost of significantly increased trade waste costs.

One of our large manufacturing members informed Business SA that "ESCOSA's proposed charging presents an 'out of business scenario' for us as the company would be forced to close and with it all jobs would be lost. As an exporter into global markets who competes primarily with Chinese manufacturers but also with manufacturers who are based interstate, it will not be possible to pass these cost increases on to our customers nor is the business in a position to absorb such increases in the cost of production. Should the recommendations from this inquiry be accepted by the State Government, large industrial users of water and trade waste services who provide the base load for SA Water will be forced to either shut down or move out of the state, neither of which comes at an affordable cost."

Another large water user member commented that "ESCOSA's proposals would be helpful to this business. We are a high water user due to the nature of our business, so paying for supply via KL of water usage distorts greatly upwards our costs of water. We are paying way higher than the cost of supply because of this."

In relation to the increases in trade waste costs though, the same business commented that “one unfortunate side effect will be the building of a ‘brick wall’ to new entrants to say our industry of food processing, as the very smallest DAF (water treatment) systems costs around $300,000 to establish, and around at least $1,000 per month to run. That’s good for us if the rules are enforced, as it will prevent start-ups competing against us, but is probably against the greater good.”

Further in relation to ESCOSA’s proposed reforms, one Business SA member stated “the imposition of these charges will increase costs yet again by the State Government and of course be negative for jobs, incomes, capital investment and sustainability. Water charges should be based on the true cost of each litre of water including all supply charges. This makes decisions on water saving infrastructure and processes reflect true return on investment. Flat fees based on any non-consumption measure encourage low investment in water efficiency and encourage waste.”

In relation to water efficiency under ESCOSA’s proposal, another Business SA member commented that “there are no incentives to be frugal with water. Levies are weighted too far towards supply potential rather than actual usage – this favours big, inefficient users and punishes those who use minimal quantities.”

Review of SA Water Revenues and Efficiency

Business SA does not believe the inquiry’s ‘Terms of Reference’ specifically preclude ESCOSA from reviewing SA Water’s revenue and efficiency. Although we have no evidence that SA Water is operating inefficiently, we are concerned that reforms to water pricing which impact the majority of businesses will be undertaken without a full and independent review of the efficiency of SA Water’s operations. We also have concerns about the value of SA Water’s regulatory asset base (RAB), from which it derives a regulated return and associated depreciation which in turn provides the majority of its revenues.

There is little argument that water prices in South Australia are the highest amongst comparable interstate water utilities. This adds to the long list of business costs, including State based taxes, which contribute to make South Australia the most expensive State in which to do business.

South Australian businesses are no longer willing to accept that the revenues SA Water earns from end users are fixed and that like all other businesses in South Australia, SA Water is not driven to maximise efficiencies in what is a very difficult economic climate. Business SA acknowledges that SA Water’s management are striving to make savings within the operational side of the business and we are encouraged by some of the savings made to date. However, there must be a holistic approach to reducing the cost of water in South Australia and everything must be ‘on the table’, including the value of the RAB which accounts for the majority of SA Water’s revenues. If ESCOSA and the State Government want to have a genuine dialogue with business about moving to cost reflective pricing, there needs to be a complete review of all components of the costs which are passed onto end users.

Furthermore, there needs to be transparency regarding the cost of each water delivery source, including the fixed and variable costs of operating Adelaide’s desalination plant. In relation to this point, Business SA is quite concerned that come the next drought, irrigators will lose allocations without proper consideration by the State Government of the economic value of agricultural, horticultural and viticultural production and associated value added activities which could be protected through strategic use of the desalination plant. We are not advocating for any sector to be subsidised, but there need to be appropriate analysis undertaken of the trade-off between allowing a significant loss to Gross State Product (GSP) and associated exports and the cost of running the de-salination plant, even if this involves consideration of cost sharing between primary beneficiaries, including the State Government as a tax collector.

Cost Reflective Water Usage Pricing

Business SA supports a move to cost reflective water usage pricing, but only on the basis that it is truly cost reflective. There is little doubt that South Australian businesses, particularly in the agricultural, horticultural and viticultural industries and associated food and beverage manufacturing industries, will benefit from a water usage price of $0.65/KL and that these industries are best placed to drive economic growth for South Australia. However, the benefits of a lower water usage rate are tapered or in many cases completely eliminated by increased supply and trade waste charges.

While more affordable water usage rates are welcomed by business, we still have many concerns over the limits of ESCOSA's analysis, particularly in relation to SA Water's revenues and the transparency in relation to the marginal cost of delivering catchment water, Murray water, de-salinated water, stormwater and re-cycled water.

Businesses need more options in relation to the types of water available so they can make informed choices on the costs and benefits to their business. Without that level of transparency in ESCOSA's inquiry, business cannot make the choice between potable water against all other alternatives.

Capacity Based Pricing

In the *2014 Charter for a More Prosperous South Australia*, Business SA supported the move towards cost reflective pricing of water infrastructure. There is no underlying economic rationale for levying water supply charges based on property value which is unrelated to the costs of providing water infrastructure.

However, we have several concerns about how ESCOSA is trying to achieve cost reflective pricing for water supply charges.

Firstly, there are issues related to the use of meter based capacity charges being entirely indicative of a user's draw on water supply infrastructure. For example, if meter based capacity charges are not set correctly, in some instances businesses or individuals will be better off installing water storages with appropriately sized meters to enable faster flows when required without needing a comparably sized connection to the network.

Secondly, there are issues related to existing meter sizes and the actual draw by businesses on water and/or sewerage infrastructure. These matters largely stem from legacy issues where a specific sized meter or sewerage connection was installed for the occupier of a property which has since changed hands and the needs of the current occupant are vastly different. In one example under ESCOSA's proposal, an auto-component manufacturing member of Business SA would see their water supply charge increase from $283 to $13,482 due to having an 80mm connection which is in excess of their actual needs. In this case, the previous occupier of the factory had a more water intensive business and consequently required a larger network connection. In terms of transitioning to capacity based pricing, there would need to be appropriate allowances to enable businesses to ensure their meter is appropriately sized for their needs and if not, SA Water would need to install a smaller meter at no additional cost to the affected business.

Finally, as previously mentioned, if there are to be wholesale changes to the way in which water supply charges are levied in South Australia, the new supply charges must be reflective of the actual costs of supply and not be artificially inflated to protect the value of SA Water's RAB. ESCOSA had made quite clear in its inquiry that supply charges will need to rise substantially in order to offset lower water usage charges while maintaining SA Water's existing revenues. Business SA does not believe this necessarily has to be the case if there is a full and independent inquiry of SA Water's revenues, including the value of the RAB. There is no justification to quarantine SA Water's revenues if the aim of ESCOSA's report is to find 'approaches to drinking water and sewerage retail services which may improve economic efficiency and/or South Australia's water security'[1].

[1] Extract from 'Terms of Reference' for ESCOSA's inquiry into reform options for SA Water pricing

Trade-Waste Pricing

Trade-waste pricing is the single biggest water related issue for Business SA members and the one which potentially has the greatest ramifications for South Australia's economy. Business SA members are well represented amongst SA Water's volume load base (VLB) trade waste customers and we note that ESCOSA's report proposes a catch-up to fully cost reflective charges which would result in an average 434% increase in trade-waste costs per VLB customer. While the average increases are alarming, for some businesses, those increases will be much greater depending on the constitution of their trade waste. For example, trade waste costs for one of Business SA's manufacturing members would increase from approximately $350,000 to over $2.1 million under ESCOSA's proposal, resulting in the closure of that particular exporter.

In another example, Coopers Brewery would see its trade waste costs under ESCOSA's proposal rise substantially from approximately $375,000 to over $1.1 million (or $1.5 million using SA Water's LRMC estimate for flow), an amount which cannot be passed onto consumers due to the highly competitive nature of the beer market. Previously in 2004, Coopers along with other trade waste customers, was informed by SA Water that trade waste charges would need to increase to enable full cost recovery which for Coopers meant an increase of approximately 1000%. Since that time, trade waste customers have endured above CPI annual cost increases on average and are now being told to accept that prices still need to rise by an average of 434% to be fully cost reflective.

To try and offset rising trade waste charges, Coopers recently engaged a local supplier of waste water treatment plants to price a 'build and operate' plant to treat trade waste on site. From this exercise, Coopers established that if trade waste charges increase by more than 85% over 2014-15 rates it will become economical for Coopers to install its own waste water treatment plant. Notwithstanding the unique characteristics of the Bolivar waste water treatment plant, if Coopers can economically operate a small scale waste water treatment plant at a lower cost than it is charged for using Bolivar, there remains questions over whether the fixed and variable costs attributed to Bolivar are fairly apportioned.

Bickfords, another iconic South Australian beverage manufacturer which has had a strong focus on reducing trade waste costs, now faces price increases of 274% under ESCOSA's proposal.

Notwithstanding ESCOSA's recommendation that apart from 'flow', remaining trade waste parameters should be subject to an independent review, like water supply charges, the biggest issue with proposed trade waste costs surrounds the lack of certainty over whether or not the charges are truly cost reflective. On that basis, we strongly recommend that the State Government instruct ESCOSA to undertake an independent review of all trade waste parameters before any further changes to trade waste charges are adopted.

Business SA is very concerned about the history of trade waste pricing and the information which has been conveyed to businesses by SA Water over many years. We appreciate the complexities of trade waste pricing but the business community clearly lacks confidence in what they are being told when the goal posts are constantly shifting. The nature of being successful in business requires constant re-structuring around underlying cost drivers to maximise efficiencies in order to remain profitable. The biggest issue with trade-waste pricing is the uncertainty involved in ascertaining what the real costs are, and the risk for businesses in investing to reduce trade waste costs when the trade waste charging structure is a moving feast. If businesses know the real costs, the level becomes less relevant (but not unimportant) as businesses will re-structure to achieve efficiencies against their competitors. However, when there is so much uncertainty, businesses are unable to invest in trade waste reducing efficiencies due to the risk that investments will be misdirected, while concurrently becoming less competitive in their respective markets.

We note from the State Government's 2005/06 transparency statement that 'when current transitional discounts have been removed in June 2006, all significant trade waste dischargers will be paying charges sufficient to cover their avoidable costs.'

By 2010, SA Water had conducted a review into trade waste charging which was updated in 2013 and subject to peer review by external consultants. This latest review concluded that trade-waste customers were still being significantly undercharged and that charges will be increasing above CPI from 2017/18 by an average of 9.5% per annum for three years in a move towards cost reflectivity.

The State Government needs to place a moratorium on future trade waste cost increases until there is a full independent and transparent review of SA Water's trade waste costs and associated charges. Business SA does not have confidence that a review of trade waste pricing can be conducted in isolation by SA Water and that it must be independently conducted with inputs from SA Water and other key stakeholders. Such a review must also be conducted in conjunction with a broader review into SA Water's revenues and operating expenditure.

Trade waste pricing is critical to South Australia's economy due to its impact on food and beverage manufacturing, which contributes more to South Australia's export earnings than any other manufacturing sector. South Australia's economy will undergo significant structural change over the next few years and food and beverage manufacturing is well placed to drive sustainable economic growth to help fill the void left by auto-manufacturing. In Business SA's pre-election survey of members, 86% of respondents agreed that the State Government should change its industry policy agenda to improve the focus on food production and food and beverage manufacturing.

Furthermore, several hundred million dollars will be spent between the State and Federal Governments to help transition South Australia's economy beyond auto-manufacturing. It is important that the State Government backs up its rhetoric about supporting 'premium wine and food' by ensuring relief on the underlying cost drivers for businesses in these sectors. This can be partly achieved by not allowing significant imposts like trade waste costs to undermine South Australia's economic competitiveness.

Setting Water and Sewerage Pricing on a Regional Basis

South Australia currently has state-wide pricing for water and sewerage and the Draft Report summarises the costs and benefits of introducing regional pricing. We note ESCOSA's findings that setting regionally based water usage charges would only lead to a small net benefit to the economy of around $2 to $3 million per annum over the longer term. Furthermore, ESCOSA notes there are unlikely to be any significant benefits in moving away from state-wide pricing of supply charges in the immediate term.

Business SA is concerned with ESCOSA's comment that "to ensure that customers received cost-reflective pricing based on all future investments, a common supply charge should be set at a point in time (based on a state-wide charge) and then supply charges should diverge across regions over time, as assets were added or removed in the future."

While we are supportive of 'real' cost reflective pricing, there must be proper consideration of past infrastructure investments to ensure that regional water users, particularly businesses, are not paying for infrastructure such as the Adelaide de-salination plant in addition to any future infrastructure requirements needed to augment capacity for their specific region. It will not be as simple as ESCOSA's proposition to 'draw a line in the sand' and we must be very careful about how the cost of water impacts regional economies which are responsible for the majority of South Australia's export earnings. South Australia is already severely behind its strategic plan target of increasing exports to

$25 billion by 2020 and any water pricing reforms adopted by Government need to facilitate further export growth, not hinder it.

Furthermore, many regional economies were developed on the back of Government policy which enabled the delivery of water infrastructure. Accordingly, any moves to restructure regional water supply pricing need to be carefully considered in terms of economic and social impact.

Considerations for Water Efficiency

As previously discussed, Business SA wants to ensure the price of water usage in South Australia is truly cost reflective. Under ESCOSA's existing approach holding SA Water's revenue constant, it would seem supply charges have been overinflated to accommodate for a significant reduction in the usage price.

While Business SA supports a usage price of $0.65/KL if that is the true marginal cost of delivering water, we are concerned that if the supply charge is not truly cost reflective, then businesses and other end users, including residential customers, will not make efficient economic choices which reflect the broader need to conserve water.

This concern is heightened due to the lack of transparency around the true marginal cost of operating the de-salination plant. If as we understand from anecdotal reports, the marginal cost of operating the de-salination plant is approximately triple the marginal cost of delivering River Murray water, come the next drought we would expect SA Water will raise the water usage price substantially once it needs to substantially draw on de-salinated water.

Accordingly, South Australia must maintain its vigilance on water efficiency to ensure we limit the need for expensive de-salinated water during the next drought. While this is a commercial imperative for businesses, it also helps to protect our environment which is important for a sustainable economy.

In essence, if the water supply and usage charges are both cost-reflective, businesses and other end users will be able to make appropriate choices about water use. However, if the total cost of water use is artificially distorted due to high supply charges, the economic incentive to aim for water efficiencies will be reduced.

Miscellaneous Comments

We make the following comments in relation to other specific issues emanating from the Draft Report:

1. Installation of water meters, including smart meters, to all properties:
    - We support ESCOSA's finding that the costs of installing water meters to all properties that are currently not metered would outweigh the associated benefits and that the installation of individual water meters to group-metered properties should remain optional.

2. Water charging on vacant land
    - We ultimately support ESCOSA's proposal to remove water charges on vacant land but it should only occur following a broader inquiry into water pricing and trade waste costs in line with the recommendations made in this submission.

3. Water cartage
    - We note that arrangements for water cartage businesses, which include small businesses, are not covered by ESCOSA's report. This omission is providing uncertainty to the industry and ESCOSA should clarify its position for affected businesses in its final report.