**Submission To:**

# Essential Services Commission of SA

**From:** **Uniting Communities**

**Regarding:**

**Enquiry into Reform Options for SA Water's Drinking Water and Sewerage Prices – Response to Draft Enquiry Report.**

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## Background

Uniting Communities is a large community service organisation in South Australia providing over 90 different services

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

We are made up of a team of more than 1500 people, both 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

It is this basis from which we consider this ESCoSA report, so we are first and foremost focussed on impacts of water and sewerage pricing changes for household consumers, particularly lower and modest income consumers, broadly defined as the first two quintiles of the income distribution.

This said, we are acutely aware of the importance of economic growth and sustainable economic development for South Australia and in particular, for job growth so that households and communities are able to develop with confidence based on employment.

## General Comments

Uniting Communities congratulates ESCoSA on an excellent report that is well researched, very carefully considered and particularly well presented. We commend all staff and board members involved with the production of this thoughtful and considered report.

However, we are concerned that the report's potential benefit has been limited, in particular by an 'understanding' that SA Water revenues must remain neutral, that is be maintained at current levels. Page 3 from the Executive Summary says, "Importantly, the enquiry 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 enquiry therefore assumes that SA Water will recover the same amount of revenue from its customers as it currently earns."

We believe that this assumption significantly skews the outcome of the enquiry, and recommend that any subsequent consideration with the enquiry take into account the significant question of efficiency of SA Water's operation. Indeed, we contend that the single most significant factor in pushing up prices for SA Water customers, particularly households, over the last 5-10 years has been the growing RAB (Regular Asset Base) of SA Water.

We believe that the SA Water RAB is significantly higher than necessary for efficient operation and that this consequently makes SA Water customer's bills higher than they should be and, indeed, is one of the factors putting growing pressure on incomes and quality of life for lower and modest income households.

Since the RAB is not considered, and yet is an essential part of considering pricing for water and sewerage charges in South Australia, we believe that it is impossible to have a "first best outcome" regarding efficiency of water and sewerage pricing in South Australia. Consequently any outcomes must be understood to be, at best, "second best". We highlight that the notion of "second best" is well understood in economic literature, and indeed the theory of "second best" was developed by economists Richard Lipsey and Kelvin Lancaster from a seminal piece of work published in 1956. We provide a little more background to the theory of "second best" as Attachment 1, but highlight that this enquiry, and any subsequent action taken in policy or pricing settings, must be undertaken in the understanding that any outcomes are at best "second best", where key issues remain 'outside of scope.'

For us the other significant shortcoming of this enquiry is its limited reference to the nature of water supply and sewerage good and services to South Australian consumers, and in particular the South Australian community. Specifically we argue that both reticulated water supply and sewerage are 'merit goods' and therefore must be considered differently from standard consumption goods in any analysis. We make some notes about merit goods in Appendix 2, but highlight that the significant public benefit of merit goods must be factored into both appropriate pricing arrangements, and in considerations of the role of government in supplying merit goods for the public good.

To state the obvious, the provision of sewerage services in modern cities, starting in the 1800s and through the early 20$^{th}$ Century, has been one of the most significant factors in reducing a wide range of disease, and in significantly increasing life expectancy and well being (e.g. as measured by Disability Adjusted Life Years) over the last 100 years. The importance of water as an essential service, sewerage as an essential service and water and sewerage as merit goods with benefits to communities that go above and beyond the utility for individual consumption, cannot be overstated. The enquiry report fails to recognise this important factor and, therefore, we suggest leads to outcomes that are not optimal from a community perspective.

We summarise our response to the enquiry report largely drawn on the two critical concepts raised above, by suggesting that this excellent report rigorously conducted demonstrates that from a practical, public policy perspective, the cure (a long run marginal cost-based, cost-reflective pricing strategy) is worse than the disease (some loss of economic efficiency, and systemic cross-subsidies in water and sewerage pricing).

Our conclusion, therefore, is that the public policy outcome from this report is a "second best" solution but, in the circumstance a "first best" solution in terms of South Australian public policy at the moment, and that is to leave water pricing and sewerage pricing structures unchanged. Rather, the focus needs to be on subsequent pricing determinations by ESCoSA whereby it is crucial that thorough scrutiny of SA Water's RAB needs to be undertaken. We believe that pricing orders that enable ESCoSA to be able to act with full independence will in fact give the best pricing outcomes for consumers.

## Current Situation

Water and sewerage prices for South Australian consumers have been rising at a faster rate than inflation for a considerable period of time; this is shown in chart 1, which compares quarterly water and sewerage charges with CPI, for the past 16 years, using indexes.

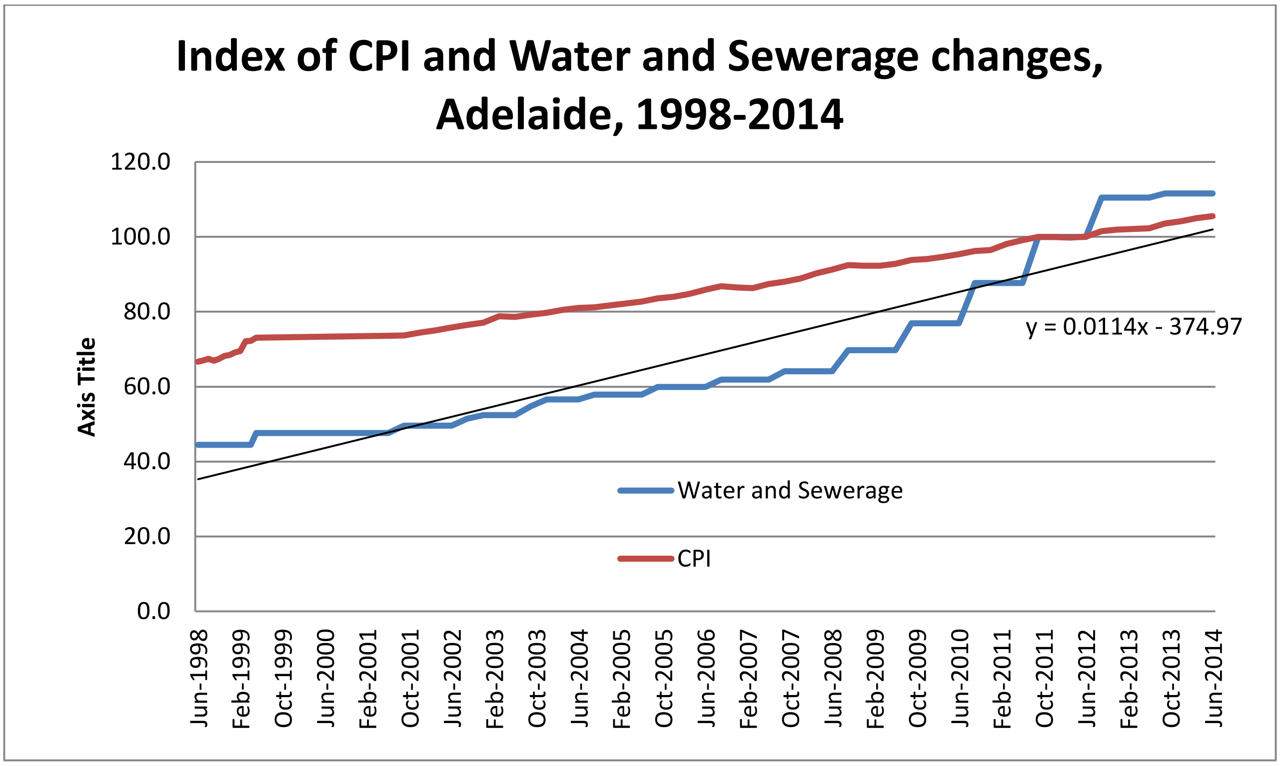


Chart 1: ABS, 6401.0 - Consumer Price Index, Australia, Jun 2014

It is evident that water and sewerage prices have grown at a faster rate than the consumer price index, which is the basis of income change for people receiving pensions and benefits and also for people whose employment income is tied in some way to minimum wage rates.

Chart 2 shows the same data but for a more recent period only, the last 6 years. We have included linear trend lines (R squared values of about 0.87, suggesting that a linear trend line is reasonable) for the water and sewerage price change index in both charts. We highlight that the x coefficient, or slope for the longer term series is 0.0114 while the coefficient for the trend line for the last 6 years is 0.0246, about double the rate of change, reinforcing what our clients have been telling us "water prices keep going up and they are going up faster now than before."

The price increases were particularly dramatic between 2010 and 2013 when water pricing was used to fund the desalination plant and when SA was experiencing drought.

The key point to be made is that water and sewerage prices have been increasing at a greater rate than CPI for some time and that rate of increase has been greater over recent years. This essential service price rise, along with significant price rises in housing, health and energy costs, with falling real incomes (post GFC) for many households have caused substantial financial pain, which frequently translates into increased relationship stress.

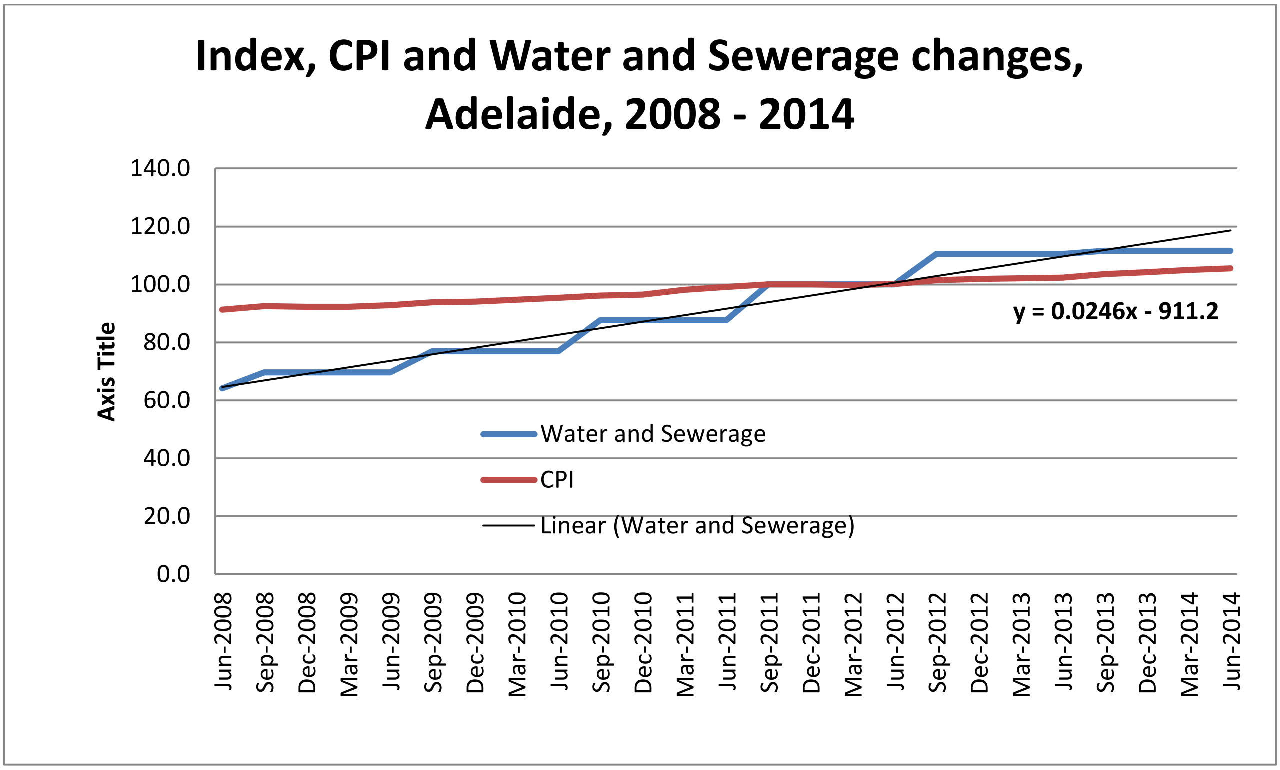


Chart 2: 6401.0 - Consumer Price Index, Australia, Jun 2014

South Australia's low and moderate income households simply cannot afford any more price rises for essential services.

## Consideration of specific aspects of the Report

### *Water Pricing*

We accept the theory presented in the report that there is potential for aggregate statewide economic efficiencies of $30-40 million from changing water pricing arrangements to be more cost-reflective. However, we reject the notion that significantly increasing supply charges, and decreasing usage charges is a good outcome for households and indeed for the State. (We will submit a separate paper in the near future, from economic theory, which shows that the theory of economic regulation of networks from the last 100 years does not lead to a conclusion that cost recovery through fixed charges is optimal. This paper is still being finalised for Uniting Care Australia, but will be sent through to ESCoSA as soon as available).

We reject the notion that higher fixed costs and significantly lower usage charges is either efficient in terms of economic pricing, or is effective in adequately signalling prices to consumers. The cost of networks, in this instance pipelines, is an integral cost of water provision and we argue supply charges need to be incorporated into the usage charges. All aspects of supply of water are a part of the supply of water and so should be included in the price paid by consumers, which should be set at long run marginal cost (LRMC). Removing longer term costs, including network costs, from pricing considerations militates against efficient pricing which economic theory and regulatory practice says should be based on LRMC.

Of course, we are very concerned by the stated impact of undertaking such an approach to cost reflective pricing on households. The ESCoSA report on page 138 states, "Figure 10.1 (not included here) shows it is likely 18% of customers would see their annual bill decrease and 74% of customers would see their annual bill increase by greater than 5%. Furthermore, it is likely that 19% of customers would see their annual bill decrease by more than $50, while 75% would see their annual water bill increase by more than $50."

This is a simply unacceptable outcome, particularly in current circumstances, where significant numbers of South Australian households are simply unable to pay for their basic living costs. Incomes are not increasing in real terms – due largely to casualisation of the labour market and uncertainty about future employment during an economically slow period. Further, households will be disadvantaged by increased water charges and increased sewerage charges leading to reduced expenditure on food, particularly healthy food, medical bills, doctors visits, training for employment skills and other important individual and community needs. The many households that we are most concerned about have to spend all of their income on basic living costs. Increasing the cost of one essential living cost, means that less can be spent on other crucial living costs. Many households simply have no 'spare capacity' in their budgets.

Increased water bills are simply unacceptable for South Australian household customers at the moment. The report from ESCoSA, whilst clearly identifying the aggregate impacts on South Australian household consumers, does not provide significant detail about the distribution impacts; we contend that lower and modest income households would be amongst those most disadvantaged by moving to the sort of cost reflective pricing structure proposed by the report. Those households that are worse off under an arrangement that increases the fixed supply charge and reduces the usage charges will be lower use households, and these we suggest would include single person households, sole parent households and pensioner households. These groups generally are low income and have limited capacity to pay higher costs. The equity impacts of a move to a more cost reflective pricing are therefore more substantial and frankly do not justify the very modest $30-40 million net benefit that would be achieved by the changes suggested by the enquiry report.

### *Regional Pricing*

We recognise the significance of this issue for South Australia where supply charges for regional and more remote communities can be significantly higher than for Adelaide based households. However, we recognise the' merit good' impact qualities of water and sewerage and believe that the same pricing for water and sewerage services are in a part the citizen rights of all South Australians. So on this basis, we strongly recommend the continuation of statewide pricing structures so that all households across the state of South Australia face similar charging, and all communities receive the 'merit goods' benefits of the supply of clean drinking water and sewerage services.

### *Sewerage Pricing*
We also recognise the dilemmas in identifying an efficient and cost reflective approach to sewerage pricing and recognise that there are some sections of the South Australian community who are strongly opposed to current arrangements where sewerage pricing is tied to property valuation. Recognising that there is no outcome that leaves everybody better off, or at least unaffected by sewerage pricing changes (a Pareto optimal outcome), we recommend the continuation of sewerage charging based on property valuation. Our rationale for this is that sewerage as a merit good should be paid for on an equitable basis, and an equitable basis is one where all consumers pay a similar proportion of their income for the service rather than a flat charge which is highly regressive. Sewerage pricing based on property valuation is therefore as good a proxy as currently exists for equitable pricing where equitable pricing is understood to be progressive in the sense that all households pay a similar proportion of income rather than paying a flat charge.

We strongly recommend the continuation of current sewerage pricing arrangements as being reasonable and as efficient and equitable as is currently practical. We recognise that people that are adversely affected by these arrangements are higher wealth, lower income households; often pensioner couples or older people staying in a long established family home. We believe that this is the area of public policy that should be considered so that higher wealth, low income households are able to pay a fair and equitable sewerage charge rather than the full price that would be suggested by the valuation of their property. This should be a priority for state concessions policy reform.

### *Tenants and Separate Metering*
Again, we recognise the importance of the proposal that all tenants should be metered separately and support this as a principal while recognising that further consideration is needed about how this should be implemented.

We recognise that there is a risk to tenants, many of whom are lower income people, that separate metering and consequently separate charging for water would most likely lead to a net increase in their costs as the full value of water pricing is unlikely to be removed in full from their rental costs. The current practice whereby tenants pay for excess water sets a reasonable and efficient basis for sending a price signal to tenants to not use water excessively, but provides for an adequate, essential use level to be incorporated into rent charges.

### *Metering*
There are potential benefits of a rollout of “smart meters”, but again we recognise the significant cost, particularly of a mandated rollout, and the uncertainty of net benefits as well as the uncertainty for individual benefits to households from such a move. The Victorian experience of a mandated rollout of electricity smart meters has been highly problematic, in part, because consumers have borne a cost i.e. the cost of new meter when the benefits for many are unknown or are quite long term in nature. We suggest that there is value in the rollout of smart meters for new properties but at the moment agree with the Enquiry’s proposition that there are simply inadequate benefits from a mandated rollout for this to be considered for all properties.

### *Transition Arrangements*
As we have said previously we do not believe that the proposals for more cost reflective pricing for

drinking water and sewerage pricing in South Australia are justified on the basis of the report. Rather the report identifies the value of staying with the status quo i.e. current pricing arrangements for water pricing and sewerage.

Notwithstanding this conclusion, we recognise that there is real merit in active consideration by the regulator and by government in approaches to increase the efficiency of water use and sewerage use. Such consideration would need to actively involve consumer interests in all considerations. The measures either suggested or implied in the enquiry report are not appropriate for now but we believe this issue needs ongoing consideration. We also note that the report, in considering transitional arrangements, highlights the importance of concessions and concessions which more adequately compensate households struggling to meet the cost of essential services including water. We strongly support this recommendation and have long called for careful consideration by the State Government of adequacy and incidence of concessions. We strongly believe that any changes in water pricing and sewerage pricing arrangements could only be put in place once equity considerations, including concessions, have been resolved and once adequate assistance is certain for the most disadvantaged households in the state.

***Appendix 1***

Summary of key concepts mentioned in this submission

## Theory of Second Best

The theory of the second best concerns the situation where one or more optimal conditions (for competitive markets) cannot be satisfied. The economists Richard Lipsey and Kelvin Lancaster showed in 1956, that if even one optimality condition in a market, cannot be satisfied, it is possible / likely that the next-best solution involves changing other variables away from the outcome that would otherwise be optimal. For public policy, the theory says that if it is impossible to remove a particular market distortion, introducing a second (or more) market distortion may partially counteract the first, and lead to a more effective outcome, in practice.

# Merit goods

Merit goods, as compared with 'standard' or 'private' goods and services, have two main characteristics:

Firstly, unlike a *private good*, the net private benefit to the consumer is not fully recognised at the time of consumption. Net private benefit is the utility (benefit) gained from consumption less any private cost incurred. In the of case education, which is widely considered to be a merit good, pupils and students cannot possibly know the specific private benefit to them of getting good grades at school, college or university. They will be well aware of the sacrifice required to study, but will not know the benefits to them in terms of a future job, salary, status and skills. Therefore, with education, as with other merit goods, there is a significant information failure in terms of expected benefits.

Secondly, merit goods also generate an external benefit to other people within a community, from which society gains, this is unlikely to be known or recognised at the point of consumption. Generally merit goods are undervalued. Given that decisions to consume are (in economic theory) driven by self-interest, it is unlikely that this external benefit will be taken into account when the consumer of a merit good evaluates its worth. For example, an individual student is generally not motivated to study hard in order to benefit others later in life, although everyone associated with them will benefit from their education in some way. Beneficiaries include future employers and all those who consume the products supplied their employer, their family, and friends. The better job they obtain, the more tax they will pay, and the greater the benefit to those who receive welfare benefits and transfers. However, putting a value on these external benefits is impossible, especially at the point of learning.

In the case of sewerage for example, the public health benefits of an effective sewerage system are huge and shared by the whole community through less disease as well as greater 'amenity' for living and recreational activities. Since the full value of society wide benefit will not be paid for by individual consumers alone, the costs to reap the public benefits should be contributed to from the public purse, as both current and future generations benefit.