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5 April 2013

Hon. J. Weatherill M.P.
Treasurer
15th Floor
State Administration Centre
200 Victoria Square
ADELAIDE SA 5000

Dear Treasurer

Commission Advice on Principles for Setting Initial Regulated Asset Base Values for SA Water

The purpose of this letter is to provide you with the Commission's advice on principles to be used in setting the initial value of SA Water's Regulated Asset Base (RAB) for water retail services and the initial RAB value for sewerage retail services.

As you are aware, the Commission released its Draft Revenue Determination in respect of the regulated revenues to be recovered by SA Water during the period 2013/14 to 2015/16 in February.

Under the Draft Revenue Determination, on 1 July 2013, SA Water's average revenue for drinking water services would fall by 5.4% in real terms and average revenue for sewerage services would increase by 1.7% in real terms. Average revenues would then be held constant in real terms for the remainder of the 3-year period.

As the former Treasurer had previously informed the Commission that he would not set the initial RAB values until May 2013, the Commission had to make its Draft Revenue Determination in the absence of specified initial RAB values. To enable the Commission to make a Draft Revenue Determination, it sought and received clarification of its understanding of the principles upon which the initial RABs would be set. This understanding was a critical input into the Draft Revenue Determination, and those principles have played a major role in the real average revenue reductions proposed by the Commission.

The Commission's understanding was that the initial RAB values would be set to ensure no upwards price surprises and that any capital and operating expenditure savings made by the Commission would be passed on in full to consumers.

Achieving these outcomes *may* require the initial RAB values to be set lower than the RAB values used by the Government in its pricing decision in the past, particularly as a significant component of SA Water's assets (pre-2006 "legacy" assets) currently receives a return that is below a commercial rate. Therefore, a movement towards a commercial rate of return on those assets would put upward pressure on prices unless it is offset by adopting a lower asset value. On the other hand, other factors such as interest rate reductions may result in higher initial RAB values.

Table (1) (attached) summarises the three key principles that form the basis of the Commission's advice on the setting of the initial RAB values. The remainder of this note summarised those principles.

Principle #1: Price path less expenditure savings

As set out in the Commission's Statement of Approach (in July 2012) and Draft Revenue Determination (in February 2013), it is our understanding that the initial RAB will be set based on the following principle:

> The initial RAB value will be set to deliver the price paths that the Government forecast in its 2012/13 Drinking Water and Sewerage Prices Regulatory Statement (**Regulatory Statement**)
>
> *plus/minus:*
>
> Adjustments to pass through to consumers the full impact of changes in capital and operating expenditures that the Commission makes relative to those forecast in the 2012/13 Regulatory Statement.

The Commission's understanding is that each initial RAB value will be set to deliver a *price path* outcome, not a *revenue path* outcome. This distinction is critical, particularly as demand for drinking water is expected by the Commission to be lower than that forecast under the Regulatory Statement. Given a predetermined price path, lower demand will result in total revenue being lower than that forecast in the Regulatory Statement. If initial RAB values were to be set to deliver revenue paths, average prices would need to be much greater than those set out in the Commission's Draft Revenue Determination. This is inconsistent with how markets work. In competitive markets, prices do not rise (and indeed generally fall) when demand falls. Ignoring the impacts of the expenditure reductions contained in the Draft Revenue Determination, if the initial water RAB value was set to deliver the Regulatory Statement revenue path, average real prices would need to **increase** by around 9.6% on 1 July 2013 (and be held constant in real terms for the remainder of the period), rather than the 0.2% increase projected in the Regulatory Statement.

The second element of Principle #1 will allow any savings in capital and operating expenditures resulting from the Commission's Revenue Determination to be reflected in future revenues and prices. This will ensure that customers benefit from the cost savings identified by the Commission, rather than the RAB being adjusted to transfer those savings to the Government. Of note, if the Government was to set an initial RAB value to deliver a revenue outcome, consumers would not benefit at all from the expenditure savings identified by the Commission, as average prices would remain broadly in line with CPI (the increase in prices due to demand falling would largely offset the reduction in revenue due to expenditure reductions).

This would not be consistent with the understanding documented by the Commission nor with general regulatory practice, in which changes in allowed expenditures are translated into changes in allowed revenue and are not capitalised into the RAB value of the regulated business.

Principle #2: Consistency with Commission's final decision on key parameters

The Commission believes that initial RAB values should be set consistent with the decisions made by the Commission on key parameter values, such as the regulatory rate of return and demand forecasts, in its Final Revenue Determination. The Commission conducted substantial due diligence in deciding on the key parameter values contained in its Draft Revenue Determination. The Commission has also publicly consulted on those parameter values and members of the community have invested substantial time and effort in making submissions. The Commission will take account of public submissions and the findings of subsequent due diligence in deciding on the key parameter values to be contained in its Final Revenue Determination. As is always the case in regulatory price/revenue determinations, the values of key parameters can change significantly between draft and final determinations as new information emerges and market changes (such as interest rates) occur.

If Principles #2 is not applied, the considerable efforts of the Commission and members of the public will be wasted and Principle #1 will not be met. Various changes are likely to occur between the Draft and Final Revenue Determinations (e.g. in the regulatory rate of return) and those changes will need to be reflected in initial RAB values in order to ensure no price surprises for customers and that customers receive the full benefit of the Commission's expenditure savings.

Principle #3: Consider interstate price comparisons and costs

Principle #1 is very valuable in considering forward-looking price changes. However, if existing prices are "too high", application of Principle #1 alone cannot address that problem. Therefore, the Commission has publicly stated in both its Statement of Approach (in July 2012) and in its Draft Revenue Determination (in February 2013) that it may also consider recommending that interstate price comparisons are considered in setting initial RAB values. For example, the Commission has previously noted that South Australian water and sewerage prices are high relative to those of other Australian jurisdictions. If the Commission concludes that South Australian water and sewerage prices remain high relative to other jurisdictions and that such price differences do not reflect efficient cost differences, the Commission may (or may not) recommend lower initial RAB values to help move South Australian prices towards those in other jurisdictions.

As the price determinations of regulators in other Australian states may not be known until about the time of the Commission's Final Revenue Determination, the Commission cannot assess whether it will need to recommend such an adjustment (and if so, the extent to that adjustment) until that time.

Finally, I wish to confirm that the Commission's Draft Revenue Determination is consistent with the former Treasurer's Pricing Order, the building block approach and National Water Initiative (NWI) Principles, as are the principles contained in this letter and as will be the Commission's Final Revenue Determination.

If you would like to discuss the principles contained in this letter further, please do not hesitate to contact myself or the Commission's CEO Paul Kerin on 8463 4321.

Yours faithfully,

Pat Walsh
CHAIRPERSON

CC: Mr. Brett Rowse, Under Treasurer
Mr. Stephen Mullighan, Deputy Chief of Staff, Office of the Premier

Table (1):
Commission's advice on principles for setting initial RAB values

Principle #1	The initial RAB values should be set to deliver the price paths that the Government forecast in its 2012/13 Drinking Water and Sewerage Prices Regulatory Statement *plus/minus:* Adjustments to pass through to consumers the full impact of changes in capital and operating expenditures that the Commission makes relative to those forecast in the 2012/13 Regulatory Statement.
Principle #2	The initial RAB values should be set consistent with the decisions of the Commission on key parameter values in its Final Revenue Determination, including those on the regulatory rate of return and demand forecasts.
Principle #3	The initial RAB values should be set after considering the differences between water and sewerage prices in South Australia relative to other jurisdictions, as well as cost considerations. If South Australian prices remain higher than other comparable jurisdictions, for reasons that cannot be explained by costs considerations, consideration should be given to setting lower initial RAB values to help move SA Water's prices towards those of other comparable Australian water utilities.