

# Report

## Response to SA Water Submission to Draft Determination

3603-34-002



Prepared for  
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## Glossary

Term	Definition
CPI	Consumer Price Index
ERAWA	Economic Regulation Authority of Western Australia
ESCoSA	Essential Services Commission of South Australia
ESCV	Essential Services Commission of Victoria
ICRC	Independent Competition and Regulatory Commission
IPART	Independent Pricing and Regulatory Tribunal, New South Wales
IS	Information Services
RBP	Regulatory Business Proposal
SA Water	South Australian Water Corporation
WWTP	Wastewater Treatment Plant

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# 1 Introduction

## 1.1 Background

The Essential Services Commission of South Australia (ESCoSA) is currently undertaking a review of the revenue requirements of SA Water for the three year period beginning 1 July 2013. To assist in this review, Cardno in association with Atkins undertook an independent assessment of SA Water's operating and capital expenditure forecasts for the regulatory period. ESCoSA released its Draft Determination on 7 February 2013.

SA Water has prepared a response to ESCoSA's Draft Determination in which it disagrees with a number of the conclusions made in the Draft Determination. The purpose of this report is to respond to the issues raised in SA Water's submission to assist ESCoSA to prepare its Final Determination. The Final Determination is scheduled for completion in May 2013.

## 1.2 Scope of this report

The scope of this report, as set by ESCoSA, is to consider and respond to the issues raised in SA Water's response document in the following areas:

1. The efficiency targets proposed for both capital and operating expenditure
2. Real cost escalation for both capital and operating expenditure
3. The revenue requirement to progress upgrade of the Murray Bridge WWTP during the regulatory period.

This scope excludes a number of items included in the SA Water response relevant to the original Cardno-Atkins report, notably expenditure on renewals programs.

## 2 Overview of SA Water Submission to Draft Determination

Generally, the SA Water response does not include new information that was not considered at the time of our review. The SA Water response, informed by the report of its consultant, Frontier Economics, generally takes the approach of focusing on individual recommendations from the review, removing these from the context in which they were made and seeking to compare them to regulatory reviews made elsewhere in Australia. This means that the recommendations of our report are compared to past regulatory decisions made in different jurisdictions, under different frameworks and relating to organisations of greatly differing maturity within an economic regulatory framework.

The SA Water response does not provide information that suggests that our understanding of its operating environment, its systems and process and its organisational capability with respect to generating operating and capital expenditure forecasts, as expressed in our review report, was incorrect. The SA Water response also does not question our methodology, only the conclusions that have been drawn. There is one instance where, based on the SA Water response, we consider that our recommendations may be revised. However, in general, we do not see that the SA Water response provides justification for broad changes to our conclusions.

The following sections of this report consider in detail each of the main areas – operating expenditure efficiency, capital expenditure efficiency, real cost escalation and the Murray Bridge WWTP project – raised in the SA Water response.

### 3 Operating expenditure efficiency

Our comments are made related to the specific points on operating expenditure efficiency as set out in the SA Water Response to the Draft Determination. However, before addressing the specifics it is important to understand the context within which our recommendations to ESCoSA were made.

In our report to ESCoSA we expressed our surprise that SA Water in its regulatory proposal had made no assumptions related to future operating expenditure efficiency. The assumption that appeared to have been made in the Plan was that the 2011/12 base year costs reflected a fully efficient company with no scope for on-going efficiency assuming a stable serviceability and risk profile over the plan period. In our discussions with SA Water we repeatedly challenged the plan assumptions that there was no scope for future operating expenditure efficiency. The Company position was that the efficiency studies undertaken and reported in detail in its plan showed it to be at the forefront of efficiency relative to other Australian water companies. In addition the Company told us that, whilst no future efficiency assumptions had been made in its regulatory proposal, there was scope for efficiency savings to be derived from planned Information Services (IS) investment over the plan period that was not included in its Plan; in other words that IS investment would be funded on a commercial pay-back basis. From what we observed such investment had not been developed to a stage where there was clarity on the business benefits to be delivered.

SA Water maintained its position in relation to its operating expenditure efficiency assumptions underpinning its plan proposals throughout our discussions with them. In our review of the SA Water documentation supporting its regulatory proposal we noted that in its corporate plan a key business objective was to seek real reductions in input costs although it was not clear from the corporate plan how much scope for such savings there was. In addition we noted in our report to ESCoSA that a number of the independent reports SA Water had commissioned supporting its planning processes commented upon the uncertainty in relation to costing assumptions<sup>1</sup>.

SA Water during our discussions also repeatedly referred to a company culture of continuous improvement and we have no reason to believe that this is not the case. However, this did not appear to be reflected in relation to future operating cost efficiencies. Therefore, we welcome the Company recognition in its response to the ESCoSA draft determination that it is appropriate that there should be an ongoing operating cost efficiency challenge to the business. This is a marked change from the position expressed by the Company in its regulatory proposal and in our discussions with them. This then raises the issue of what that challenge should be and we consider this to be at the heart of the SA Water response to the ESCoSA Draft Determination.

We accepted the conclusions of the econometric studies related to the relative efficiency position of SA Water and detailed in the Company regulatory proposal. Thus, in the context of the continuing and catch-up efficiency model, we did not think it appropriate to apply a catch-up operating expenditure efficiency challenge. We think there is general agreement on this and do not consider it further.

The issue is about what is the appropriate level of continuing efficiency, and to what base it should be applied. We noted in our detailed review of the company's operating cost base the significant movement in costs in the years preceding the 2011/12 base year, movements arising from organisational change such as the management of maintenance contracts, movements arising from legislation, movements arising from changes in the operating environment and, in particular, in relation to the extreme drought conditions and the measures taken to mitigate the effects. Within this environment disentangling real efficiency from more general movements in cost can be problematic. We accept that any efficiency savings realised in that period will have been embedded in the 2011/12 base year, but the scale of the claimed efficiency appears to us to be difficult to evidence.

In our assessment of efficiency going forward we were conscious of the issue as to what it should be applied to. There is a view, expressed in the SA Water response, and by its economic consultants, that it should be "applied to controllable operating costs only and managed by SA Water". Clearly there are many factors influencing the degree to which a company can manage its cost base, these cover both price and volume

<sup>1</sup> See for example p.67 of *Review of capital and operating expenditure plans of SA Water - 2013/14 to 2015/16 price determination, Final Report*. Cardno-Atkins 2012.

and factors related to externally imposed costs including legislative and related taxes. Effective procurement will provide for a degree of cost management but volume is also a key factor. Thus, if we take the example of energy, the degree to which procurement can limit the impact of price increases is but one side of the equation. Energy efficiency is one factor on the other side.

In England and Wales, the water regulator (Ofwat) has historically applied a general efficiency target to the whole of a Company's operating cost base, with specific adjustments to cost drivers allowed where there was clear evidence that the future would be different from the past, but with all costs subject to the general efficiency challenge. In this respect we take issue with Frontier Economics' statement that "Good regulatory practice is to apply continuing efficiency targets only to defined components of expenditure".

There was no specific discussion in the SA Water regulatory proposal on the issue of controllable and non-controllable costs and, in its response to the draft determination, it refers to the issues in generic terms rather than with specific proposals. We believe that, in the context of the SA Water regulatory proposal, that it is appropriate for the efficiency challenge to be applied across the Company cost base. It is for the Company to decide how, in the context of the management of the Company, the efficiency challenge should be met and, indeed, out-performed. It was on this basis that the recommended efficiency targets were set.

When we discussed efficiency with the Company we asked whether there were plans in place for business improvement programs. In the context of a regulatory proposal, we would have expected to see evidence of internal review of its current cost base, in addition to the econometric relative analysis that appears to underpin the Company's assumptions on the potential headroom for future efficiency savings. Whilst historic relative efficiency was dealt with in detail in the regulatory proposal, there was little in relation to the potential for future efficiency. For this reason, we suggested a phased profile for the efficiency challenge to enable the Company to develop how the efficiency challenge should be addressed.

Our recommendations on the level of continuing efficiency represent our judgement based on our review of the current cost base. Our judgement reflects our experience of what one might expect to see a company of the size of SA Water deliver. The SA Water response makes reference to a number of regulatory decisions applied to other water utilities in Australia. It is noted that these decisions apply lower efficiency targets than that proposed by Cardno-Atkins. We note this concern but reiterate that these are the product of different regulatory frameworks and different circumstances.

For example, the SA Water response makes reference to the IPART review of Sydney Water where a continuing efficiency factor of 0.25% per annum was applied. It is important to note that our reference points for determining continuing efficiency, the Reckon LLP report<sup>2</sup> and Ofwat's PR09 determination, make specific reference to the maturity of the economic regulation framework as a consideration in determining continuing efficiency. Sydney Water has been through a number of price reviews in a regulatory environment that has developed over time. In contrast, this is SA Water's first determination and therefore, we believe that there is scope for continuing efficiency gains to be achieved that exceed those of businesses that have been subject to regulatory scrutiny for longer periods.

Further, and importantly, the water utilities referred to by SA Water had generally already included in their regulatory submissions significant efficiency reductions proposed internally. Therefore, the judgements made take into account these self-imposed efficiency gains.

As previously noted, we repeatedly requested SA Water to provide to us information on how efficiency savings had been included in its submission, but were not provided with any relevant information. However, SA Water did provide in early April 2013, after its first response to the Draft Determination had already been submitted, information detailing \$27M in efficiencies that SA Water claimed had already been embedded in its operating expenditure forecasts. On inspection of these claimed efficiency savings though, at least \$20.2M are for discontinued or reduced rebates and, therefore, represent the reduction in costs commensurate with reduced outputs. These are, therefore, not efficiency gains and again suggest that SA Water has not recognised or delivered productivity savings in its Regulatory Business Proposal (RBP).

An important context of our review is that this is the first time that SA Water has been exposed to regulation and we, therefore, consider that it has scope to achieve substantial efficiency savings as a result. This is

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<sup>2</sup> PR09 Scope for Efficiency Studies, Reckon LLP, October 2008

evidenced for example in analysis undertaken by IPART of the productivity achieved by urban utilities since the commencement of regulation<sup>3</sup>. The utilities referred to by SA Water in its response have all been subject to multiple regulatory reviews.

We recognise that, in its response to the Draft Determination, SA Water has suggested a 1% efficiency on controllable costs, although it does not state whether this 1% efficiency be applied cumulatively over the plan period, or whether it is an absolute 1%. It makes a general statement that the draft determination assumptions would have significant impact on SA Water's ability to deliver services to customers at the same standard and quality they expect. However, it gives no indication as to what this impact is, and this suggests that its regulatory proposal was very limited in respect of the Company's own internal understanding of the efficiency headroom. Our judgement is based upon what we observed and our experiences elsewhere. We would have expected any counter proposal from SA Water to provide a significant level of detail related to its current and future costs and serviceability risks. In lieu of this analysis, and in lieu of evidence of future efficiencies being accounted for in its regulatory submission, we recommend that ESCoSA adopt the continuing efficiency factors proposed in our final report.

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<sup>3</sup> Review of the Productivity Performance of State Owned Corporations, IPART, 2012.

## 4 Capital expenditure efficiency

### 4.1 Continuing efficiency

In our review report, we recommend that a continuing efficiency target of 0.5% per annum be applied to SA Water's capital costs in line with the continuing efficiency applied to the United Kingdom water businesses. This efficiency factor was determined through a study<sup>4</sup> by Reckon LLP which concluded that:

*We forecast a growth rate for both water and sewerage of –0.5 per cent per year relative to the RPI. This forecast is for changes in unit capital costs. These are the changes attributable to productivity growth and to changes in input prices relative to the RPI, excluding any changes attributable to changes in the nature, quantity or quality of the capital outputs delivered by the capital program.*

This target was not applied to works already contracted.

SA Water's response countered that the efficiency factor set out in the Reckon LLP report included both continuing and catch-up efficiency and it was therefore appropriate that the catch-up efficiency be netted from the total efficiency factor. We acknowledge that it is more appropriate to net the continuing efficiency factor determined from the Reckon LLP report of the implicit catch-up component and, therefore, recommend that ESCoSA apply a 0.4% continuing efficiency factor.

SA Water's response also argues that, as a frontier company, it should have had a lower continuing efficiency factor applied rather than the 0.4% factor which, in the context of the report, applied to a 'middle ranking' company. We do not agree that SA Water is a frontier company with respect to capital expenditure based on the evidence provided and we have not been provided with information since our review to suggest otherwise. Therefore, we believe that the target for a 'middle ranking' business is appropriate.

Further, SA Water's response also questioned the applicability of the Reckon LLP report on the basis that it is "is over 5 years old and relates to UK businesses and therefore not particularly relevant to SA Water".

We do not consider the age of the report to be an issue and are not aware of a more recent, relevant report. Also, given that South Australia is part of a global economy where technical innovations from across the world can readily be adopted, we see no reason why a report developed with respect to the UK water businesses would not also apply to South Australia. The technologies, processes and management approaches used in Australia and the UK to provide water and wastewater services are fundamentally similar.

This is not to say that SA Water is not pursuing new technologies and approaches to lower its costs. We observed and note in our review report a number of areas where SA Water undertakes good practice and is improving its capital delivery.

Lastly, SA Water disagreed with the continuing efficiency factor applied to capital expenditure, on the basis that it did not align with other regulatory decisions applied to Australian water utilities. We disagree with this assertion and note that this argument reflects that SA Water perhaps does not appreciate the methodology applied by us in determining efficiency targets and does not appreciate how its circumstances differ from those utilities cited in its response. Specifically:

- > Essential Services Commission of Victoria (ESCV) 2012 – the regulatory framework adopted by the ESCV is different from that applied by ESCoSA with respect to capital expenditure. The ESC (Victoria) framework does not include capital efficiency factors, only that a sample of capital projects be assessed and adjustments made to these based on assessment criteria defined by ESC (Victoria). That continuing efficiency factors are not applied is solely a product of the regulatory framework
- > Economic Regulation Authority of Western Australia (ERAWA) 2012 – capital efficiency factors were not applied in this review because it was found that the West Australia Treasury applied significant

<sup>4</sup> PR09 Scope for Efficiency Studies, Reckon LLP, October 2008, p165.

constraints to Water Corporation's capital expenditure that exceeded the magnitude of any efficiency constraints that may have been applied.

- > Independent Pricing and Regulatory Tribunal (IPART) 2012 (Sydney Water) – SA Water appears to have been misinformed by its consultant in asserting that no “across-the-board capital expenditure efficiency targets” were applied in the review of Sydney Water conducted by IPART. In fact, capital efficiency savings of \$143M were applied as noted in the IPART Determination<sup>5</sup> and as derived from the review report<sup>6</sup>

We also note that the SA Water response overlooks two recent regulatory reviews:

- > IPART 2013 (Hunter Water) (draft) – no top-down continuing or catch-up capital efficiency factors have been applied by IPART in its draft decision because it found that Hunter Water had applied significant capital constraint in proposing a forward four year works program totalling \$299.3M, compared to \$658.9M for the previous regulatory period and because, importantly, Hunter Water had set itself internal capital efficiency targets of 10.8% over the four year period. These internally imposed targets were greater than those assessed in the detailed expenditure review.
- > Independent Competition and Regulatory Commission (ICRC) 2013 review of ACTEW (draft) - the ICRC decided to go beyond the recommended capital expenditure targets proposed and instead reduced ACTEW's proposed capital program by 41% over two years.

On the basis of the above analysis, we recommend that ESCoSA reduce the continuing efficiency target applied to capital expenditure from 0.5% to 0.4% per annum.

## 4.2 Catch-up efficiency target

We proposed a catch-up efficiency target of 0.6% per annum to be applied to SA Water's capital expenditure on the basis that our review identified a number of areas where SA Water could gain savings through improving its practices. The SA Water response counters that applying a catch-up efficiency target to capital expenditure is “without foundation given that the benefits from the areas of improvement that have been identified, have already been incorporated by SA Water in the RBP 2013.”

We disagree with this statement and note that the SA Water response provides no new information that was not already accounted for in reaching our judgement. We are aware of the timing of the transfer of the asset management function and we allowed for this in our recommendation. We also do not consider that SA Water's cost estimating approach adequately incorporates contingencies on a risk basis, as suggested in its response, and we have formed this judgement on the basis of reviewing capital expenditure items included in its RBP.

In its response, SA Water conflates operating expenditure efficiency with capital expenditure efficiency. We reiterate that these are two separate considerations under the methodology applied by us and as documented in our review report.

We recommend that ESCoSA adopt the catch-up efficiency targets proposed in our review report.

<sup>5</sup> Review of prices for Sydney Water Corporation's water, sewerage, stormwater drainage and other services, IPART, 2012, p17.

<sup>6</sup> Detailed Review of Sydney Water Corporation's Operating and Capital Expenditure - Final Report. Atkins-Cardno, 2011. p.146.

## 5 Real cost escalation

A key part of our recommendations to ESCoSA was that the real cost escalator assumptions, apart from energy, should be treated as a business risk, consistent with the approach adopted in the UK Water Industry. We note that SA Water has put forward arguments that real cost escalators should be recognised. The key reasons being noted as:

- > The application CPI escalation is not consistent with regulatory practice
- > The weight of evidence is that the input costs for SA Water would not revert to CPI
- > Allowance for real cost escalation would not weaken the incentives for SA Water to seek efficiencies;
- > There is a double-counting due to the interactions between the Cardno's recommended efficiency targets and the rejection of real cost escalation.

We consider that there is a fundamental principle at issue when considering the appropriate cost escalators to apply to SA Water. That is, to what extent, if at all, should SA Water be protected from forecast increases in cost over and above the CPI? The three key areas for which SA Water included cost escalators in its regulatory proposal were labour, materials and contracted services. These are all areas that the Company has a degree of control over and to us it seems perverse that the recognition of forecast real cost escalators will inevitably be reflected in the future management of such costs rather than seeking to contain such costs. The fundamental question for ESCoSA is whether the customers of SA Water should bear the risk of such cost increases. In other jurisdictions, the principle is that such costs are essentially business risk and we support this position.

SA Water notes that while CPI is applied as a cost escalator by IPART in New South Wales and Ofwat in the United Kingdom, it is not applied by ESC in Victoria, ERAWA in Western Australia and ICRC in the ACT. As noted, we believe that the treatment of cost escalation is fundamentally a decision to be made by regulators as to what degree a utility should manage its own costs and therefore can only be considered in relation to the regulatory framework in which it is applied. The SA Water response overlooks this important point. For example, the ESC regulatory framework broadly considers escalation on electricity, labour and other items separately. In its recently released Draft Determination, ESC has generally adopted CPI to index all of these components except in isolated cases.

SA Water's second argument against use of CPI as a cost escalator is that it does not reflect its input costs. We agree and make this very point in our report "CPI, as a measure of general inflation, does not directly measure the cost of the inputs that SA Water will use to produce its services" (p63 and 72). However, we note that CPI has the following advantages in its use as a cost escalator: "transparency, independent calculation, and difficulty in manipulation". We noted that these were key reasons why CPI has been used by regulators as a cost escalator. No cost escalator, including those prepared by Evans and Peck, will perfectly match SA Water's input costs. Therefore the appropriate question is which cost escalators are appropriate to apply accounting for multiple factors such as SA Water's input costs, the regulatory framework and SA Water's ability to manage input costs. It is on this basis, as outlined in our report, we prefer CPI.

SA Water has provided further information as to why, for example its input costs are not reflective of CPI and highlights labour costs as an example. We acknowledge this analysis but do not consider that this materially changes our conclusion that CPI is appropriate for application to SA Water, given wider considerations over issues such as risk sharing between SA Water and its customers, and the benefit of the use of an independently derived indicator.

We note that SA Water believes that our recommendations in relation to a general efficiency challenge and real cost escalators results in double counting of efficiency. We do not believe this to be the case. The general efficiency challenge relates largely to the 2012/13 base year costs. The cost escalators are about managing future increases in costs.

A theme in SA Water's response is that it has little or no ability to manage the impact of input cost changes on its operating costs. We disagree with this assertion. SA Water, through its procurement practices, can

manage its input costs. Importantly, it also has direct control over the quantity of inputs used and can also substitute lower cost inputs in some areas. This is what we would expect of a well-managed utility.

Based on the above, we recommend that CPI be used to escalate SA Water's operating expenditure and capital expenditure forecasts, except for electricity costs.

## 6 Murray Bridge WWTP

In our review report, we recommended that expenditure for construction of a new wastewater treatment plant at Murray Bridge be deferred to outside the regulatory period, on the basis that SA Water had not provided sufficient evidence to justify the need for this project. We recommended that expenditure of \$1.75M only be allowed in the regulatory period, to allow SA Water to further investigate the need, and prepare a strong justification, for the project.

In its response, SA Water states that it will require some \$8.1M in expenditure over the review period for the following activities related to a new treatment plant at Murray Bridge:

- > Investigation and project development: \$5.7M
- > Land acquisition: \$1.4M
- > Works at plant to provide short term odour management infrastructure, manage operational reliability of the recycled water pumps and mains and provide additional treatment capacity to accommodate township growth: \$1.0M

We note that the SA Water response provides no new information that was not considered at the time of our review, other than the claim for additional expenditure.

We reiterate the important point made in our review report that SA Water has not provided any analysis to justify that this project is prudent expenditure, and certainly not that it is required within the 2016-2020 regulatory period. To repeat the main items of analysis presented in our report:

- > Organic loading on the plant has decreased in recent years and effluent quality has remained acceptable or improved. This suggests that, despite the plant being over its theoretical design loading, it is performing adequately to meet the service levels required of it. We note that it is not unusual for wastewater treatment plants to be able to perform satisfactorily over their design loadings.
- > The evidence of odour complaints recorded are relatively low, especially in proportion to the proposed expenditure totalling around \$200M.
- > SA Water does not have formal standards for protection of assets from flood risk and, therefore, any judgement of the flood risk to this plant is qualitative, and not made on a risk basis aligned with good practice. The 1956 flood referred to is considered the largest ever flood in South Australia's European history. Without reference to a standard for protection and the return period of the flood, it is difficult to consider that the works are required on this basis.

SA Water has not completed, to our knowledge, a business case or feasibility report that investigates each of the factors considered by SA Water that drive the need for this project and assesses whether the risk posed by each is acceptable or not. It is of concern that SA Water would consider such a large investment without rigorously testing that there is, in fact, a need for works to be undertaken. It appears that the project may have developed a momentum of its own.

Our allowance of \$1.75M is for SA Water to prepare a comprehensive business case for this project that thoroughly tests the need for expenditure, identifies various options to achieve what SA Water desires from the project, and tests these options against cost and non-cost criteria. We do not consider that any expenditure should be made on approvals or other activities until this business case is completed and approved by the SA Water board. Further, we do not believe that expenditure on land acquisition is justified, given that the need for the project has not been adequately established at this point in time.

We do not consider that SA Water requires additional expenditure in the upcoming regulatory period as a result of the deferral of the project. This is because:

- > As noted, there is no evidence of increased organic loading or deterioration of effluent quality
- > There are significant operating expenditure items already included in SA Water's forecasts that will help maintain plant performance over the regulatory period, most notably desludging of the lagoons

> The recycled water pumps do not assist plant performance as they simply transfer treated effluent.

These conclusions do not suggest that SA Water should not take the actions it sees fit to manage its operational risks. We simply seen no evidence to justify that this project is required in the timeframe proposed by SA Water. We reiterate that, given the magnitude of this project, we are concerned that more rigorous analysis has not been completed before this time.

We recommend that ESCoSA only allow \$1.75M of capital expenditure in the upcoming regulatory period for SA Water to prepare a business case that tests the need for this project, and assesses options to identify the most appropriate and efficient solution.