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South Australian Council of Social Service

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Determination of SA Water's Drinking Water and Sewerage Revenue 2013/14 - 2015/16
Essential Services Commission of SA
GPO Box 2605
Adelaide SA 5001

By email: escosa@escosa.sa.gov.au

18 March, 2013

Dear Commissioners,

Thank you for the opportunity to comment on the Draft Determination of SA Water's Drinking Water and Sewerage Revenue 2013/14 - 2015/16.

As the peak body for the community services sector in South Australia, SACOSS has had a long–standing interest in the delivery of essential services and particularly the cost of basic necessities like water because they impact greatly and disproportionately on low incomes and disadvantaged people.

This letter provides detailed analysis of why it has become apparent to SACOSS that the only way consumers can avoid even more increases in water charges is for a significant reduction in the Regulated Asset Base value. As ESCOSA's role in the final price that residential consumers will actually pay is constrained to determining revenue, the role of the Treasurer in setting the actual price to be paid is critical.

SACOSS commends ESCOSA for what would appear to be a thorough review of SA Water's expenditure proposals and for, in effect, prioritising expenditure in order to contain revenues (and hence price rises) over the regulatory period.

However, the interplay between ESCOSA's revenue determination, the Treasurer's determination of the initial Regulatory Asset Base in the next *Pricing Order* and an overall push for 'cost reflective pricing' still leaves significant uncertainty for consumers and the potential for some consumers to see significant cost increases even if SA Water's revenues stay the same or fall.

While we believe that current South Australian water prices are already excessive, SACOSS urges all stakeholders but particularly the State Government to prioritise the stabilisation of prices for consumers. In the context of significant price jumps in water and energy over recent years, there is little capacity left in the community to continue to absorb these '*bill shocks*'. Unless prices can be reduced, a commitment to a smooth transition between pricing structures must be made.

SACOSS intends to write to the Treasurer on this matter to emphasise the need to consider such impacts when setting the initial value of the Regulated Asset Base in the next *Pricing Order* due in May.

Background and Introduction

The draft determination forms part of ESCOSA's first review of SA Water's revenue and will apply for the three years from July 1st, 2013. However, as it is the first determination, a number of key parameters in the complex formulae that determine revenue are still to be established by government (the Treasurer) under a yet to be released *Pricing Order*.

The consequence of ESCOSA's draft determination is an expectation that the prices for consumers should follow a 5.4% reduction in water revenue in real terms. This is offset somewhat by a 1.7% real increase in sewerage charges. Overall, the combined water and sewer revenues have been set to reduce by around 3.3% in real terms under the draft determination. The question remains as to whether the Treasurer's next pricing order allows this to occur.

As a result, this initial revenue determination for SA Water has some unique attributes that make it extremely difficult to comment constructively on individual elements. Despite our frustrations with the overarching process, SACOSS has reviewed the draft determination to ensure that the revenue that is allowed is to be spent efficiently and that the longer term implications of any other settings are properly considered.

ESCOSA appear to have thoroughly reviewed the expenditure proposals and have, in effect, prioritised expenditure in order to contain revenues (and hence price rises) over the regulatory period.

A key theme in the determination is the overall push for 'cost reflective' pricing to form the basis of a balance of risks between the regulated business and consumers. The end result for consumers will be pressure to increase the fixed component of water prices. At this point in time the entity most able to influence this is the South Australian Government – not ESCOSA or SA Water. SACOSS is strongly of the view that the vulnerability of households is linked to not just high prices but to their rate of change. This potential for '*bill shock'* for vulnerable consumers can be and should be managed – any changes to tariffs or structures that increase costs for households must be gradual.

The key issues for SACOSS are discussed further below.

Forms of Control

This part of the draft determination (Chapter 5) refers to the way in which SA Water's annual revenue is capped and is summarised at page 24:

> *"The appropriate form of revenue control turns on the question: who should bear demand risk – SA Water or consumers?"*

From SA Water's perspective it is only the under-recovery of revenues that is a "risk" and they have an incentive to minimise the probability and severity of such an outcome. ESCOSA has expressed concern that the initial Pricing Order seeks to insulate SA Water (and hence the dividend back to Government) from such an outcome (as has occurred previously) and that this may not be in the long-term interests of consumers.

Both COTA SA and SACOSS commented on this in submissions to SA Water's Regulatory Business proposal in November 2012[1]. The general argument being that SA Water is compensated for accepting a level of risks in the "rate of return" formula that drives a lot of its revenue and that SA Water shouldn't be allowed to have it both ways: talking up the risks to ensure a solid rate of return then seeking to push the actual risks back onto consumers. The SACOSS submission to the separate process on the Regulatory Rate of Return[2] explicitly highlighted a view that the relevant parameter (the 'equity beta') has been set higher than necessary. SACOSS therefore has little sympathy for any attempt to shift more risk onto consumers.

We note that the Treasurer's Pricing Order at s4.1.6 states:

> *"The determination must include a mechanism which allows for the adjustment of the allowable revenue to be derived where the Commission determines there to be a relevant and material variation between forecast and actual rates of water consumption or sewerage connections."* (emphasis added)

The Draft Determination seeks to cap average revenue (i.e. \$/kL) and includes an adjustment mechanism that would apply at the end of the regulatory period. Average revenue caps that are only adjusted infrequently can be considered to provide the strongest price certainty for consumers amongst the options canvassed and are therefore acceptable to SACOSS.

The adjustment mechanism proposed only allows for a proportion of the revenue difference to be 'corrected for' in the subsequent period (i.e. from July 2016 in this case). ESCOSA's judgement is for a 30% adjustment factor: i.e. if revenue over the regulatory period falls short of that forecast then SA Water can claw back 30% of this shortfall in the next period. However, if revenue exceeded forecasts then only 30% of the cumulative difference would be clawed back off SA Water.

SACOSS has conducted its own analysis and discussed the proposal with Commission staff. We have formed a view that:

- The 70:30 adjustment 'factor' biases the incentives for SA Water towards increasing sales volumes. On the basis that ESCOSA has determined the most probable demand forecasts for the regulatory period, there are reasons to prefer a more neutral setting of 50:50.
- The interpretation of 'a relevant and material variation' must acknowledge the level of risk implied in the Regulatory Rate of Return and should therefore include a relatively high materiality threshold (e.g. around 3% of revenue) or a reduction in the relative level of risk assumed in the WACC parameters.

Cost-reflective pricing

The draft determination repeatedly encourages the use of "*cost-reflective prices*" to manage demand risks (see, for example, pages 28-31). The ESCOSA view is that, consistent with the National Water Initiative Pricing Principles (NWI PP), SA Water's prices should rebalance the fixed and variable components so as to reduce consumption charges to long-run marginal cost (LRMC, estimated to be well below current consumption charges). Of

[1] www.escosa.sa.gov.au/projects/186/determination-of-sa-water-s-drinking-water-and-sewerage-revenue-2013-14-2015-16.aspx#stage-list=1
[2] http://www.escosa.sa.gov.au/library/120106-RateOfReturnSAWaterSubmission-SACOSS.pdf

course, for a given revenue allowance, this can only mean an increase to the fixed component.

SACOSS also draws ESCOSA's attention to the potentially disproportionate impact on residential consumers in particular. SA Water's current tariffs classify drinking water consumers as residential, commercial and 'other non-residential'. The residential tariffs comprise a fixed supply charge and a three-tiered consumption charge. All of the other tariffs include a supply charge (determined in a range of ways) and a common, single consumption charge of $3.45/kL. Taking ESCOSA's preferences to their logical conclusion would reduce the consumption charge to something around $2.75/kL or less for all consumers (see footnote 49, page 28). SACOSS notes that residential consumers currently face an average usage charge around $2.75/kL from 2012-13 tariffs (while the average household faces a marginal cost in the second tier of charges, $3.45/kL, consumption up to 120kL per annum is charged at $2.42/kL – a value that itself is well within the range of LRMC)

So, to rebalance non-residential tariffs to include a reduction in consumption charge from $3.45 to $2.75 (i.e. -20%) implies that either:

- Fixed supply charges for these customers must increase significantly to make up the revenue difference, or;
- More revenue must be recovered from residential consumers, and;
- Since residential consumers already face an average usage charge at or just above LRMC, any additional revenue must come from a further increase to supply charges.

SACOSS is therefore extremely concerned that households, especially consumers of small volumes of water, may face significant cost increases even if overall regulated revenues fall.

SACOSS intends to write to the Treasurer on this matter to emphasise the need to consider such impacts when setting the initial value of the Regulated Asset Base in the next *Pricing Order* due in May. It is becoming apparent that the only way consumers can avoid even more increases in water charges is for a significant reduction in these assumed asset values.

Further, the Draft Determination makes reference to The Treasurer's request for an inquiry into pricing reforms[3]. The final report of that inquiry is not due until December 2014 and SACOSS is concerned there is a clear disconnect in these processes and cautions both Government and ESCOSA about making any changes that might deliver a '*bill shock'* to any consumers. Consumers of relatively small volumes of water are the ones most vulnerable in this context.

Expenditure Forecasts

Capital Expenditure

ESCOSA have removed some 16% from SA Water's proposed capital expenditure (capex) program. SACOSS is of the view that this emphasises the need for rigorous scrutiny of proposals and to express disappointment that SA Water appear to have made some ambit claims for expenditure needs – a practice with which we are familiar from energy regulation.

[3] The "Inquiry into Drinking Water and Sewerage Retail Services Pricing Reform" was referred to ESCOSA in December 2012: www.escosa.sa.gov.au/projects/189/inquiry-into-drinking-water-and-sewerage-retail-services-pricing-reform.aspx

It has not been possible to provide a detailed examination of each expenditure proposals but to emphasise the point made in the previous SACOSS submission that projects need to be prioritised in a way that ensures overall revenue needs (and hence price rises), for a given set of service standards, do not exceed the general rate of inflation. The regulatory framework, as has been observed in electricity networks in particular, tends to incentivise ‘gold plating’ and consumers will continue to rely on ESCOSA to ensure this practice does not extend to water infrastructure.

<u>Operating Expenditure</u>

ESCOSA have reduced SA Water’s Operating Expenditure (opex) proposal by around 9.5%. The analysis by ESCOSA and its consultants has found reduction across a wide range of areas and such scrutiny is obviously important. The comments above about ambit claims also apply here.

Pass Throughs

SACOSS has expressed concern in a number of regulatory processes in relation to the existence of incentives to regulated businesses to accept cuts to their revenue proposals only to pursue ways to claw some or all of this back though ‘pass through’ events. As mentioned previously, there must be a connection between the risk premiums afforded these businesses and their ability to withstand the cost impacts of ‘unforseen events’.

It is highly unfair for businesses to claim a risky environment to elevate the rate of return allowed on their asset base and to subsequently push risk back on to consumer through cost pass throughs.

The Draft Determination appears to allow for only a limited pass through regime and SACOSS supports such an approach.

Summary

In summary, this initial revenue determination for SA Water has some unique attributes that make it extremely difficult to comment constructively on individual elements. ESCOSA appear to have thoroughly reviewed the expenditure proposals and have, in effect, prioritised expenditure in order to contain revenues (and hence price rises) over the regulatory period.

However, the interplay between ESCOSA’s revenue determination, the Treasurer’s determination of the initial Regulatory Asset Base in the next *Pricing Order* and an overall push for ‘cost reflective pricing’ still leaves significant uncertainty for consumers and the potential for some consumers to see significant cost increases even if SA Water’s revenues stay the same or fall.

In terms of the ‘form of control’ to be applied to the regulatory period, SACOSS is of the view that a neutral ‘adjustment factor’ of 50:50 rather than the Commission’s 70:30 is more in long term interests of consumers.

Further, SACOSS is of the view that the Regulatory Rate of Return already allows for SA Water to accept a reasonable amount of revenue uncertainty. The materiality threshold for any revenue adjustment must therefore be set relatively high or the risk-adjusted rate of return must be lowered.

SACOSS acknowledges the need to finalise matters for the commencement of the regulatory period from July 1st this year and would be pleased to engage further in resolving these issues. We thank you in advance for your consideration of our comments.

Thank you for your consideration of these comments. If you have any questions relating to the above responses, please contact SACOSS Senior Policy Officer, Jo De Silva on 8305 4211 or via jo@sacoss.org.au.

Yours sincerely,

Ross Womersley
Executive Director